United States General Accounting Office

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Report to the Honorable
Tom Harkin U.S. Senate

July 1999

DOD CONTRACT MANAGEMENT

Greater Attention Needed to Identify and Recover Overpayments

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United States General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-280329

July 19, 1999

The Honorable Tom Harkin
United States Senate

Dear Senator Harkin:

In October 1997, we reported to you that from October 1992 through April 1997, defense contractors refunded $5.1 billion to the Defense Finance and Accounting Service's (DFAS), Columbus Center, the largest Department of Defense (DOD) payment center, and we discussed the reasons for the refunds. As requested, we (1) updated this information through fiscal year 1998 and (2) visited 13 contractor locations to ascertain if the contractors were retaining overpayments and how quickly overpayments were refunded. We also obtained information on the backlog of contracts waiting to be examined for possible overpayment.

Results in Brief

In the 5 years between fiscal year 1994 and 1998, defense contractors returned about $4.6 billion to the Columbus Center--in fiscal year 1998, $746 million. The Center attributes most of the returned money to overpayments caused by factors outside its control. However, payment errors by the Center were also a factor.

It took about a year, on average, before the 13 contractors refunded overpayments of $56.2 million to the Center. In addition, four of the contractors were still retaining overpayments totaling $1.1 million. After we brought these overpayments to the contractors' and the government's attention, the contractors refunded the overpayments. A Defense Contract Management Command area office also instructed its personnel to ask contractors reporting overpayments to immediately return the money. In some cases, government personnel were aware of overpayments, but they did not take timely action to obtain recovery. Under current law, there is no requirement for contractors who have been overpaid to notify the government of overpayments or to return overpayments prior to the government issuing a demand letter.[1]

[1]A demand letter is a formal notification to the contractor to pay money owed the government.

The Center has a sizable and growing backlog of contracts waiting to be examined to ensure that contractors were properly paid—a process called reconciliation. Reconciliation has often resulted in claims against contractors for overpayments. The longer a contract remains unreconciled, the longer any overpayment identified through reconciliation will remain undetected, and the greater will be the government's loss of the timely use of these monies. Further, delays in seeking return of overpayments may result in increased difficulty in collection or actual monetary loss to the government.

We are making recommendations to the Secretary of Defense to improve the process for identifying and collecting overpayments.

Background

In August 1988, the Defense Logistics Agency established a finance center in Columbus, Ohio, to consolidate contract payments and other functions previously performed at 20 agency sites. In January 1991, the Agency's finance operations at Columbus became part of DFAS, a consolidated DOD finance and accounting function under the DOD Comptroller. According to the Columbus Center, in fiscal year 1998, it paid about $70.5 billion on over 1 million invoices.

DOD's payment process involves several organizations, including DFAS. Some of the organizations are the Defense Contract Management Command (DCMC), which administers contracts, and the Defense Contract Audit Agency (DCAA), which reviews contractors' records, internal controls, and billing systems. The contractors that perform the contracted work and bill the government are also involved in the process.

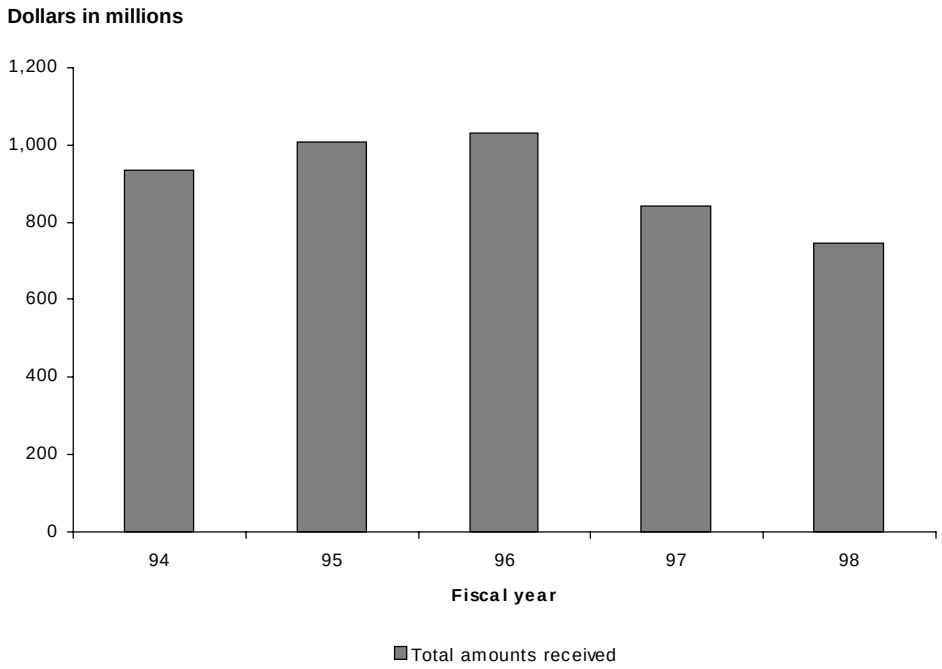
Contractors retaining overpayments is not a new issue. In 1994, based on our work at nine contractor locations, we reported that while each contractor had returned some overpayments, all were retaining additional overpayments.[2]

[2] DOD Procurement: Overpayments and Underpayments at Selected Contractors Show Major Problem (GAO/NSIAD-94-245, Aug. 5, 1994).

Refunds Amount to Hundreds of Millions of Dollars a Year

Between fiscal year 1994 and 1998, the Columbus Center received refunds from defense contractors totaling $4.6 billion. The amounts have declined since fiscal year 1996. (See fig. 1.)

Figure 1: Refunds from Defense Contractors



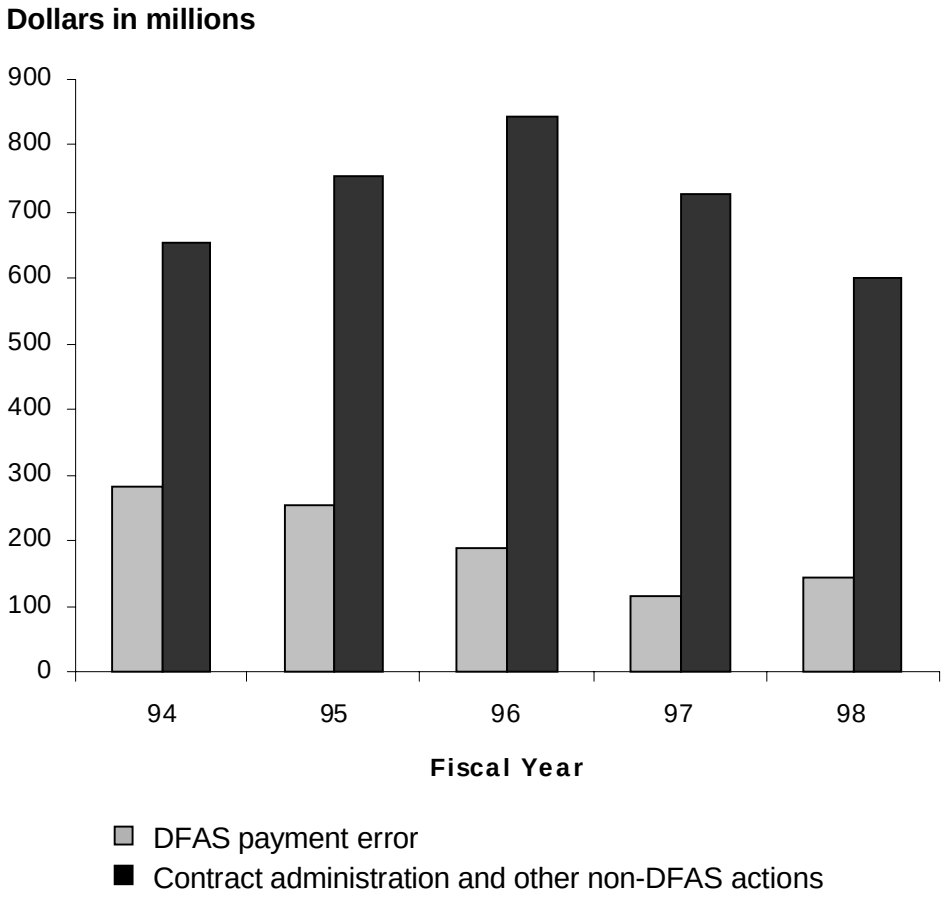
Source: DFAS, Columbus.

According to the Columbus Center, $3.6 billion of the $4.6 billion it received was due to factors outside its control, such as downward contract price adjustments that resulted in overpayments. The remaining $984 million was attributable to Center payment errors, such as paying the same invoice twice, making erroneous progress payment liquidations, and misreading invoice amounts.

As indicated in figure 2, Center payment errors decreased from fiscal year 1994 to 1997 but increased in fiscal year 1998. According to Center personnel, the increase was due to a computer problem resulting in two overpayments to one contractor, one for $20 million and another for

$10 million. The overpayments were promptly returned, and DFAS said the computer problem was immediately corrected.

Figure 2: Contractor Refunds by Reason



Source: DFAS, Columbus.

Review of Selected Contractors Discloses Additional Payment Problems

From overpayments returned to the Center in fiscal year 1998, we selected and visited 13 contractor locations to ascertain (1) if contractors were retaining overpayments and (2) how quickly overpayments were refunded.

Some Contractor Locations Retain Overpayments

Four of the 13 contractors were retaining overpayments totaling about $1.1 million. Contractor personnel at each location told us they had not returned the money because each contractor had a practice of retaining overpayments until the government issued a demand letter. Under current law, there is no requirement for contractors who have been overpaid to notify the government of overpayments or to return overpayments before the government issues a demand letter.

Contractor officials at one location we visited in May 1998 told us that they were retaining an overpayment of about $36,800 received in 1995 because their practice is to retain overpayments until the end of a contract unless a demand letter is received. They said without a demand letter, they could not be sure that their account would be properly credited. For that reason, they said they did not notify DOD about the overpayment. At our request, the contractor reported the overpayment to the government's administrative contracting officer (ACO) who issued a demand letter. The contractor refunded the overpayment in June 1998. After our visit, DCAA issued an audit report on an audit that was ongoing at the time of our visit, requiring the contractor to establish written policies and procedures to ensure overpayments are identified and reported to the government. According to DCAA, the contractor has established such controls.

At another location, a contractor was retaining overpayments of about $41,700 that it had known about since January 1997. A contractor official said that it is company policy to first resolve payment discrepancies with DFAS. The official also said that unless this is done and a demand letter issued, DFAS does not properly credit their account. At our request, the contractor notified the ACO of the overpayment in June 1998. The ACO requested the Center to verify the accuracy of the reported overpayment. Initially, the Center concluded that no overpayment had occurred. However, upon closer examination, the Center concluded that the government had overpaid the contractor. In October 1998, the Center issued a demand letter, and the contractor refunded the money promptly. The DCMC area office also issued a memorandum to its field operations personnel instructing them to ask a contractor reporting an overpayment to immediately return the money.

We also found cases where the government was aware of overpayments but did not take timely action to obtain recovery. For example, the ACO at one contractor location told us that he had identified overpayments of more than $400,000 in March 1997. According to the ACO, he notified the Center of the overpayments because it had access to the payment records and

was, therefore, in a position to determine the amount of overpayments and issue a demand letter. According to the ACO, the Center informed him that the overpayments would be recovered from the contractor's future shipment, even though he had informed the Center that the contract had been completed and no future shipment would be made. Notwithstanding this information, the Center did not issue a demand letter. After our visit, the ACO issued two demand letters for about $425,000, which the contractor refunded.

At another location, according to a contractor official, contractor personnel notified the Center of overpayments beginning in 1991 but did not refund the money because they were waiting for a demand letter. According to this official, their experience has been that their account was not properly credited when they refunded money without a demand letter. As a result, the contractor kept track of the overpayments and waited for the government to issue a demand letter. At our request, the contractor provided us a list showing accumulated overpayments of about $627,000. In August 1998, we provided the Center the list and requested it to recover the overpayments, and in December 1998, the Center requested that the overpayments be returned. In April 1999, a company official advised us that the money had been refunded and that the company would revise its procedures to refund overpayments without a demand letter.

Timeliness in Obtaining Refunds of Overpayments

Obtaining timely return of overpayments is important. If overpayments are not recovered promptly, DOD forgoes the use of these monies and may suffer actual monetary loss if the debt becomes uncollectible. It took about a year, on average, before overpayments of $56.2 million were refunded to the Center by the 13 contractors. This varied from about 2 weeks to nearly 6 years in one case.

At one location, the contractor was overpaid $6.1 million between 1992 and 1996. In December 1997, the contractor voluntarily refunded the money. According to a contractor official, the company's practice was to retain overpayments in an advance payment account until a demand letter was received or the end of the contract to ensure the Center would properly credit the company's account. Due to a change in company practice, the overpayments were remitted before the end of the contract.

At a second location, the government's contracting officer did not request a refund when, in August 1995, the government agreed to replace contractor purchased material with government-furnished material, resulting in the

contractor being overpaid. According to contractor officials and the DOD contracting office, the amount of overpayment was difficult to determine because the extent of use of the government material was uncertain. Yet, even after production was completed and contract items had been delivered in November 1996, the contracting officer did not request a refund. The government ultimately negotiated price reductions of over $1.6 million in July 1997 and requested repayment in September 1997.

At a third location, the ACO did not take timely steps to recover overpayments of over $4 million that had been identified as early as June 1989 in contractor reports to the ACO. By June 1993, the reported overpayment totaled about $8.5 million. Partial refunds of about $2.9 million and $4.4 million were made in 1994 and late 1997, respectively. According to government officials, the total amount of overpayment was not determined until November 1997 due to staffing constraints, priorities given to new contracts, and unknown requirements that could surface during contract performance. Production requirements, however, had been completed in March 1990.

The timeliness of obtaining refunds of overpayments is not a new issue. In March 1994, we reported that the Center did not collect overpayments promptly when reported. In some cases, contractors planned to return overpayments but were told to hold the money until the contracts could be reconciled and demand letters issued.[3] We found similar problems in 1995 and estimated that delays in recovering about $84 million in overpayments cost the government about $10.6 million in interest.[4] In that review, we also found that the Center did not pursue timely recovery even after a contract reconciliation identified overpayments.

DCAA Did Not Identify Overpayments

A key procedure for identifying overpayments is to have the contractor periodically reconcile its billings to the government with its accounting data and with the payments it receives from the government. Since June 1994, DCAA, as part of its periodic review of contractor billing systems, has been required to ensure that a contractor (1) has written procedures for periodically reconciling its billing and accounting data and notifying the

[3] DOD Procurement: Millions in Overpayments Returned by DOD Contractors (GAO/NSIAD-94-106, Mar. 14, 1994).

[4] DOD Procurement: Millions in Contract Payment Errors Not Detected and Resolved Promptly (GAO/NSIAD-96-8, Oct. 6, 1995).

government of overpayments and (2) is effectively implementing these procedures. At two locations, we noted that DCAA auditors did not identify overpayments.

For example, in September 1997, while reconciling its accounts in preparing its final billing on the contract, one contractor discovered it had erroneously billed and been overpaid $591,000 in March 1994. The contractor said that its procedures in effect at the time did not catch the overbilling or the resulting overpayment and that it has since established stronger controls that provide for periodic reconciliation of billing and accounting data. However, we noted that in reviewing the contractor's billing system in 1996, DCAA did not identify the overpayment and concluded that the system was adequate.

At another contractor location, the company's practice was to keep overpayments in an advance payment account until it received a demand letter or the contract was completed. The advance payment account had a balance of at least $6.1 million that had been accumulating since 1992 before the contractor refunded it in December 1997. DCAA auditors said they were unaware of the overpayments in that account. Moreover, DCAA did not test the contractor's comparisons of amounts received to amounts billed for each invoice and did not determine if the contractor had a policy of timely notifying the paying office of overpayments, which it should have based on its audit guidance. According to the auditors, they used the standard DCAA billing system audit program, dated October 1993, to conduct their audit in October 1994. This audit program did not require DCAA to evaluate the contractor's controls for identifying and notifying the government of any overpayments. However, in June 1994, DCAA had revised its audit program to require such an evaluation. The revised program was provided to DCAA regional directors and field detachments in September 1994, before DCAA began its review of this contractor.

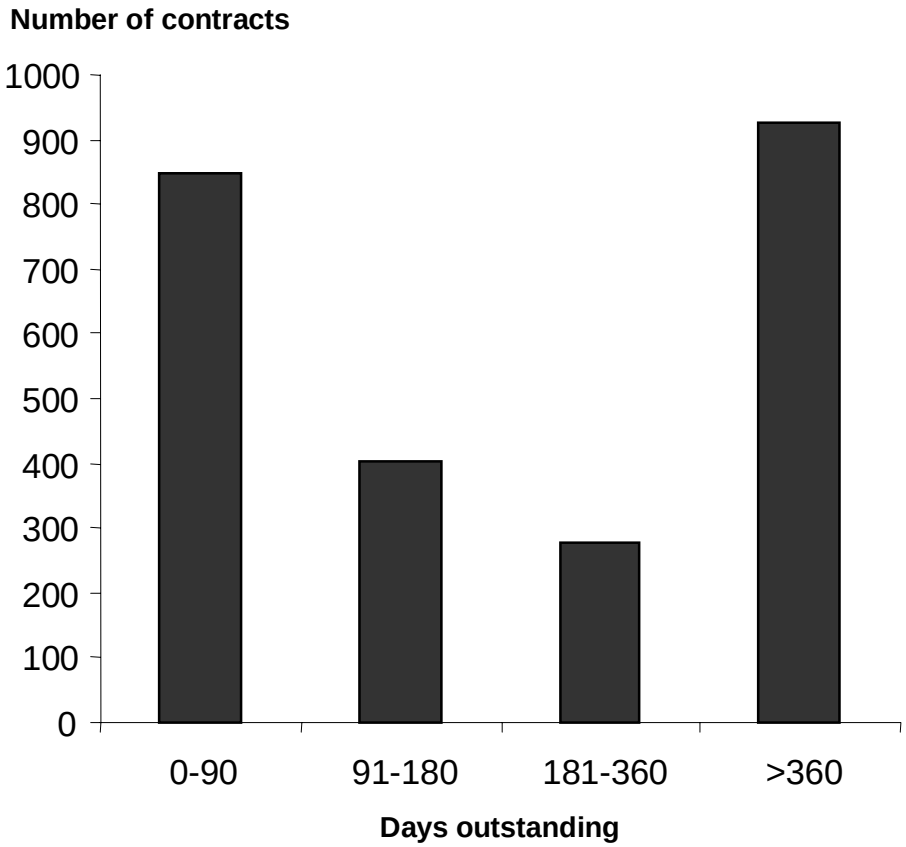
Growing Backlog of Unreconciled Contracts Precludes Timely Identification of Overpayments

In our March 1994 report, we pointed out the large backlog of contracts requiring reconciliation and the large sums of money owed the government that come about through reconciliation. For example, we noted that the reconciliation results of a public accounting firm employed by the Center showed that from October 1990 through November 1993, about $208 million had been identified as being owed to the government.

The Center continues to have a sizable and growing backlog of contracts to be reconciled. As of January 1999, the Columbus Center had a backlog of

2,453 contracts requiring reconciliation. About 38 percent of these contracts have been waiting reconciliation for more than a year. (See fig. 3.)

Figure 3: Contracts Waiting Reconciliation



The January backlog of 2,453 contracts had increased from 1,660 contracts a year earlier. The number of unreconciled contracts may increase before it gets better. According to the Center, while the number of contracts requiring reconciliation has increased, the number of staff available to perform contract reconciliation has decreased. The number of Center contract reconciliation employees decreased from 156 in March 1998 to 109 in January 1999, and staff obtained from a public accounting firm to assist in reconciling contracts decreased from 60 staff years in 1997 to 40 staff years in 1998. The Center estimates that it will take 387 staff years to reconcile the January backlog.

In June 1998, DFAS revised its contract reconciliation procedures to improve the timeliness and the accuracy of its payments and reduce problem disbursements. According to the Center, these revised procedures, issued in January 1999, are intended to improve resource efficiency and provide for more timely reconciliation.

Conclusions

Contractors return overpayments to the Columbus Center amounting to hundreds of millions of dollars a year. However, this represents only the amount that has been identified and returned. There are likely more overpayments that have yet to be identified and returned. We found 4 of the 13 contractors were retaining overpayments of about $1.1 million. In addition, there are likely to be substantial overpayments in the Center's backlog of contracts that are waiting to be reconciled.

Given the past problems that the Center has had making accurate payments, and the Center's backlog of contracts waiting to be reconciled, a number of steps can be taken to identify overpayments and obtain timely refunds. These steps involve actions by both the contractor and the government contracting and payment personnel and should not place an unreasonable burden on either the contractor or government personnel. These steps would require (1) contractors to immediately notify the government when they have been overpaid, (2) DOD to reemphasize the need for government contracting or payment personnel to request refunds immediately upon becoming aware of overpayments and not wait for the more formal demand letter, and (3) the Center to consider periodically requesting contractors to provide the Center with the status of their accounts with the government.

The increasing backlog of unreconciled contracts is of particular concern. The longer a contract remains unreconciled, the longer any overpayments identified through reconciliation will remain undetected and in the contractors' possession and the greater will be the government's loss of the use of these monies. Further, the longer a debt remains outstanding, the greater may be the difficulty in collection and the chance that the debt will become uncollectible.

Recommendations

We recommend that the Secretary of Defense

- require contractors to promptly notify the government of overpayments made to them;
- direct the Director, DFAS, and the Commander, DCMC, to reemphasize the need to request refunds of overpayments promptly and to perform timely reconciliation; and
- direct the Director, DFAS, to examine the cost-effectiveness of requiring contractors to periodically provide a status of their accounts with the government.

Agency Comments and Our Evaluation

In commenting on a draft of this report, DOD concurred with our recommendations and agreed that it could strengthen its ability to identify overpayments. However, DOD stated that it believes the Federal Acquisition Regulation (FAR) and the Defense Federal Acquisition Regulation Supplement (DFARS) contain appropriate procedures to recover overpayments.

While the FAR and DFARS require that debts be collected as rapidly as possible, they do not require contractors to notify the government when they have been overpaid. In addition, we noted instances where government personnel, when made aware of overpayments, were not requesting refunds in a timely manner. DOD should reemphasize to its contracting and payment personnel the need to make timely requests for overpayment refunds. If, upon final debt determination, these refunded amounts are found to be in error, the erroneous amounts can be refunded to a contractor.

DOD took exception to our comment that DCAA failed to perform the required audit steps and commented that the cited overpayment was due to an inadvertent contractor error. We have revised our report based on DCAA's comments. The key point is that DCAA's audit procedures did not identify the overpayment at the subject contractor location.

Scope and Methodology

To update our prior data on checks received by the Columbus Center and the reasons for them, we analyzed the Center's database of checks received, but did not verify the accuracy of the data. To ascertain the reasons for the increase in checks received due to the Center's errors, we reviewed the Center's policies and procedures to ensure payment accuracy. We also discussed with Center officials the controls to ensure that the policy to obtain timely refunds is followed. We did not examine any

underpayments that may have resulted from the Center's payment activities.

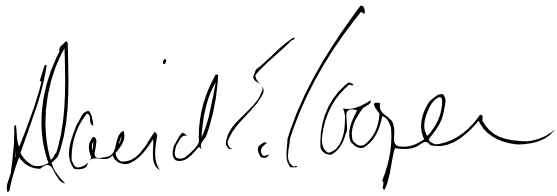
To ascertain if contractors were retaining overpayments, and how quickly overpayments were refunded, we selected 13 contractor locations that had returned overpayments from October 1, 1997, through March 31, 1998, for a detailed review. These contractors were selected to represent the various reasons, as determined by the Center, for the overpayments, as well as to reflect differences in contractor size and geographical location. We visited each contractor location to obtain a better understanding of the reasons for the overpayments and to ascertain the contractors' controls to prevent erroneous billing and to ensure prompt refunds. We also asked each contractor to provide us a reconciliation of its accounts with the government to determine if it was retaining overpayments. At each contractor location, we reviewed contract documents, billing records, contractor billing policies and procedures, and discussed with contractor officials their policies or practices for identifying and returning overpayments. We also discussed with DOD contracting officials and government auditors the controls used to monitor contractor billings and payment accuracy. We conducted our review between April 1998 and February 1999 in accordance with generally accepted government auditing standards.

Because the backlog of unreconciled contracts was a problem we had identified previously, we obtained information from the Center on the current status of the backlog and its progress in reducing the backlog.

As agreed with your office, we plan no further distribution of this report until 30 days from its issue date unless you publicly announce its contents earlier. At that time, we will send copies to the Honorable William Cohen, Secretary of Defense; the Honorable Jacob Lew, Director, Office of Management and Budget; Major General Timothy P. Malishenko, Commander, Defense Contract Management Command; and Mr. William Reed, Director, Defense Contract Audit Agency. We will make copies available to others upon request.

Please contact me at (202) 512-4587 if you or your staff have any questions concerning this report. Major contributors to this report are Charles W. Thompson, Odi Cuero, and Kenneth Roberts.

Sincerely yours,



David E. Cooper
Associate Director
Defense Acquisitions Issues

Contractors Reviewed

Lockheed Martin, Tactical Aircraft Systems, Fort Worth, Tex.

Allied Signal, Inc., Electronic Systems, Teterboro, N.J.

Sikorsky Aircraft Corporation, Stratford, Conn.

Bell Helicopter, Textron, Fort Worth, Tex.

Hughes Aircraft (now Raytheon), Fullerton, Calif.

TRW, Sunnyvale and Redondo Beach, Calif.

Raytheon, Bedford, Mass.

Earth Tech, Long Beach, Calif.

Northrop Grumman Electronics & Systems Integration, Melbourne, Fla.

Primex Technologies, Inc., Downey, Calif.

Lockheed Martin Electro-Optical Systems, Pomona, Calif.

Harris Corporation, Electronic Systems Sector, Melbourne, Fla.

Boeing, Long Beach, Calif.

Related GAO Products

Contract Management: DOD Is Examining Opportunities to Further Use Recovery Auditing (GAO/NSIAD-99-78, Mar. 17, 1999).

Contract Management: Recovery Auditing Offers Potential to Identify Overpayments (GAO/NSIAD-99-12, Dec. 3, 1998).

DOD Procurement: Funds Returned by Defense Contractors (GAO/NSIAD-98-46R, Oct. 28, 1997).

Contract Management: Fixing DOD's Payment Problems Is Imperative (GAO/NSIAD-97-37, Apr. 10, 1997).

DOD Procurement: Millions in Contract Payment Errors Not Detected and Resolved Promptly (GAO/NSIAD-96-8, Oct. 6, 1995).

DOD Procurement: Overpayments and Underpayments at Selected Contractors Show Major Problem (GOA/NSIAD-94-245, Aug. 5, 1994).

DOD Procurement: Millions in Overpayments Returned by DOD Contractors (GAO/NSIAD-94-106, Mar. 14, 1994).

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