

GAO

Report to the Chairman, Committee on
Governmental Affairs, U.S. Senate

March 1994

DOD PROCUREMENT

Millions in Overpayments Returned by DOD Contractors





United States
General Accounting Office
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National Security and
International Affairs Division

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The Honorable John Glenn
Chairman, Committee on
Governmental Affairs
United States Senate

Dear Mr. Chairman:

In July 1993, we testified before your Committee¹ that the Defense Finance and Accounting Service (DFAS), Columbus, Ohio, had received \$751 million in payments from defense contractors during a recent 6-month period. You subsequently requested that we review (1) the nature of the contractors' payments, (2) the length of time government funds were outstanding, (3) the Department of Defense's (DOD) efforts to detect and recover contract overpayments, and (4) the actions being taken by DOD to strengthen its contract payment system. As agreed, we are continuing to review DOD's policies and procedures for detecting and recovering overpayments.

Results in Brief

During a 6-month period ending April 8, 1993, DFAS processed \$751 million in checks from defense contractors. We researched checks totaling \$392 million (52 percent of the total dollar amount) and found that \$305 million were returned contract overpayments. Most of these overpayments resulted because DFAS Columbus Center either (1) paid contractors' invoices without recovering progress payments or (2) made duplicate payments. Overpayments also occurred for a variety of other reasons, including government contractual errors and contractor errors.

Virtually all the overpayments we examined were detected by the contractors rather than the government. DFAS' process for detecting payment errors primarily relies on reconciliations, a process for identifying needed corrections in a contract payment record after errors or potential problems are identified. When DFAS reconciles contracts, it identifies millions of dollars in overpayments, but it has not reconciled most contracts. As of December 1993, the Columbus Center had identified about 6,600 problem contracts that required reconciliation.

¹Financial Management: DOD Has Not Responded Effectively to Serious, Long-standing Problems (GAO/T-AIMD-93-1, July 1, 1993).

For \$240 million of the \$305 million in overpayments, government records contained adequate data to determine when the overpayments occurred. Using this data, we determined that these overpayments remained outstanding an average of 108 days from the date of overpayment to the date of refund, with about 40 percent of the overpayments outstanding over 90 days. Using a 6.5-percent interest rate, we calculated that the \$240 million in overpayments resulted in an interest cost of \$2.3 million. The DFAS Columbus collection process did not ensure prompt return of overpayments identified and reported by contractors. In some cases, contractors planned to return overpayments but were told to hold the monies until the contract could be reconciled and a demand letter issued.

After we testified about the \$751 million in contractor payments before your Committee, DOD attempted to determine the causes of overpayments and to identify corrective actions. DOD is currently pursuing a number of ways to strengthen existing internal control procedures designed to prevent overpayments and more rapidly detect such payments when they occur. Also, DOD officials said that a number of initiatives are underway to reform and streamline complex regulatory policies and procedures and that a high-level council has been established to oversee major financial management changes. Because of DOD's on-going actions and our continuing review, we are not making any recommendations at this time.

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. The Defense Logistics Agency continues to provide contract administration services to DOD and other agencies through five geographically dispersed Defense Contract Management Command (DCMC) districts.

A computer-based system, Mechanization of Contract Administration Services (MOCAS), is used in the DFAS Columbus Center to manage and pay contracts administered by DCMC. The MOCAS system, in use since 1968, is designed to allow contract administrators and finance personnel to monitor the status of funds, deliveries, and other contract actions required through contract closeout. As of September 30, 1993, MOCAS had about 373,000 active contracts with payments totaling about \$64 billion in fiscal year 1993.

The MOCAS financial management subsystem provides the accounting data used to control obligations and payments on contracts. Data on contract payment terms and prices are also entered into the MOCAS system. Fixed-price contracts with a value of \$1 million or more and a delivery period of 6 months or longer usually include provisions for progress payments. Progress payments permit the contractors to receive payments for costs incurred and work performed prior to delivery. When the contractor delivers contract items, the contractor submits an invoice to DFAS requesting payment for the delivered items. Progress payments received prior to items being delivered are to be deducted from the invoiced amounts. This process of recovering progress payments upon delivery is called "liquidation" or "recoupment" of progress payments.

Contract payment terms and conditions depend upon such factors as the type of contract awarded by the buying activity and contract modifications, if any, issued after contract award. Accurate and timely contract payments are influenced by the activity awarding the contract, the activity administering the contract, the payment office, and the contractor.

Most Returned Checks Resulted From Government Overpayments

DFAS processed about 4,000 checks from contractors totaling \$751 million for the 6-month period we examined. The checks, written by hundreds of contractors located throughout the country, ranged from a few dollars to several million dollars. Our analysis of the 190 largest checks received by three of the five DFAS payment directorates disclosed that 136 checks valued at about \$305 million were returns of contract overpayments. The remaining checks, with a value of \$87 million, included other collections such as refunds because of contractor accounting adjustments and other contract administrative actions not directly related to recovering erroneous overpayments.

The 136 checks accounted for 228 erroneous contract overpayments. Table 1 shows the distribution of these overpayments by type of error.

Table 1: Distribution of Overpayments by Type of Error

Dollars in millions

Type of error	Number of overpayments	Percentage of total overpayments	Amount returned	Percentage of total amount returned
Progress payments not recovered	115	50	\$176	58
Duplicate payments	58	26	37	12
Other errors	55	24	92	30
Total	228	100	\$305	100

Progress Payments Not Recovered

We identified 115 overpayments that occurred because DFAS did not recover progress payments as required. The DFAS Columbus Center analysis of refunds identified a number of employee errors in processing progress payments. Also, if the MOCAS system does not contain correct contract terms and complete and accurate records of progress payments, progress payments may not be correctly liquidated against delivery invoices, and overpayments can occur.

For example, in January 1993, DFAS paid \$27 million to a contractor for two delivery invoices. Upon receipt, the contractor discovered an overpayment of \$19.2 million because DFAS did not reduce the invoice amounts by the total amount of previous progress payments. The overpayment occurred, according to DFAS Columbus Center officials, because of confusion over funding sources when an appropriation account used to pay this contract was no longer available. This ultimately led to paying the invoices without fully recovering progress payments. The contractor returned both overpayments in one check for \$19.2 million. Using a 6.5-percent rate, the interest cost while these overpayments were outstanding 15 and 18 days was about \$59,000.

In another case, a contractor refunded over \$24 million on one contract that had been transferred to the Columbus Center for payment in May 1992. When the contractor submitted delivery invoices, DFAS paid the invoiced amounts with no deductions for previous progress payments because the records transferred to the Columbus Center omitted the payment history. In August 1992, DOD contract administrators requested that DFAS reconcile the contract payments, but were told that a reconciliation could not be completed because of missing records and lack of resources. In October 1992, the contractor returned the overpayments in four separate checks, even though a demand letter had not been issued

by DFAS and the contract had not been reconciled. As of December 1993, this contract was still scheduled for reconciliation. Because of missing data, we could not readily determine the total interest cost on these overpayments, but at 6.5 percent, the interest cost on \$24 million is about \$4,300 per day.

In another instance, a contractor refunded about \$4 million in contract overpayments in March 1993, more than 3 months after identifying the overpayment. Shortly after receipt of the overpayment in late November 1992, the contractor notified DFAS that progress payments had not been recovered when the delivery invoice was paid. A DFAS official advised the contractor to hold the overpayment until the Columbus Center could reconcile the contract. In late February 1993, about 3 months after the overpayment, DFAS issued a demand letter to the contractor asking that the monies be returned within 30 days. A contractor official told us that after the March refund, the contractor received a \$5.9-million overpayment on the same contract and advised DFAS about the overpayment in September 1993. DFAS did not issue a demand letter until November 1993, and the contractor refunded the overpayment later that month. The official believed the second overpayment resulted from progress payment records not being corrected after the previous overpayment.

Duplicate Payments

We identified 58 overpayments that occurred because DFAS paid an invoice or progress payment request twice. Furthermore, these duplicate payments resulted from DFAS errors, not DCMC or contractor actions. Our examination and DFAS' analysis of duplicate payments indicated that incomplete records or incorrect manual intervention with system processing generally caused the duplicate payments. A payment processed within the system requires a match of all necessary payment documents, such as invoices and receiving reports, with the contract payment provisions before a payment is made. Payments processed outside the system should meet similar standards, if not, payment errors can occur.

For example, in March 1993, a contractor refunded about \$521,000, with most of the overpayment resulting from 14 duplicate invoice payments on a contract. For 12 invoices, duplicate payments occurred when DFAS issued initial payments based on contractor invoices and then erroneously issued second payments based on shipping documents for each of the previously paid invoices. For two invoices, duplicate payments occurred when DFAS initially paid the invoices by offsetting a prior government overpayment and later erroneously paid the same invoices again. The contractor

notified DFAS about the errors. The interest cost on these overpayments, which were outstanding from 57 to 233 days, is about \$13,400.

A finance official for the contractor told us that because of frequent payment errors, the contractor had set up a special account for government overpayments that once had a balance of about \$1.9 million, but was about \$290,000 at the end of December 1993. According to the contractor official, both DFAS and the government contracting officer have been informed about the account. The official also said that the company had received only one demand letter, for \$110,000, pertaining to funds in this account since July 1990. We were told that rather than refunding overpayments, the company decided the most efficient way of handling overpayments was to offset them against future billings. In the past, the company returned the overpayments with a written explanation, but the explanations were sometimes lost at DFAS, which made the company have to re-explain refunds. Offsetting the overpayments eliminated the refunds and overpayment explanations. Contractor personnel told us that they informally advised DFAS personnel about the overpayments and offsets.

In another case, DFAS made a progress payment in May 1992 of about \$700,000 to a contractor. Six days later, DFAS issued a second check for the same progress payment request. DFAS Columbus Center officials believe this duplicate payment occurred because the voucher examiner did not adequately research the records prior to the second payment. The contractor notified a government contracting officer of the duplicate payment about 4 months after the second payment was issued and offered to return the overpayment. Because DFAS could not document that an overpayment had been made, the government contracting officer asked the contractor to document the duplicate payment. After reviewing the documentation, DFAS issued a demand letter for a refund in October 1992, and the contractor returned the overpayment. Interest cost while this overpayment was outstanding for 170 days is about \$21,000.

Other Overpayment Errors

The 55 payment errors we classified as "other" included 30 errors considered atypical because they stemmed from a variety of circumstances. For example, a contractor was overpaid \$9,999,999.99 because a DFAS Columbus Center employee made a data input error that was not detected. Another contractor was overpaid about \$1 million because a center employee paid from the first page of the contractor's progress payment request rather than the second page, which contained the contracting officer's reduction to the contractor's requested amount.

The remaining 25 errors in this group occurred because of government contractual or contractor errors. Overpayments can occur from errors during contract award or contract administration throughout the life of a contract. Overpayments also can occur if the contractor does not follow correct procedures when submitting invoices and progress payment requests.

For example, five overpayments resulted because contract modifications changed prices already paid under prior contract terms. When a contract modification affects contract prices or progress payment provisions, the modified terms and conditions must be entered in MOCAS before payments can be made in accordance with the new provisions. In total, we examined \$8.4 million in overpayments that were primarily attributable to contract modifications affecting payments already made by DFAS.

In one case, a delayed modification resulted in a contractor returning \$552,000 in March 1993 as the net overpayment due the government. In a November 1989 letter, the government contracting officer had directed the contractor to eliminate certain packaging requirements. The contractor eliminated the requirement, but continued to be paid at prices that included the packaging services because the contract price was not modified. According to a contractor employee, the company was instructed to bill at the original contract price because the contract modification had not been finalized. The contract modification was not finalized until May 1992. At that time, the contractor had been overpaid about \$922,000. The contract modification also included other price adjustments resulting in the \$552,000 net overpayment. Although the modification was entered into MOCAS in May 1992, a demand letter for a refund was not issued until February 1993, about 9 months later. When the contractor apparently did not receive the first demand, a second demand letter was issued and the refund check was issued in March 1993.

In another instance, a contractor refunded about \$1 million in December 1992. The refund resulted from a September 1992 contract modification that established final prices for items ordered based on estimated prices 2-1/2 years earlier. In total, the modification reduced the estimated prices by \$1.6 million and the contracting officer issued a demand letter in November 1992 for that amount. The contractor disagreed with the amount and refunded about \$1 million. The contracting officer accepted the amount as a refund of the overpayment.

The overpayments we examined also included 11 instances totaling \$9.9 million that were primarily attributable to contractors submitting incorrect payment requests. For example, a contractor submitted four requests for excess progress payments totaling \$5.8 million in December 1992. We were told that the errors occurred when the contractor submitted requests that incorrectly doubled part of the contractor's costs. The contractor's internal controls detected the erroneous amounts. The overpayments were outstanding from 1 to 29 days.

Detecting and Collecting Overpayments

Contractors detected and advised the government about 219 of the 228 overpayments we examined. In most cases, contractors refunded the overpayments without the government issuing a demand letter. When demand letters were issued, the contractors, in accordance with current policy, were allowed 30 days to make the refund without incurring interest charges.

Contractors Detected Overpayments

Contractors detected most of the overpayments that we analyzed. The overpayments remained outstanding for an average of about 108 days after the payment. About 40 percent of the overpayments were outstanding more than 90 days. The government's primary method of identifying and correcting contract payment errors is by auditing or reconciling contracts with known or suspected problems. DFAS's Director of Contractor Entitlement told us that the Columbus Center does not systematically reconcile contracts. As of December 1993, the Center had 6,603 problem contracts that required reconciliation.

Past reconciliations have identified millions of dollars in overpayments. The Director of Contractor Entitlement at Columbus said that reconciliations are typically performed on an ad hoc basis, typically doing the oldest ones first. In fiscal year 1993, the Columbus Center had about 130 personnel assigned to contract reconciliations, and it had reconciled 6,619 contracts. DFAS did not tabulate the dollar amount of contract adjustments that resulted from its effort.

In addition to its own reconciliations, a public accounting firm was engaged by DFAS to reconcile selected problem contracts. Monthly reports of the firm's activities from October 1990 through November 1993 show the following:

- About 4,300 contracts at the Center had been reconciled by the firm.
- About \$38 billion in accounting adjustments were needed to correct payments that had been made from the wrong accounts.
- About \$208 million had been identified by the firm as being owed to the government and an additional \$52 million in possible debts were being reviewed.
- About \$61 million had been identified as being owed by the government to contractors.
- Demand letters had been issued to contractors for \$175 million based on the firm's reconciliations, with about \$73 million collected.
- About \$17 million might not be collectable for one or more reasons, including \$8 million from contractors involved in bankruptcy.

Demand Letters Provide Interest-Free Grace Period

Demand letters were issued to recover contract overpayments on 22 of the checks we reviewed. The demand letters we examined provided the contractors a 30-day grace period to return a contract overpayment before being assessed interest charges. This 30-day period was provided regardless of how long the overpayment has been outstanding or the contractor's willingness to return the monies. Contractors, if they request it in writing, are given the option of an offset action in lieu of mailing a check. Contractors were not encouraged to immediately refund overpayments or to accept immediate offsets against subsequent payments.

In accordance with terms of the demand letter, DFAS did not assess interest charges if refunds or offsets were made within the 30-day period. Also, in several cases we reviewed, DFAS instructed contractors to retain overpayments until the contract was reconciled and the amount of overpayments confirmed, which can take months. For example, a contractor who had returned overpayments during our 6-month examination period received another overpayment of \$15.7 million in June 1993 because DFAS had not appropriately deducted prior progress payments in paying production invoices. Although the contractor planned to repay the overpayment immediately, DFAS instructed the contractor to withhold payment pending completion of a contract reconciliation. The government contracting officer at the plant, recognizing the significant interest cost to the government of such a large overpayment, issued a demand letter in July 1993 and the contractor mailed a refund to DFAS 6 days after the demand letter was issued.

Actions to Reduce Overpayments and Improve Collections

DOD officials attribute some of the payment problems discussed in this report to the accelerated consolidation of contract payment functions at the DFAS Columbus Center. During 1992, the planned consolidation was accelerated because the quality of payment efforts at closing sites deteriorated to an unacceptable level as experienced employees resigned. Officials said that the accelerated transfer of contract payments to the Columbus Center overloaded the Center's computer system and created an environment where normal controls were not available. They also said that the available staff were relatively new and lacked experience in some of the more complex and specialized contract payments being transferred.

DFAS Columbus Center officials have analyzed the causes for the payment errors discussed and have initiated a number of actions to correct persistent errors. These actions include the following:

- stricter adherence to operating procedures that previously had not been followed in order to facilitate payments and changes to other procedures;
- improved maintenance of the progress payment master files;
- increased management and supervisor attention to errors and their causes, including training on how to address specific payment problems; and
- computer system changes such as rejecting large dollar payments if progress payments are not liquidated.

DFAS Columbus Center officials acknowledged that delaying the return of erroneous overpayments is costly and have taken action to encourage quicker return of overpayments. A November 5, 1993, letter instructs personnel to have contractors immediately refund overpayments when contractors advise them that an overpayment has occurred.

DOD officials said that a number of other actions are being taken to clarify and strengthen payment practices, reinforce prompt debt collection procedures, and issue clearly stated and complete contract documents to deal with contractor overpayments. For example, DCMC has issued policy letters to field activities highlighting payment issues and developed a handbook outlining key contract administration functions influencing the payment process. DOD officials expect these efforts to contribute to improved payment practices.

DOD officials said that DOD is committed to developing solutions to major financial management problems and that a Senior Financial Management Oversight Council was established in July 1993 to provide sustained high-level attention across functional areas. Officials said that a broad

range of initiatives are underway to reform the acquisition system and streamline complex regulatory policies and procedures. Changes being considered include projects to redesign the progress payment process; improve the quality of contract preparation; revise a number of contract, payment, and debt collection regulations; and increase the use of electronic data interchange for delivery, acceptance, payment, and review.

The actions being taken by DOD have recently been implemented or require additional review before being implemented. As we continue our review of DOD's detection and recovery of overpayments, we will further analyze these actions and their potential effects.

Scope and Methodology

In order to examine checks representing about half of the funds returned to DFAS, we examined checks that exceeded \$500,000 in two of five DFAS directorates and \$200,000 from a third directorate. We researched 190 checks totaling \$392 million, or about 52 percent of the \$751 million returned during the 6-month period ending April 8, 1993.² In researching each of the 190 checks, we obtained data from

- DFAS, including payment documents and their analysis of the reasons for the contractor payment and
- administrative contracting officers, the responsible DCMC regional offices, and selected contractors.

In addition, we reviewed laws and regulations pertaining to the administration and management of contracts and contract payments, including those related to collection of contractor debts. We also interviewed Defense Logistics Agency, DCMC, and DFAS officials about the reasons for the overpayments, and we discussed actions taken or planned to preclude future overpayments.

As agreed with your office, we did not obtain formal DOD comments on a draft of this report; however, we discussed the results of our review with officials from the DOD Comptroller Office, DCMC, and DFAS. We considered their comments in preparing this report. In general, they concurred with our report.

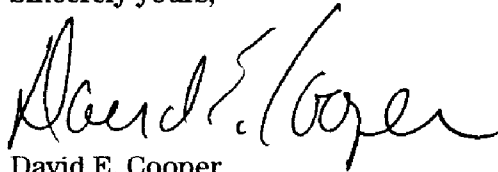
²The period we examined included a \$252-million refund check that we excluded because its large amount and unusual nature would have distorted our results. The refund concluded an unusual transaction that involved the transfer of work and funds between two contracts. DFAS officials requested the return of all progress payments on the first contract (\$252 million) and paid an amount equal to the progress payments earned on the materials transferred to the second contract (\$250 million). The contractor received the \$250 million in September 1992 and returned the \$252 million in October 1992. The DOD Inspector General and others have examined this transaction.

We conducted our review between March 1993 and January 1994 in accordance with generally accepted government auditing standards.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to the Secretary of Defense; the Director, Office of Management and Budget; and other interested congressional committees. Copies will also be made 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 listed in appendix I.

Sincerely yours,



David E. Cooper
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