FINANCIAL MANAGEMENT: TIME TO REFORM THE PROMPT PAYMENT ACT?

HEARING

BEFORE THE

SUBCOMMITTEE ON NATIONAL SECURITY, VETERANS AFFAIRS, AND INTERNATIONAL RELATIONS

OF THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED SIXTH CONGRESS

FIRST SESSION

JUNE 16, 1999

Serial No. 106–28

Printed for the use of the Committee on Government Reform

Available via the World Wide Web: http://www.house.gov/reform

U.S. GOVERNMENT PRINTING OFFICE

59–451 CC WASHINGTON : 1999

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FINANCIAL MANAGEMENT: TIME TO REFORM THE PROMPT PAYMENT ACT?

WEDNESDAY, JUNE 16, 1999

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON NATIONAL SECURITY, VETERANS AFFAIRS, AND INTERNATIONAL RELATIONS,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:01 a.m., in room 2247, Rayburn House Office Building, Hon. Christopher Shays (chairman of the subcommittee) presiding.

Present: Representative Shays, Souder, and Terry.

Staff present: Larry Halloran, staff director and chief counsel; J. Vincent Chase, chief investigator; Bob Newman, professional staff meber; Jason Chung, clerk; and David Rapallo, minority counsel.

Mr. SHAYS. I would like to call this hearing to order.

In January, the General Accounting Office [GAO], reported that serious financial management weaknesses continue to plague Department of Defense [DOD], stewardship of $1 trillion in assets and $250 billion in annual spending. Despite ongoing reform efforts and some improvements to financial systems, erroneous, fraudulent, and improper payments persist. While not always asked to do so, contractors returned almost $1 billion in overpayments from DOD every year.

Today we focus on one aspect of the complex, erratic disbursement process, compliance of the Prompt Payment Act. Designed to bring predictability, and a modest measure of speed to a largely paper-based Federal payment regime, the act appears to be showing signs of age. In the decade since the act was last amended, narrow interpretations and rigid applications of key provisions have hampered the Department's ability to pay bills on time, pay them accurately, capture available discounts, and embrace commercial best practices.

As a result, the volume of late payments by DOD seems stuck at 7 percent of the 12 million invoices paid each month by the Defense Finance and Accounting Services [DFAS]. The current $1 threshold for separate interest payments under the act requires DFAS to process tens of thousands of checks worth less than the time and effort it takes to print them.

Still, from fiscal year 1995 through March of this year, DFAS paid $139 million in interest and penalties under the Prompt Payment Act. While that figure may be only three one-hundredths of 1 percent of total disbursements during that period, today it would

buy five F–16's for the Air Force, 140 new Army trucks, and more than 400 Navy Tomahawk missiles.

Without question, more careful attention to the bottom line can have a direct and substantial impact on the front line.

Our witnesses this morning will help us examine how the Prompt Payment Act may be amended or reinterpreted to enhance rather than impede the DOD efforts to modernize payment processing and adopt successful commercial business practices.

I would like to welcome our witnesses and announce who they are. Speaking first, Mr. Thomas Bloom, Director, Defense Finance Accounting Service, U.S. Department of Defense, accompanied by Mr. Gregory P. Bitz, Director of Finance, Defense Finance and Accounting Services [DFAS].

We also have Mr. Robert J. Lieberman, Assistant Inspector General, U.S. Department of Defense, accompanied by Mr. F.J. Lane, Director, Office of Inspector General, Finance and Accounting Directorate.

And third, we have Mr. David E. Cooper, National Security and International Affairs Division, U.S. Accounting Office, accompanied by Mr. William P. Woods, Assistant General Counsel, National Security and International Relations Division.

As is our practice, we would invite all six of you to stand. Is there anyone else that might respond to a question? If so, I would like them to stand, and we would swear them in, too.

OK. This is for the first panel. If you would raise your right hands?

[Witnesses sworn.]

Mr. SHAYS. Thank you. Note for the record that all our witnesses have responded in the affirmative.

We are going to take testimony from three witnesses, but all will be welcome to respond to questions. And we will put on the light, but—and we will let it go. It is a 5-minute timer. If you go over we will reset it for an additional 5 minutes. We would hope that you would finish before the second 5 minutes.

And we will start with you, Mr. Bloom.

STATEMENTS OF THOMAS BLOOM, DIRECTOR, DEFENSE FINANCE AND ACCOUNTING SERVICE, U.S. DEPARTMENT OF DEFENSE, ACCOMPANIED BY GREGORY P. BITZ, DIRECTOR OF FINANCE, DEFENSE FINANCE AND ACCOUNTING SERVICE; ROBERT J. LIEBERMAN, ASSISTANT INSPECTOR GENERAL, U.S. DEPARTMENT OF DEFENSE; F. JAY LANE, DIRECTOR, OFFICE OF INSPECTOR GENERAL, FINANCE AND ACCOUNTING DIRECTORATE, U.S. DEPARTMENT OF DEFENSE; DAVID E. COOPER, ASSOCIATE DIRECTOR, NATIONAL SECURITY AND INTERNATIONAL RELATIONS DIVISION, U.S. GENERAL ACCOUNTING OFFICE; AND WILLIAM T. WOODS, ASSISTANT GENERAL COUNSEL, NATIONAL SECURITY AND INTERNATIONAL RELATIONS DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. BLOOM. Thank you, Mr. Chairman. I am pleased to be here today representing the Department of Defense and to talk about the Department's financial operations, the Defense Finance and Ac-

counting Service, and, in particular, the Prompt Payment Act and other issues related to the payment process.

Today is actually my 17th working day as the Director of DFAS. So I am actually looking forward to this as a great learning experience for me as well as the committee. [Laughter.]

And as a former IG and a former independent auditor, I have a full appreciation for what the GAO and the IG community have to say and appreciate their remarks also.

Mr. SHAYS. Well, let me just say, I like that attitude, one, and, second, it is very convenient for us and helpful for us to be able to have you from the Department to be able to testify with the Inspector General's Office and the General Accounting Office. It makes it easier for us to do our job, and so we thank your willingness to do it that way and not demand that you have a single chair at one table.

Mr. BLOOM. Happy to do that.

First, let me provide some background. The Defense Finance and Accounting Service was created in 1991 to improve the quality and to reduce the cost of financial operations within the Department of Defense. These financial operations are so vast that DFAS is the largest entity of its kind in the world.

We make monthly payments totaling more than $24 billion. That is more than $1 billion a day. We make almost 9 million payroll payments every month. We make over a million payments a month to businesses and process a million travel, transportation, and miscellaneous payments every month. And we account for the expenditures of every dollar for each defense entity.

To achieve higher quality and lower cost financial operations, we consolidated over 330 finance offices in the United States into 26, a reduction of over 90 percent. We completed that consolidation last year, 2 years ahead of schedule, and we are saving DOD and the taxpayer $120 million a year in operating costs as a result.

We have reduced our staff from 31,000 to 20,000, more than a third. And we expect to reduce it by another 4,000 in the near future. When we were created in 1991, we inherited over 300 finance and accounting systems owned and developed by the military services and defense agencies. These systems did not talk to each other, and they did not meet the requirements of the Chief Financial Officers Act.

We have eliminated 200 of these systems, a two-thirds reduction. The number of systems we have now is less than many of the Fortune 500 companies. And we expect in the near future to eliminate another 70.

We already have introduced standard systems in most of our pay areas and soon will have standard practices in other accounting areas. All of our critical systems are Y2K compliant.

Our operations cost our customers less than one-half of 1 percent of their budget, a level that compares favorably with the private sector.

We pay 99 percent of our payroll on time and 98 percent of it accurately. And given the complexity of the payroll entitlements that apply to military and civilian personnel we believe this is a significant accomplishment.

But good as these numbers are, I am committed to improving them. We will work closely with the private sector to be sure that we adopt the best practices and use state-of-the-art technology. In fact, about one-fifth of our work already is contracted out to the private sector, and we are involved in a number of cost comparison competitions that the private sector could win.

We have a rigorous benchmarking program to compare ourselves against public and private finance and accounting operations, both domestic and foreign, and we use the results of such studies to guide us in our planning.

I would caution, however, that outsourcing is not always a panacea, as you may well remember, and I remember from my Department of Education days as the IG there. I would hope the subcommittee would treat with some skepticism the claims that you will hear that major corporations in America outsource their finance and accounting operations. Today, none of the top 10 in the Fortune 500 currently outsource these operations due to complexity.

Let me turn now to our processes for paying contractor-vendors. Timely and accurate payments are imperative for ensuring we have goods and services available when and where we need them. Sometimes, rarely, we are late with our payments, and we have to pay interest and, even more rarely, a penalty. In fiscal year 1998, our interest payments amounted to less than three-one-hundredths of 1 percent of our total payments to contractors and vendors, still a significant number, as the chairman pointed out.

Why do we sometimes make payments late? There are two main reasons. First, though we are rapidly adopting electronic commerce business practices throughout the Department, we still process a great deal of paper. In order to make a payment, we must have several crucial documents in our hand. When those documents are paper rather than electronic, the mail and paper handling sometimes results in a delay.

Second, when we pre-validate our payments to make sure that we have the money on hand in exactly the right pot and in the right amounts, we sometimes require more time than allowed by the Prompt Payment Act to determine that amounts are correctly obligated by our customers.

In other words, to avoid making an improper payment, we spend whatever time it takes working with the various military services and DOD components to make sure we get it right.

Sometimes, again rarely, we overpay our contractors and vendors. We estimate that our overpayments total less than seven one-hundredths of a percent of the total amount paid in fiscal year 1998. Paradoxically, taking the time to ensure that we do not make an overpayment can result in our making a late payment and paying interest.

The advent of new payments systems that take full advantage of the benefits of electronic commerce will put an end to these problems. We expect that next generation of systems to be available within the next 2 years and are working hard to implement them.

Thus, we think we are able to comply with both the spirit and the letter of the Prompt Payment Act. And we don't think that major revision of it is necessary. We believe that though it was last

amended more than a decade ago, well before electronic commerce became as commonplace as it is today, its provisions, if interpreted properly, do not unduly hamper us. In fact, the Office of Management and Budget is updating the circular that guides Federal agencies in carrying out the provisions of the statute to ensure we are able to take full benefit of electronic commerce and at the same time fully comply with the Prompt Payment Act.

I understand that the subcommittee is also interested in recovery auditing. This practice, common in the private sector, seeks to recover overpayments to contractors. DOD recently conducted its own pilot program in recovery auditing. Of the $29 million identified in potential overpayments, the Department has collected about $2.5 million. Nearly $20 million is currently disputed by the contractors, and we are working out those disputes.

The remaining $6.5 million is deemed uncollectible. Still preliminary indications are that the amounts recovered exceed the cost of the program. We would like to explore the further potential of this area.

Mr. Chairman, this concludes my formal statement. And Mr. Bitz and I would be happy to entertain any questions.

[The prepared statement of Mr. Bloom follows:]

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Subcommittee on National
Security, Veterans Affairs, and
International Relations,
Committee on Government Reform

STATEMENT OF MR. THOMAS R. BLOOM

DIRECTOR
DEFENSE FINANCE AND ACCOUNTING SERVICE

BEFORE THE

SUBCOMMITTEE ON NATIONAL SECURITY, VETERANS AFFAIRS
AND INTERNATIONAL RELATIONS

COMMITTEE ON GOVERNMENT REFORM

ON

"FINANCIAL MANAGEMENT: TIME TO REFORM THE PROMPT
PAY ACT?"

JUNE 16, 1999

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Subcommittee on National
Security, Veterans Affairs and
International Relations
Committee on Government Reform

Mr. Chairman and Members of the Subcommittee, I am pleased to be here today representing the Department of Defense and to talk to you about the Department's financial operations, the Defense Finance and Accounting Service, and in particular the Prompt Payment Act and other issues related to the payment process.

First, let me provide some background. The Defense Finance and Accounting Service was created in 1991 to improve the quality and reduce the cost of financial operations within the Department of Defense. These financial operations are so vast that DFAS is the largest entity of its kind in the world. We make monthly payments totaling more than $24 billion. We make almost 9 million payroll payments every month. We make over a million payments a month to businesses and process a million travel, transportation, and miscellaneous payments every month. And we account for the expenditure of every dollar by each Defense entity.

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When we were created in 1991 we inherited over 300 finance and accounting systems owned and developed by the Military Services and Defense Agencies. These systems did not talk to each other, and they did not meet the requirements of the Chief Financial Officers Act "CFO Act". We have eliminated 200 of these systems – a two-thirds reduction. The number of systems we have now is less than that of many of the Fortune 500 companies, and we expect in the near future to eliminate another 70. We already have introduced standard systems in most of our pay areas, and soon we will have standard practices in our accounting areas. All of our critical systems are Y2K compliant.

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program to compare ourselves against public and private finance and accounting operations, both domestic and foreign, and we use the results of such studies to guide us in our planning.

I would caution, however, that outsourcing is not a panacea. There is no question that the services provided by DFAS are commercial in nature. Our guiding principle for determining when the Government engages in commercial activities and when it considers reinvention, consolidation, outsourcing, privatization or competition is that we ensure that we get the best possible deal for the taxpayer. Because agencies operate in different ways, not all of these tools, techniques and strategies apply equally to each agency and department, but every agency and department can benefit from a number of them. As I have noted, DFAS is engaged in restructuring, consolidations, streamlining and the elimination of field offices; procurement reform, including the use of performance based contracting and the use of commercial purchasing strategies; competitions conducted to improve our own operations and with both public and private sector competitors for new customers; and, improvements in the use and acquisition of information technology. All of these tools, not just private sector performance, should be measured by their contribution to improved performance and performance quality, customer and, in many cases, public satisfaction and by reduced costs.

A-76 and outsourcing are important reinvention tools available to the agencies. As the result of a data call issued by Deputy Secretary Hamre last January and the

more recent Federal Activities Inventory Reform Act (FAIR), we are reviewing our full and part time positions to determine which support activities are inherently governmental and cannot be contracted-out and those that are commercial and subject to the dynamics of public-public and public-private competition. I would hope that the Subcommittee would treat with some skepticism the claims you will hear that the major corporations in America outsource their finance and accounting operations. None of the top ten Fortune 500 corporations currently outsources these operations.

Let me turn now to our processes for paying contractors and vendors. Timely and accurate payments are imperative for ensuring we have goods and services available when and where we need them. Sometimes – rarely – we are late with our payments and we have to pay interest and even more rarely, a penalty. In fiscal year 1998 our interest payments amounted to less than three one-hundredths of one percent of our total payments to contractors and vendors.

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Thus, we think we are able to comply with both the spirit and the letter of the Prompt Payment Act, and we don't think a major revision of it is necessary. We believe that though it was last amended more than a decade ago, well before electronic commerce became as common as it is today, its provisions – if interpreted properly – do not unduly hamper us. In fact, the Office of Management and Budget is updating the circular that guides Federal agencies in carrying out the provisions of this statute to ensure that we are able to take full benefit of electronic commerce and at the same time fully comply with the Prompt Payment Act.

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Mr. Chairman, this concludes my formal statement. I would be happy to entertain any question you or other Members of the Subcommittee might have.

Mr. SHAYS. Thank you very much.

I just would like to recognize the presence of Lee Terry from Nebraska. Do you have any statement you would like to make?

[Mr. Terry shakes head indicating no.]

Mr. SHAYS. OK, it is nice to have you here.

And I would take this opportunity to ask unanimous consent that all members of the subcommittee be permitted to place an opening statement in the record and that the record remain open for 3 days for that purpose. And without objection, so ordered.

And I ask further unanimous consent that all witnesses be permitted to include their written statement in the record. And without objection, so ordered.

At this time, we will invite Mr. Lieberman to address us.

Mr. LIEBERMAN. Thank you, Mr. Chairman. I appreciate the opportunity to be here today to talk about DOD financial management. As you know from previous testimony to this committee by the IG and from the IG's semi-annual reports to the Congress, we have long agreed with GAO's assessment of DOD financial management as being a principal high-risk area in the Federal Government.

We have been working very hard with DFAS throughout the decade of the nineties to improve the situation. And I think a fair accounting of where we are would indicate that a lot of progress has been made. But serious problems remain.

The financial reporting problems, the inability to generate auditable financial statements, tend to get the most play in the media, but certainly our problems with the payment processes are at least equally important, and I think it is very appropriate for a congressional subcommittee to focus on the subject.

My statement contains some of the general background about DFAS. I don't want to repeat that. Mr. Bloom has just made the point that it is a tremendously large and complex operation. That is an important factor to keep in mind when we are talking about something such as changing the provisions of the Prompt Payment Act. We should not do something that makes the disbursement process more complicated or retards the progress that is being made toward improving its efficiency.

I hate to spoil Tom by agreeing with him in our first side-to-side discussion of a DOD financial subject here. But I agree generally with his feeling that the Prompt Payment Act does not need major revision. This is not to say that some updating and clarification would not be appropriate.

Certainly the requirement to pay interest payments as little as $1 needs to be revisited, because we are talking about thousands of payments in the magnitude of $1 to $5. And they are taking up the time of DFAS personnel that could be better used for other purposes.

DFAS is not doing as well in terms of bill-paying timeliness as it should and could. I think the best metric of the relative efficiency of the process in terms of the payment deadline is how many invoices are paid on time and how many are not. If I recall the numbers correctly, in fiscal year 1998, DFAS paid against approximately 18.1 million invoices, and 1.2 million of those invoices were not paid on time.

There was a 17 to 1 ratio of on time versus not on time, but still a pretty healthy number of transactions were not paid within the generally prescribed 30-day time limit for payment.

Now, this is not to say that the law is too tough and we should allow more than 30 days for payment. I agree very much with the general observation that DFAS is now putting in the systems and the processes that will enable it to dramatically improve its timeliness record in the future.

So even though we have paid a healthy sum in terms of interest penalties in the last fiscal year, I don't think that the process is out of control. And prospects for near-term improvement are very good. I think DFAS should be held to the expectation that we will see fewer delayed payments and fewer interest penalties in the future.

I would like also to comment that a change to the Prompt Payment Act that would complicate the disbursement process would probably aggravate some of the other chronic problems that plague DOD at the present time. One of the best known of those, that we have done recent audit work on, is so-called problem disbursements or unmatched disbursements. This has been compared to the inability to balance one's checkbook against one's bank statements.

It is a little bit more complex than that. Basically, it reflects the fact that we are still transitioning out of a rather Rube Goldberg arrangement for doing disbursement accounting, where we have the paying going on in one activity and the accounting going on in another. Over the years, we have developed a process which was extremely inefficient, remains inefficient to this day, and results in any given time is having about $10 billion worth of disbursements that we can't match to proper obligations.

We should achieve victory over that problem within the next 2 or 3 years, provided that the systems that are now being developed are fielded on time and live up to expectations.

But right now it is a real problem. It ties up money that the Department needs for other purposes; it makes us vulnerable to Anti-Deficiency Act violations; and it makes us unable to readily detect fraud, overpayment, and other errors.

In my written statement, I mention several other payment problems that we have, that we shouldn't lose sight of. Our pay systems are lucrative targets for hackers who wish to break into them and either steal money or disrupt DOD financial operations. We need to pay particular attention to the security of our financial systems.

Mr. Bloom mentioned the year 2000 problem. DFAS has been working at it very hard, but that is a serious near-term concern that we have to deal with. The overpayment problem remains very much a major concern for the Department. We tend to talk about the payments to contractors from Columbus Center, which handles most of our large contracts. We also have to keep in mind that there are lots of small payments being made in other activities.

I am particularly concerned about the transportation area, where we have thousands and thousands of invoices being paid annually. Each one may be very small, but we have indications of a lot of fraud going on in that area. There are active criminal investigations now, which I think will prove the point.

These are areas that are amenable to technological solutions, or at least technology will help to improve the efficiency of the process. But management emphasis is extremely important, and I am pleased to be able to report to you that DFAS management has been very responsive to the IG in terms of taking an active interest in improving DFAS anti-fraud protections, including DFAS ability to detect fraud and then help us investigate and bring these people to justice.

So we think the future for DFAS is reasonably bright. The agency had a very difficult startup period. It was put together in a top-down decisionmaking process. The parts of the puzzle didn't want to be in the puzzle. The military departments did not want to give up their own financial operations. DFAS had to live through an extremely turbulent period, and I think it has now settled into an organizational structure that makes sense and has the right system improvements in process.

I believe that, probably not next year but 2 years from now, you can have a hearing and talk about DOD financial management problems and you would probably be looking at a much shorter list.

Thank you.

[The prepared statement of Mr. Lieberman follows:]

Hold for Release
Until Delivery
Expected 10:00 a.m.
June 16, 1999

Statement by

Robert J. Lieberman

Assistant Inspector General for Auditing

Office of the Inspector General,

Department of Defense

Before the

Subcommittee on National Security,

Veterans Affairs, and International Relations

On

Financial Management:

The Prompt Payment Act and DoD Payment Processes

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to be here today to discuss the Prompt Payment Act and the Department of Defense (DoD) payment processes. As you know from the Inspector General's testimony to this Subcommittee last February 25 and from the Inspector General's semiannual reports to the Congress, we fully agree with the General Accounting Office's assessment of DoD financial management as a high risk area. It should be noted that the Department itself has candidly acknowledged numerous material financial management control weaknesses in its annual Federal Managers Financial Integrity Act assessments to the President and the Congress over the past several years. Although most Congressional interest and media attention have been directed toward the Department's financial reporting problems--specifically, the continued inability to produce auditable financial statements--problems affecting the efficiency with which the Department makes an average of $22 billion in payments each month also merit close oversight.

Background

The Defense Finance and Accounting Service (DFAS) is responsible for making most DoD disbursements. DFAS was activated on January 15, 1991 with the mission of reducing the cost and improving the overall quality of Department of Defense financial management through consolidation of 332 finance and accounting offices, as well as standardization and integration of previously decentralized and diverse finance and accounting operations, procedures and systems. DFAS has a key role in the Department's processes for purchasing an enormous range of goods and services. Its disbursing operations cover civilian and military pay, retiree and annuitant pay, progress payments to contractors, other contract payments for goods and services, travel reimbursements and transportation fees.

Typically, DFAS processes a monthly average of 9.8 million payments to DoD personnel; 12 million commercial invoices; 450,000 travel vouchers/settlements; 500,000 savings bonds; and 120,000 transportation bills of lading. Because of the volume of transactions, the disbursement processes depend heavily on computer systems.

The 1990's have been a decade of enormous change in the DoD financial management community. Besides the physical consolidation of finance and accounting operations into 5 centers and just 18 operating locations, several thousand personnel positions were eliminated. DFAS has drastically reduced the number of separate automated systems, with the intention of moving from 69 to 9 finance systems between FY 1996 and FY 2002 and from 150 to 23 accounting systems over the same period. The extensive DFAS systems development program is intended to field modern, fully integrated systems that will considerably improve operational efficiencies in both accounting and finance. Meanwhile, two successive administrations and Congress have instituted major acquisition, logistics and other process changes that profoundly impact the financial community. In addition, DoD financial managers are operating in public and private sector environments where previously radical innovations like electronic funds transfer and electronic commerce are now considered routine.

The Prompt Payment Act

Among various statutes and regulations governing DoD disbursing operations, the Prompt Payment Act, Chapter 39

of Title 31, United States Code, is probably the best known.

The Act requires Federal agencies to pay interest penalties on late payments and, at the same time, adhere to sound cash management principles by not paying bills prematurely. Bills are to be paid within 30 days after an invoice date, but not more than 7 days prior to the due date. The Act also specifies that, if the Government and contractors agree to payment terms differing from the Act, the contract terms take precedence. Implementation of the Act was expected to result in timely payments, better business relationships with suppliers, improved competition for Government business, and reduced costs through better cash management.

The last audit that we conducted on DoD compliance with the Prompt Pay Act was in 1993; resource constraints and heavy workload associated mostly with the Chief Financial Officers Act have caused us to defer further coverage recently.

The 1993 audit, which was a joint effort by my office and the Army, Navy and Air Force audit services, indicated that

both the timelines of payments and internal controls in the vendor payment process needed improvement. The interest penalties on late payments, forfeited discounts, and interest paid by the DoD on funds borrowed to make inappropriately early payments totaled an estimated $36 million for the 6-month period covered by the audit.

In response to the audit findings, the Department took various corrective actions. We understand that there was temporary improvement, but recently interest penalty payments climbed as follows:

FY 1995	$25 million
FY 1996	$28 million
FY 1997	$27 million
FY 1998	$37 million

With the continuous introduction of new technologies, processes and systems over the next several years, DoD should find compliance with the Prompt Payment Act increasingly less difficult. Therefore it is reasonable to anticipate the number of untimely payments and related interest penalties dropping in the future.

We consider it important for the Government to be a reliable business partner when dealing with the private sector. This is especially true in light of the current DoD emphasis on changing or avoiding practices that may inhibit some firms with high technology commercial products from doing business with the Government. Unreliable bill paying processes could be such an inhibitor, especially for small businesses. We consider the Prompt Payment Act timeframes for determining late payments to be both reasonable and generally achievable. We also agree with GAO that there is no clear linkage between Prompt Payment Act requirements and DFAS disbursing problems. Even if it were demonstrated that hasty decision making is necessary to pay invoices within 30 days, the lesson to be drawn is that the disbursement processing procedures are cumbersome and need reengineering, not that the standard is too tough.

Likewise, we counsel caution in considering changes to the law or related policies with the intention of mandating earlier payments and imposing very broad use of anticipatory discounts. Considerably complicating the disbursement process by mandating earlier payments in a process that already is troubled by inaccurate payments and accounting errors could retard expected DFAS performance

improvements. Also, we have not seen indications that firms from across the full spectrum of DoD suppliers, from major contractors to small businesses, would support a mandated shift toward anticipatory discount pricing. The Prompt Payment Act already authorizes payments on negotiated schedules and related discounts. We have not seen any data on the extent to which contracts with such provisions are already in use or to what types of commodities they apply.

In summary, with regard to the Prompt Payment Act, our work has not resulted in any indication that the law is not working reasonably well. This is not to say that some fine tuning, such as revisiting the requirements to pay interest penalties as little as $1, would not be useful. Again, I must caveat these opinions by noting that there has not been recent DoD audit coverage of Prompt Payment Act issues.

Recovering Audits

Although wider application of post-payment "recovery auditing" could enhance the controls for some DoD disbursement processes, we think such a tool should be

applied selectively. Primary emphasis should be placed on making the payments correctly in the first place. Problems such as overpayments take money out of the DoD acquisition, logistics, and operational programs during the actual execution of contracts and projects. It does those programs little good to have funds returned to the Department years after they were needed and almost certainly not to the same specific programs. The DoD needs to accelerate implementation of the expanded recovery audit demonstration program mandated last year by the Congress. Until the results of those pilot efforts are known, we believe it would be premature to legislate further expansion of recovery audit requirements.

Other DFAS Pay Issues

Over the last five years, we have reported on a variety of DFAS pay issues including inadequate computer security, lack of verification of transportation bills and inaccurate disbursement accounting. The Defense Criminal Investigative Service (DCIS), the investigative arm of the Inspector General, DoD, has also been active in a number of initiatives to deter, detect and bring to justice any perpetrators of fraud against DFAS operations.

Problem Disbursements

To maintain proper fiscal control and have reliable information on amounts available for obligation and expenditure, DoD needs to be able to match disbursements reported to the U.S. Treasury with obligations shown in DoD accounting records. Unfortunately, the disbursing and accounting functions are performed by separate activities, which are not yet linked in fully integrated systems and often are not collocated. Disbursement data therefore must "transit" to the accounting stations. Excessive delays and errors can occur in recording the disbursements in the accounting systems. DFAS uses the term "aged intransit disbursements" to denote excessive delays. If attempts to match disbursement and obligation data fail, the term "problem disbursements" is used. This overall problem is often compared to inability to balance a checkbook, but on a massive scale.

The DoD has been working to reduce aged intransit and problem disbursements for several years. DFAS reported a decrease in aged intransit disbursements from $22.9 billion in June 1997 to $9.6 billion in June 1998. DoD also has

indicated a reduction in problem disbursements from $34.3 billion in June 1996 to $10.9 billion in February 1999. Despite those significant decreases, unmatched disbursements will remain a major DoD financial management problem until fully integrated systems are fielded and the backlog of unmatched disbursements is eventually eliminated. Until then, the Department must make the best of a bad situation and try to minimize its exposure to Antideficiency Act violations and undetected improper payments.

Last year, we conducted an audit of the reporting for aged intransit disbursements and problem disbursements. The audit indicated that, while there continued to be overall progress, some DoD components were actually losing ground and the unmatched disbursements in their accounts were increasing.

To help avoid problem disbursements, Congress has directed the DoD to phase in efforts to match pending disbursements to corresponding obligations before making payments. This is referred to as "prevalidating disbursements." Thus far, full implementation has been hampered because significant payment delays were encountered when trying to prevalidate

all disbursements over $2,500 at DFAS Columbus Center. The DoD is committed to implement prevalidation fully by July 2000, which could possibly cause a temporary spike in late payments and interest penalties. Eventually, however, we are confident that better systems will virtually eliminate problem disbursements, making prevalidation less necessary or at least easier.

Transportation Pay

In an ongoing audit, we have identified over $1.7 million in overpayments to carriers/freight forwarders on a limited sample of DoD Government Bills of Lading (GBLs) for air freight shipments and $12.4 million on motor freight shipments during FY 1997. Management controls and processes for the preparation, submission, acceptance, approval, and distribution of tenders; carrier selection; verification of delivery of freight; payment of GBLs; and monitoring of carrier performance were inadequate. Additionally, transportation management functions and responsibilities are fragmented among DoD components that have different transportation priorities. The risk of fraud in this area is high and neither the DoD pre-payment screening nor GSA post-payment auditing is an effective

control. Implementation of the new Power Track freight payment system under DoD's Management Reform Memorandum No. 15 will improve the payment process and controls. However, we are concerned that the remaining weaknesses will continue to allow substantial overpayments. We will issue a report to the Department on this matter later this year.

Our DCIS and Audit offices are taking proactive efforts focusing on fraud affecting transportation pay. For example, a DCIS project at DFAS Center Indianapolis, Indiana targets transportation carriers who have received duplicate payments. The DCIS reviews found 1,083 duplicate payments for personal property shipments totaling approximately $1.5 million and 590 duplicate payments for other freight shipments totaling $160,055. The recoveries to date exceed $1.4 million.

Other Contractor Pay Issues

During the past year, the Department has stepped up efforts to: ensure appropriation integrity when making progress payments to contractors; encourage managers not to add to the accounting burden by creating unnecessary extra

accounts; and introduce extensive use of credit cards for purchasing goods and services. We have not yet had an opportunity to provide an independent evaluation of these initiatives, although it is clear that the Department has made only limited progress. For example, there continues to be a lack of sound procedures for controlling credit card use. We continue to support all three concepts, however, and hope to provide at least some audit coverage later in FY 1999 or 2000.

Systems Security

Turning to other challenges confronting the DoD financial community, I would like to emphasize concern about information assurance. As numerous recent hacker and virus incidents demonstrated, any automated system may be attacked or misused. Motives can include vandalism, sabotage, thrill seeking, propaganda, pranks, invasion of privacy and fraud. DoD financial systems that process tens of millions of disbursements worth over $250 billion annually are clearly at risk from individuals with any of those motives. For the computer criminal who intends to hack into systems controlling money, the DoD disbursement systems are prime targets.

We have been working closely with the Defense Information Systems Agency and the DFAS over the past several years to address this problem. Fortunately, one byproduct of DoD efforts to reduce the number of separate financial management systems will be somewhat reduced exposure from a security standpoint. To minimize risk, however, it is imperative that security awareness be stressed, adequate training be provided, periodic security audits be performed for every system and processing center, and prudent measures be taken to detect, react to and learn from unauthorized intrusions.

We have issued 20 audit reports during the 1990's on security matters related to DFAS systems and about 185 of our 220 recommendations have been implemented. Most of the recommendations were made just recently and action on many of them is still ongoing. As demonstrated by those numbers, the Department has been quite responsive to audit advice. Currently there is a huge backlog of general and application control reviews and other computer security audits and the risks related to limited security oversight for DoD systems, including finance systems, are worrisome.

We hope to be able to apply more resources to this area in the future.

A positive move along those lines is that the Defense Criminal Investigative Service recently established an Information Infrastructure Team. This new unit works in partnership with other law enforcement organizations and DISA to react immediately to system penetration incidents. Additionally, we have a special agent assigned full time to the FBI National Infrastructure Protection Center.

Vulnerability to Fraud

Numerous factors have contributed to the vulnerability to fraud of DoD finance operations. Those factors have included a weak internal control environment, staff turbulence and lack of sufficient fraud awareness training for finance personnel. Congressional hearings in September 1998 before the Senate Committee on the Judiciary graphically identified control weaknesses and the damage done by a few unscrupulous individuals who exploited those weaknesses.

The DCIS has primary investigative jurisdiction concerning allegations of fraud that directly impact the DFAS, including fraudulent conduct by contractors and government employees. The Military Criminal Investigative Organizations have primary investigative jurisdiction concerning allegations of fraud pertaining to DFAS services provided at individual military installations, as well as pay, allowance and travel fraud committed by a civilian employee or Service member of a Military Department. DCIS currently has 84 open investigations involving DFAS, 25 of which are theft or embezzlement cases. DCIS efforts over the past 5 years have resulted in 73 convictions and recovery of $4.9 million from cases related to DFAS operations.

At the February 25 hearing, the Inspector General described the rather notorious case of Staff Sergeant Robert H. Miller to this Subcommittee. Miller and an accomplice were convicted of stealing nearly a million dollars in Government checks. Miller was stationed at a DFAS disbursing office.

An example of a more recently closed case and conviction was that of Cabel Calloway, who defrauded DoD of about

$78,000. This individual's three companies obtained approximately 200 contracts between 1991 and 1997 to provide goods from manufacturers directly to military bases and various other DoD facilities. Calloway was paid for numerous items which he never provided. He concealed his scheme and was able to obtain additional DoD contracts by using multiple company names and fictitious employee names. Calloway was sentenced to 4 months home detention, 5 months probation and restitution of the $78,000. The DoD debarred his companies. Although the amounts involved in individual fraud cases like this are seldom huge, we are concerned that weak controls leave the Department vulnerable to numerous abuses of this type, which cumulatively could amount to very significant losses.

Since 1994, IG, DoD, auditors and investigators have supported Operation Mongoose, a Deputy Secretary of Defense initiative involving the use of computer matching techniques to detect fraud. Problems with data base accuracy have been an inhibiting factor; however, the project has been a useful laboratory for determining the viability of various matches as internal controls and fraud detection tools.

More recently, DCIS has conducted over 70 fraud awareness briefings for DFAS personnel, reaching an audience of about 6,600 employees and participated in a DFAS stand down day for such training last year. We are working with DFAS on new training initiatives specifically addressing vulnerability in the vendor pay area and on improving fraud referral procedures.

Summary

The DoD faces continued challenges in providing proper stewardship of the resources provided to the Department by the taxpayers for national defense. Improving controls in the fund disbursement process is a vital aspect of that stewardship. The DoD needs to be able to control payments to prevent errors and fraud; however, at the same time it must be a reliable business partner and comply with the reasonable requirements of the Prompt Payment Act. We believe that advanced technology and application of sound management principles, including a good internal control plan and effective oversight, can enable the Department to meet these goals.

Mr. SHAYS. Thank you, Mr. Lieberman.

Mr. Cooper.

But before I ask you to address us, I just would want to recognize the presence of our vice chairman, Mark Souder. And, Mark, do you have any comments you want to make or should we——

Mr. SOUDER. No.

Mr. SHAYS. Thank you.

Mr. SOUDER. I'm catching up on the testimony.

Mr. SHAYS. I am almost tempted to have someone tell a joke in the middle of this. This is a very dry subject. [Laughter.]

Mr. COOPER. I think I can start with one. [Laughter.]

Mr. SHAYS. OK.

Mr. COOPER. Mr. Chairman, it is a pleasure to be here this morning. We have followed DOD payment problems for the last 5 years, and I might just start by saying how this came to our attention.

We were doing some work back in the 1980's with concerns about $600 toilet seats and $400 hammers and things like that, and we had a team down in a contractor's plant in Texas. And one of the contractor employees came up to us and asked, "What can we do about all these extra checks we are getting from DFAS?" They asked for our help to bring this problem to someone's attention, and we have tried to highlight the problem in our high-risk series that you referred to in your opening statement.

And I am encouraged that DFAS has a number of efforts underway to correct the problems, but it will be a while before we see some real improvements.

But, anyway, I would like to first talk a little bit about the problems that we have seen. We have issued a number of reports over the last several years that show that contractors are returning very significant amounts of money to DOD. In fact, during the 5-year period ending—the 5-year period covering 1994 to 1998, almost $5 billion was returned to the Columbus Center.

While that is encouraging, we have also found through our audits that all contractors don't necessarily return the moneys they have been overpaid. We found one contractor that was overpaid $7.5 million, kept that overpayment for almost 8 years before it was returned. And it happened then only because we visited the contractor and asked about it.

We have just recently finished some additional work, visiting 13 contractor locations. At four of those contractor segments, they were retaining about $1.1 million of overpayments. And what is discouraging about that is that those four contractors each told us that their policy was to keep that money until the Government asked for it through a demand letter. That is a formal request for those moneys to be returned.

In fact, there is really no requirement, either regulatory or statutory, for contractors to return overpayments when they receive them. And more discouraging, no one really knows the magnitude of the moneys that have not been returned. We have attempted to look at that a few times and have been frustrated in our efforts to get a handle on that problem.

We have also reported that DOD wastes million of dollars annually because it is paying its bills late. We have already heard some of that from the other witnesses. I have visited the contract entitle-

ment director in DFAS earlier this month to get some updated information on late payments. During the first half of this fiscal year, more than 31,000 late interest checks have been written by that directorate totaling almost $16 million in late interest.

We have also heard from the other witnesses the payment process is a very complicated one, that solutions won't be easy. DOD is taking a number of initiatives to improve their systems, integrating their systems, improving their technology, training their employees, and we hope those actions will bring about some improvements.

Let me quickly just speak about recovery auditing for a second. We were directed to do an audit of the DOD demonstration program on recovery auditing. We found it had a lot of potential to help identify and recover overpayments. There is a bill before the Congress now to expand that to other Federal agencies. We think that is a good bill and it could go toward improving recovering overpayments.

We do caution, though, that in implementing recovery auditing, if that be the case, that agencies carefully consider the extent to which recovery auditing applies to their type of operations and assess the cost benefits of undertaking moderate internal recovery efforts before they turn to an outside group to do that.

Regarding the Prompt Payment Act, it may be time to increase the minimum threshold for the interest payments. It is currently set at $1. We have already heard from the other witnesses that many of the checks that DOD issues on late payments are for very small amounts. In fact, when I was in Columbus, I was provided some information that shows there were 31,000 checks issued the first 6 months of this fiscal year. Nearly 41 percent of those checks were for interest payments of less than $25. And that represents less than 1 percent of the dollars that are being paid.

The DFAS officials conservatively estimate that it costs them $24 for each check they issue. And my math shows the taxpayers paid about $303,000 to issued interest payments totaling $114,000. That is probably not a good use of our taxpayers money.

Mr. SHAYS. Want to just give that number again?

Mr. COOPER. It costs about $303,000 to issue those checks for $25 or less in interest, and the total interest for all of those checks amounted to only $114,000. So it is costing more than double the amount of interest we are paying to process the checks.

Now given the cost of processing, the administrative costs of processing an interest-payment check, it might be cost-effective to increase the minimum dollar threshold.

That completes my statement. I will be glad to answer any questions you or the other Members might have.

[The prepared statement of Mr. Cooper follows:]

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on National Security, Veterans' Affairs, and International Relations, Committee on Government Reform, House of Representatives

For Release on Delivery
Expected at
10:00 a.m.,
Wednesday,
June 16, 1999

DEPARTMENT OF DEFENSE

Improving the DOD Payment Process, Using Recovery Auditing and Changing the Prompt Payment Act

Statement of David Cooper, Associate Director, Defense Acquisition Issues, National Security and International Affairs Division

GAO/T-NSIAD-99-193

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to discuss the Department of Defense's (DOD) payment problems and how recovery auditing is being used to identify and recovery overpayments. I will also make some comments on changes to the Prompt Payment Act. To put these issues in perspective, in fiscal year 1998, DOD spent about $115 billion contracting for goods and services. DOD contract dollars account for about two-thirds of total federal government contract spending for goods and services. Thus, it is vital that DOD have sound controls to ensure that contract payments are proper, accurate, and timely.

RESULTS IN BRIEF

The need for DOD to achieve effective control over its payment process remains an imperative. If DOD does not, it will continue to risk erroneously paying contractors hundreds of millions of dollars and perpetuating other financial management and accounting control problems. Further, improving the efficiency of the payment process could save millions of dollars annually in reduced processing costs.

While DOD is taking steps to improve its payment process and controls, it will likely take many years before DOD gets its payment problems under control. The focus of DOD's actions needs to be on making better use of technology to improve and integrate its payment systems and to streamline and simplify its payment requirements. These actions will, however, require sustained top-management effort.

DOD needs to also concentrate on reducing overpayments and, recognizing that some overpayments are inevitable, adopt best practices to quickly identify and recover them. We believe that recovery auditing offers a low-risk opportunity to

achieve both these goals, and we are supportive of the recently introduced legislation to require federal agencies to use recovery auditing.

Currently, contractors are not required to inform the government when they have been overpaid. Contractors should be required to notify the government of overpayments when they become aware of them. This requirement should not impose a significant burden on the contractor. Once notified, government contracting personnel should immediately ask contractors to refund the overpayment.

It may be time to raise the minimum dollar threshold required by the Prompt Payment Act. Currently, the Defense Finance and Accounting Service (DFAS) pays interest amounts that are less than it costs them to process the checks. However, raising the threshold should be part of an overall assessment of the efficiency of the payment process.

ERRONEOUS DOD PAYMENTS ARE A LONG-STANDING ISSUE

In recent years, our reports have identified hundreds of millions of dollars in erroneous government payments, and interest expense on late payments, and other financial management problems. For example, in March 1994, we reported that during a 6-month period in fiscal year 1993, the Defense Finance and Accounting Service (DFAS) in Columbus, Ohio--a principal DOD contract paying activity--processed $751 million in payments returned by defense contractors.[1] Our examination of about one-half of these checks disclosed that about 78 percent represented overpayments by the government. We also found that while some contractors returned overpayments, others did not. In one case, an overpayment of $7.5 million was outstanding for 8 years. We estimate that the government lost interest on the overpayment amounting to nearly $5 million. We

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

concluded that neither DOD nor some contractors appeared to be aggressively pursuing resolution of payment discrepancies.

DOD continues to make substantial erroneous payments to its contractors. For example, in the 5 years between fiscal year 1994 and 1998, defense contractors returned about $4.6 billion to DFAS Columbus--in fiscal year 1998, they returned $746 million. However, some contractors were still retaining overpayments. For example, 4 of the 13 contractors we visited during a recent review were retaining overpayments totaling about $1.1 million. At each location contractor personnel told us that they had a practice of retaining overpayments until the government issued a demand letter requesting the overpayments be returned.[2] 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 for a refund. The magnitude of overpayments defense contractors are retaining is not known.

We have also found problems that contribute to improper and fraudulent payments. For example, in September 1998, we reported on internal control and system weaknesses that contributed to two cases of Air Force vendor payment fraud—one resulting in the embezzlement of over $500,000 and the other resulting in embezzlement of $435,000 and attempted theft of over $500,000.[3] We found that the lack of segregation of duties and other control weaknesses created an environment where employees were given broad authority and the capability, without compensating controls, to perform functions that should have been performed by separate individuals under proper supervision. We also found that over 1,800 DFAS and Air Force employees had access to the vendor

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[2] A demand letter is a formal notification to the contractor that it owes the government money.

[3] Financial Management: Improvements Needed in Air Force Vendor Payment Systems and Controls (GAO/AIMD-98-274, Sept. 28, 1998).

payment system that allowed them to submit all the information necessary to create fraudulent and improper payments.

In testimony before the Congress earlier this year, the DOD Inspector General commented on the vulnerability of DOD finance operations, particularly to fraud in the vendor pay area. According to the Inspector General, the Defense Criminal Investigative Service (DCIS), an arm of the DOD IG, is working with the DFAS to decrease that vulnerability through such measures as increased fraud awareness training. She said at the time that DCIS has about 80 open criminal investigations related to finance operations.

Factors Contributing To Erroneous Payments

In an April 1997 report,[4] we concluded that DOD's erroneous payments are due, in part, to (1) nonintegrated computer systems that often require data to be entered manually, and with data that are often erroneous or incomplete; and (2) payments that are required to be allocated among numerous accounting classifications. In addition, these factors increase the cost of paying contract invoices.

The need for DOD to effectively control its payment process remains an imperative. If DOD does not, it will continue to risk erroneously paying contractors hundreds of millions of dollars and perpetuating other financial management and accounting control problems. Further, improving the efficiency of the payment process would save additional millions of dollars annually in reduced processing costs. Two key areas where DOD needs to focus its efforts are (1) better using available technology by developing seamless, fully integrated payment systems, and (2) streamlining and simplifying, to the extent practical, its payment processes.

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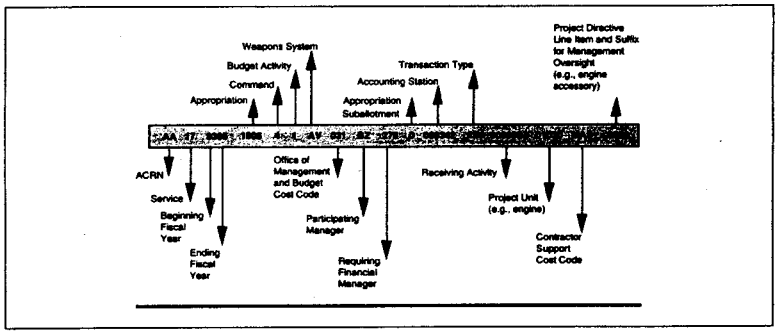
[4] Contract Management: Fixing DOD's Payment Problems Is Imperative (GAO/NSIAD-97-37, Apr. 10, 1997).

Detailed Accounting Requirements
Are A Burden On Payment Process

Let me give a few examples of the detailed accounting requirements that DFAS payment personnel are faced with when paying a bill. These examples clearly suggest the need for simplification.

DOD uses what is called a "long line of accounting" to accumulate appropriation, budget, and management information for contract payments. For all contracts, the buying activity assigns a two-character code called an accounting classification reference number (ACRN) to each accounting line containing unique information. Figure 1 is an example of an accounting line--the type and quantity of information varies among the services.

Figure 1: Example of DOD's Long Line of Accounting



Source: DOD.

Contracts can be assigned anywhere from 1 to over 1,000 ACRNs. A contract with numerous ACRNs may involve extensive data entry, increasing the chance for errors and manual payment processing. Manual payment processing costs an average of $15 per ACRN, according to a consulting firm's study.

Payment allocations to numerous ACRNs can be time-consuming and may not provide useful or reliable management information. For example, in one case we reviewed, a single payment on a contract with many ACRNs took 6 to 8 hours to process. The contractor, required to bill by ACRN, took 487 pages to assign $2.1 million in costs and fees to 267 ACRNs. Ten of the ACRNs cited by the contractor had insufficient obligation balances to cover the payment, according to DFAS records. The remaining 257 ACRNs corresponded to eight annual appropriations covering from 1 to 5 fiscal years and included Army, Air Force, and general defense funds. Of the 257 transactions processed, 38 were for less than $10, and some involved debits or credits for pennies. Unresolved discrepancies, such as insufficient funds on some ACRNs, have persisted for about 3 years.

Even for a simple purchase, assigning numerous ACRNs can cause extensive and costly rework and provide information of questionable management value. For example, a $1,209 Navy contract for children's toys, candy, and holiday decorations for a child care center was written with most line items (e.g., bubble gum, tootsie rolls, and balloons) assigned a separate ACRN. A separate requisition number was generated for each item ordered, and a separate ACRN was assigned for each number. In total, the contract was assigned 46 ACRNs to account for contract obligations against the same appropriation. To record this payment against the 1 appropriation, DFAS had to manually allocate the payment to all 46 ACRNs. Figure 2 is an actual portion of this contract showing the ACRNs assigned to each item.

Figure 2: Contract Excerpt

ITEM NO.	SUPPLIES OR SERVICES	QUANTITY ORDERED	UNIT	UNIT PRICE $	AMOUNT $
0025	HALLOWEN PINBALL GAME - FA380	5.00	DZ	1.750000	8.75
	Accounting and Appropriation Data: BF 1751805 61CO 548 62585 0 062863 2D SRK001 PP0050026K179				
	PR #: N62585-5026-K179				
0026	PUMPKIN BANK - BB28	5.00	DZ	9.500000	47.50
	Accounting and Appropriation Data: BG 1751805 61CO 548 62585 0 062863 2D SRK001 PP0050026K180				
	PR #: N62585-5026-K180				
0027	DINOSAUR PENCIL TOPS - 1545L	5.00	DZ	1.500000	7.50
	Accounting and Appropriation Data: BH 1751805 61CO 548 62585 0 062863 2D SRK001 PP0050026K181				
	PR #: N62585-5026-K181				

Source: DOD.

The contract was modified three times--twice to correct funding data and once to delete funding for out-of-stock items. The modification deleting funding did not list all of the affected ACRNs. DFAS personnel made errors in both entering and allocating payment data, compounding errors made in the modification. Consequently, DFAS allocated payment for the toy jewelry line item to fruit chew, jump rope, and jack set ACRNs--all of which should have been deleted by the modification. Contract delivery was completed in March 1995, but payment was delayed until October 1995. DFAS officials acknowledged that this payment consumed an excessive amount of time and effort when compared to the time to process a payment charged to only one ACRN. The contract could have been assigned a single ACRN, according to a Navy official, thus making it easier to pay without losing useful information. A single ACRN would also have significantly reduced the amount of data entered into the system and the opportunities for errors.

User requirements for detailed accounting place unreasonable or unachievable demands on the payment system. Moreover, DOD's current pricing structure does not reflect the time it takes DFAS to meet user requirements. Thus, the user has little incentive to critically evaluate the level of detail being required and its associated costs.

DOD Is Taking Actions To Address Payment Problems

DOD is taking steps to address its payment problems. Its initiatives include testing and adopting some best practices. In the long term, it is developing procurement and payment systems that will be linked by sharing common data. This linkage is expected to allow one-time entry of contract data critical to making correct payments. In the meantime, DOD is enhancing its current technologies to further automate the payment process. It is also testing streamlined payment practices and making efforts to reduce the number of contract fund citations. But, as we point our in our January 1999 recent high-risk report,[5] it will be many years before DOD gets its payment problems under control.

Additional Steps Could Be Taken

Recognizing DOD's actions and the fact that DOD continues to overpay its contractors, one question is: are there additional steps that DOD might take to improve the process for both identifying and collecting overpayments? The answer is yes.

First, we believe that defense contractors should be required to promptly notify the government of overpayments when they become aware of them. This seems

[5] Major Management Challenges and Program Risks, Department of Defense (GAO/OCG-99-4, Jan. 1999).

simple enough, but currently a contractor is not required to return an overpayment until the government becomes aware of the overpayment and issues a demand letter for repayment. And, as pointed out earlier, the true magnitude of contractor retention of overpayments is not known. In this regard, we will shortly begin a review to assess the extent to which defense contractors are retaining and not promptly returning overpayments to the government.

Second, we believe that DOD should take advantage of best practices that commercial companies use to identify and recover overpayments. One such practice is the use of recovery auditing procedures. For both private industry and government agencies, some payments are processed incorrectly for a variety of reasons. For instance, vendors make pricing errors on their invoices, forget to include discounts that have been publicized to the general public, neglect to offer allowances and rebates, or miscalculate freight charges. Government payment activities may also neglect to take discounts to which they are entitled. These mistakes, when not caught, result in overpayments. Identifying and recovering overpayments is referred to as recovery auditing.

RECOVERY AUDITING OFFERS POTENTIAL TO IDENTIFY OVERPAYMENTS

Recovery auditing started about 30 years ago, and it is used in several industries, including the automobile, retail store, and food service industries. Within DOD, the Army and Air Force Exchange Service, and the Navy Exchange Service use recovery auditing. An external audit recovery group may be the only group used by an organization or it may be used in combination with an internal group that examines invoices for overpayments prior to an external group's review.

Recognizing its potential value to the government, the Fiscal Year 1996 National Defense Authorization Act required the Secretary of Defense to conduct a

demonstration program to evaluate the feasibility of using recovery auditing to identify overpayments made to vendors by DOD. Authority to expand the program was provided in the Fiscal Year 1998 National Defense Authorization Act.

The DOD demonstration program began in September 1996, when the Defense Supply Center, Philadelphia (DSCP), competitively contracted with Profit Recovery Group International (PRGI). The contract covers purchases made during fiscal years 1993-95 and requires PRGI to identify and document overpayments and to make recommendations to reduce future overpayments. PRGI receives a fee of 20 percent of net collected funds.

In our review of the demonstration program, we concluded that recovery auditing offers potential to identify overpayments but implementation problems hindered DOD from fully realizing the benefits of the program.[6] As of August 1998, PRGI had identified $19.1 million in overpayments. However, recoveries of overpayments amounted to only $1.9 million, in large part, because vendors took issue with some of the overpayments. This caused the recovery process to virtually stop for 8 months while the Defense Supply Center, Philadelphia (DSCP) reviewed the merits of the vendors' issues. DSCP has concluded that the claims of overpayment are valid. However, according to the contracting officer, his letter of final decision regarding vendors' indebtedness has not been issued. PRGI continues to identify overpayments. As of June 1999, according to PRGI, it had identified $29.3 million in overpayments, and collections by DOD amount to $2.6 million.

PRGI has also made recommendations to DFAS and DSCP to reduce future overpayments, but, at the time of our review, DOD had not implemented them. In addition, PRGI identified about $1.8 million in overpayments that were outside

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

the scope of its contract, either because they were not within the contractual review period or because they involved other government agencies. Neither DFAS nor DSCP chose to pursue payment recovery or inform the other government agencies of the overpayments so that they could pursue recovery and take steps to avoid future overpayments.

DOD Is Slow To Use Recovery Auditing Techniques

DOD has been slow to embrace recovery auditing. For example, in House Report 105-532, which related to a bill providing for fiscal year 1999 DOD authorizations, DOD was directed to use recovery auditing by selecting at least two commercial functions within its working capital fund and issuing a competitive request for proposal by December 31, 1998. We found, however, that DOD had not done either[7]. While DOD issued an August 1998 memorandum encouraging the use of recovery auditing, and some activities have expressed interest, no contracts had been awarded at the time we completed our work in March 1999. In June 1999, we checked with the recipients of the August 1998 memorandum and, with the exception of the U.S. Transportation Command, which told us it just entered into a contract for recovery auditing services, no other contracts have been let. The Defense Commissary Agency said it has completed a statement of work, and plans to have a contract by July 30, 1999. The Defense Logistics Agency told us it issued a solicitation on May 28, 1999 to expand the use of recovery auditing from the demonstration program in place at DSCP to its other four supply centers. The Defense Logistics Agency said it plans to have a contract by August 31, 1999. Each of the services and the Defense Information Services Agency also expressed an interest in recovery auditing and they are evaluating whether to use it.

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

Issues Related To Using Recovery Auditing

While we believe that recovery auditing could be beneficial to DOD and other federal agencies, there are some important implementation issues that need to be considered as federal agencies evaluate using recovery auditing to identify and recover overpayments. First, it is not clear how DOD agencies should organize to perform recovery auditing. Should it be contracted out? Should it be performed with in-house personnel? Should some combination of the two be used? We believe that agencies need to carefully consider the extent to which recovery auditing is applicable to their operations and, if applicable, if it would be cost-effective to undertake moderate internal recovery auditing efforts to pick the "low hanging fruit" before turning audit recovery efforts over to an external group.

Second, it is important that there be (1) periodic reporting by those performing recovery auditing on the factors causing overpayments and on recommendations to reduce overpayments and (2) a process to evaluate these recommendations and implement those that make sense. One of the criticisms we made of the demonstration program was that DOD did not implement the contractor's recommendations to reduce overpayments.

These issues has been addressed in the "Government Waste Corrections Act of 1999" (H.R. 1827) introduced on May 17, 1999, by Congressmen Burton, Armey, and Ose. We believe the bill is a positive step in the government's effort to reduce overpayments and to obtain timely identification and recovery of overpayments when they occur.

PROMPT PAYMENT ACT ISSUES

Mr. Chairman, you also asked us for our views on how the Prompt Payment Act could be improved to support DOD's efforts to reduce the risk of overpayments.

The Prompt Payment Act of 1982, as amended, provides governmentwide guidelines for establishing due dates on commercial invoices and paying interest on invoices paid late. Except where otherwise specified within contracts, the act provides that agencies should pay within 30 days after the designated office receives the vendor invoice or the government accepts the items ordered as satisfactory, whichever is later. The act also states that if a payment is late, a business concern shall be entitled to any interest penalty of $1 or more from the government (interest penalties of less than $1 are not required to be paid).

In a report we issued in May 1997,[8] we stated that small interest payments made by the DFAS Columbus Contract Entitlement Directorate comprised a large portion of the number of payments made but accounted for a very small portion of the total interest dollars paid. For example, of the 47,773 interest payments in fiscal year 1996, 10,789, about one quarter of all interest payments, were for $5 or less, and totaled $28, 701—less than one quarter of 1 percent of total interest payment dollars. Interest payments up to $25 comprised over 50 percent of all interest payments but less than 2 percent of total interest dollars paid.

DOD officials said that the current minimum payment of $1 might need to be increased because the benefits from such small interest payments may not justify the costs of making the payments. According to DOD, it takes an average of 45 minutes to process each interest payment at DFAS, Columbus, and that the time spend processing such payments could be better spent on other high priority tasks.

We recently obtained updated information on the interest payments made by the DFAS, Columbus Contract Entitlement Directorate under the act. This information shows that in fiscal year 1998, the directorate issued 23,355 checks totaling $15 million in interest payments to defense contractors. Thirty-eight

[8] Financial Management: The Prompt Payment Act and DOD Problem Disbursements (GAO/AIMD-97-71, May 23, 1997).

percent were for payments of $25 or less. According to the Contract Entitlement Directorate, its cost to process an interest payment check in fiscal year 1998 was at least $24. DFAS issues a separate check for interest payments.

Through the first half of fiscal year 1999, the DFAS Columbus Contract Entitlement Directorate issued 30,781 checks totaling $16.6 million in interest for late payments. About 41 percent of these checks representing less than 1 percent of the dollars were for $25 or less. According to directorate personnel, the increase in interest payments is due to a priority initiative to reduce the backlog of late payments.

Given the cost of processing an interest payment check, it might be cost-effective to increase the minimum dollar requirement for paying interest under the act. Alternatively, the late payment interest could be included in the same check with the principal payment, which would significantly reduce the costs of processing interest payments. We believe that any initiative to change the minimum interest payment should consider the efficiency of agency payment processes.

CONCLUSIONS

In closing, Mr. Chairman, DOD needs to achieve more effective control over its payment process. If DOD does not, it will continue to risk erroneously paying contractors hundreds of millions of dollars and perpetuating other financial management and accounting control problems.

Recovery auditing, which has a long-standing track record in the private sector, offers a low-risk opportunity to identify overpayments and to recovery them and we are supportive of the recently introduced legislation to require federal agencies to use recovery auditing.

Currently, contractors are not required to inform the government when they have been overpaid. Contractors should be required to notify the government of overpayments when they become aware of them. Once notified, government contracting personnel should immediately ask contractors to refund the overpayment.

Finally, it may be time to raise the minimum dollar threshold required by the Prompt Payment Act. However, raising the threshold should be part of an overall assessment of the efficiency of the payment process.

Mr. Chairman, this concludes my statement. I will be glad to answer any questions you or the other Members of the Subcommittee may have at this time. Major contributors to this testimony were Daniel J. Hauser and Charles W. Thompson.

(707429)

Mr. SHAYS. Thank you very much.

First, I want to say Mr. Bloom, the nice thing about you starting in this position is that you can kind of look at it fresh, and you don't have to defend something that you did. But I also know you want to be fair to the Department and your unit within the Department. So you are going to want to make it clear what you think is wrong and what's right.

And I do agree that, from a percentage standpoint, it's tiny percents, but given the magnitude of the Department of Defense, the numbers are huge.

It is unsettling for me to think that there would be, in some cases, voluntary return and in other cases at request, but total $1 billion a year. I mean, that just boggles my mind to think of that—$1 billion gets returned, because I just know human nature. And it is very difficult to just voluntarily return money that was sent to you. Kind of think of it as a gift, and you think, well, we will just wait until they ask for it. So it makes you wonder how much more is actually being overpaid. Mr. Cooper, so that is one area of concern.

Another one is, obviously, late payments and the penalties. The third is the issue of checks, and it just seems to me like we could all agree pretty quickly that number should be increased.

I am going to expose my ignorance here by first asking: These are checks for interest payments? Explain that to me, if you would, Mr. Bloom.

Mr. BLOOM. In every case where we haven't met the 30-day deadline, we owe the interest. And the current procedure is that we issue a separate check for that amount.

Mr. SHAYS. And this is Government law that requires it?

Mr. BLOOM. It is Government law that we pay the interest.

Mr. SHAYS. So there is nothing that prevents us. And then tell me what the negative would be on it to take a threshold of $5 or maybe even more. Or $25. Would you show the numbers again on that—all right.

And so I would ask each of you what you would recommend. For instance, is this from a statement—OK.

From our briefing memo, this is DFAS's Columbus contract entitlement interest payments. And it shows that from $10 to $25, that constitutes 1.2 percent of the total interest but it represents—so it was 1.2 percent of the total interest that was required to be paid, but it represents 18 percent of the total payments. And I make an assumption that that is basically at cost or more. Because you are basically at $24.

So I guess what I would like you to do, I would like each of you to think about what you would recommend. I'll come back to you because I don't want a quick answer. What would that threshold be? Would it be $1, $5, $10, $15, $20, so on?

Mr. BITZ. Mr. Chairman.

Mr. SHAYS. Yes.

Mr. BITZ. Excuse me. If I can make a clarification?

Mr. SHAYS. Sure.

Mr. BITZ. The GAO report is addressing our Columbus operation, and the system there is called MOCAS, and it does produce separate payments. But all of our other vendor-paying contractor sys-

tems that are at our other 25 locations, the payment of the interest is in the normal payment. So if we owe them an EFT or a check for an invoice for $1,000, the interest will just be added when that payment is computed. It is only our Columbus Center where it is a separate transaction.

Mr. SHAYS. Why?

Mr. BITZ. The system is 30 years old, sir, and it is being replaced within the next 3 years. It's a very old system.

Mr. SHAYS. So, what we looked at was a system that wasn't as typical as most of the systems?

Mr. BITZ. Correct, sir.

Mr. SHAYS. Anybody else want to comment on that?

Mr. LIEBERMAN. Well, it is the biggest system.

Mr. COOPER. Yes. It is the largest payment system, and it pays the most late interest. So it is important that you fix that problem. [Laughter.]

Mr. SHAYS. And that is called "the rest of the story." [Laughter.]

No, it is important to point that out. But it is important.

Let me just ask another question, and then let me get to the other committee members.

Mr. Cooper, in your statement on page 8, you say—I am just taking a certain part—DOD is enhancing its current technologies to further automate the payment process. What improvements might be implemented in the short term to reduce payment process complexities and the number of late payments?

Mr. COOPER. We have made recommendations in the past. There are a lot of different factors that are causing the overpayment problem. One of the issues that I talk about in the statement is the long line of accounting classification numbers that are used to record the payments.

And going back to something the DFAS witness talked about is DOD has been trying to move to integrate its various systems. You have a payment system at one location, an accounting system at another location, and the procurement people at a different location. And all of these people are generating the paper that was referred to earlier that you use to make payments.

And a lot of times there are errors made in the paperwork. The accounting line has 51 digits on it, and it is very easy to get those digits transposed or recorded incorrectly. When the payment people who are trying to write the checks are sitting there trying to match a disbursement with the accounting classifications and the obligations data, it almost has to be done manually. It can't be done automatically.

And there are just any number of errors that are made in all of this. So I mean that is a long way of saying, where the action needs to be taken is, and DOD is headed in that direction in many cases, is in fixing the technology, the systems. We need systems that talk to each other. We need systems that share the same data so that everyone can have the same data in front of them.

And they are moving in that direction. It will be a few more years before we see that. I think some training of the people would help. We have seen some errors that just are really mind-boggling.

I mean, contractors will send in an invoice for $5 million, and marked on the invoice is a statement saying that we have already

been paid progress payments of $3.8, and they ask for the net amount. Well, we have seen time after time the full amount of the invoice paid.

Mr. SHAYS. But wouldn't they be able—wouldn't DOD be able to check its own records to determine what's been paid? It shouldn't rely on what's on the statement.

Mr. COOPER. Well, unfortunately, right now, DOD is relying very much on the contractors to return the money. What we have suggested—in fact, we are starting another effort very shortly—going out to the contractors and asking for a reconciliation. We think that is a fairly easy thing to do. DFAS tried it once and they only got a 20 percent response from the contractors they went to.

And I might just add—and you will hear more about this later—but in the recovery auditing process, a reconciliation or request for the contractor to reconcile his accounts and provide that information to the Government is a pretty normal step to take. DOD could easily do that to identify more of these overpayments.

Mr. SHAYS. I said one question, but you really answered the long term. I gather from your point there is no short term?

Mr. COOPER. There is no short term.

Mr. SHAYS. The answer to the first question is no. And you have given me the answer to my second question, which was what long-term steps.

Just because I don't want to forget it, and it was the issue on which you said you were frustrated early in your statement, I was very tempted to—you said you wanted to do something, but you were frustrated and didn't know what——

Mr. COOPER. We were frustrated in trying to identify the amount of overpayments that are with contractors today.

Mr. SHAYS. How frustrating, because you didn't get cooperation, frustrating because it is hard to determine because of the record?

Mr. COOPER. It is a very difficult task. I mean, there are literally thousands and thousands of contractors that do business with DOD. One of the problems with the records is just identifying where these contractors are, getting a good address and——

Mr. SHAYS. What that raises, though, to me is that there are going to be mistakes made as you talk about the various—you know, they can record the data incorrectly. But it strikes me that if you are frustrated because it is hard to determine, that this system opens itself to a tremendous amount of fraud.

Mr. COOPER. It has that potential, and I think the IG has seen some of that. We have done some work showing that some Air Force vendors had committed fraud against DOD. Yes, it is a ripe opportunity for a lot of waste and abuse.

Mr. SHAYS. Let me just, before going to Mr. Terry—any of you want to comment—Mr. Lieberman, Mr. Bloom, Mr. Lane, or Mr. Woods—on what I just asked Mr. Cooper?

Mr. LIEBERMAN. I agree with Dave's comments. I think that one of the very most important challenges facing DFAS is to improve all of the internal controls that would apply in the vendor-payment process. To some extent, the new systems will eliminate some of this manual processing that is very inefficient now and will improve the recordkeeping.

We don't have good audit trails. I understand what GAO is saying when they say it is very difficult to reconstruct what exactly has transpired, and we don't know how much overpaying is going on.

Mr. SHAYS. But it shouldn't be difficult to reconstruct. Correct? I mean——

Mr. LIEBERMAN. That is right.

Mr. SHAYS. That is not what we should expect?

Mr. LIEBERMAN. Absolutely not. In an acceptable internal-control environment, you wouldn't have this confusion and this vulnerability. So this is an area that needs to be worked intensively. And frankly, I think it is probably more important to get on top of this particular problem than it is to be able to comply with the CFO Act, which I suppose is heresy in some quarters.

But we are not, for instance, doing enough auditing to help DFAS identify exactly what these control weaknesses are and to monitor their progress because we are drawn away from the finance side of the operation to audit the accounting records, specifically the annual statement that is required by the CFO Act. And we really have no choice in the matter.

Now if there were an unlimited number of auditors available, we could do both, but there aren't. So we have to do what is mandated by law.

And I have to tell you, candidly, that our audit coverage of these financial operations is just completely inadequate, even though we are doing our best to cope.

Mr. Lane has done a terrific job in stretching very limited resources to do what we can. But this is a continuing problem, and it has aggravated the situation in DFAS.

Mr. SHAYS. I think it is important, given that you made that statement, to tell us in a written letter what you would need in order to do that. In other words, what you are saying is that the CFO requirements have diverted your attention from other areas. And we need to know what you would logically need. Maybe you could give me three different grades, and I could argue that this happens.

Mr. LIEBERMAN. Be happy to.

Mr. SHAYS. And the staff will followup on this.

[The information referred to follows:]

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

JUL 2 1999

Honorable Chris Shays
Chairman, Subcommittee on National Security,
Veterans Affairs and International Relations
Committee on Government Reform
House of Representatives
Washington, D.C. 20515-6143

Dear Mr. Chairman:

This is in response to the request that you made during the June 16, 1999, hearing held by the Subcommittee on National Security, Veterans Affairs and International Relations for additional details on audit coverage of Department of Defense (DoD) disbursement processes. Specifically, you requested information on what audits would be advisable to help the Department overcome major weaknesses in those processes, but are not currently planned because of resource constraints and other priorities. Also, you requested that we indicate what resources would be needed to conduct those audits.

A list of finance audit topics that are unlikely to receive coverage by DoD auditors in fiscal years 1999 or 2000 is at Enclosure 1. It should be noted, of course, that the General Accounting Office conducts audits on DoD disbursement operations and may address at least a few of these topics. Nevertheless, it is virtually certain that audit coverage of the disbursing processes, systems and offices will be very limited.

The primary reasons for limited audit coverage in this area are overall resource constraints, specifically the 24 percent reduction in the Office of Inspector General, DoD, staffing levels between fiscal years 1995 and 1999; the heavy audit workload mandated by the Chief Financial Officers (CFO) Act and related statutes; and the competing high priority requirements in other key areas. The financial statement audits required by the CFO Act are labor intensive and focus on the accounting and financial reporting facets of DoD comptrollership functions, not controls over payments. In FY 1999 this office is employing 137 work years directly for CFO Act audits. Currently, 194 work years are earmarked to meet those statutory audit requirements in FY 2000.

The Inspector General, DoD, has expressed concern in the last several semiannual reports to the Congress over the shortfalls in audit and investigative coverage across the spectrum of DoD high risk areas. Those areas include acquisition, financial management, information technology, health care and logistics.

The DoD budget request for FY 2000 contains sufficient funding to stabilize Office of Inspector General, DoD, staffing levels and prevent the coverage gaps in the high risk areas from widening. Unfortunately, S. 1059, the House National Defense Authorization Bill for FY 2000, cut the DoD request by $8 million. This creates the immediate concern that the oversight shortfalls could get significantly worse. On June 22, 1999, I wrote to the Chairmen of the House and Senate Committees on Armed Services, asking the conferees on the National Defense Authorization Act to support the budget level proposed by the DoD and approved by the Senate. Copies of those letters are at Enclosure 2.

We believe audit and investigative coverage is a key element in identifying weaknesses in DoD disbursing operations and ways to improve them. We will continuously reassess the audit priorities in all areas and realign resources to meet as many requirements as possible. We appreciate your interest in our efforts in this important high risk area.

If further details or discussion would be useful, please contact me or Mr. John R. Crane, Office of Congressional Liaison, at (703) 604-8324.

Sincerely,

Donald Mancuso
Acting Inspector General

Enclosures

cc: Honorable Rod R. Blagojevich
Ranking Minority Member

Unresourced Audit Requirements
for DoD Disbursement Operations

The following audit topics have been identified by the office of the Inspector General, DoD, as having strong potential for identifying internal control weaknesses and other impediments to improved DoD disbursement operations, but are not included in the approved FY 1999 or tentative 2000 audit plans.

1. General and Application Control Reviews (Security Audits). The DoD has identified nearly 200 automated information systems as critical for financial reporting purposes. About 42 of those systems have functions related to paying personnel or contractors and were deemed mission-critical for Year 2000 conversion purposes. Eight of those systems are actual disbursement systems. Because of the significant information assurance threat to DoD systems and a more general requirement that auditors must consider system security when opining on the reliability of financial statements, it is important that general and application controls for all of those systems be audited periodically. To date, only a few of the finance related systems have undergone such reviews. At present resource levels, it is feasible to conduct or to contract out about 3 reviews per year. A level of effort that would be more reflective of the underlying requirement would be at least 6 reviews per year by this office, giving priority to disbursement systems and primarily using contractor resources. To achieve that level of effort in FY 2000, another $1 million would be required.

2. Prompt Payment Act. Office of Management and Budget Circular A-125, "Prompt Payment," requires Inspectors General to periodically review compliance with the Prompt Payment Act. The last DoD-wide audit on this topic was in the early 1990's. The DoD paid $38 million in late payment interest penalties and had 1.2 million late payments in FY 1998. An audit would require 4 workyears.

3. Transportation Payments. Recent criminal investigations and related audits have indicated potentially widespread management control weaknesses and vulnerability to fraud in processes used for 1.5 million DoD transportation payments annually. A new system, Power Track, is currently being deployed. Additional comprehensive auditing would be advisable to assess the success of the new system in

improving the internal control situation. This would require 6 workyears.

4. Management Control Self-Assessments. Each Defense Finance and Accounting Service (DFAS) center and operating location manages multiple processes. The Federal Managers Financial Integrity Act and related regulations require rigorous self-assessment of the adequacy of management controls on an annual basis. The effectiveness of DFAS self-assessment efforts has never been reviewed. It is unclear whether all DFAS processes and the related controls are sufficiently documented and whether personnel who are responsible for those controls are held accountable. Audits should be performed on the management control program at each DFAS center and its web of operating locations. Priority should be given to Columbus Center, which handles the large dollar contract payments. Conducting the audit at Columbus Center would require 3 workyears.

5. Payments at Contract Termination. To help prevent overpayments and improve financial management, it is advisable to periodically audit a sample of contract terminations. The audit would follow up previous audit recommendations and evaluate processes intended to close contracts in a timely manner, remove excess funds and recover overpayments. Also, the audit should determine if controls are effective to prevent payments to contractors after termination and to contractors who have been suspended or debarred. The audit would require 3 workyears.

6. New Disbursement Systems. The DoD has a poor record for developing new automated information systems on time, at budget and in accordance with the users' requirements. We believe that all major system acquisition programs would benefit from periodic comprehensive audits. Currently such audits are being done on a very selective basis and it is not known whether many new systems, including disbursement related systems, will be more effective from a management control perspective than were their predecessor systems. About 4 workyears are needed for a system acquisition audit.

7. Debt Collection. No audit has yet been conducted to assess DoD compliance with the Debt Collection Improvement Act of 1996. Such an audit would entail 4 workyears.

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

JUN 22 1999

Honorable Floyd Spence
Chairman
Committee on Armed Services
House of Representatives
Washington, D.C. 20515-6035

Dear Mr. Chairman:

I am writing in regard to the FY 2000 funding authorization for the Office of the Inspector General, Department of Defense (OIG, DoD), contained in S. 1059, the National Defense Authorization Act for FY 2000, as passed by the House on June 14, 1999.

The House Bill cuts the President's Budget request for the OIG, DoD, by $8 million. The cut eliminates price and program funding increases for FY 2000 and would seriously impair the operations of the OIG, DoD. Through a program of investigations and audits, the OIG, DoD, promotes the economy, efficiency and effectiveness of the programs and activities of the Department of Defense. By detecting and preventing fraud and identifying opportunities for improving DoD programs, the OIG, DoD, makes a positive contribution to increasing the readiness of our Armed Forces. For example, audits have identified overpricing that aggravates spare parts shortages and deficiencies in chemical defense readiness. In FY 1998, Inspector General audits and investigations saved over $2.1 billion as a result of investigative recoveries or agreed-upon monetary benefits from audits.

Over the last five years, OIG, DoD, staffing levels have declined 24 percent. The President's budget request is intended to partially offset the reduction and stabilize the organization's workforce. Funding for the OIG, DoD, at the level contained in the President's Budget request is needed to meet legislative requirements, such as audits of financial statements mandated by the Chief Financial Officers Act (CFO Act); improve audit coverage of high risk areas, including readiness problems; provide adequate coverage for the investigation of major procurement fraud and health care fraud; sustain the development of a computer intrusion investigative capability; provide adequate oversight of intelligence activities; and sustain administrative investigative capabilities for allegations against senior officials and whistleblower reprisals.

The OIG has sought to work closely with the Congress and the Department in allocating resources to high risk

areas that have the greatest vulnerability to fraud, waste or mismanagement. Eliminating program growth will require that the OIG focus its available resources on mandated activities such as CFO Act audits and whistleblower reprisal investigations. The ability of the OIG, DoD, to conduct proactive oversight of DoD programs will be considerably diminished. If the cuts proposed by the House are sustained in conference the OIG will have to make reductions in the following areas:

- audit coverage of non-CFO Act areas including high risk areas like weapon system acquisition, supply management, health care, and computer security;
- training for agents conducting computer intrusion investigations;
- health care fraud investigations; and
- intelligence oversight activities.

I urge the conferees on the National Defense Authorization Act to support funding for the Office of Inspector General at the level proposed by the President's Budget and approved by the Senate.

If you need any further information, please contact me or Mr. John R. Crane, Office of Congressional Liaison, at (703) 604-8324.

Sincerely,

Donald Mancuso
Acting Inspector General

cc: Honorable Ike Skelton
Ranking Minority Member

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884

JUN 22 1999

Honorable John W. Warner
Chairman
Committee on Armed Services
United States Senate
Washington, D.C. 20510-6050

Dear Mr. Chairman:

I am writing in regard to the FY 2000 funding authorization for the Office of the Inspector General, Department of Defense (OIG, DoD), contained in S. 1059, the National Defense Authorization Act for FY 2000, as passed by the House on June 14, 1999.

The House Bill cuts the President's Budget request for the OIG, DoD, by $8 million. The cut eliminates price and program funding increases for FY 2000 and would seriously impair the operations of the OIG, DoD. Through a program of investigations and audits, the OIG, DoD, promotes the economy, efficiency and effectiveness of the programs and activities of the Department of Defense. By detecting and preventing fraud and identifying opportunities for improving DoD programs, the OIG, DoD, makes a positive contribution to increasing the readiness of our Armed Forces. For example, audits have identified overpricing that aggravates spare parts shortages and deficiencies in chemical defense readiness. In FY 1998, Inspector General audits and investigations saved over $2.1 billion as a result of investigative recoveries or agreed-upon monetary benefits from audits.

Over the last five years, OIG, DoD, staffing levels have declined 24 percent. The President's budget request is intended to partially offset the reduction and stabilize the organization's workforce. Funding for the OIG, DoD, at the level contained in the President's Budget request is needed to meet legislative requirements, such as audits of financial statements mandated by the Chief Financial Officers Act (CFO Act); improve audit coverage of high risk areas, including readiness problems; provide adequate coverage for the investigation of major procurement fraud and health care fraud; sustain the development of a computer intrusion investigative capability; provide adequate oversight of intelligence activities; and sustain administrative investigative capabilities for allegations against senior officials and whistleblower reprisals.

The OIG has sought to work closely with the Congress and the Department in allocating resources to high risk

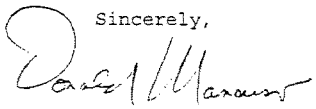
areas that have the greatest vulnerability to fraud, waste or mismanagement. Eliminating program growth will require that the OIG focus its available resources on mandated activities such as CFO Act audits and whistleblower reprisal investigations. The ability of the OIG, DoD, to conduct proactive oversight of DoD programs will be considerably diminished. If the cuts proposed by the House are sustained in conference the OIG will have to make reductions in the following areas:

- audit coverage of non-CFO Act areas including high risk areas like weapon system acquisition, supply management, health care, and computer security;
- training for agents conducting computer intrusion investigations;
- health care fraud investigations; and
- intelligence oversight activities.

I urge the conferees on the National Defense Authorization Act to support funding for the Office of Inspector General at the level proposed by the President's Budget and approved by the Senate.

If you need any further information please contact me or Mr. John R. Crane, Office of Congressional Liaison, at (703) 604-8324.

Sincerely,



Donald Mancuso
Acting Inspector General

cc: Honorable Carl Levin
Ranking Minority Member

Mr. SHAYS. Mr. Bloom, any comment? And then, I am sorry, my one last question was a joke. I had 10 questions. [Laughter.]

Mr. BLOOM. As a lawyer, I am used to that.

Mr. SHAYS. Well, I don't like to be like that.

Mr. BLOOM. We do agree that this is a significant situation. And actually, when I was briefed on this last week or so, I was very uncomfortable to hear that the solution really is a system that may be 2 or 3 years away. That is what we are faced with. We are being as diligent as we can. We are going to be more diligent. We agree it is a significant problem. We may not agree with all the numbers, but certainly the magnitude is that it is a significant problem.

Mr. SHAYS. Well, Mr. Bloom, you are a young man. So you can wait a few years. My request would be that you not be reluctant to share with the committee information you have, because we are not a committee that will take it and have a press release and throw stones at you. But we would like very much to deal with this issue.

Mr. Terry.

Mr. TERRY. Thank you, Mr. Chairman.

I just need to get a feel for this, so I probably won't ask as deep and probing a questions as the chairman.

Mr. Bloom, I have a personal history, with outsourcing and privatization. I think that this is an asset and should be pursued. You mentioned during your statement, and it piqued my attention, about outsourcing.

First of all, what is being outsourced? I heard a number like one-fifth or 25 percent—20 percent. But I didn't know what was being outsourced. And 20 percent of what?

Mr. BLOOM. It is 20 percent of our budget, the DFAS budget.

Mr. TERRY. Oh. So of the dollars, 20 percent of the overall dollars are outsourced. And what are the specifics of the outsourcing?

Mr. BITZ. Sir, we are currently performing A–76 studies of our civilian pay business area, our retired and annuitant pay business area, and our transportation accounting business area. We will be bringing forward to the Department some additional business areas in the next year, also to be considered for A–76 or outsourcing studies.

We are not directly outsourcing any of our activities at this time, but we do have a significant contractor support in our automation areas, our systems development areas, and in some of our specialty areas such as conducting studies and in some our auditing areas checking our activity-based costing and our efforts to do business process re-engineering.

Mr. TERRY. Now I am more confused. But this is an area I don't want to get bogged in. There are just so many other questions. Let me just followup on one more thing.

Are you telling really that there is no total area that is privatized or outsourced? It is just some outsourced support within each of the departments?

Mr. BITZ. Currently. But we do have three items on the street, Congressman, that we are looking at moving the entire business area if private industry wins.

Mr. TERRY. And what's the timetable?

Mr. BITZ. We are closing the packages at this time. All three are looking to come due right after January 2000. They would have come due on a normal 2-year time cycle during the holiday period this year, but because they are payment areas, we thought that might be disruptive and cause us to miss payments to our civilians and our retirees. So we basically got a 2-month extension to have it come due in January.

Mr. TERRY. What does "come due" mean?

Mr. BITZ. There is a process where we bid our best processes and the private industry bids their best package against it, and the winner gets the business area.

Mr. TERRY. All right. Managed competition.

Mr. BITZ. Yes, sir.

Mr. TERRY. Mr. Cooper, you mentioned some facts and figures that also piqued my interest, and that was in the comparison of the costs to process the interest check in relationship to the percentage of checks that were cut for a lesser amount—equal or lesser amount.

You stated that 41 percent of the checks—I assume that what you are saying, is that 41 percent of all of the interest checks were less than $25?

Mr. COOPER. That is right. In the first half of this fiscal year, DFAS, the entitlement directorate, issued 31,000 checks; 41 percent of those were for $25 or less. And the value, the total dollar value of that interest was 0.68 percent of the total interest paid during that time.

Mr. TERRY. And I do agree that is an important figure to bring up and discuss. I see it at two different levels. The first question is, is the minimum dollar amount too low? Do we need to reassess that? But, also, I have got to tell you that it costs $24 to process a penalty check, 45 minutes of time in manpower involved to me seems absurdly high.

How does it benchmark to the private sector? How does it compare? And what type of protocol is even used to raise the red flags in the system?

Mr. COOPER. I can't comment on how it compares to the private sector. I think it is significantly higher. But one of the problems—and I think some of the other witnesses alluded to it—the system is so antiquated there—they call it a MOCAS system—so antiquated that, when they make a payment and if it is late, you would normally just add the interest to that payment, issue one check. Well, today they are having to issue two checks, one for the late interest, one for the actual payment. And that problem is not going to go away for a few years. And that is adding to that inefficiency.

Mr. TERRY. Do you suggest that in the short term we increase the amount of the minimum from $25 to $50 or something?

Mr. COOPER. Well, current threshold is $1.

Mr. TERRY. Right.

Mr. COOPER. $25 I don't think would be a bad number to use.

Mr. TERRY. Good point.

Mr. COOPER. As I mentioned, it was only $114,000 of the total of $16 million. So it is a very small portion of the total.

Mr. TERRY. Mr. Bloom and Lieberman, would you like to comment on that?

Mr. BLOOM. On the threshold?

Mr. TERRY. Threshold.

Mr. BLOOM. I would be comfortable with $25 as the minimum because for the vendors there is also a cost. We send them a check; there is a cost for them to process that and post it to their books. And while I don't want to say that $24 isn't a lot of money, because it may be to certain vendors, but it would seem that a number like $25 is certainly in the ballpark.

Mr. TERRY. All right. Mr. Lieberman, would you like to comment?

Mr. SHAYS. You have had time to think about this. Now don't—[laughter.]

Mr. LIEBERMAN. I wish I were confident that we knew how much it costs to process the check.

Mr. COOPER. That $24 is probably a very conservative number.

Mr. LIEBERMAN. Yes, we could certainly live with $25. I think that would probably eliminate several thousand transactions. And anything we can do to just reduce workload in these centers is going to make them more efficient.

Mr. SHAYS. Would the gentleman yield?

Mr. SOUDER. I would like to ask a supplement to that, which is, presumably the point of dollar payments wasn't the financial damage; it was to try to encourage people to do it on time. Has it actually increased the number of payments going on time? And when you say moving it to $25, presumably, it would be right away? Or is there another tinkering process with this that you would have 30 days out?

Mr. TERRY. For example, 30 days to 45 days?

Mr. SOUDER. Do we have any data whether it actually increased the rate of response?

Mr. BITZ. Congressman, the number of late payments has decreased each of the last 3 years, the actual number of late payments. The dollar amount of interest last year increased significantly, but the number of claimants went down. There are a lot of causes, from significant systems issues over more than a couple months, making Y2K changes; we couldn't post records; bills were allowed to accumulate. And we did our best to catch up and we think we have done that.

I need to ask, though, if I can correct something earlier. Again, the $24 a check is related to one system, and that system makes a lot of payments. But it is still only about 10 percent of all of our payments. All of our other systems, the interest is in the original payments, and those payments average around $1.80 to $2.20, counting on the system. We don't pay $24 to make every check or every EFT in the Department of Defense. It is just one big antiquated system that makes the biggest payments, but it doesn't make the most.

Mr. SHAYS. Would the gentleman, Mr. Terry, yield for just a second?

Mr. TERRY. I yield.

Mr. SHAYS. Would another possibility be that we just allow the interest rate to accumulate? In other words—pardon me? I am being corrected here. Not the rate but the amount? So maybe over

3 months there might be a penalty, or would the interest just accumulate?

Mr. SOUDER. But it is still $1. It would be a check for $1.

Mr. SHAYS. Yes, because I make an assumption that you are not going to make the same mistake again and not pay. Right? [Laughter.]

And have another interest payment.

Well, it is interesting. But there is some consensus that the dollar rate is too low.

Do you have—Mr. Souder, you may have the floor, if you like.

Mr. SOUDER. You've got momentum.

One of the things that it is hard for me to understand, it seems like we could have had a consensus on the $1 in the beginning. And I am trying to figure out how we wound up with the $1. My question, which I assume was to try to—I grew up in a small retail store, and it sounds to me like simultaneously some of the things used by the Department of Defense aren't that dissimilar to what we used in a little tiny retail operation, and other things that we did in a little retail operation aren't being used.

For example, you have the bills and you know when they are due and the date is flagged right before that. The question is, why 3 days before the bill is due does it get delayed? And isn't there kind of like a red flag in the system that says this is about to become due?

Mr. BITZ. Yes, sir. Again, I would like to take a second to differentiate between vendor payment systems and the contractor payment system that they are talking about. In our vendor payment systems—Indianapolis, Omaha, and those locations—the system itself ages the transaction and tells us that we are missing a document, one of the three components to make the payment.

And we send out notices, whether it be the receiving report or acceptance document. If we have all three items in, it prepares it for disbursement and then it warehouses it, waiting for the cash management date to occur. What will happen is, since we are still paper-based on receiving reports and some other elements, the No. 1 cause is still that we have not received a document from somewhere in the world saying the item was received. And we can't match that up to the other two parts that are usually timely, which is the contract and the invoice from the vendor.

In the contract payment system, besides being very old, it also has multiple categories of types of payments that are available, progress payments, down payments, partial payments. And the system doesn't know what it is flagging. So they were never able to build an accurate flag to say, we are still missing one of the three parts to do that.

Mr. SOUDER. That's in Columbus?

Mr. BITZ. That is in Columbus, that one big system we run there. We run other systems at Columbus that don't have this problem. So in the majority of our systems, we have the red flags. We have the red flags that it is not all together yet. And we have the red flags that it is together and it is time to release it.

But in the MOCAS system, we don't have a flagging system today. It is human beings going in, checking to make sure all three components have arrived, taking the latest document and saying it

is ready to pay, going out to look for a pre-validation to the accounting system to make sure the obligation is there. That is very human-driven right now on that system, sir.

Mr. SOUDER. It seems to me that a second thing, to some degree, is going on, and that is that the accounts payable area is co-mingled with internal management accounting, in the sense of, for example, one of the examples in the written testimony was assigning some toy purchase to three different accounts, which sounds to me like, in a small operation we had, one of our small stores was a general store and many errors occur when you have one supplier you are trying to put into six different categories. Any mathematical error in there goofs up the whole account.

But as you get bigger, as another company I had worked with, you generally don't co-mingle the payables. You have a simpler system to make sure you are not getting hit with the interest rates, and then you have another document that tracks how you want to internally know what you have been spending, what you have been buying, what the sales rates are.

I am curious whether some of this is a mixing of accounting functions between internal reporting, reporting for Congress, and logical payables?

Mr. BITZ. I apologize, sir. This answer is going to probably be a little more confusing than intended. In the payment system, the accounts payable system, we have a specificity desired by the Department that requires that we break down to very finite levels the different components of an item that we are buying.

It is not that we are buying a tank; it is that that we are buying 1,132 parts on the tank. And that detail is in the accounts payable system. In the accounting system, resident at another location, that same detail is present. Where the complication comes in, and the auditors have tried to help us with over the years, is to reduce the number of lines in the accounts payable system, so that the accounting system worries about that distribution.

Again, I hate to say it, but when we migrate to the new system in a few years, we have that. Both systems will share the same level, and it will be electronic. But, currently, with pre-validation requirements, we are not supposed to make any payment for which we cannot find an obligation. We have to keep the detail in the accounts payable system, so that when we go ask the accounting system the day before the payment, "Do you have a valid obligation for the U.S. Government? Is it there?", that they match. And we get lots of errors there, as the auditors have pointed out, and a lot of mismatches.

Mr. SOUDER. Is it possible, until you transfer to that system—I grew up in the furniture retail business, and we would get these trucking bills. And they would have three or four different things, and one wouldn't be shipped. Then you were trying to figure out whether in the freight bill you were paying the full amount or whether they accidentally put that in at the last minute, when they were loading the truck, they didn't have it there.

It becomes an auditing nightmare. I can't imagine doing this in billions of dollars. If you don't have the computer systems, could you say that no single bill can have more than one item on it, and that if there is a—if whatever is on the bill hasn't been shipped to-

gether, then—in other words, are there some things that can be required from the company's billing process to help the Government?

Mr. BITZ. One of the problems we are trying to address this fall—we are going to make some interim changes to the current system—is the ability to do something very similar to that, Congressman. It is a partial payment, where we will take the lines that do match, make the payment for that, and then go back to the accounting system of the contractor and see if we can determine between their records and ours why the other portion didn't match. That will accelerate our payments and reduce some of our interest.

The complexity of some of these contracting vehicles and the items being delivered, though, precludes us from going one to one, one item for one thing. We get a delivery of a tank. It just has 1,100 parts. And we ordered one tank and it is delivered, but those parts were probably subbed: Someone else produced the 50-caliber. So we have to keep track of that through our system.

Mr. SOUDER. I know, for example, the Hummer, I had more parts of the Hummer in my district than another congressional district, and the general showed me the sheet. I had 2.1 percent, and they happened to have covered 235 congressional districts, by no accident.

Mr. SHAYS. Are you serious?

Mr. SOUDER. Serious.

I have a question of Mr. Cooper on the overpayments. In at least your written testimony—I was trying to simultaneously listen and catch up on all the written testimony here—you said, on page 10, that PRGI identified 19.1 million overpayments. However, recovery amounted to only 1.9, which looks like about 10 percent, in large part because vendors took issue with some of the overpayments.

Could you explain? I mean, 90 percent are taking issue. Is it this complication of sorting out the actual part that was delivered? Or what? Well, it causes a 90 percent challenge.

Mr. COOPER. Let me try to comment on that, and I am sure the PRGI people will provide you more detail. But that $19 million was at the time we issued that report, and that demonstration program was in progress. The numbers are now up to about $29 million of overpayments have been identified. I think still about 10 percent has been recovered, but there are a number of reasons why all that money has yet to be recovered.

One is that when the vendors receive notice—and they receive the notice from PRGI—their first reaction was, "Who is PRGI? We deal with the contracting office in Philadelphia." There was an issue about who had the authority to ask for the money back. As soon as they got those notices, everything came to a stop for about 8 months.

The Philadelphia people who issued the contract to PRGI have agreed that PRGI is correct in the claims that they have identified as overpayments, and they are pursuing those amounts. The delay in receiving money back is not unusual. When contractors are asked to give money back to the Government, it takes many, many years in some cases——

Mr. SOUDER. Nobody likes to send money back.

Mr. COOPER. Nobody likes to give money back.

Mr. SOUDER. But in the process of nobody—I am curious because it is natural, then, to challenge, but part of the requests that came in here was that we should potentially say that you have some kind of obligation if you feel there is an overpayment.

What I am trying to get underneath this, is there actually a dispute as to whether these are overpayments, and should the burden of proof really be on the individual company, because if these were large items—in other words, could there be a threshold of saying, if it is an overpayment of "X" amount, you are accountable?

But a lot of this stuff sounds like it is relatively small, and you may not even realize it, and then you may have to go out and sort it out. And I, as the company, because, yes, the Government is taking a bunch in, but a lot of these defense contractors are pretty big, too, moving a lot, trying to sort out what went what day. I am trying to get a feel for, from their perspective, why 90 percent would be questioning. Besides not wanting to give up the money and feeling the burden of proof is on the Government, is there some real substance under here as to whether or not it was an overpayment? And the second part of that was, what about a threshold? If it is over a certain amount the company would be——

Mr. COOPER. OK. There is a dispute between the contractors and vendors involved here, and PRGI and DOD in this case. We have looked at some of the issues. One of the biggest issues is that there is a clause in the contracts that are involved here that is generally referred to as the "most-favored customer clause." In other words, the Defense Department will get as good of terms as any other person the company does business with.

In this case, one of the issues is whether the Government was given the opportunity to get discounts for early payments. A lot of the invoices came in for those goods that were delivered, and the 2 percent/net 10 terms were blanked out, and DOD wasn't afforded the opportunity to get discounts. So there are some lost discounts.

There are a host of issues that are——

Mr. SOUDER. I am interested—those host of issues are actually pretty substantive when it is your dollars, that when we went into the Prompt Payment Act question to guarantee that they got their money on time, did the Government not address the question? In other words, in return for prompt payment to the private sector, rather than getting delayed, should not one of those have been some kind of a standard that you get the same interest terms? Or do manufacturers view it that, when they bid on a Government contract at that date, it is a fixed price because they are supposed to give the absolute bid at that point? And therefore, typical finance charges don't apply because it is a different type of a bid process?

Mr. COOPER. Right. It is all those issues, and in addition, there is the other issue of price comparability. Part of a recovery auditing process is to look at companies' published price lists to see what prices they are giving other customers. When PRGI did that, they saw that the Defense Department wasn't always given the same prices for things like candy bars and bleach and soap, and all those kinds of things.

Now the companies have claimed that, in fact, DOD was given lower prices when those goods were shipped to commissaries or

other locations. There is no documentation. That is part of the dispute. All those issues.

I don't know if that answers your question or not.

Mr. SOUDER. It shows the complexity of the problem.

Mr. COOPER. It is a very complex problem.

Mr. SOUDER. It isn't just a simple matter that we are not collecting overpayments. There is a difficult, substantive question under here that has potentially huge paperwork questions as well as equity questions. On one hand, the Government—I mean, I completely agree you don't want to have the Government—we are supposed to get the lowest price. On the other hand, having functioned in retailing, boy, the lowest price changed by day.

Mr. COOPER. Right. One of the problems with the demonstration program—and we have pointed this out in the report—is that it went back and covered 1993, 1994, and 1995, so they were looking at old contracts. The recovery auditing process normally deals with very current transactions, so that if there are disputes, the evidence or the information will be readily available and won't lead to these kind of disputes.

A lot of the problems in the demonstration program is that the contractors did not have information, and they said it wasn't worth their time and effort to go try to re-create the transactions. So, I mean, that is part of the problem.

Mr. SOUDER. A lot of defense contractors, because of downsizing, have had a different thing, and that is that they will make the bid on a defense contract, which will kind of be their base, and then their additive business, which may be a slight variation or a different run, they will have to price compete differently at that point than they did on their first contract. But, then, if they had to redo their first contract, they wouldn't even be in the market for the second one. I don't know how to resolve that question.

Mr. Lieberman, do you have any comments? You are nodding your head, but I don't know—it doesn't sound like there is an easy solution to this other than we need better computers in Columbus.

Mr. LIEBERMAN. I totally agree with you that we could be looking at a paperwork nightmare, if we inadvertently create a requirement to do anything other than take advantage of the flexibility that the Prompt Payment Act already gives to the Government and to vendors. That is the flexibility to specify what the pricing terms are going to be in the contract.

If the contractor is going to offer a discount if we pay early, that can be spelled out in the contract. The contractual terms override the don't-pay-before-7-days and must-pay-within-30-days rule. So in those sectors of our buying, where this kind of approach makes sense and is felt to be equitable from both the Government and the contractor sides, there is already authority to deviate—the way is clear to do that.

Frankly, we don't have any information on how often that option is already exercised, how many contracts we have that already match those parameters. That is one of the unknowns here.

DOD buys so many different things from so many different sectors of the private economy that we have to be careful that we don't generalize off of a very limited pilot program to date, which has dealt mostly with what we call subsistence items, food stuffs,

things going into the PX's, the commissaries, and things like that. When we are talking about buying pieces of major weapon systems, we are talking a whole different ballgame here in terms of pricing.

Also, we have to be careful to consider the impact of the changes, such as really pushing anticipatory discounts such that both large and small businesses are affected. Large businesses are very interested in getting money from the Government as soon as possible, and they are going to instantly electronically transfer it into a bank account someplace and be earning interest on it. And they literally fly planes around to pick up checks—they used to fly planes around; I guess we do it electronically now—because they understand the value of money.

With some small businesses, it is a different ballgame. Somebody who gets a check is going to have to go stand in line at a bank someplace to cash it. And they will say: I send in an invoice for $100; I expect to get $100 back. I don't want some bureaucrat deciding I am only going to get $90 because they paid me a couple days early, and I am supposed to run down to the bank to make sure that I recover the difference. So I think we have to be careful on that end.

And then on recovery auditing, frankly, the prospect of getting money back several years after the fact is better than not getting it back at all. But we have to remember the money does not go back into the programs that need it at the time the overpayment is made.

We are talking about executing contracts and executing projects for all sorts of purposes, and those programs need the money right then. When it comes back several years later, it is too late. Those programs either would have been made whole from other funding sources or perhaps they won't even exist anymore.

But what we need, I think, is a lot more emphasis on accurate payment on the front end. There is a place for recovery auditing, and I think the Congress' approach in encouraging incremental pilot programs, so that we can learn lessons about where it works best, is the way to go, rather than just mandating application across the board at this point.

Mr. SOUDER. Well, thank you very much. I need to get to a couple of other things here. I won't say it was the most riveting session, but actually it was pretty interesting. And I don't envy the difficulties that you are all facing in trying to sort through these things.

Mr. SHAYS. Mr. Lieberman—I thank the gentleman—when we were doing Medicare and Medicaid audits, we had overpayments; we called it pay and chase. It sounds to me like we don't do much chasing.

I have two areas, and then I really do want to get to the next panel. One is—and, Mr. Bloom, you or Mr. Bitz maybe would be better apt to describe it—I am told there are five pieces of paper that have to kind of be accounted for. Two are internal and three are external. And that you don't make a payment until you have those five papers that agree with each other. Is that an accurate description?

Mr. BITZ. It is actually—we focus on three pieces in accordance with the act. We require a contract in our hands to make the pay-

ment, not just in the DOD, but it has to be into the paying office; in support of that contract, all established amendments. We require a proper invoice.

Mr. SHAYS. Are we still at one?

Mr. BITZ. That is one, but that sometimes gets counted as two because of the amendments.

Mr. SHAYS. OK. And then two is invoice?

Mr. BITZ. Then the invoice from the vendor or contractor, a proper invoice, into the paying location.

And three is an acceptance receiving document, and that is sometimes split as two. The acceptance location can be different from the receiving location. Someone can receive it at the installation, but the acceptance may be inside the hospital or something like that.

Mr. SHAYS. And a 10-day discount payment would be when you receive the bill?

Mr. BITZ. Well, actually, this is one of the inconsistencies in the statute, Mr. Chairman. For paying interest penalty, we use the date that we received the invoice in the proper paying office. But for discounts, we are instructed to use the date on the invoice. And we receive some invoices after the discount period has already expired due to mail processes and for other reasons.

Mr. SHAYS. So what is the net effect?

Mr. BITZ. The net effect is that we don't take a lot of discounts that are offered.

Mr. SHAYS. So we lose them?

Mr. BITZ. Yes.

Mr. SHAYS. All right. So that is something that I would think, Mr. Bloom, that you would want to be addressing? Correct?

Mr. BLOOM. Yes, and I guess to the extent that there is the difference between when the clock starts for prompt payment and when the clock starts for taking a discount, that is statutory and that might be something that——

Mr. SHAYS. Yes, but don't wait for us to figure it out. This is the kind of thing that you who are in the field, you should just be coming to us and saying—this is the committee that—not this subcommittee—but we would recommend to Mr. Horn's subcommittee and to the full committee that we just take action, and we will. I mean, that could go on the consent calendar.

That's funny, I call it the consent calendar because that is what it is in Hartford.

The other area would be, I would like to ask all three of you, and I am not looking for long answers, but testimony from the next panel says that the interim and progress payments under service contracts should be covered by the Prompt Payment Act. I want to know if you agree. We'll start with you, Mr. Cooper. Service contracts are not part of the Prompt Payment.

Mr. Woods. Mr. Woods, I have a theory that the person who says the least actually knows the most. [Laughter.]

Mr. WOODS. Well, actually, let me shoot a hole in that theory because we don't have a position on that, Mr. Shays. The regulations do provide that contract financing payments are not covered under the Prompt Payment Act. And that would cover a lot of service contracts because they are paid in a contract financing mode.

Mr. SHAYS. So the bottom line is that GAO has no opinion yet?

Mr. WOODS. Not on that issue, sir.

Mr. SHAYS. I would love it if you would have a dialog with your people and see what you might recommend.

[The information referred to follows:]

United States General Accounting Office
Washington, DC 20548

Office of the General Counsel

August 2, 1999

Mr. Jason Chung
Clerk
Committee on Government Reform
Subcommittee on National Defense
B-372 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Chung:

This responds to your request for any revisions to the transcript of my testimony at a hearing on the Prompt Payment Act held by the Subcommittee on July 16, 1999. I have reviewed the relevant pages of the transcript and have no suggested changes.

This also responds to Chairman Shays' request for a supplemental response to his question on whether interim and progress payments under service contracts should be covered by the Prompt Payment Act. My response for the record is as follows:

> "Mr. Chairman, the Prompt Payment Act requires the payment of an interest penalty if an agency fails to pay for a "complete delivered item of property or services by the required payment date." With the exception of construction contracts, the Act does not provide for the payment of interest on late progress payments. The regulations implementing the Act, Subpart 32.9 of the Federal Acquisition Regulation (FAR), distinguish between an "invoice payment" and a "contract financing payment." An invoice payment is a payment for goods or services accepted by the government. A contract financing payment is a payment made prior to acceptance, including non-construction progress payments and interim payments on cost-type contracts. The regulations provide for payment of an interest penalty on late invoice payments, but under FAR section 32.907-2, no interest penalty may be paid for a delayed contract financing payment. We have no recommendation on the policy issue of whether interim or progress payments should be subject to the interest provisions of the Act."

Sincerely yours,

William T. Woods

William T. Woods
Assistant General Counsel

Mr. SHAYS. Mr. Lieberman.

Mr. LIEBERMAN. I am going to have to give you an answer for the record on that, Mr. Chairman. We haven't had a chance to think about it.

Mr. SHAYS. I would like you to think about it.

[The information referred to follows:]

The Office of the Inspector General, Department of Defense, understands that the Office of Management and Budget is revising its Circular A-125 on prompt payments and intends to form a working group to study expanding the Prompt Payment Act to include interim and progress payments. We endorse this approach, because there is insufficient information available on both current practice and the prospective impact of expanded coverage.

We have not seen any data showing significant numbers of excessively slow payments for interim and progress payments. In fact, informally derived data indicated that service contractors are usually paid between 7 and 14 days after the paperwork is submitted to the Defense Finance and Accounting Service. If the Prompt Payment Act applied to such payments, many of them conceivably would not be made until the 23rd day.

Another consideration is that any expansion of Prompt Payment Act applicability would entail cost to the Government in the forms of administrative burden and interest penalties. As indicated in our written testimony, we believe that great caution is needed when considering legislative or policy changes that would add to the complexity of the Defense disbursement process.

In summary, we recommend that the Congress postpone consideration of this proposal until the Office of Management and Budget, and the Department of Defense, have had the opportunity to clarify whatever problems exist and the pros and cons of expanding Prompt Payment Act coverage.

Mr. SHAYS. Mr. Lane, do you have any comment, please?

OK. Mr. Bloom. Mr. Bitz.

Mr. BITZ. Mr. Chairman, we support the rewrite of the OMB circular that establishes that contract financing payments, of which progress payments and certain service contracts are, are moneys actually being paid prior to acceptance of goods on services and, therefore, shouldn't be under the Prompt Payment Act. But we will do whatever the committee chooses.

Mr. SHAYS. I realize that, but we want to do what makes sense.

Let me ask this: If any of you would have a final comment—I will get to the next panel, but I would invite all our witnesses up there to make a comment they would like or to make an observation. I will start with you. Do you have any observation to make to the subcommittee?

Mr. COOPER. Mr. Chairman, I can't add much more than what has already been said, but, I mean, we have reported, and I think the committee understands, the payment problems in DOD are very serious, that some action is underway to address some of the problems. It will be a number of years before we see those initiatives come to fruition. In the meantime, we have got to be diligent and try to continue doing the audits that identify these overpayments and try to recover the moneys.

Mr. SHAYS. Thank you. Mr. Lane.

Mr. LANE. Just a comment: One of the things that we are doing, we are trying to work very closely with DFAS on a number of these areas, and I think, as was alluded to earlier, the most important thing is to make the payment right the first time and on time. That is what we are really trying to do, and trying to get the systems that will make sure that will happen.

Mr. SHAYS. Thank you. Mr. Lieberman.

Mr. LIEBERMAN. I would like to just underscore the fact that we think the Prompt Payment Act is extremely important to keep the Government as a reliable business partner. The Department is trying very hard not to discourage contractors, particularly those who are offering high-technology products, from doing business with the Government.

Mr. SHAYS. Very good point.

Mr. LIEBERMAN. And certainly not paying people on time means you are an unreliable partner. So I think what we are talking about here, in terms of the value of the Prompt Payment Act and the need to comply with it, is the need to keep it there as a means to hold our feet to the fire. This is very important and fits very well into the Department's overall acquisition reform goals in that respect.

Mr. SHAYS. Thank you. Mr. Bitz. Mr. Bloom.

Mr. BLOOM. I would echo what Mr. Lieberman said about the supply chain being very important. We need to make sure we are keeping our vendors in business. Clearly, there has been a lot of work done at DFAS, and there is a lot left to do. And we are working hard at it.

Mr. SHAYS. That is why you were hired, right?

Mr. BLOOM. Absolutely.

Mr. SHAYS. I thank the panel, and I will call our next panel. Thank you very much.

Lieutenant General Thomas G. McInerney, president and CEO of Business Executives for National Security [BENS], based in Washington, DC, accompanied by Dr. Erik Pages, vice president for Policy and Programs at BENS.

Our second testimony is from Mr. Paul Dinkins, executive vice president, the Profit Recovery Group [PRG], based in Atlanta, GA, accompanied by Mr. Jack Kenny, director of Operations, Government Audits.

And Mr. Rodney Mateer, partner, Deloite and Touche, Professional Services Council [PSC].

I would like them all to come, and if you would remain standing, I will administer the oath.

Mr. Pages, why don't we move you down one. Thank you.

If you would raise your right hands, please?

[Witnesses sworn.]

Mr. SHAYS. For the record, our witnesses responded in the affirmative.

And we will go in the order that I called you. I welcome you, and I appreciate your patience in listening to our first panel. If you want to comment on what the first panel said, I would be happy to have you do that. And obviously, your full statements will be in the record. And we will do the same thing; we will put a 5-minute clock and roll it for a second 5 minutes. If you would stop at least before the second one, that would be great.

General.

STATEMENTS OF THOMAS G. MCINERNEY, LIEUTENANT GENERAL, USAF (RETIRED), PRESIDENT AND CEO, BUSINESS EXECUTIVES FOR NATIONAL SECURITY, ACCOMPANIED BY ERIK PAGES, VICE PRESIDENT FOR POLICY AND PROGRAMS, BUSINESS EXECUTIVES FOR NATIONAL SECURITY; PAUL J. DINKINS, EXECUTIVE VICE PRESIDENT, THE PROFIT RECOVERY GROUP; JACK KENNY, DIRECTOR OF OPERATIONS, GOVERNMENT AUDITS, THE PROFIT RECOVERY GROUP; AND RODNEY W. MATEER, PARTNER, DELOITE AND TOUCHE, PROFESSIONAL SERVICES COUNCIL

Mr. MCINERNEY. Mr. Chairman, Counsel. As you know, I am president of the Business Executives for National Security [BENS], which is a national, non-partisan organization of business and professional leaders dedicated to the idea that a strong but affordable national security structure is everyone's business.

Now roughly 2 years ago, we created the BENS Tail to Tooth Commission chaired by former Senator Warren Rudman and Mr. Josh Weston, honorary chairman of ADP. The commission is composed of senior business executives, former political leaders, and retired military officers. For instance, Sam Nunn, Bo Callaway, Vin Weber, Bernie Marcus of Home Depot, Fred Smith of FedEx, Mort Zuckerman of U.S. News and World Report, General Jack Vessey, former chairman of the Joint Chiefs of Staff, General Tony McPeak, Chief of Staff of the Air Force, and Gordon Sullivan, Al Gray, Marine Corps Commandant. We have very prominent American business people and defense leaders.

We believe that the Pentagon now spends too much on administration and bureaucracy. In fact, nearly 70 percent of the current

defense budget supports what we call the defense tail. We need to see new investment in the Pentagon's core business of combat capability, what we call the defense tooth. And you were talking a lot about defense tail in the previous discussions.

We believe that DOD's financial management problems have structural causes that cannot be fixed through small-scale reforms, such as changes to the Prompt Payment Act. Nonetheless, we do believe that the solutions I will list can significantly improve DOD's performance, especially if they are included as part of a more comprehensive financial management reform package.

The following six recommendations are the results of discussions we have had with BENS members, in the industry, Government and other experts. The recently completed study of DFAS by the Joint Chiefs of Staff supports many of the following recommendations.

No. 1, reform of the Prompt Payment Act. One of the major concerns regarding application of the Prompt Payment Act is that current regulations do not effectively cover service contracts. And you asked them those questions and they didn't have the answers.

We believe that it would be important and that the subcommittee support clarification of current regulations to ensure fair coverage for service contracts.

No. 2, outsourcing of non-core defense DFAS functions that was touched on but, frankly, we think it missed the mark widely. We continue to support aggressive outsourcing of non-core functions at DFAS. Since 1995, DFAS has initiated eight outsourcing studies by the A–76 process for public-private competition. Three have been completed, with none of the work going to the private sector.

Two current outsourcing studies, which were mentioned, defense civilian payroll and the retired annuitant payroll are so unwieldy and risky that few if any private-sector bidders are likely to emerge. We fear that these efforts have been designed to fail. The subcommittee should endorse a more effective strategy for outsourcing these activities.

No. 3, fix feeder systems. Much of the problem with DOD financial management can be traced back to the old adage, GIGO, garbage in, garbage out. Currently, about 80 percent of all financial data processed by DFAS originates in the services. And this data often contains errors or is not compatible with existing information processing systems. The subcommittee should also examine efforts to improve the quality of information generated by the military services.

No. 4, use activity-based costing. DOD will never meet private-sector standards until its financial operations are placed on an activity-based cost foundation. Only on this basis, can DFAS benchmark its operations against the best in the private sector and conclude its outsourcing competitions in equitable and auditable manner. This process will take time, but it should be pursued.

No. 5, continued consolidation. The Pentagon should continue to consolidate finance and accounting operations DOD-wide by reviewing the exceptions that were granted in the early 1990's by the services to retain finance and accounting functions.

Mr. SHAYS. General, I just need to interrupt you. I am very sorry. Someone left a suitcase outside the door. Is there anyone here who

might have done that? Otherwise, the bomb squad is going to be called. I would like to avoid that.

Your suitcase? You are the man? Thank you very much.

I just want to make sure that suitcase is OK if you are bringing it in here. But that is another question. [Laughter.]

Mr. MCINERNEY. In particular, the Air Force and the Navy retain large in-house financial management teams.

Six, create a corporate board of directors. DOD should establish a DFAS board of directors composed of military, civilian, Government, and private sector leaders to approve expenditures and reform initiatives. This board will also improve cooperation between DFAS and financial officers in the military services.

My concluding thoughts, Mr. Chairman: DOD can and should be able to comply with, and take advantage of, provisions of the PPA. In fact, with the proper focus on the customer, DFAS can be a model for the rest of the Federal Government.

By looking at the lessons of the private sector accounting industry, DFAS can access the talent and technology that already exists. There is no need to start from scratch. America's modern private sector has prospered on the basis of sound financial management and adherence to standards and accepted accounting practices. Were the Federal Government to do the same, there would be no need for Congress to enforce compliance through repeated legislation.

With respect to DOD and DFAS, BENS believes that improving its finance and accounting posture will allow them to identify and free up the resources so desperately needed for force structure modernization.

Thank you, Mr. Chairman.

[The prepared statement of Mr. McInerney follows:]

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Statement of

Thomas G. McInerney
Lieutenant General, USAF (Ret.)
President and CEO
Business Executives for National Security

before the

Committee on Government Reform
Subcommittee on National Security, Veteran's Affairs and International Relations

June 16, 1999

Mr. Chairman, members of the Subcommittee, thank you for this opportunity to speak to you today. I am Thomas G. McInerney, President and CEO of Business Executives for National Security (BENS), a national non-partisan organization of business and professional leaders dedicated to the idea that national security is everyone's business. BENS members apply their experience and commitment to help our nation's policy makers build a strong, effective, affordable defense, and find practical ways to prevent the use of even one nuclear, chemical, or biological weapon.

Before joining BENS, I spent 35 years as a pilot, commander, and strategic planner in the U.S. Air Force. In my last assignment on active military duty, I was the Assistant Vice Chief of Staff of the Air Force. I also served as Director of the Defense Performance Review that was initiated by Vice President Gore as part of the National Performance Review. Many of our recommendations, such as a call for greater use of outsourcing, directly addressed DoD's financial management requirements. I will elaborate further on this in the appropriate parts of my testimony

The BENS Tail-To-Tooth Commission

Roughly two years ago, we created the BENS Tail-to-Tooth Commission, chaired by former Senator Warren Rudman and Josh Weston, Honorary Chairman of ADP, Inc. The Commission, which is composed of senior business executives, former political leaders, and retired military officers, is designed to bring "the best of business" to management practices at the Department of Defense. We believe that the Pentagon now spends too much on administration and bureaucracy. In fact, nearly 70% of the current defense budget supports

what we call defense "tail." We need to see new investment in the Pentagon's core business of combat capability, or what we call defense "tooth."

As part of this initiative, we have focused much of our attention on the issue of DoD's financial management, and the operations of the Defense Finance and Accounting Service (DFAS). We believe that many of the problems that the Subcommittee seeks to address are merely symptoms of larger management challenges facing DFAS and the entire financial management system at DoD. Thus, I would like today to discuss some of these larger challenges and how they relate to issues surrounding the Prompt Payment Act.

The Prompt Payment Act

As you are aware, the Prompt Payment Act was designed to encourage federal agencies to pay their bills on time. If they do not, the government's creditors are entitled to earn interest on their unpaid balances. This was a sensible policy that treated contractors to a fair and equitable standard and created clear benchmarks for effective business practices inside the government. By and large, the Act has had a positive effect on the problem of late payments. In 1978, before the Prompt Payment Act was in place, the government paid nearly 30% of its bills late. Today, the late payment rate has declined to less than 10%.

Thus, the basic components of the Prompt Payment Act have worked fairly well. However, the Prompt Payment Act addressed more than just the problem of late payments. The Act also sought to encourage contractors to offer price discounts for early payments and to require government agencies to push for these discounts. As the General Accounting Office (GAO) has noted, this part of the Prompt Payment Act has suffered some serious shortcomings.

Discount payments—which are standard in the business community—turn on a question of trust when the federal government is involved. Many vendors,

wary of the government's past performance, do not believe discounts are viable. Since they cannot rely on quick payment, they have been unwilling to offer deep discounts. This trust can emerge, but contractors need to see real performance. Government agencies must improve their prompt payment performance if this discounting policy is to succeed.

Current Challenges

Since 1995, the improvement in the Government's prompt payment performance seems to have stagnated. The percentage of late payments is hung up at about 7%. Even worse, the number of early payments, which entitle the government to a price discount, have actually declined to less than 1% of all vouchers processed.

In the age of Electronic Data Interchange, Electronic Malls and IMPAC cards, we must ask why the government cannot move, to borrow a term from the private sector, at the "speed of business?" We believe that government agencies can and should strive for performance improvements that allow them to match their efficiency with the best of business.

It is clear that most agencies share this goal, and they have been moving in the right direction. However, reform in the way government pays its bills remains a patchwork. Some systems work very well, but other processes and systems have not caught up. What is needed is complete systemic reform of the government's overall financial mangement system as envisioned by the Government Performance and Results Act (GPRA) of 1993, the Government Management Reform Act (GMRA) of 1994, the Federal Financial Management Improvement Act (FFMIA) of 1996 and the Debt Collection Improvement Act (DCIA) of 1996.

Obviously, Congress has detected a persistent pattern of financial shortcomings. This steady stream of attempted legislative fixes is clear evidence

of Congressional concern. Unfortunately, this strong message has not been heeded at many Federal agencies, including the Department of Defense.

We believe that fundamental government-wide financial management reform must start at the Department of Defense. The Pentagon's size and market power make it the ideal candidate for fostering change in the way our entire government manages its finances.

There is no question that reforms in DoD are challenging. DoD runs the world's largest finance and accounting operation, dispensing nearly $13 billion in vendor payments each month and handling roughly 100 million accounting transactions a year. From a highpoint of 31,000 personnel when DFAS was formed from the military services in 1991, the organization has downsized through reengineering and other efficiencies to 20,000 employees in 1998. However, DFAS is merely the front end of a huge DoD finance and accounting operation that still harbors between 18,000 and 21,000 additional workers in the military services exclusive of budgeting personnel. The very size of this bureaucracy is disconcerting; it is indicative of the age and obsolescence of its procedures and systems.

While reforming this huge operation is challenging, it is not impossible. Let me focus briefly on what BENS sees as necessary to put the Department of Defense on a sounder financial management footing.

Financial Management at DoD

In 1997, DoD paid over 18 million invoices on time. However, it also made about 9% of its payments late. Out of a total of nearly 20 million bills, DoD managed to pay only 9,545 early.

According to statistics reported to the Office of Management and Budget, the individual penalties for nearly half—roughly 660,000 bills—of DoD's late

payments were under $1 each. This means that many of DoD's late payments are "almost on time," as big interest charges did not accrue.

This record of almost on-time payment is the good news; it indicates that small performance improvements can have a big impact. However, the bad news is fairly damning. DoD still has another 660,000 bills that are late by any definition of the term. This is a huge amount, especially when one compares these late payments to the miniscule number of only 9,000 early payments. One must surmise that, to this point, DoD, and in particular, the Defense Finance and Accounting Service, has not been able to create the financial management structure to support prompt payment.

Management Structure at DoD

BENS has been highly critical of DoD's financial practices, and we have strongly supported the outsourcing of key parts of DFAS. However, we also recognize that DoD's current organizational structures complicate reform. In theory, DFAS serves as the DoD's financial management arm. In practice, it must share this responsibility with the military services and other DoD components.

Most finance and accounting functions are not consolidated in DFAS. For example, bill-paying actions originate in the military Services, are processed by DFAS, and are then forwarded to the Defense Information Services Agency for further analysis. Thus, simply "fixing DFAS" will not fix these financial management problems. As the Committee considers changes in DoD financial management practices, I urge you to consider a comprehensive reform package that addresses problem areas at DFAS, the military services, and other Pentagon component offices.

To their credit, the current DFAS leadership is trying to change its management structures. But, most of these efforts have been fairly limited and their effects are quite small. DFAS continues to face difficulties in trying to meet its GPRA and other compliance act challenges because it continues to use the wrong measures of merit. It has tied itself to the downsizing metric: i.e., closed 313 accounting offices, reduced number of management systems by 215, eliminated 11,000 positions; rather than addressing the fundamental management reform metrics: why am I performing this function in-house?, and are my customers better off? Real change demands that DoD do a better job of using private sector talent and technology to improve its inefficient and outmoded finance and accounting processes.

Suggestions for Reform

As these comments suggest, we believe that DoD's financial management problems have structural causes that cannot be fixed through small-scale reforms such as changes to the Prompt Payment Act. Nonetheless, we do believe that the solutions listed below can significantly improve DoD's performance, especially if they are included as part of a more comprehensive financial management reform package.

- **Reforms of the Prompt Payment Act**

  One of the major concerns regarding application of the PPA is that current regulations do not effectively cover service contracts. Because service contract payments are regularly excluded from PPA coverage, contractors are placed in a severe financial bind when payments are untimely. We urge the Subcommittee to support clarification of current regulations to ensure fair coverage for service contracts.

- **Outsourcing of non-core DFAS Functions**

We continue to support aggressive outsourcing of non-core functions at DFAS. Since 1995, DFAS has initiated 8 outsourcing studies via the A-76 process for public-private competitions. Three have been completed, with none of the work going to the private sector. Two current outsourcing studies—defense civilian and retiree/annuitant payroll—are so unwieldy and risky that few, if any, private sector bidders are likely to emerge. We fear that these efforts have been "designed to fail." The Subcommittee should endorse a more efficient strategy for outsourcing these activities.

- **Fix Feeder Systems**

Much of the problem with DoD financial management can be traced back to the old adage: "garbage in, garbage out." Currently, about 80% of all financial data processed by DFAS originates in the Services, and this data often contains errors or is not compatible with existing information processing systems. The Subcommittee should also examine efforts to improve the quality of information generated by the military services.

- **Use Activity Based Costing**

DoD will never meet private sector standards until its financial operations are placed on an activity-based cost foundation. Only on this basis can DFAS benchmark its operations against the best in the private sector and conclude its outsourcing competitions in an equitable and auditable manner. This process will take time, but it should be pursued.

Once activity-based costing principles are implemented, DFAS should investigate other organizational models, including "co-sourcing"—that is,

bringing the private sector in as an equal partner, creating a government corporation, or perhaps, even taking DFAS private.

- **Continue Consolidation**

The Pentagon should continue to consolidate finance and accounting operations DoD-wide by reviewing the "exceptions" that were granted in the early 1990s to the Services to retain finance and accounting functions. In particular, the Air Force and the Navy retain large in-house financial management teams.

- **Create a Corporate Board of Directors**

The Defense Management Council provides some management oversight for the Pentagon's finance and accounting system, but does not examine DFAS operations in detail. DoD should establish a DFAS Board of Directors composed of military, civilian government, and private sector leaders to approve expenditures and reform initiatives. This board will also improve cooperation between DFAS and financial officers in the military services.

Concluding Thoughts

DoD can and should be able to comply with—and take advantage of—the provisions of the Prompt Payment Act. In fact, with the proper focus on the customer, DFAS can be a model for the rest of federal government. By looking at the lessons of the private sector accounting industry, DFAS can access the talent and technology that already exists. There is no need to start from scratch. America's modern private sector has prospered on the basis of sound financial management and adherence to standards and accepted accounting practices. Were the federal government to do the same, there would be no need for

Congress to enforce compliance through repeated legislation. With respect to DoD and DFAS, BENS believes that improving its finance and accounting posture will allow them to identify and free up the resources so desperately needed for force structure modernization.

Thank you, Mr. Chairman. This concludes my prepared testimony. I would be glad to answer any questions that you or members of the subcommittee might have at this time.

Mr. SHAYS. General, thank you very much.

Mr. Dinkins.

Mr. DINKINS. Thank you, Mr. Chairman. I appreciate the opportunity to testify before the committee today.

My company, the Profit Recovery Group, pioneered an accepted business practice known as recovery auditing about 30 years ago. Basically, this practice is designed to identify and recover overpayments that have been inadvertently been made to suppliers of goods and services.

And it is a well-known fact that even the best known, best run companies around the world with the best systems still make overpayments typically in the area of about one-tenth of 1 percent a year.

In our written testimony, we have made reference to results to date in several Government programs, the oldest of which is AAFES. And, for example, last year we recovered just about $30 million on a purchase basis of about $5½ billion.

We have been doing this now for about 30 years. We serve over 3,000 clients worldwide, across 22 countries, about half of which are the Fortune 1,000 here in the United States. And because of this global experience, we are pretty well experienced in the purchase and payment processes in large organizations. And I think it is worth mentioning that the Department of Defense is the largest bill-paying entity in the world.

It is an extremely complex environment, and we think they do a pretty good job given what they have to work with, the age of the systems and the consolidation and processes that they have gone through over the last few years.

Having said that, at DOD or any other entity, there will always be overpayments. And the purpose of the recovery audit process is to be a safety net to identify them and recover them after the fact.

We are now finalizing a recovery audit demonstration program within the Department of Defense. A side benefit of this process is the identification of factors that contribute to financial loss. As a result of our experience in this program, we have become familiar with the Prompt Payment Act and have prepared a series of recommendations to revise the act to better mirror private-sector business practices and eliminate millions of dollars of financial loss.

It is our understanding that the Prompt Payment Act was originally enacted at a time when the Government was unable to meet the private sector's standards for paying invoices accurately and on time. While that situation has improved, we at this point believe it is a good time to re-look at the Prompt Payment Act and the following recommendations we make to improve lost cash discounts, to reduce penalty interest that we believe is paid in error, and to improve contract prices that are achieved by the Government.

The first recommendation concerns cash discounts, and one of the gentlemen had brought this point up earlier. The private sector practice is to calculate cash discount due-dating from the later of either the receipt of invoice, the receipt of goods, or the resolution of invoice discrepancies, whichever is most advantageous.

The Prompt Payment Act, however, stipulates that cash discount due dating begins with the date of the invoice. And as you have heard in prior testimony, invoices are often received after the in-

voice cash terms—cash discount due-dating, which means that the Government cannot avail itself of cash discounts. This results in the inability to take advantage of cash discount terms. The clock starts ticking oftentimes before the invoice is received.

In our limited scope of the demonstration program, we estimate that roughly $20 million was lost on cash discounts that would otherwise have been taken advantage of on a base of payments of only $6 billion in purchases. Therefore, you can extrapolate from that there is a significant opportunity here when extended across the entire purchase base for DOD. And we estimate this to be minimally at $100 million a year in savings with this correction.

The second topic and recommendation is penalty interest. First, the private sector does not pay penalty interest. We do not recommend elimination of penalty interest, but rather revising this portion of the act. The Prompt Payment Act stipulates that the Government must pay penalty interest for any disbursements made later than the due date stipulated by in the act even if the terms offered by the vendor are more favorable. We recommend revising the act to provide the Government the ability to accept vendor terms stated on the invoice if more advantageous.

Our next recommendation concerns recognition of extended dating terms. Private industry offers extended dating terms in many instances as an added incentive to take goods early. The Government is forced to pay these invoices within 30 days of receipt. This results in many cases in the loss of use of this money for 60 days or more. Again, we recommend revising the act to provide for acceptance of vendor terms invoiced if—vendor terms on the invoice if more favorable to the Government but not stipulated in the Prompt Payment Act.

As an example of that, often times extended dating terms would be offered on an invoice that where goods are shipped and received but the invoice stipulates payment, say for example, within 120 days. Based on the act today, that bill would have to be paid within 30 days, losing 90 days of interest on that money.

Our next recommendation has to do with recognition of commercial practice. Some Government contracts do stipulate that the Government must receive terms of sale at least as favorable as that offered to the private sector. We recommend that the act be revised to include this language and provide for uniformity across all Government purchases of commercial items. This will help to ensure Government receives the best price.

Last, but not least, our recommendation concerns anticipation. Anticipation is a term used to describe a reduction of disbursed dollars based on the time value of money when payment is made in advance of the actual due date. In effect, anticipation is the reverse of penalty interest.

The Prompt Payment Act should be revised to provide for use of anticipation on invoices paid early, as is common in the private sector. We recognize that it is not the Government's intention to pay invoices early; however, situations can and occur where payment is in fact made early. In these instances, the time value of money can be identified and recovered as part of the recovery audit process as is common in the private sector.

In summary, Mr. Chairman, the Prompt Payment Act has helped to improve Government's ability to pay vendors on time. Now that these processes have been somewhat improved, we think it is a good time to revise the Prompt Payment Act to adopt private-sector business practices.

Our recommendations to revise the act will provide for improved tax management, significantly reduce penalty interest paid, and the loss of cash discounts. These recommendations in no way mitigate the beneficial aspects of the act. In fact, we believe these changes will provide for a clear interpretation of the original intended purpose of the act.

Thank you, Mr. Chairman. We are happy to entertain questions.

[The prepared statement of Mr. Dinkins follows:]

Congressional Testimony
"Financial Management: Time to Reform the Prompt Payment Act?"
June 16, 1999

Thank you Mr. Chairman for the opportunity to testify before this committee. My name is Paul Dinkins, Executive Vice President of The Profit Recovery Group International, Inc. (PRG).

I. Introduction

Recovery Auditing is a risk free professional service, which identifies and recovers overpayments and under-deductions inadvertently made to suppliers of goods and services that would otherwise remain undetected and lost. It is risk free because contractor fees are a negotiate share of recovered monies with no other associated costs. We are now finalizing a recovery audit demonstration program for the Department of Defense. Our fee for this program is 20% of recovered monies. As part of our service, we identify and recommend improvement opportunities. Incorporated into this testimony is background on our work within government, recommendations for improvement and expansion of the program, and recommendations for changes to the Prompt Payment Act that would save the government millions of dollars per year and more closely mirror private sector business practices.

PRG's Recovery Auditing is an accepted business practice deployed by organizations around the world with large accounts payable operations. This service recovers hundreds of millions of dollars each year and has been in use in the private sector since 1971. Audits are conducted each year on the prior year purchase and payment transactions. The process involves a complete review of all related transaction media such as supplier contracts, correspondence, purchase orders, invoices, paid history files, vendor statements, etc. These transaction records are reassembled as part of the audit including both physical and electronic media. Much of today's purchase and payment transactions are electronic in nature. Therefore, sophisticated software applications are utilized to search historical records to identify potential overpayments along with other sources of documents that may be paper, microfilm, fiche, or images.

On average, our practice in the private sector recovers approximately .1% of annual purchase volumes or $1 million per $1 billion of annual purchases. Our experience to date at AAFES is .45% and at the Department of Defense demonstration program .48% (90% complete). We do not have a broad enough sampling of results within the Department of Defense to accurately project the benefit of the program when applied to all DOD purchases. However, we can very safely estimate the range of benefit to be at minimum the .1% experienced in the private sector up to and beyond the .48% currently experienced with the demonstration program. We understand that there will be different issues and opportunities for different types of purchases audited. It is also worth mentioning that we typically produce higher results in the second and third years with a new client based on improved information access, understanding of the client and greater participation and support by the client. Therefore, we estimate the rate of recovery for program expansion to all Department of Defense purchases to be .3% or $3 million per $1 billion of annual purchases.

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Using the .3% estimated rate of recovery, annual benefit from program expansion to all of the Department of Defense is $510 million. This is based on annual DOD purchases of goods and services of $170 billion. The first year of program expansion would produce an added benefit because at minimum, the last three fiscal periods of purchases and payments can be audited at one time producing a one-time recovery of $1.53 billion.

The Profit Recovery Group provides a unique perspective on the recovery audit industry because:

- PRG is the only public company in the industry with a market capitalization over $1 billion
- PRG is the largest service provider world wide
- PRG has served over 3,000 clients including over half of the Fortune 1000
- Staff is comprised of over 2,000 employees in 23 countries
- PRG's global practice spans 29 years of experience.

As such, we understand industry best practices and norms and are well qualified to provide expert opinions on practices and policies related to the purchase and payment of goods and services.

II. Program Background and Recommendations to Expedite Benefits for Department of Defense/Government Recovery Audit Programs:

Background:

Our first work within government began in 1991 with AAFES (Army Airforce Exchange System). We are now in our 9th year of service to AAFES. The most recent audit of fiscal 1997 produced $30 million dollars in identified and recovered overpayments. We began discussions in 1993 to expand services to other government entities including the Department of Defense. The results of these activities to date are:

- The 1996 Defense Authorizations Act called for a "Recovery Audit" demonstration program (354 Program) within the Department of Defense. The Profit Recovery Group was selected through a competitive bid process as the contractor for the original demonstration program. This program is 90% complete. To date, the program has identified over $29 million in overpayments made to suppliers on purchase volumes of roughly $6 billion. We expect this number to net down to about $25 million after all research is finalized. These monies are in various stages of recovery through administrative offsets.
- The 1998 Defense Authorizations act called for program expansion (388 Program) to the balance of the Defense Working Capital Fund entities within the Department of Defense. To date, no program expansion has occurred. The GAO has issued a favorable report on the program and recommended expansion within the Department of Defense. We understand that there is ongoing activity regarding program expansion within DLA, DECA, US Transcom, Army, Airforce, Navy and DISA.
- Discussions with the General Services Administration generated interest in promoting Recovery Auditing throughout government and the creation of a multiple award schedule contracting vehicle specifically for Recovery Auditing. This contract was awarded in March 1998 through the General Services Administration, Federal Supply Service, Multiple Awards Schedule program. This contract is under the Financial Management Services schedule,

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Solicitation FCXB-T3-990003-N; Special Item Number 872-1(F) – Recovery Audits. This provides an efficient contracting vehicle for future program expansion within the Department of Defense.

- In May 1999 PRG was awarded a contract with the U.S. Department of Veterans Affairs.
- Discussions with the U.S. Postal Service, GSA, HHS (HCFA), IRS, DOI, DOE are in progress.
- "The Government Waste Reduction act of 1999" promoting application of Recovery Audit programs throughout government was introduced to the house on May 17, 1999. This act calls for the application of recovery auditing across all government agencies.

Recommendations:

Our demonstration program experience and interaction with other Department of Defense entities designated for program expansion leads us to make the following recommendations to expedite program application and benefits:

1. **Expedite Program Expansion:** The program should be expanded to include all Department of Defense purchases. To date, program expansion has been targeted at the Defense Working Capital Fund (DWCF) areas totaling about $30 billion in annual purchases. The program should also be expanded to all appropriated fund areas representing the balance of $140 billion in annual purchases

   Program expansion activities, as called for in the 1998 Defense Authorizations Act and as recommended in various GAO reports, have been protracted. On August 20th, 1998, Under Secretary of Defense, William Lynn sent a memo to nine Defense Working Capital Fund (DWCF) entities encouraging each to undertake application of Recovery Audit Programs. To date, there has been no program expansion. Understanding of program benefits and the determination of how to proceed has been left to each DWCF entity including the Defense Commissary Agency, U.S. Transportation Command, Army, Navy, Airforce, Defense Information Systems Agency and Defense Logistics Agency. The largest reason for the delay in program expansion is that each Department of Defense entity must go through the time consuming process of designating someone to head up the program, developing a Statement of Work and Contracting. To date, we have not encountered any entity that does not want to proceed with the program, but there are significant delays associated with the development of a statement of work and contracting. Status of each follows:
   - US. Transcom has made the most progress with a completed statement of work and contracting officer assigned.
   - Defense Logistics Agency is developing their statement of work and plan to issue it in June.
   - Airforce has communicated their desire to complete contracting, but delay program start until after operations in Kosovo have ended. The Statement of Work will need to be developed prior to contracting.
   - Defense Information Systems Agency has communicated their intent to complete contracting, but still needs to develop a statement of work.
   - DECA communicated in December 1998 that they were in process of developing a statement of work, which as of this date has not yet been issued.
   - Army and Nave have expressed intent to participate, but have yet to determine who within their organizations will take the lead and develop a statement of work.

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It is imperative that each DOD entity supports the program for it to be successful. To expedite each entity's ability to expeditiously benefit from the program, we suggest that a lead entity be selected, such as DFAS, to establish a generic Statement of Work. This lead agency would then contract for the program expansion using the generic statement of work. The contract would provide the ability for each Department of Defense entity that has not yet contracted for recovery auditing to piggy back onto this master contract with any needed modifications to the statement of work. Each entity will need it's own Contracting Officer's Technical Representative assigned to the program to deal with aspects unique to each entity and maintain ownership. This will be particularly helpful in the expansion of the program beyond the Defense Working Capital Fund areas.

There are many reasons why expansion of the Recovery Audit program would be more effective and expeditious if both program acquisition and administration were centralized within a lead agency such as DFAS:

- A single contracting authority will help to ensure uniform program application and benefits. We also suggest periodic discussions with the Contracting Technical Officers Assigned to facilitate coordination and standardization of program approaches.
- There have been many legal interpretations and program policies/practices developed and refined through the demonstration program application at DFAS. These interpretations and program policies and practices should not have to be redeveloped for each new DOD entity that joins the program, thus expediting program application and benefit.

2. **Expand the Recovery Audit Program to all Department of Defense Purchases:** The 1998 Defense Authorizations Act calls for program expansion to the balance of the Defense Working Capital Fund procurements representing roughly 18% of annual DOD procurement ($30 billion annually). We recommend that the program be expanded to include a comprehensive audit of total annual procurements of roughly $170 billion and all related DFAS payment locations to maximize program benefits.

3. **Reimbursement of Direct Costs Associated with the Recovery Audit Program to DFAS:** Both the 1996 and 1998 Defense Authorization Act sections (354 and 388 respectively) related to Recovery Auditing provides for up to 25% of the recovered monies to be paid to the contractor. PRG's fee rate is 20% (20.2% under the GSA Multiple Award Schedule), leaving an additional 5%. Under current contracting, PRG is compensated with the balance of the monies remitted back to the DOD entity for which the overpayment was recovered. Under this scenario, DFAS is not reimbursed for any costs associated with the administration of the program. Primarily, DFAS encounters some level of expense associated with Contracting Officer's Technical Representative(s), reviewing overpayments identified, offsetting overpayments through the accounts payable system, and opening closed contracts where overpayments have been identified and re-reconciling to include the amounts recovered. Reimbursement to DFAS for these direct costs is appropriate and would promote a win-win environment. Currently, we are experiencing a delay at DFAS in the offsetting of overpayments identified and approved by suppliers in the MOCAS (Mechanization of Contract Administration Services) system. MOCAS system management has communicated that they have costs associated with the offsets and re-reconciling of closed contracts. MOCAS system management has requested that the Recovery Audit program be denied future access to the MOCAS system due to these costs, which are considered to be minor in

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comparison to the amounts recovered. We believe that this issue will be resolved shortly, however, reimbursement for direct costs would avoid these kinds of delays in the future.

4. **Contractor Authority to Act as an Agent for the Government:** Provisions should be made to establish the authority of the contractor to act as an agent of the government in matters related to recovery auditing. Current regulations stipulate that only a contracting officer may assert a claim on behalf of the government, and that the contracting officer must accomplish all communications, negotiations, or settlements regarding an asserted debt.

   In order to maximize both the effectiveness and efficiency of the program, the contractor should be granted the authority to 1) initiate claim actions, 2) communicate and negotiate directly with vendors, and 3) negotiate and agree to settlements where appropriate. This should be done under authority of the contracting officer, as his/her designee. The contracting officer retains full over-site authority for the program, and directs all aspects of the process. The routine aspects and daily operation of the recovery audit process are the responsibility of the contractor. The contracting officer need only become involved if an impasse is reached in negotiations with a vendor, at which point the final determination as to the disposition of the claim is the contracting officer's.

   Treating the recovery audit process as a true out-sourced initiative, with the contractor acting as a designated agent of the government, would provide for a more efficient operation, minimize the time demands on government employees, enhance recoveries, and more closely mirror "usual and customary" private sector business practices vis-à-vis recovery auditing.

III. Lessons Learned – Recommendations for Improvement of the Prompt Payment Act:

A key benefit of the recovery audit service is the identification of procedural and control issues that contribute to error rates and recommendations for correction. As such, we have identified a number of issues related to the Prompt Pay act of 1998, which detrimentally impacts the Government's ability to avail itself of cash discounts, or otherwise practice effective cash management techniques. Among these are the following:

- Inability to recognize and take cash discounts as offered,
- Erroneous payment of penalty interest due to mis-interpretation of the "due dating" provisions of the Prompt Payment Act, and
- Loss of time value of money benefits to the Treasury due to early disbursement of funds, sometimes as much as 30 days in advance of the actual due date, and
- Recognition of Commercial Practices

Each of these areas is discussed in detail below, with examples as appropriate.

1. Cash Discounts:

Potential cash discounts, amounting to millions of dollars annually, are lost solely due to a specific requirement in the Prompt Payment Act. Language in the Act specifically mandates that

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the calculation of invoice due dates, for the purpose of realizing cash discount terms offered, must be based upon the invoice date on the vendors document, rather than the invoice receipt date. This practice effectively precludes the Government's ability to avail itself of cash discounts based on ***receipt*** of a proper invoice, and is at variance with usual and customary practice in the private sector.

A common discount term, for example, is 2%/10 net 30, meaning that if the invoice is paid in 10 days, a 2% deduction is allowed, or that the net invoice (without discount) is due in 30 days. In many instances, invoices offering 2% discount 10 days, were noted where the perforation date of the invoice (date of receipt) was on or after the discount due date. Since both the regulations and common sense dictate that an invoice cannot be paid until received and verified, such late submissions in essence guarantees that cash discounts cannot be taken. Usual and customary business practice in the private sector is to calculate the discount period from the later of receipt of invoice, or receipt of goods, or resolution of invoice discrepancies, whichever is most advantageous.

Example
An invoice is presented for payment with the following specifics:

Invoice date: 6/1/99
Discount terms; 2% 10 days, net 30 days
Invoice received at DFAS (perf) Date: 6/8/99

Under the current regulations, the invoice would be "due" on 6/11/99 for the purposes of earning cash discount (10 days from the invoice date). The same invoice would be due for the purposes of avoiding "late payment penalty interest" on 7/9/99 (30 days from date of receipt). This inconsistency in due dating (different "start the clock" dates for the same invoice) is the result of a specific requirement in the current Act. As dictated by usual and customary private sector business practices, the discount due date for this example would be 6/19/99, or 10 days from receipt of the invoice. In actuality, many such invoices reviewed at DFAS were not even received until after the cash discount period had already expired, making it impossible for the Government to avail itself of the cash discount terms offered.

Summary and Recommendation
The Act, in its current form, denies the Government the opportunity of earning millions of dollars in cash discounts annually. Prior to 1989, this language did not exist in the Act, and the requirements more closely mirrored private sector practice. Further, the current language requires two separate calculations for each invoice where cash discount terms are involved. The due date for calculation of penalty interest is based on receipt of invoice, not invoice date. The effect is that there are essentially two different "clocks" for each invoice containing an offered discount, with differing methods of determining Due dates. For example, an invoice dated 11/1/96 with terms of 2%/30 Net 31 (a common dating), received at DFAS on 11/5/97 could be paid "on time" on 12/4/96 without penalty. However, the cash discount component could not be taken as the *discount due dating* would have mandated that the invoice be paid by 12/1/96. The situation is exacerbated in cases where discount terms are shorter, such as 2%/10 net 30.

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The language governing the calculation of due dates for discount purposes should be amended to reflect private sector practice, and to make it consistent with the due dating methodology employed by the same Regulations in calculating Prompt Pay due dating.

2. Penalty Interest Paid in Error:

The Government is disbursing millions of dollars annually in "late payment interest penalties" that in fact is not owed. This is due to a fundamental lack of clarity in the intent of the Act, and the failure of the language to establish an "Order of Precedence" between provisions of the act, the contracting document and the vendor's invoice.

The Prompt Payment Act "mandates" payment of vendor invoices in 7 days, 10 days, 15 days (OConUS shipments, pursuant to "Fast Pay"), or 30 days, dependent on the type of commodity involved. No explicit provision is made in the act for circumstances where the vendor terms, as presented on the invoice, are more favorable to the Government than the payment terms stipulated by the Act. Vendor invoicing terms such as net 45 days, net 60 days, or net 10 prox, are not recognized nor provided for in the Act.

The interpretation which has been given to the Act by the disbursing centers is that the due dating provisions of the act take precedence, regardless of what may be stipulated in the vendors invoice. Since there is no language in the Act permitting the acceptance of terms more favorable to the Government, it is presumed that the Act takes precedent regardless of what may be stated on the vendor's invoice. The result is that if an invoice paid "late" pursuant to the provisions of the Act, a penalty interest amount calculated and applied to the disbursement, even though the payment may have been effected well in advance of the vendor's invoice due date.

As a result of this interpretation, invoices which fall, for example, under the 10 day payment parameter, but which are not paid until day 18 will have 8 days of penalty interest added to the disbursement, even if the invoices themselves state "net 30" terms. In this instance, had the Act provided for acceptance of the vendor's terms, the invoices would have actually been paid 12 days early, not 8 days late. In practice, the disbursement would have been held until the vendor stipulated due date, the funds would have been retained by the Government, and the time value of those funds realized for 12 additional days.

The government recognizes this concept in many other Financial Management Regulations, including the Department of Defense-Financial Management Regulations at section 020101 paragraph C. which states ***"If discount terms on an invoice differ from those in the contracting document, use those that are most cost effective for the government, except for progress payments liquidations..."*** *A* simple amendment to the Prompt Payment Act, including similar language would result in substantial future cost avoidance for the Government.

Example

A nationally known brand name vendor provides frozen fish dinners, frozen shrimp dinners, and frozen fish sticks. The vendor's standard terms of sale, and the terms reflected on each of the invoices is "NET 30". Payment sub-vouchers recorded payment for ten (10) of the vendor's invoices as follows:

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Invoice	Dated	Received	Paid Date	Delivered to / Marked for
23812	11/2/94	11/21/94	12/12/94	Norfolk, VA (Sea Van) / for Kaiserslautern
23771	11/2/94	11/21/94	12/12/94	Norfolk, VA (Sea Van) / for England
23866	9/27/94	11/21/94	12/12/94	Comm. Resale WCSVL Youngsan / Korea
23776	10/27/94	11/21/94	12/12/94	Bldg. 35 / Bayonne, NJ
23760	11/3/94	11/21/94	12/9/94	Norfolk, VA (Sea Van) / for Kaiserslautern
23768	11/2/94	11/21/94	12/9/94	Norfolk, VA (Sea Van) / for England
23763	10/31/94	11/21/94	12/9/94	Norfolk, VA (Sea Van) / for England
50235	11/9/94	12/6/94	12/19/94	Comm. Resale WCSVL Youngsan / Korea
50393	11/8/94	12/6/94	12/19/94	Norfolk, VA (Sea Van) / for Bremerhaven
50423	11/11/94	12/6/94	12/19/94	Norfolk, VA (Sea Van) / for Kaiserslautern

All of the above were due dated seven (7) days from date of receipt; all vendor invoices were marked as due "Net 30 days"; none were marked as FAST PAY.

Penalty interest accrued and was paid on all 10 invoices, but all were paid well in advance of the ***vendors indicated*** due date, and should not have incurred penalty interest.

Summary and Recommendation
Penalty interest should be accrued and paid whenever a vendor remittance is truly late. The establishment of the due date in calculating whether penalty interest is due and payable, however, should be predicated on the terms that are most advantageous to the government. The dating stipulated by the Prompt Payment Act, in its current form, should not take precedence over the vendor's invoiced terms where those terms are more favorable.

Regulations should provide for the payment of penalty interest where legitimately due, but recognize that usual and customary business practices in the commercial sector can and should apply to the Government as well.

3. Recognition of Extended Dating Terms

A closely related issue involves recognition that vendor-invoicing terms frequently extend beyond 30 days, either as a standard published policy, or on an exception basis. Even vendors with standard terms of NET 30, will periodically provide extended dating to facilitate the movement of seasonal goods, to alleviate warehouse overstocks, or as part of a promotional effort.

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Toy manufacturers and candy manufacturers, among others, routinely use this technique. For example, Halloween candy is frequently offered with 90 or 120 day dating (i.e. take delivery by September 1st, and the invoice is not due until after Halloween). Additionally, there are a great many vendors who provide either "date specific" dating or "End of Month" (prox) dating. In these cases, the term may vary by as much as 45 days. The Prompt Payment Act does not recognize or make any provision for handling these types of terms. As a result, invoices that are not due until the 60th day after receipt are being paid on day 30 to avoid interest penalties, when in reality, the payment is being made 30 days earlier than the vendor requested or expected.

Recognizing that there is a significant cost associated with the time value of money, disbursements made so far in advance of the actual vendor-requested due date have a negative impact on effective cash management, and have a tangible, quantifiable cost associated with them in terms of "lost" earnings potential.

Summary and Recommendation
The Prompt Payment Act should recognize, and make provision for terms and conditions of sale such as these, which are pervasive in the commercial marketplace. As indicated in the previous point, the Act should include language stating that the Government will recognize and accept the terms that are most advantageous. This practice is the norm in the private sector.

4. Recognition of Commercial Practice

One issue related to the recognition and acceptance of vendor terms as outlined above is that there should be a provision in the Act preserving the Government's rights to ensure it is receiving equitable treatment.

Currently there is nothing in the language of the Act that requires a vendor to provide the Government with terms of sale, which are at least as favorable to the Government as those offered in the commercial marketplace. The result is that a vendor, who provides 2% 30 day, net 31-day terms, or net 60-day terms in the commercial market, could offer Net 10-day terms to the Government for the same products, without the Government having recourse.

The concept of recognizing terms and conditions of sale most advantageous to the Government is significantly weakened if vendors can circumvent this by selling to the Government at terms not reflective of those offered in the commercial marketplace.

Summary and Recommendation
The fundamental fact is that in today's environment of ever increasing electronic commerce, the deficiencies which the Prompt Payment Act attempts to remedy are no longer a significant factor. Doing business with the Government is among the safest transactions into which a vendor can enter. Short of the Government becoming insolvent, the vendor is assured of being paid, and the inordinate payment delays which used to characterize Government payment processing in the past, by in large no longer occur.

There is procurement contract language in certain contracting activities requiring vendors to provide the government with terms and conditions of sale at least as favorable as those provided

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to the commercial market. However, there is no language in the Prompt Payment Act, the FAR, or any other legislative or regulatory document that sets forth this principle as a government-wide policy.

The Prompt Payment Act should reflect the commercial reality of today, requiring the vendor to provide the government with terms and conditions of sale as good as, or better than terms offered in the commercial marketplace

5. Anticipatory Charges

One area not addressed by the Prompt Payment Act is the concept of "anticipation".
A significant source of recovery dollars can be realized from assessing anticipatory charges in conjunction with the early payment of vendor invoices. The underlying philosophy is that there is a time value component to the cost of money and that funds disbursed in advance of the actual due date should be discounted to present value.

For example, an extended dating invoice stipulating payment terms of "NET 60 Days" is submitted for payment. The effective invoice date is 10/1/97, making the payment due date 12/1/97. The payment of the invoice is actually effected on 11/1/97, or a full 30 days in advance of the stipulated due date. In this example, the payment should have been reduced by the time value of money (daily rate times 30 days) for the early disbursement, recognizing that the disbursing entity has lost the potential interest income associated with retaining funds for an additional 30 days, and provided the recipient with this advantage.

Anticipatory charges are widely recognized in the private sector, and in fact, the Government already recognizes the concept of time value of money. The Prompt Payment act mandates that payments not made in a timely manner, (late payments) must include "penalty" interest over and above the face value of the payment being effected. The basis for the calculated payment is identical to that detailed above; a daily interest rate is multiplied times the number of days "late" times the principle amount to arrive at the value of the additional amount due.

Conceptually, this is identical to anticipation, with the only difference being that the calculation is a **reduction** to the disbursement amount (based on the number of days paid early); in effect a "negative" interest penalty. An invoice paid five days late would have five days interest added to the payment amount, therefore the same invoice, paid five days early, should have five days interest deducted; it is two sides of the same coin.

Further mitigating in favor of this practice is the fact that the Government routinely pays in advance of the stipulated due date, by virtue of its interpretation of the Prompt Payment Act, as discussed previously. Under the current paradigm, invoices are paid on an accelerated basis, regardless of the stated terms on the invoice, if the commodity purchased is enumerated in the Act as subject to accelerated payment. The base on which anticipatory charges could be assessed is therefore quite large, and the magnitude of the potential savings to the Government is substantial.

It should be noted that in the private sector there are some vendors who routinely dispute anticipation charges. The basis for their objection is usually that "we do not charge interest for

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late payments, therefore we do not accept reductions for early payments." This reasoning does not apply in the Government, however, as the Government (unlike private industry) DOES pay late interest, as required by the Prompt Payment Act, making the argument for collection even stronger.

We believe this makes for an even stronger argument in favor of anticipatory charges for early disbursement; as time value of money transactions are already a part of the Government's mode of doing business.

Summary and Recommendation
The Prompt Payment Act should recognize that there will be circumstances in which it is in the best interests of the Government to pay early, and that in those situations, the payment will be reduced by the calculated anticipation amount. While adoption of the prior recommendations in this document, particularly regarding acceptance of the vendor's invoice due date, should significantly reduce the instances of "early" disbursement, there will be times when payment is made early. Whether intentional, or as a result of human or systemic error, the government must stipulate that it has the right to apply anticipatory charges. In its most fundamental interpretation, anticipation simply reimburses the Treasury for the interest it lost disbursing prematurely.

Summary

As our work within the Department of Defense progresses, we will continue to highlight recommendations that will improve business practices and mitigate future overpayments. The observations and recommendations contained in this document appear to be common sense issues. With your help, revisions to the Prompt Pay Act will move government practices closer to that of the private sector and provide a significant financial impact:

- Cash discounts, amounting to millions of dollars annually, will be recognized and taken by the Government. These discounts were previously unrecoverable, due solely to a provision in the current Act.
- The amount of penalty interest paid by the Government will be greatly reduced, simply by recognizing that vendors have the right to provide terms of sale to the Government which are more favorable than those currently mandated by the Act.
- Cash management techniques will be enhanced by retaining funds within the Government until actually due to vendor, according to the vendor's terms of sale.
- Provide for a significant reduction in disbursed dollars, by recognizing that anticipatory charges be applied in circumstances where payment is effected early, and,
- Provide for equitable treatment of Government expenditures by requiring that the Government be afforded terms and conditions of sale consistent with those afforded the commercial market for the same commercial items.

Thank you Mr. Chairman.

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Mr. SHAYS. Thank you very much.

Mr. Mateer. Let me have you bring that microphone a little closer. Am I saying your name correctly?

Mr. MATEER. Yes, you are. Thank you.

Good morning, Mr. Chairman, I would like to thank you for the opportunity to comment today on the Prompt Payment Act, its implementation, and how the professional and technical services companies who work for the Federal Government are being harmed by some of the deficiencies in that implementation.

I am a partner and the national director of our Government contract consulting practice with Deloite and Touche. We are a national and international accounting firm. Many of our clients are members of the professional services council, and I am here today to speak for that trade association.

PSC members are technology companies that make up the fastest growing sector of our Nation's economy. Primarily, these services are applications of professional, expert, and specialized knowledge used to assist Government and private-sector clients to solve operational, technical, and management problems.

Overall, this sector performs $600 billion in services in the economy, including more than $100 billion in the Federal Government each year in such areas as defense, international affairs, health, environment, and others.

Before I explain the specific problems that I believe we are experiencing, allow me to briefly frame the issue for you, because this gets into some technical details with the regulations, vis-a-vis the law.

First off, Representative Jack Brooks sent a report which accompanied the original Prompt Payment Act, stated as follows: "Every Federal agency shall pay an interest penalty on amounts owed to business concerns through the acquisition of property or services when the agency does not pay on time."

And that is fundamentally what our issue is here today. The issues I will address in this testimony are essentially twofold. One, the purpose of the Prompt Payment Act is fundamentally fair, but the implementing regulations are at best unclear and at worst inconsistent with the law. And two, the application of these regulations have resulted in an inequity in the professional and technical services community by excluding the protections of the Prompt Payment Act on certain billing transactions where valid services have otherwise been performed.

I also want to emphasize that at the very onset of my testimony that we acknowledge that the agencies have in certain circumstances will pay in less than 30 days. In fact, they have policies in some cases. The Department of Defense will pay certain transactions in 7 days or 14 days. We believe this scenario is ideal, and we would like to see that efficiency applied to all payments.

But more to our concerns: Our concerns rest primarily with the facts that an unacceptably high number of services contractors are not getting paid under the Prompt Payment Act. In fact, a number of our members have indicated that they have had delayed payments that are 50 to 80 to 100 days or more. This can result in a significant cash drain on a company's operations, particularly for small business. And most companies secure lines of credit or other

forms of financing to float those delinquent payments. Obviously, this is a hardship on the contractor community because these types of costs are not allowable, these financing costs, under the Federal acquisition regulations.

Particularly perplexing and in our opinion indefensible is the fact that service contractors are in effect being treated differently than other Federal contractors. The fundamental equity argument here is that the Prompt Payment Act does not intend to make a distinction between service and non-service contractors. The problem arises in the regulations and their interpretation in implementing the act.

By way of background, service contractors perform—are performed by both large and small companies, are typically reimbursed—and this is a point you brought up earlier in your question, Mr. Chairman—reimbursed as interim payments or as progress payments based on costs incurred or on fixed hourly rates.

This is important because the regulations expressly exclude these forms of payment from the Prompt Payment Act coverage. However, in our view, each labor hour that is billed and its related costs incurred is a service performed. And if that service complies with the other requirements of the act and the regulations in terms of a valid invoice, compliance with the terms and conditions of the contracts and the like, it should be subject to the Prompt Payment Act.

Focusing on the Prompt Payment Act purpose for just a moment, the law, we are most interested in stressing that the purpose of the act, which is to protect to a certain degree the contractor community by providing an incentive for the Government to pay its bills on time and to compensate contractors for delays in those payments. That is essentially the purpose.

The Prompt Payment Act generally provides that the Government must pay a proper invoice within 30 days. The act applies to the acquisition of property or services. However, we believe that the regulations again do not reflect the clear intent of the act and are not in step either with acquisition reform.

The current regulations properly state the law's purpose to pay contractors fairly for work performed; however, again, at best they are unclear or at worst inconsistent regarding the exclusion of terminology that has occurred in the regulation that is not in the law called contract financing payments. Contracting financing payments in the regulations are specifically excluded from the Prompt Payment Act.

Now, as was mentioned earlier today, these are very common types of payments for the professional services business. In the FAR they are defined as Government disbursements of moneys to a contractor under a contract clause or other authorization prior to acceptance of supplies and services by the Government. And it gives illustrations as to particular types of billing transactions that are excluded, such as the interim payments.

The problem with this language is that we believe that the regulatory definition of a contract financing payment has resulted in the Government's misapplication of the law's requirements. The definition has—and this is a key point—has essentially legitimized the Government's acceptance process as being integral to applica-

tion of the Prompt Payment Act. This categorically lists specific types of payments that are not covered by the Prompt Payment Act. The FAR does that as well.

In contrast to the law, the FAR coverage on contract financing payments, the law uses no such terminology, as I indicated, but instead the law, I believe, focuses on the substance, not the form, of the payment. The legal prerequisites for application of Prompt Payment Act are particularly very clear in the 1988 amendments to the Prompt Payment Act, are one that there is an invoice, and if required by the contract, for supplies delivered or services performed.

Let me point out that some of the confusion on this in the past, I believe in its application, has been that there has to be something tangibly provided. It has to be delivered; it has to be given; it has to be accepted, approved, signed off, et cetera.

However, the 1988 amendments to the law make it very clear that Congress was concerned about activities that were taking during the performance of the contract and that prompt payment should apply to in-process work as well. And so I think that is pretty clear in the 1988 amendments.

And, too, the law speaks in terms of requirements as acceptance of the property or services. We see the term "acceptance," but we also see, particularly in the 1988 amendments, "or a determination by such employee that such performance complies with contract terms and conditions." Again, my sense is that the act is much more flexible in its application than the FAR is as it relates to these types of issues.

In conclusion, Mr. Chairman, it is our recommendation that as you and this committee look at improvements to the Prompt Payment Act, we ask that you carefully consider the inequities that have resulted in its implementation. We strongly believe that there is no valid reason for service contractors to be singled out and treated differently because of the type of payments requested and submitted in a way that is inconsistent with the intent of the Prompt Payment Act.

We believe that the Government should promptly pay for services performed, that conform to contract terms and conditions in the same manner as other transactions. I would also advise you that we have requested that the FAR council revise the FAR language.

We have had meetings to this date with them on contract financing payments so that it complies with the intent of the law. We have also requested that the Office of Federal Financial Management revise OMB circular A–125 so that it, too, complies with the intent of the Prompt Payment Act. We hope the committee will stress these changes as well in its oversight capacity.

Thank you, Mr. Chairman, and I stand ready for any questions.

[The prepared statement of Mr. Mateer follows:]

Testimony of

Mr. Rodney W. Mateer

On behalf of the Professional Services Council

Wednesday, June 16, 1999

Before the House Subcommittee on National Security, Veterans Affairs, and International Relations

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Good morning, Mr. Chairman. I would like to thank you for the opportunity to comment today on the Prompt Payment Act, how it is being implemented and how the professional and technical services companies who work for the federal government are being harmed by certain deficiencies in that implementation.

I am a partner and national director of government consulting services with the firm of Deloitte and Touche. My company is a worldwide public accounting firm offering a variety of professional services in the areas of auditing, consulting, and taxation to a broad cross section of commercial and industrial clients. My company and a number of our clients are members of the Professional Services Council (PSC), the national trade association which I am representing today.

PSC's members are technology services companies that make up the fastest growing sector of our nation's economy. Our sector's products are ideas, problem-solving techniques and systems that enhance organizational performance. Primarily, these services are applications of professional, expert and specialized knowledge used to assist government and private-sector clients to solve operational, technical, and management problems. PSC's members are experts in areas such as defense, space, environment, energy, education, health, international development, and others. Members use research and development, information technology, program design, analysis and evaluation, and social science tools in assisting their clients to carry out programs. Overall, this sector performs $600 billion in services in the economy including more than $100 billion to the federal government, each year.

Before I explain the specific problems we are experiencing with implementation of the Prompt Payment Act (PPA), I want to emphasize a very important point. We acknowledge existing agency policies that enable payments to contractors, under certain circumstances, in less than the standard 30 days. For example, I know that the Department of Defense is able to process some payments in 7 to 14 days. That scenario is ideal and we would like to see that efficiency applied to all payments.

Rather, our concern rests primarily with the fact that an unacceptably high number of professional and technical services contractors are not getting paid in a prompt fashion. Indeed, some of our members have payments delayed 50, 80, 100 days and more. This can result in a significant cash drain on a company's operations, particularly for small business. Most companies secure lines of credit, or other forms of financing, to float the delinquent payments. This is an unfair hardship on contractors since the cost of financing interest is an unallowable cost under the Federal Acquisition Regulation (FAR).

Particularly perplexing, and in our opinion indefensible, is the fact that service contractors are in effect being treated differently than other federal contractors. The fundamental equity argument here is that the PPA does not intend to make a distinction between service and non-service contractors. The problem arises in the regulations and their interpretation in implementing the PPA.

Service contracts performed by both large and small contractors are typically reimbursed as interim payments, or as progress payments, based on costs incurred or fixed hourly rates. Regulations expressly exclude these forms of payment from

PPA coverage. However, each hour of labor billed and related costs incurred is a "service performed." If that service complies with the contract terms and conditions, and is billed with the appropriate information, the request for payment should, in fact, be subject to PPA.

I'm sure that other witnesses this morning will be commenting on the effectiveness of built-in safeguards that the government has to assess the validity of contract costs which enable the government to avoid overpayments, such as, audit oversight of billing and accounting systems, application of the Cost Accounting Standards and/or FAR cost principles, and the False Claims Act. It is our opinion that, properly employed, these safeguards are more than adequate to protect the government's, and ultimately the taxpayers', interests.

We are most interested in stressing the purpose of the PPA, which is to protect, to a certain degree, the contractor community by providing an incentive for the government to pay its bills in a timely manner, and to compensate contractors for delays in government payments. The PPA generally provides that the government must pay a proper invoice within 30 days after receipt. The Act applies to the acquisition of property or services. However, we believe that the regulations do not reflect the clear intent of the Act and are not in step with acquisition reform.

The current regulations properly state the law's purpose to pay contractors fairly for work performed. However, the regulations are at best unclear, or at worst inconsistent with the law regarding the exclusion of "contract financing payments" from PPA coverage. Regulations define a contract financing payment as: A *"government disbursement of monies to a contractor under a contract clause or other*

authorization prior to acceptance of supplies or services by the Government... includ[ing] advance payments, progress payments based on cost..., progress payments based on a percentage or stage of completion... and interim payments on cost-type contracts. Contract financing payments do not include invoice payments or payments for partial deliveries."[1]

We believe that the regulatory definition of a "contract financing payment" has resulted in the government's misapplication of the law's requirements. The definition has effectively legitimized the government's "acceptance" process as the basis for denying application of PPA. The definition is further deficient in that it categorically lists specific types of payments that are not covered by PPA. The FAR has also added other payment types that are excluded, e.g., performance-based payments and commercial item interim payments, which coincidentally are increasing in use as a result of acquisition reform.[2]

In contrast to the FAR language on contract financing payments, the law uses no such terminology, but instead focuses on the substance, not the form, of the payment. The legal prerequisites for application of PPA include: (1) an invoice, if required by the contract, for supplies delivered or services performed, and (2) acceptance of the property or services by an authorized agency employee or a determination by such employee that performance complies with the contract terms and conditions.[3]

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[1] FAR 32.902 defines contract financing payments. Progress payments based on cost fall under the clause at 52.232-16. Progress payments based on percentage or stage of completion fall under 32.102(e)(1).
[2] Performance-based payments are described in FAR 32.1001 and commercial item interim payments are covered by FAR 32.202-2.
[3] P.L. 100-496 (1988 PPA Amendments, 31 USC 3903, (a) (5).)

Mr. Chairman, it is our recommendation that as you and this committee look at improvements to the Prompt Payment Act, you carefully assess the inequities that have resulted in its implementation. We strongly believe that there is no valid reason for service contractors to be singled out and treated differently because of the type of payment request submitted, and in a way that is inconsistent with the intent of the PPA. We believe that the Government should promptly pay for services performed that conform to contract terms in the same manner as other transactions. We have requested that the FAR Council revise the FAR language on "contract financing payments" so that it complies with the intent of the Prompt Payment Act. We have also requested that the Office of Federal Financial Management revise OMB Circular A-125 so that it too complies with the intent of the PPA.

We hope that the committee will stress these changes, as well, in its oversight capacity.

Thank you, Mr. Chairman. I stand ready to answer any questions you have.

Mr. SHAYS. Thank you very much, Mr. Mateer.

Let me start with you, General McInerney. From your basic report, I think you wanted to make the point before we talked about Prompt Payment Act that you believe that we have to totally reexamine our military from a standpoint of what are its core missions as too much into administration and not for the combat. We refer to that as the "Tail-to-Tooth Commission." And this committee will be looking at that in some measure, or are we deferring to other committees on that, because I do think it is really one of the very key questions.

Your point, I think, was that the Prompt Payment Act is a tiny, tiny part of the overall. And I am going to accept that because I do concur. Even when it is a small part, we are still talking billions.

Mr. MCINERNEY. We think it is important, Mr. Chairman.

Mr. SHAYS. Yes, right. And you then made a number or recommendations. You, obviously, talked about your deep concern about DOD's financial practices, and we have strongly supported the outsourcing of key parts of DFAS. In some ways, I almost wish this panel goes first and then I can have the other panel follow, but it has been an improvement just to have DOD sit in with GAO and the inspector general. It has been helpful.

I am going to take your recommendations and I am going to ask Mr. Dinkins and Mr. Mateer and Mr. Kenny, please feel free to jump in, what you—I think there is consensus, and you have given me the structure to do that.

One was just general reforms of the Prompt Payment Act. And there is consensus here. I think that the service contracts should be included. Obviously, you think——

Mr. MCINERNEY. Yes, sir.

Mr. SHAYS. Yes. Mr. Dinkins, that service contracts should be——

Mr. DINKINS. Yes. Without having studied this at any length, it sounds reasonable.

Mr. SHAYS. It is reasonable but this isn't something you have really focused——

Mr. DINKINS. No. It is not our area of expertise.

Mr. SHAYS. Right. Mr. Mateer.

Mr. MATEER. Yes.

Mr. SHAYS. Clearly, yes. OK. The outsourcing of non-core DFAS functions, describe to me, first, Mr. McInerney, the difference between outsourcing. Oh, excuse me, that was basically Mr. Souder's comments and you responded to that. You think they haven't even gotten to first base on this issue?

Mr. MCINERNEY. Not at all. And we have studied very closely their RFP. They put out a request for proposal for those two, civilian pay and retired annuitant. It is a very convoluted request for proposal. It is 3,500 pages, including attachments. That stack or pile will go here. They have broken it down into four different proposals. And it is in the A–76 process. Frankly, Mr. Chairman, I don't think the industry is going to bid on it.

And, of course, they will win. And the danger of that is then they have what they call their most efficient organization, the MEO and the A–76 process, and they don't really jump forward on the latest

information technology and the latest business practices that industry today is using, and which we have a financial sector and people that do this in all industries. So they are not able to benchmark the very best practices.

And when they say several years, Mr. Chairman, they mean several years. They will say 2 to 3, but I think you will see, from being implemented, it ends up being 3 to 5.

Mr. SHAYS. One of the discouraging things from my standpoint, when we looked at healthcare billings, was that the Government would lock into a system that was obsolete practically before they even started to implement it.

Mr. MCINERNEY. That's correct.

Mr. SHAYS. Yes. Any comments on that, Mr. Dinkins, Mr. Mateer?

Mr. DINKINS. No.

Mr. MATEER. No.

Mr. SHAYS. Any disagreement about outsourcing, or is this just not something you have looked at?

Mr. MCINERNEY. Could I just add one thing on that so people understand? Companies like ADP, Automatic Data Processing, Inc., they pay 26 million people a month, 23 million in the United States, 3 million outside the United States. They are the largest payroll provider in the world. You have Ceridian that does 2 to 4 million. So you are often overwhelmed when Government witnesses come here, and the numbers that clearly DFAS states are correct.

Mr. SHAYS. Right.

Mr. MCINERNEY. It is not the numbers that is so significant. It is the processes they are using. Today, with computers, no one cares if it is a $1 billion airplane, B–2, a $2 billion B–2. The fact is, the process they are using, is that the best process?

Mr. SHAYS. Yes. I think that comes through pretty loud and clear in the hearings and other things we looked at.

Explain to me what you mean by the fixed-feeder systems.

Mr. MCINERNEY. Well, the fixed-feeder systems are, you know, the services have still large financial people working there, and they feed those dollars over to DFAS. Those, as I said in my testimony, those parts of their——

Mr. SHAYS. OK. I hear you.

Mr. MCINERNEY. So that interconnecting system needs to be improved.

Mr. SHAYS. When you refer to the services, I refer to them as the branches. Am I——

Mr. MCINERNEY. The branches, that is correct. Well, Army, Navy, Air Force are the services.

Mr. SHAYS. OK. Oh, good.

Mr. MCINERNEY. Same.

Mr. SHAYS. And so, your basic point is that what we are getting from them is just pretty antiquated?

Mr. MCINERNEY. That is correct. Time-consuming.

Mr. SHAYS. Any comments from others?

[No response.]

Mr. SHAYS. The activity-based costing, want to just explain that?

Mr. MCINERNEY. That is clearly what the private sector uses. So you know what each activity costs you. Today, unfortunately, in

Government, people don't know what it costs them to do different business processes. And because they don't, they don't know where to focus their effort.

And you hear the discussions on checks. It costs $8.50 to pay a uniform serviceman, but really the fully burdened cost, they had an activity-based costing system that could—it is probably $12.50. And so, they are not able to identify clearly what their costing is.

And the Congress has directed DOD to go into the activity-based costing, and they just have not aggressively pursued it.

Mr. SHAYS. Continued consolidation? That is the finance and accounting, merging the two?

Mr. MCINERNEY. Well, today the services still have 18,000 to 22,000. DFAS has roughly 20,000, and the services have, say, roughly, 20,000. So we have 40,000 people in the Department of Defense in finance and accounting.

Mr. SHAYS. And now when you do tooth to tail, that would be the tail?

Mr. MCINERNEY. That is correct.

Mr. SHAYS. But if you then outsource, we would still be legitimate and utilize the outsourcing costs when we look at tooth to tail?

Mr. MCINERNEY. Yes, sir. What I would say is, I got the chairman, General Shelton, when I told him that he had—this was a year-and-a-half ago—23,000 in DFAS and not one of them pulled a trigger; he went back and did his due diligence and found out from the staff that was correct. That is why we are working very closely with the Chiefs of—JCS.

Now, DFAS, the bill is about $1.67 billion today in their working capital fund that they get. We think the fully burden costs are higher. But the fact is, the private sector benchmark standards would probably be about half that, and you could save upwards of $800 million by using the very best business practices. Then you shift those dollars over to modernization that is required.

Wouldn't take it away from the services because they have a major problem in modernization. They are depreciating the force at $118 billion—the tanks, airplanes, and that—and last year they only modernized at $44 billion.

So the military is going to break. The aircraft in Bosnia today—I am digressing, but to give you feel of the importance of this—the average age in Kosovo is 26 years. So our force is aging, and this has not been brought up. And that is why what you are doing this oversight; it is so important to be looking in these areas. The Prompt Payment Act is worthwhile, the look you are giving it, because it is part of the overall problem.

Mr. SHAYS. And then, finally, you had mentioned about creating a board of oversight. I am just going to make a comment, and then I will ask the others, too.

Mr. MCINERNEY. Yes, sir. We think that by having, say, the service comptrollers involved and some private-sector people that have no vested interest in this, but that bring in the outside experience, would be very helpful.

Mr. SHAYS. Mr. Dinkins, when you were speaking, I was thinking, your basic task is you come in and you help chase the dollars and recover them. Then you take a percent of the recovered money.

Mr. DINKINS. Yes, the first task is to identify that there was, in fact, an overpayment.

Mr. SHAYS. Right. And I am struck by—the gentleman who had written "Up the Organization Man," Townsend, I think it was, he talked about how salesmen should get whatever they bring in business even if they get 10 times more than the president. And the foolish company is the one that starts to tell their salesmen that they are not going to get paid as much, and they start not having the sales.

So I am sympathetic to the fact that if you are able to bring in a certain amount, that you are going to take a percent of it, but the one thing I don't want to make is it so easy because we are so foolish in our overpayments that you come in and quite easily get that. I would rather it be more difficult for you. And then you will have earned your percent, which is to say, is your assessment—you made comparisons of percent—is your assessment when you have looked at this, that there are some overpayments that clearly never should have been made?

Mr. DINKINS. Yes. Well, I would revise that to say that overpayments always occur in every organization that we work for, which includes the largest corporations around the world. They always occur. It is a fact of life.

Mr. SHAYS. I realize that. I really do. But it is kind of astounding to me to think of $1 billion coming back, and most of it, a chunk of it voluntarily. That is a lot of money.

Mr. DINKINS. Right. It is probably appropriate to comment here; there was some prior discussion about that fact. In the private sector, there is no obligation to tell another private-sector company that they have been overpaid. And I think that is the same situation you will find with the Government.

You will find instances——

Mr. SHAYS. So I hear you clearly, you mean there is no obligation for the company to return the money?

Mr. DINKINS. Absolutely. Unless it is found—actually, in many cases they don't know where to apply it. So they don't even, in fact, know they have been overpaid. They just know that they have unapplied cash sitting in an account and don't know what to tag it.

Mr. SHAYS. Must be wonderful.

Mr. DINKINS. So they let it sit there until it is identified and that they have something to tag it to. And then they are happy to give it back.

And, you know, a further point of view is that——

Mr. SHAYS. So that really argues for making sure we don't overpay?

Mr. DINKINS. Yes, but even as diligent as you will be on the front end of that process, there will always be overpayments. And this process is one to ensure that they are identified and recovered.

Mr. SHAYS. Especially when you have archaic systems.

Mr. DINKINS. Yes.

Mr. SHAYS. I mean, if you have already made a payment and you get an invoice that says you owe a 100 percent when you have paid 30 percent already, and you just don't have that on your records

because you can't compare the data, you are going to make overpayments you should never make.

Mr. DINKINS. Yes, but this is not a unique situation to the Federal Government. You can go to—I mean, the people who get the money last in every organization tends to be accounts payable in back-office financial systems.

Mr. SHAYS. Yes. I learned something about the private sector. And the difference is, when the private sector is foolish, they go out of business. And I remember Combustion Engineering; they went out of business. And they had two buildings, and the CEO didn't like the fact that the underground passageway sloped down. He wanted it straight across. And he spent a half a million dollars to have a straight tunnel instead of a sloping one. And I thought, if we had done that in Government, we would have been very criticized. I don't use the private sector always as the benchmark.

Mr. DINKINS. Right.

Mr. SHAYS. But, with the private sector, especially when times aren't good, they go out of business. So we don't have that same kind——

Mr. DINKINS. True, but their priorities are different. For example, if a large retailer has $100 million to spend, they are more likely to spend it on new stores and merchandise as opposed to fixing a back-office system. But they do get around to fixing these things.

Mr. SHAYS. Yes.

Mr. DINKINS. It is probably worth mentioning that this process of recovery auditing is a repetitive process that just goes on year after year, and try as our clients will to clean it up, there are always overpayments.

Mr. SHAYS. Right. You are still going to have work from DOD; I just want to make sure that we reduce. I think that any organization—I go back to my first point, the salesman who makes the sale should get that percent. If you are able to recover money that we wouldn't have recovered otherwise, God bless you.

Mr. DINKINS. One thing to keep in mind though: This is a little bit like an automotive assembly line. For every minute that goes by, it is one more car that doesn't come off the line if it stops. And this process is similar in the sense that you can only go back so far before the records become too aged. In the private sector, typically, this year we would be auditing last year—not 4 and 5 years ago.

And so I would encourage the committee to think about how to expedite the process such that it is more current to the transaction.

Mr. SHAYS. Well, I am left with one bias, and that is that privatization or outsourcing is more important in the public sector because what we pay our employees and our ability to modernize is, I think, a greater lag in the public sector. And so I don't think we are always able to be on the cutting edge. The private sector, I think, clearly has a better option.

Let me ask each of you if you would like any closing comments. And, Mr. Kenny, is there any comment you would want to make, any statement that you would like to—any observation, actually?

Mr. KENNY. No.

Mr. SHAYS. OK. Mr. Mateer.

Mr. MATEER. I have no additional comments.

Mr. SHAYS. OK. Mr. Dinkins.

Mr. DINKINS. No, sir.

Mr. SHAYS. Thank you. I really appreciate your testimony. I think it is very helpful. And we obviously have lots of opportunities here. Thank you very much.

This hearing is closed.

[Whereupon, at 12:02 p.m., the subcommittee was adjourned.]