June 2000

CONTRACT MANAGEMENT

DOD's Use of Recovery Auditing
B-284763

June 5, 2000

The Honorable Thomas Harkin
United States Senate

The Honorable Peter DeFazio
The Honorable George Miller
The Honorable Carolyn Maloney
House of Representatives

You requested that we evaluate the Department of Defense’s (DOD) use of recovery auditing, a process that identifies and collects overpayments made to vendors. This report assesses DOD’s progress in (1) recovering overpayments and the reasons for any delays and (2) expanding the use of recovery auditing. It responds to your request and updates information we reported in 1998 and 1999.1

Although the vast majority of payment transactions are processed correctly, errors occur. Vendors may make pricing errors on their invoices, forget to apply advertised discounts, neglect to offer allowances and rebates, miscalculate freight charges, and so forth. These mistakes, when not caught, result in overpayments. In 1996, the Defense Supply Center, Philadelphia, hired a private firm to identify overpayments on its purchases of food and grocery items, clothing and textiles, and medicines and medical supplies. This effort was a demonstration program exploring the applicability of recovery auditing to DOD purchases. The recovery auditor, Profit Recovery Group International, identified and documented overpayments. The Supply Center reviewed identified overpayments, accepted those it viewed as valid and supported, and initiated collection efforts. If the DOD contracting officer could not resolve the claim through negotiation, the officer issued a letter of final decision demanding payment of the claim. Vendors have the right to appeal the contracting officer’s final decision to the Armed Services Board of Contract Appeals or to a federal court.

Since the program began in 1996, the Defense Supply Center has collected $5.3 million of the $17.9 million in overpayments it now recognizes as valid. The Supply Center has written letters to vendors demanding payments of an additional $4.0 million and continues to negotiate with other vendors to settle disputed payments. The collection process has proceeded slowly in part because of the time and effort required to review disputed claims. In particular, the Supply Center and vendors disagree over the interpretation of contract provisions that require vendors who sell brand-name products to guarantee that prices offered to the government are as good as those offered to their most favored customers. Thirty-four of the 59 vendors who have received letters demanding payment have appealed to the Armed Services Board of Contract Appeals.

DOD is expanding its use of recovery auditing. Since June 1999, six Defense agencies have contracted for recovery audit services, and a seventh is planning to do so soon.

To minimize disagreements between DOD and vendors in the future, we are recommending that, after the Armed Services Board of Contract Appeals rules on the appeals, DOD examine the need to clarify price warranty provisions in its contracts. DOD concurred with our recommendation.

In September 1996, the Defense Supply Center, Philadelphia, awarded a contract to Profit Recovery Group International for recovery auditing services. This demonstration program responded to a congressional mandate (section 354 of the Fiscal Year 1996 National Defense Authorization Act) to evaluate the feasibility of using private firms to identify overpayments to vendors. Under the program, the recovery auditor was tasked with identifying potential overpayments. The Supply Center would then assess whether proposed claims were valid and adequately supported and would begin collection efforts for those it recognized as valid. Collection efforts continue, although the demonstration program ended in November 1999.

To collect an overpayment, a contracting officer can notify a vendor by issuing a letter of apparent indebtedness. If the claim is not resolved through negotiations, federal regulations require the contracting officer to issue a letter of final decision demanding payment. The vendor can send the government payment for the amount owed or, more typically, the government can offset the claim against future invoices submitted by the
vendor. A vendor can appeal the contracting officer's final decision to the Armed Services Board of Contract Appeals or a federal court.

The contracts identified by the recovery auditor involving possible overpayments included purchases of subsistence (food and grocery) items, clothing and textiles, and medicines and medical supplies made during fiscal years 1993-95. The food and grocery items were purchased by the Supply Center for resale to the Defense Commissary Agency and shipped to commissaries in Europe. Many of these purchases involved brand-name products, such as Kellogg's Corn Flakes, and a specific brand was specified for procurement, precluding full and open competition.3

In 1998, the House report (H.R. Rep. 105-532) accompanying the fiscal year 1999 DOD authorization bill directed DOD to expand its use of recovery auditing to at least two commercial functions within its working capital funds accounts2 and to issue a competitive request for proposals by December 31, 1998. In March 1999, we reported that DOD had not expanded the program as directed because it was still reviewing the merits of recovery auditing.

DOD Has Achieved Limited Progress in Recovering Overpayments

By the time the demonstration program ended in November 1999, the recovery auditor had identified $30.4 million in potential overpayments, and the Supply Center had recognized $22.9 million as valid and supported. On March 1, 2000, however, the Supply Center reduced that figure to $17.9 million because it concluded it did not have sufficient data to support $5.0 million in overpricing claims. (Additional data on overpayment claims is in app. I.)

From 1996, when the program began, until March 2000, the Supply Center recovered $5.3 million in overpayments and wrote letters of final decision demanding payment of $4.0 million. Thirty-four vendors have appealed to

---

2 In its comments, DOD pointed out that brand-name products were a small subset of food items purchased by the Supply Center.

3 Working capital fund agencies bill customers, primarily the military services, for the cost of their operations. A working capital fund is a revolving fund that generally relies on sales revenues, rather than direct appropriations, to finance its operations.
the Armed Services Board of Contract Appeals. In response to the appeals, the Supply Center has suspended collection efforts on these claims.\(^4\)

The collection process to recover overpayments has proceeded slowly because, according to the Supply Center, it takes a long time to review vendors' positions on these claims. The Supply Center's efforts to collect overpayments included sending letters of apparent indebtedness to vendors, rather than letters demanding payment, to afford vendors the time to provide documentation refuting overpayment claims. The Supply Center also hosted legal reviews and numerous meetings, both within government and with vendors, to review overpayment claims and the methodology by which the claims were determined. In addition, Supply Center officials stated that they tried to negotiate settlements to preclude appeals to the Armed Services Board of Contract Appeals or federal court. Although some recoveries were realized, vendors generally did not agree with the claims. Consequently, the Supply Center issued letters of final decision demanding payment. Because of the appeals, the Supply Center does not plan to pursue additional claims on the basis of the same issues until the Armed Services Board of Contract Appeals issues a ruling. However, the Supply Center continues to attempt to negotiate with vendors to resolve other claims and reach settlement.

Vendors Disagree With the Supply Center's Interpretation of Contract Price Warranty Provisions and Overpricing Claims

A majority of overpayments claims are based on a contract clause that requires vendors of brand-name subsistence items to warrant that all prices offered the government be as low as those offered to their most favored customer.\(^5\) This price warranty provision is included in contracts for brand-name products, such as Kellogg's Corn Flakes because specifying a brand precludes full and open competition.

This provision expressly includes quantity discounts, allowances, rebates, special promotions, and billing advantage. The Supply Center maintains that the contractual obligation to offer the government the same billing

\(^4\) In its comments, DOD pointed out that the Supply Center suspended collection action against vendors who requested a deferment until the Defense Logistics Agency (the headquarters agency for the Supply Center) completes its evaluation of the request.

\(^5\) This provision was in contracts for subsistence items bought by the Supply Center for resale to the Defense Commissary Agency. Because the Supply Center no longer purchases these items for the Defense Commissary Agency, it no longer includes this provision in its contracts. However, the Commissary Agency uses similar language in its contracts.
advantage as is offered to a brand-name vendor's most favored customer includes cash discounts for prompt payment. For example, many vendors offer commercial customers 2-percent discounts if the bill is paid within 10 days rather than 30 days.

To ensure compliance with the price warranty, contracts for brand-name products give the government's contracting officer the right to examine the vendor's books, documents, records, and any other evidence necessary to determine the basis for the prices offered. The price warranty provision states that the government's examination "...will compare the average price paid by the government versus commercial customers for the same item during the offeror's latest fiscal year." As a result of the price warranty provisions, the recovery auditor identified overpayments for:

- cash discounts offered to commercial customers that had not been offered to the Supply Center and
- overpricing (the Supply Center paid a higher price than commercial customers).

However, when letters of apparent indebtedness were initially sent and, more recently, when letters of final decision demanding payment were sent to vendors of brand-name items, vendors protested. Many disagreed with the Supply Center's cash discount claims. Some argued that (1) they had already deducted the discount from the price in their invoice; (2) other benefits the government received, such as vendor stocking and in-store demonstrations, compensated for not offering cash discounts; and (3) cash discounts were not offered because, historically, the government did not pay its bills within the discount period.

In contrast, the Supply Center contends that a cash discount is not a component of a product's unit cost but rather recognition of the time-value of money and is designed to induce accelerated payment of invoices. Hence, regardless of the price of an item, if cash discounts were offered to commercial customers for prompt payment, they should have been offered to the Supply Center. In response, vendors argue that the basis of an overpayment claim, as specified by contract, is the average price paid by the government versus commercial customers for the same item during the offeror's latest fiscal year. As a result, they dispute the Supply Center's claim that a cash discount is separate and distinct from the average price paid by the government.
Vendors also contest overpricing claims. Vendors argue that the government received most favored customer prices because of price reductions given directly to European commissaries. Vendors maintain that they gave price reductions directly to the European commissaries for promotional purposes and that these reductions reduced costs to most favored customer prices.\(^6\)

Vendors also argue that the methodology used to establish overpricing claims is flawed because, for example, the claims were based on what the government paid, rather than the prices offered to the government. According to vendors, due to consumer demand patterns, the government does not accept all promotional offers. For example, because commissary customers may choose to buy relatively large quantities of 40-ounce containers of catsup compared with 14-ounce containers, commissaries will likely accept all of a vendor's promotional dollars for catsup in the 40-ounce size. This translates into a price reduction for the larger container of catsup but not for the smaller. Hence, the commissary rejected promotional offers, and thus price reductions, on the 14-ounce containers. Vendors contend that overpricing claims did not reflect price reductions rejected by the government but accepted by a commercial customer. They say that the price warranty provision covers prices offered, not prices received. Finally, vendors argue that higher prices are driven by the additional costs of doing business with the government, including (1) the requirement to distribute and deliver products to commissaries, (2) the regulation for extra stenciling, labeling, and marking on cases, and (3) the need for personnel familiar with military buying practices in both customer service and accounts receivable.

Generally, the Supply Center and its recovery auditor could not verify that price reductions received after the payment transaction reduced costs to most favored customer prices because supporting documentation was not available or not easily retrieved. For example, although the recovery auditor reviewed documentation maintained at both the Defense Finance and Accounting Service (the payment center) and the Supply Center, neither of these organizations had been apprised of or had received any documentation relating to the deals and allowances made after the Supply Center resold brand-name products to European commissaries. Claims for overpayment were made on the basis of documentation made available to

\(^6\) Price reductions are given through vendor credit memoranda and these credit memoranda result in the vendor writing a check directly to the commissary.
the recovery auditor. Also, the recovery auditor did not have documentation on promotional price reductions that had been accepted by commercial customers but not by the government. Records of deals and allowances resulting in price reductions are located at the commissaries in Europe or with vendors.

The Supply Center attempted to obtain the pricing information and financial data needed to substantiate the vendors’ arguments, first by requesting the data from the Defense Commissary Agency and then directly from the vendors. The Commissary Agency responded that it did not have the resources to provide the required documentation and did not provide the requested data. The vendors did not provide the documentation either. Vendors responded that the price warranty provision gives the government the right to examine their books, documents, records, and any other evidence necessary to determine the basis of prices offered. However, they argue that the government has only the right of access and that they are not required to conduct a review of their own records and select documentation for the government’s review. Further, some vendors said it would take a large number of hours and a substantial financial cost to retrieve the requested data, if it were still available, from fiscal years 1993-95.

In the end, the Supply Center pursued overpayment claims on the basis of cash discounts and began issuing letters of final decision demanding payment. The Supply Center believes that in order for vendors to contest these claims successfully, they must present documentation that supports their position. However, the Supply Center chose not to pursue the $5 million in overpayment claims that were based on overpricing because it did not have sufficient documentation to verify whether price reductions were given directly to European commissaries, reducing prices to those of most favored customers.

The House report (H.R. Rep. 105-532) accompanying the fiscal year 1999 DOD authorization bill directed DOD to expand the recovery audit demonstration to at least two commercial functions within its working capital fund agencies. The report directed DOD to issue a competitive request for proposals by December 31, 1998.

DOD did not expand the program by December 1998 because it was still reviewing the merits of recovery auditing. However, in response to an August 1998 DOD memorandum encouraging the use of recovery auditing,
the Defense Logistics Agency has contracted competitively for audit recovery services at all four of its buying centers. In addition, the U.S. Transportation Command and a Navy working capital fund have also contracted for recovery audit services. Finally, a working capital fund agency within the U.S. Army Tank-Automotive and Armament Command plans to contract for recovery audit services by June 30, 2000. The working capital fund agencies that have contracted or soon plan to contract for recovery audit services are shown in table 1.

Table 1: Working Capital Fund Agencies That Have Contracted or Soon Plan to Contract for Recovery Audit Services

<table>
<thead>
<tr>
<th>Working capital fund agency</th>
<th>Date of recovery audit contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Transportation Command</td>
<td>June 9, 1999</td>
</tr>
<tr>
<td>Defense Supply Center–Philadelphia</td>
<td>September 1, 1999</td>
</tr>
<tr>
<td>Defense Supply Center–Columbus</td>
<td>September 1, 1999</td>
</tr>
<tr>
<td>Defense Supply Center–Richmond</td>
<td>September 1, 1999</td>
</tr>
<tr>
<td>Defense Energy Supply Center</td>
<td>September 1, 1999</td>
</tr>
</tbody>
</table>

The Air Force has expressed an interest in recovery auditing and is evaluating whether to use it, as have the other recipients of the August 1998 DOD memorandum, the Defense Commissary Agency, Defense Information Services Agency, and Defense Finance and Accounting Service.

Conclusions

The recovery audit process identified overpayments to vendors of grocery, medical, and clothing items. Collections of these claims have been slow, in large part due to disagreements between vendors and the Supply Center. These disagreements center on the meaning of contract provisions covering the pricing of brand-name items. These issues are currently before the Armed Services Board of Contract Appeals.
Recommendation

To minimize disagreements between DOD and vendors in the future, we recommend that, after the Armed Services Board of Contract Appeals rules on the appeals, the Secretary of Defense examine the need to clarify price warranty provisions in its contracts.

Agency Comments and Our Evaluation

In written comments on a draft of this report, DOD concurred with our recommendation. DOD stated that recovery auditing is a tool of good government and is useful for identifying overpayments and underpayments and providing feedback for continuous process improvement. It also stated that since some claims are under litigation, our report should only discuss arguments that have been made to the Armed Services Board of Contract Appeals. DOD also offered technical comments, which we incorporated as appropriate. DOD comments are reprinted in appendix II.

All of the arguments presented in the report were expressed to us by either vendor or government officials. We have not limited our presentation to arguments made to the Board and DOD offered no rationale for such a limitation. Rather, we included these issues to illustrate that price warranty clauses have been subject to varying interpretations.

Scope and Methodology

To determine the progress DOD has achieved in recovering contractor-identified overpayments since our first report, we reviewed the types and amounts of overpayments the Supply Center considered as valid and supported. We then reviewed the efforts the Supply Center made to notify vendors of the overpayments and to recover them. We also obtained the views on the validity of the overpayment claims from the vendor community through the correspondence they sent to the Supply Center and by interviewing officials from their trade association, the American Logistics Association, and two vendors, General Mills and Kraft Foods, Inc.

To determine the progress DOD has achieved in expanding its use of recovery auditing, we obtained information from the recipients of an August 1998 DOD memorandum encouraging the use of recovering auditing.

We performed our work at the Defense Finance and Accounting Service—Columbus, Columbus, Ohio; the Defense Supply Center—Philadelphia, Philadelphia, Pennsylvania; the Defense Commissary Agency, Fort Lee,

We performed our review from October 1999 through March 2000 in accordance with generally accepted government auditing standards.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to interested congressional committees; the Honorable William Cohen, Secretary of Defense; the Honorable F. Whitten Peters, Secretary of the Air Force; the Honorable Louis Caldera, Secretary of the Army; the Honorable Richard Danzig, Secretary of the Navy; Lieutenant General Henry T. Gilsom, Director of the Defense Logistics Agency; the Honorable Jacob Lew, Director of the Office of Management and Budget; and other interested parties. We will make copies available to others upon request.

Please contact me at (202) 512-4587 if you or your staff have any questions concerning this report. Key contributors to this report were Karen S. Zuckerstein and Daniel J. Hauser.

[Signature]

David E. Cooper
Associate Director
Defense Acquisitions Issues
Table 2: Amounts of Overpayments Identified and Recovered by Commodity, as of March 6, 2000

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Number of vendors</th>
<th>Identified</th>
<th>Recovered</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subsistence</td>
<td>219</td>
<td>$12,517,455</td>
<td>$2,043,220</td>
</tr>
<tr>
<td>Medicines and medical supplies</td>
<td>27</td>
<td>2,849,595</td>
<td>2,060,251</td>
</tr>
<tr>
<td>Clothing and textiles</td>
<td>48</td>
<td>2,519,826</td>
<td>1,240,806</td>
</tr>
<tr>
<td>Total</td>
<td>294</td>
<td>$17,886,876</td>
<td>$5,344,277</td>
</tr>
</tbody>
</table>

Source: Profit Recovery Group International.
### Table 3: Types and Amounts of Overpayments Identified and Recovered, as of March 6, 2000

<table>
<thead>
<tr>
<th>Type</th>
<th>Identified</th>
<th>Recovered</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash discounts</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Not offered (discount not offered to the Supply Center but offered to commercial customers)</td>
<td>$12,033,919</td>
<td>$1,709,855</td>
</tr>
<tr>
<td>2. Earned but not taken (the payment system did not override cash discount terms specified in contract with more liberal terms specified on invoice)</td>
<td>609,373</td>
<td>306,656</td>
</tr>
<tr>
<td>3. Deducted at wrong rate</td>
<td>104,237</td>
<td>98,858</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td><strong>$12,747,529</strong></td>
<td><strong>$2,115,369</strong></td>
</tr>
<tr>
<td>Overcharge by comparison (vendor charged the Supply Center more than its most favored customer)</td>
<td>1,851,865</td>
<td>925,943</td>
</tr>
<tr>
<td>Duplicate payment</td>
<td>597,153</td>
<td>437,549</td>
</tr>
<tr>
<td>Unposted credit memorandum (as a result of returned merchandise, vendor sent a credit memorandum that remained outstanding)</td>
<td>1,429,998</td>
<td>1,267,435</td>
</tr>
<tr>
<td>Accounting error</td>
<td>440,985</td>
<td>450,102*</td>
</tr>
<tr>
<td>Price protection (losses to the value of a retailer's inventory, should a vendor reduce prices to other retailers)</td>
<td>519,128</td>
<td>124,329</td>
</tr>
<tr>
<td>Allowances (vendor failed to give financial considerations in exchange for meeting specific requirements such as advertising or promotional sales)</td>
<td>33,797</td>
<td>0</td>
</tr>
<tr>
<td>Shortage discrepancy (vendor sent less than the quantity ordered)</td>
<td>421</td>
<td>421</td>
</tr>
<tr>
<td>All other errors</td>
<td>266,000</td>
<td>23,130</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$17,886,876</strong></td>
<td><strong>$5,344,278</strong></td>
</tr>
</tbody>
</table>

* One vendor, in responding to an overpayment claim, identified and repaid an additional $9,117 in overpayments.

Source: Profit Recovery Group International.
Mr. David E. Cooper  
Associate Director, Defense Acquisitions Issues  
National Security and International Affairs Division  
U.S. General Accounting Office  
Washington, D.C. 20548

Dear Mr. Cooper:

This is the Department of Defense (DoD) response to the GAO draft report, "CONTRACT MANAGEMENT: DoD's Use of Recovery Auditing", dated April 7, 2000 (GAO Code 707440/OSD Case 1981).

GAO recommends that, after the Armed Services Board of Contract Appeals rules on the appeals, DoD should examine the need to clarify price warranty provisions in its contracts. The Department concurs with comment on this recommendation. The Department's detailed response to the recommendation is contained in the attachment.

Since some claims are under litigation, arguments regarding the "price warranty clause" should be limited to arguments made to the Armed Services Board of Contract Appeals, which is of public record. Most of the arguments that are listed in the audit were not made to the Armed Services Board of Contract Appeals and therefore should be eliminated.

Recovery audit is a valuable management tool and the Department is expanding its use, where applicable, as part of ongoing efforts to improve business practices.

[Signature]

BRUCE A. DAUER  
DEPUTY COMPTROLLER  
(PROGRAM/BUDGET)
GAO DRAFT REPORT DATED APRIL 7, 2000
(GAO CODE 707473) OSD CASE 1938

"CONTRACT MANAGEMENT: DoD's Use of Recovery Auditing"

DEPARTMENT OF DEFENSE COMMENTS TO
THE GAO RECOMMENDATION

RECOMMENDATION: The GAO recommends that after the Armed Services Board of Contract
Appeals rules on the appeals, DoD should examine the need to clarify price warranty provisions in its
contracts.

DOD RESPONSE: Concur with comments.

The Defense Department wants to make the point that it is expanding its use of recovery auditing and
is committed to improving its business practices. Recovery audit is a tool of good government. The
fact that the process identifies overpayments and underpayments provides feedback for continuous
process improvement. DoD notes that the validated recovery amounts from the 3 year prototype to
date and the associated percentage error rate are comparable to those experienced by the leading
corporations using recovery audit.

The report implies that the Defense Supply Center (a component of the Defense Logistics Agency)
buys only brand-name products. Brand-name products, purchased for resale in commissaries, are a
smaller sub-set of the total food items purchased for troop support at the center.

Footnote 2 states that the contract clause was in use in contracts for subsistence items. That is
misleading. The clause was used only for brand name items for resale in the commissary. There
were thousands of other subsistence item contracts awarded by the Defense Supply Center that did not
contain the contract clause.

On page 4, the second paragraph includes an incorrect statement. The center did not suspend
collection efforts on these claims. The center suspended collection action for vendors who requested
a deferment until the Defense Logistics Agency completed its evaluation of the request.

Since some claims are under litigation, arguments regarding the "price warranty clause" should be
limited to arguments made to the Armed Services Board of Contract Appeals, which is of public
record. Most of the arguments that are listed in the audit were not made to the Armed Services Board
of Contract Appeals and therefore should be eliminated.

Attachment to Memo
GAO Draft Report,
OSD Case 1938

Now on p. 3.
Ordering Information

The first copy of each GAO report is free. Additional copies of reports are $2 each. A check or money order should be made out to the Superintendent of Documents. VISA and MasterCard credit cards are accepted, also.

Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:
U.S. General Accounting Office
P.O. Box 37050
Washington, DC 20013

Orders by visiting:
Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders by phone:
(202) 512-6000
fax: (202) 512-6061
TDD (202) 512-2537

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

Orders by Internet:
For information on how to access GAO reports on the Internet, send an e-mail message with "info" in the body to:

info@www.gao.gov

or visit GAO’s World Wide Web home page at:

http://www.gao.gov

To Report Fraud, Waste, or Abuse in Federal Programs

Contact one:
- e-mail: fraudnet@gao.gov
- 1-800-424-5454 (automated answering system)

PRINTED ON RECYCLED PAPER