

August 17, 2005



Financial Management

Identification and Reporting of DoD Erroneous Payments (D-2005-100)

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Acronyms

DFAS	Defense Finance and Accounting Service
GAO	Government Accountability Office
OMB	Office of Management and Budget
DJMS	Defense Joint Military Pay System
USD(C)/CFO	Under Secretary of Defense (Comptroller)/Chief Financial Officer



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

August 17, 2005

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE
(COMPTROLLER)/CHIEF FINANCIAL OFFICER

SUBJECT: Report on the Identification and Reporting of DoD Erroneous Payments
(Report No. D-2005-100)

We are providing this report for information and use. We considered management comments on a draft of this report in preparing the final report.

The Deputy Chief Financial Officer comments on the draft of this report conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the staff. Questions should be directed to Mr. James L. Kornides or Mr. Curt W. Malthouse at (614) 751-1400. See Appendix B for the report distribution. The team members are listed inside the back cover.

By direction of the Deputy Inspector General for Auditing:

Patricia A. Marsh
for Paul J. Granetto, CPA
Assistant Inspector General
Defense Financial Auditing
Service

Department of Defense Office of Inspector General

Report No. D-2005-100

(Project No. D2004-D000FJ-0118.000)

August 17, 2005

Identification and Reporting of DoD Erroneous Payments

Executive Summary

Who Should Read This Report and Why? DoD financial managers and contracting officials responsible for identifying and reducing erroneous payments should read this report. It discusses ways in which DoD can more accurately analyze and report erroneous payments.

Background. The Office of Management and Budget requires Federal agencies to complete annual reviews to determine whether programs and activities may be making significant erroneous payments. It also requires DoD to report estimates of the annual amount of erroneous payments made by programs and activities designated as susceptible to making such payments, and to report in the DoD Performance and Accountability Report on progress made in reducing them. For FY 2004, DoD reported in the annual Performance and Accountability Report that none of its programs and activities exceeded the Office of Management and Budget reporting thresholds for erroneous payments.

Results. In FY 2004, DoD improved its process for reviewing programs and activities and identifying and reporting on those susceptible to making significant erroneous payments. Using an improved data call, DoD estimated that there were approximately \$977.5 million in erroneous payments associated with its operations in FY 2004. Additionally, DoD identified the military pay activity as being at high risk for erroneous payments. However, additional improvements were needed. DoD did not complete its preliminary estimates or identify the high risk areas until January 2005. As a result, the amount of erroneous payments DoD reported in its FY 2004 Performance and Accountability Report was understated, and DoD did not report the new high-risk area. DoD needs to continue to improve the process of gathering and analyzing data to develop an accurate baseline from which it can measure progress in reducing the likelihood of erroneous payments. (See the Finding section of the report for the detailed recommendations).

Management Comments and Audit Response. The Deputy Chief Financial Officer concurred with the audit recommendations. She planned to issue guidance on estimating improper payments early in each fiscal year and indicated DoD has taken action to use sampling techniques to measure the dollar amount of improper payments. She planned to explore the use of DoD improper payments survey data in post-payment reviews to reduce the risk of pecuniary liability to accountable officials and certifying officers. Additionally, the Deputy Chief Financial Officer believed the improper payment survey data collected by DoD are a fair representation of actual improper payments. She stated that although the amounts DoD reports are well below the Office of Management and Budget criteria for reporting them as high risk, DoD recognizes the need for a comprehensive, statistically sound methodology to estimate and baseline commercial payments and it plans to report the lack of this methodology as a material weakness.

The Chief Financial Officer (Health Affairs) provided unsolicited comments and he disagreed with the report's conclusions that the sample of medical claims his office conducted was not valid. He indicated he did not include claims under \$100 in his sample because Government risk is not involved. He cited a study completed in FY 2000. We disagree with the comments. The Health Affairs statistician who designed the sample determined that the sample was not appropriate for estimating the total amount of erroneous payments. In addition, Health Affairs operations have changed since the FY 2000 study. For example, in FY 2003, Health Affairs began making secondary payments on medical claims from the DoD Medicare Eligible Retiree Health Care Fund. Health Affairs needs to ensure that all Medicare secondary payments are included in samples because that area has been determined to be high risk by the Office of Management and Budget.

See the Finding section of the report for a discussion of management comments and the Management Comments section of the report for the complete text of the comments.

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Background

In FY 2002 the President sent to Congress an agenda focused on improving the management and performance of the Federal Government. One component of the President's management agenda was an initiative to improve financial management by reducing erroneous payments. In May 2003, the Office of Management and Budget (OMB) issued memorandum M-03-13, "Improper Payments Information Act of 2002," (OMB Memorandum M-03-13), that outlines how Federal agencies should reduce erroneous payments, including the following four steps.

- Review all programs and activities and identify those that are susceptible to significant erroneous payments.
- Statistically estimate the annual amount of erroneous payments for those programs and activities making significant erroneous payments.
- Implement a plan to reduce the incidence and amounts of erroneous payments.
- Report estimates of the annual amount of erroneous payments made by programs and activities and progress made in reducing them.

The memorandum defines erroneous payments as any payment that should not have been made or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirement. Erroneous payments include the following.

- overpayments;
- underpayments (including inappropriate denials of payment or service);
- payments to an ineligible recipient or for an ineligible service;
- duplicate payments;
- failure to reduce payments by applicable sales discounts, cash discounts, rebates, or other allowances; and
- payments for items not received.

The memorandum requires agencies with more than 2.5 percent of annual payment amounts, as well as more than \$10 million in annual erroneous payments, to estimate the annual amount of erroneous payments made by the agency's programs and activities.

Objective

The audit objective was to determine whether DoD adequately reviewed all programs and activities it administered, and identified and reported those that may be susceptible to making significant erroneous payments. We also determined whether DoD adequately estimated the amount of erroneous payments and prepared accurate progress reports on actions to reduce them. See Appendix A for a discussion of the audit scope and methodology and prior audit coverage.

DoD Erroneous Payments

In FY 2004 DoD improved its process for reviewing programs and activities and identifying and reporting on those susceptible to making significant erroneous payments; however, there is still room for improvement. Using an improved data call, DoD estimated that there were approximately \$977.5 million in erroneous payments associated with its operations in FY 2004.* DoD also added the military pay activity group to its list of activities considered to be at high risk for making erroneous payments. However, DoD did not complete its preliminary estimates or identify the additional high-risk area until January 2005 because the Under Secretary of Defense (Comptroller)/Chief Financial Officer (USD[C]/CFO) was not timely in disseminating guidance for erroneous payment data collection. Further, the guidance did not adequately address the use of statistical methods. Additional delays resulted because the Defense Finance and Accounting Service (DFAS) had not fully developed a standard method for gathering and analyzing erroneous payment data. As a result, DoD did not report the military pay activity as high risk in the 2004 Performance and Accountability Report, and the amount of estimated erroneous payments it reported was misstated. Further, DoD cannot effectively measure its progress in reducing the incidence of erroneous payments without an accurate baseline to measure against.

Timeliness of Guidance

One of the primary reasons for the delay in determining the extent of erroneous payments in FY 2004 was the lack of timely guidance. The USD(C)/CFO did not issue policy on collecting information and reporting on DoD erroneous payments until October 2004.

Specifically, on October 7, 2004, the USD(C)/CFO issued a policy memorandum to implement the annual review requirements of OMB Memorandum M-03-13. The memorandum instructs the Military Departments and other DoD agencies and organizations to assist DFAS in completing a survey to identify erroneous payments made in FY 2004. The memo followed step one of the OMB Memorandum M-03-13.

Review all programs and activities and identify those which are susceptible to significant erroneous payments. Many agencies already know which programs and activities are at the highest risk of erroneous payments. Agencies shall institute a systematic method of reviewing all programs and identifying those it believes are susceptible to significant erroneous payments. For the purposes of this guidance, significant erroneous payments are defined as annual erroneous

* The DoD universe of payments made by programs and activities totaled about \$521.1 billion, so erroneous payments of \$977.5 million equal about two-tenths of a percent of the total.

payments in the program exceeding both 2.5% of program payments and \$10 million. The agency shall maintain documentation to support this review and the results.

The policy memorandum also requires the Military Departments, Defense agencies, and Defense activities to address payment areas within a program or activity that may have a greater risk of erroneous payments than the overall program or activity. The guidance requires narrative risk assessments that address the strength of internal control procedures in place to prevent improper payments, system weaknesses identified internally or by outside audit activities, and voluntary returns of overpayments by vendors.

The sheer size of DoD prevented the timely collection of the data for the November 15, 2004, deadline for completing the FY 2004 Performance and Accountability Report. DoD needs to issue any new FY 2005 guidance more timely to ensure the policy is in place well before reporting deadlines.

Improved Identification and Reporting Process

For 2004, DFAS used the guidance and performed risk assessments to determine whether DoD activities and programs were susceptible to erroneous payments under the OMB reporting thresholds. DoD had planned to complete the risk assessments by November 15, 2004, so that the information could be included in the FY 2004 Performance and Accountability Report. However, as late as January 2005, DFAS was still in the process of determining the full extent of its erroneous payments and had not assessed the amount of erroneous intra/intergovernmental payments.

As shown in Table 1, the FY 2004 risk assessment identified \$734 million more erroneous payments than had been reported in FY 2003 for seven activity groups.

**Table 1. DoD Erroneous Payments
Risk Assessment Results**

Program/Activity	FY 2003 Erroneous Payments	FY 2003 Assessed Risk	FY 2004 Erroneous Payments	FY 2004 Assessed Risk
Military Pay	\$113,964,530	Moderate	\$316,608,764	High
Retired & Annuitant Pay	33,087,129	Low	66,003,097	Low
Civilian Pay	8,118,193	Low	24,061,011	Low
Travel Pay	3,350,788	Low	13,579,866	Moderate
Health Care	54,049,681	Low	100,194,997	Low
Commercial Pay	30,935,183	Low	456,597,027	Low
Afloat & Deployed	Not Assessed		497,427	Low
Total	\$243,505,504		\$977,542,189	

Use of Statistically Valid Methods

Although it improved its method of estimating the amount of erroneous payments, DFAS did not apply valid sampling techniques to the extent necessary to estimate a complete baseline. In most of its major programs and activities, DFAS used statistical sampling to estimate the number of erroneous payments (attribute sampling), but not the dollar amounts (variable sampling). The following areas would benefit from the use of an improved sampling strategy that identifies dollar amounts.

Military Pay. The DFAS estimate of the amount of erroneous payments for military pay increased from \$113.9 million for FY 2003 to \$316.6 million for FY 2004. However, DFAS used attribute sampling in past payment reviews, not variable sampling to derive estimates, and that resulted in an estimate that did not include the full extent of the FY 2004 payments that were processed in its military pay system, the Defense Joint Military Pay System (DJMS). DFAS recognized that internal control procedures over military pay were inadequate, and, as of April 2005, was still in the process of implementing post-payment audit procedures to estimate the dollar value of erroneous payments.

In an effort to identify erroneous payments, the Office of Statistical Review, Military and Civilian Pay Services, DFAS Kansas City, Missouri, completed limited post-payment reviews of military pay transactions. The DFAS reviews identified calculation errors made by the DJMS system and detected some reporting errors caused by data input errors.

The post-payment reviews designed by DFAS provided statistically valid estimates of the number, but not the dollar amount, of erroneous payments. As a result, the post-payment reviews did not provide a reliable means for estimating the dollar amount of errors. The reviews also fared poorly in detecting errors in intra/intergovernmental payments, such as when the wrong State or locality was provided taxes withheld from paychecks.

Improving the adequacy of sampling will also aid certifying officials. According to DFAS Kansas City and DFAS Indianapolis officials, the post-payment reviews were not designed to satisfy the requirements of Financial Management Regulation volume 5, chapter 33, "Accountable Officials and Certifying Officers." When properly designed and approved, use of valid samples for post-payment reviews can provide relief from pecuniary liability to accountable officials and certifying officers who unknowingly approve erroneous payments.

DoD personnel acknowledged that the military pay activity group was at high risk for erroneous payments. One of the greatest risks is that DFAS may not detect all data input errors because they cannot readily access information that is put into the Military Department personnel systems. The information in these systems is used to compute military pay. The Marine Corps pay system is the only service application which can be easily accessed by DFAS. The lack of integration between DJMS and military pay systems was a long-standing problem identified by the Government Accountability Office in 1993.

To improve the process, DFAS will need to complete a statistically valid estimate for dollar amounts for FY 2005 in accordance with OMB guidance. In addition, the USD(C)/CFO should design the post-payment reviews to provide relief from pecuniary liability to accountable officials and certifying officers.

Retired and Annuitant Pay. OMB Circular A-11 requires DoD to use statistically valid methods to estimate the amount of erroneous payments for the DoD retirement benefit programs. DoD reported that it identified more erroneous payments in retiree and annuitant pay in FY 2004 than in FY 2003, from \$33.1 million in FY 2003 to \$66.0 million in FY 2004. However, as of January 2005, DoD officials stated that DoD was still working on methods to accurately statistically estimate the amount of erroneous payments on retirement programs.

Civilian Pay. DFAS estimated that erroneous payments in civilian pay increased from \$8.1 million in FY 2003 to \$24.1 million in FY 2004. However, DFAS did not have processes in place to accurately estimate the amount of erroneous payments on civilian payroll accounts. Specifically, DFAS did not use valid statistical methods to estimate the dollar amount of erroneous payments, did not review intra/intergovernmental payments for amounts withheld from paychecks to identify erroneous payments, and did not complete an analysis of FY 2004 collections on civilian pay accounts to determine how many of the collections were related to prior overpayments.

In an effort to identify erroneous payments that were similar to military pay, the Office of Statistical Review, Military and Civilian Pay Services at DFAS Kansas City completed limited post-payment reviews of civilian pay transactions. The post-payment reviews were designed to provide statistically valid estimates of the number of erroneous payments. According to DFAS Kansas City, the post-payment reviews were not appropriate for estimating dollar amounts and were not designed to provide relief from pecuniary liability to accountable officials and certifying officers.

The following illustrates the additional scrutiny that is needed in the DFAS review process to identify the extent of erroneous payments related to civilian pay. DFAS processed \$461 million in collections on civilian pay accounts during FY 2004. DFAS did not review the collections to determine how many of the collections were related to the recovery of prior overpayments. Collections are highly indicative of overpayments and should be reviewed.

DoD concluded that the civilian pay activity group was at low risk for erroneous payments and that a valid estimate of erroneous payments was not required. However, intra/intergovernmental payments withheld from paychecks on civilian pay were not reviewed and the \$461 million in FY 2004 collections made for civilian pay indicate that activities within the civilian pay group could have made erroneous payments that exceeded OMB thresholds.

We believe DoD needs to require DFAS to use statistically valid methods to establish a baseline of erroneous payments for civilian pay in accordance with steps 2 through 4 of OMB Memorandum M-03-13. DoD should require methods that provide relief from pecuniary liability to accountable officials and certifying

officers. DFAS cannot show progress in reducing the amount of erroneous payments on civilian pay until statistically valid methods are used to establish an accurate baseline.

Travel Payments. The amount DFAS identified in FY 2003 as erroneous payments related to travel payments was \$3.4 million. In FY 2004 it identified \$13.6 million. For FY 2004, DoD rated the overall travel payments activity group as being at moderate risk for erroneous payments. DFAS did not use valid statistical methods to estimate the amount of erroneous payments related to travel payments. The attribute sampling DFAS used was designed to estimate the number of erroneous payments and not the dollar amount which could be estimated using variables sampling. To improve FY 2005 reporting, DFAS will need to estimate the amount of erroneous travel payments processed in the system using statistically valid methods.

Commercial Payments. The amount DFAS Columbus reported as erroneous payments on commercial payments was \$30.9 million in FY 2003. In FY 2004 it was \$456.6 million. DFAS Columbus officials indicated that the \$456.6 million figure represented a compilation of queries of various payment systems. DFAS Columbus believed the commercial and vendor pay activity group was at low risk for erroneous payments because \$456.6 million represented only two-tenths of one percent of the \$247.6 billion in FY 2004 payments.

Despite the increase in the reported amount for FY 2004, the \$456.6 million in erroneous payments was not reconcilable to \$1.1 billion in potential FY 2004 erroneous payments DFAS Columbus identified in its management reports as shown in Table 2.

Table 2. FY 2004 DFAS Management Reports (in millions)	
Type of Management Exception Report	
Interest Penalties on Late Payments	\$ 28.3
Demands Issued	137.9
Underpayments	406.4
Overpayments	112.6
Refunds Received	306.8
Discounts Lost	1.0
Returned Funds	109.4
Total FY 2004 Potential Erroneous Payments	\$1,102.4

DFAS Columbus believed there was duplication in the data contained in the management reports. As of February 2005, DFAS Columbus was developing procedures to improve the baseline of FY 2005 potential erroneous commercial and vendor payments. DFAS officials told us that it would be impractical to use the statistical methods required by OMB Memorandum M-03-13 to estimate the

amount of erroneous payments on commercial and vendor payments because of the complexity of DoD contracts.

We concluded that the low-risk rating for the commercial and vendor pay activity group was not supportable due to the significant amount of potential erroneous payments in the DFAS Columbus management reports and the lack of statistical procedures in place to identify erroneous payments. DoD required DFAS to determine whether payment areas within a program area were susceptible to erroneous payments; however, DFAS Columbus did not show these payment areas were at high risk for erroneous payments. We believe that the amount of potential erroneous payments shown in the management reports should cause DoD to report the commercial and vendor pay activity group as being at high risk for erroneous payments for FY 2005. If DoD believes the work needed to comply with the OMB requirements is too costly and complex, it needs to coordinate the methods it uses to estimate erroneous payments with OMB, and request a waiver from the requirements.

Military Health Benefits. The Assistant Secretary of Defense (Health Affairs) did not provide statistically valid estimates of the FY 2004 amount of erroneous payments made on health benefits. The Tricare Management Activity did use statistical samples designed to test contract compliance, and estimated that erroneous health benefit payments increased from \$54.0 million for FY 2003 to \$100.2 million for FY 2004. However, these procedures did not result in a statistically valid estimate.

In FY 2003 the Tricare statistician reported to Tricare management that the statistical methods used to test for contract compliance were not appropriate to estimate dollar amounts of erroneous payments because of timing issues and because large amounts of information were not included. He stated that different methods would be needed to accurately estimate dollar amounts. However, the same methodology was used again to estimate FY 2004 erroneous payments. Therefore, the estimated amounts do not represent a statistically valid baseline of erroneous payments.

OMB determined that the Military Health benefit activity group was susceptible to erroneous payments and it required the use of the OMB sampling formula (contained in step 2 of OMB Memorandum M-03-13) to estimate the amount of the erroneous payments. However, DoD officials stated that OMB verbally gave DoD approval to use the existing samples to estimate erroneous payments for FY 2004. We believe DoD needs to use statistically valid methods to establish a valid baseline of erroneous payments in the area of military health benefits for FY 2005.

Establishment of Accurate Baseline

DoD cannot demonstrate progress toward reducing the occurrence of erroneous payments unless it issues policy early in the fiscal year and establishes an accurate baseline of erroneous payments. During FY 2004, DFAS improved methods to establish a valid baseline of DoD erroneous payments. However, to

effectively use existing resources to reduce erroneous payments, DoD needs to ensure that the methods used by DFAS to identify them are statistically valid and provide relief from pecuniary liability to accountable officials and certifying officers. The reduction of erroneous payments is a part of the President's Management Agenda and the USD(C)/CFO needs to take aggressive action to identify and accurately inventory erroneous payments so that it can demonstrate progress in reducing the occurrence of erroneous payments in DoD.

Management Comments on the Finding and Audit Response

Management Comments. The Deputy Chief Financial Officer indicated that the Defense Travel System was not at high risk for erroneous payments as reported in the draft report because an erroneous supporting schedule was provided to the auditors.

Audit Response. We revised the finding to eliminate the information on the reporting of the Defense Travel System as a high-risk area.

Management Comments. The Chief Financial Officer (Health Affairs) provided unsolicited comments and he disagreed with the report's conclusions that the sample of medical claims his office conducted was not valid. He indicated he did not include claims under \$100 in his sample because Government risk is not involved. He cited a study completed in FY 2000.

Audit Response. We disagree with the comments from the Chief Financial Officer (Health Affairs). The Health Affairs statistician who designed the sample determined that the sample was not appropriate for estimating the total amount of erroneous payments. In addition, Health Affairs operations have changed since the FY 2000 study. For example, in FY 2003, Health Affairs began making secondary payments on medical claims paid from the DoD Medicare Eligible Retiree Health Care Fund. Health Affairs needs to ensure that all Medicare secondary payments are included in samples.

Recommendations and Management Comments

We recommend that the Under Secretary of Defense (Comptroller)/Chief Financial Officer:

1. Issue policy early in the fiscal year on the use of valid statistical methods to estimate erroneous payments. Specifically, those sampling techniques should focus on estimating the dollar amount of erroneous payments instead of the number. The policy should ensure that post-payment reviews support erroneous payment reporting and provide relief from pecuniary liability to accountable officials and certifying officers. The policy should include a process to obtain waivers from the requirements of the Office of Management and Budget if the work is too costly and complex.

Management Comments. The Deputy Chief Financial Officer concurred and stated DoD will use sampling techniques that focus on estimating the dollar amount of erroneous payments instead of the number; the Defense Finance and Accounting Service has already taken action and revised its methodology accordingly. She also stated that the use of erroneous payment data will be explored as the source of post-payment reviews to provide relief from pecuniary liability to accountable officials and certifying officers as DoD estimating techniques improve. She stated that guidance for the FY 2006 erroneous payment survey will be issued in October 2005.

2. Report in the Performance and Accountability Report that the commercial and vendor pay activity group is at high risk for erroneous payments due to the high volume of erroneous payments and the lack of consistent procedures to identify erroneous payments.

Management Comments. The Deputy Chief Financial Officer partially concurred with Recommendation 2. She stated that the Defense Finance and Accounting Service would report a material weakness related to the lack of a statistically valid method of estimating erroneous payments for commercial payments in the FY 2005 Performance and Accountability Report. She stated that DFAS will develop a process for estimating erroneous commercial payments that will provide reasonable assurance that it represents the actual amount of such payments. Additionally, she stated that when accurate estimates are developed, DoD will determine whether commercial payments should be identified as a high-risk area.

Appendix A. Scope and Methodology

We assessed whether DoD complied with the requirements of the “Improper Payments Information Act of 2002” (Public Law No. 107-300) and OMB memorandum M-03-13, May 21, 2003. We obtained DoD FY 2003 and FY 2004 survey information that was compiled by DFAS on payments and erroneous payments. We analyzed the survey information to determine whether DFAS identified an accurate inventory of total DoD payments. We also analyzed the payment information to determine whether DFAS identified all erroneous payments as defined by OMB guidance. We determined whether DoD had a program to reduce erroneous payments. We performed this audit from April 2004 through April 2005 in accordance with generally accepted government auditing standards.

Use of Computer-Processed Data. We reviewed summary payment information compiled by DFAS in performance reports and management studies. We compared the payment information contained in the reports and studies to amounts reported as payment information for budgetary accounts presented in the FY 2003 and FY 2004 DoD financial statements and budgetary reports. We also determined whether DFAS included information from relevant performance reports and studies in its compilation of erroneous payment information. We determined whether DFAS used valid statistical methods in compiling the erroneous payment information. We did not review the reliability of data used to produce the summary information in the management reports and studies.

Government Accountability Office High-Risk Area. The Government Accountability Office (GAO) has identified several high-risk areas in DoD. This report provides coverage of the contract payment and financial management high-risk areas.

Use of Technical Assistance. The Quantitative Methods Division of the Office of the Deputy Inspector General for Auditing reviewed the methodology used by DFAS to estimate the amounts of FY 2003 and 2004 erroneous payments.

Management Control Program Review

DoD Directive 5010.38, “Management Control (MC) Program,” August 26, 1996, and DoD Instruction 5010.40, “Management Control (MC) Program Procedures,” August 28, 1996, require DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of the Review of the Management Control Program. The management control program was not an announced audit objective. However, since the reporting of erroneous payments is a part of the President's Management Agenda, we determined whether DoD reported a material weakness related to the identification and reporting of erroneous payments.

Adequacy of Management Controls. Management did not have controls in place to ensure that a statistically valid baseline was identified for erroneous payments. Therefore, we consider the identification and reporting of erroneous payments as a material weakness. Recommendation 1. will establish post-payment reviews to estimate the volume of erroneous payments and provide relief from pecuniary liability to accountable officers and certifying officers. Recommendations 1. and 2. will provide needed controls over the identification and reporting process. We will give a copy of the report to the management control official at DFAS Headquarters.

Adequacy of Management's Self-Evaluation. DoD did not properly consider the materiality of results from prior audit reports and internal management studies that indicated that significant problems existed related to the identification and reporting of erroneous payments. For example, for FY 2004, DoD believed problems reported by the GAO on military pay (see prior coverage below) were immaterial. As a result, DoD did not establish an assessable unit for erroneous payments.

Prior Coverage

During the past 5 years GAO issued two reports on military pay issues and two reports on erroneous payments. Unrestricted GAO reports can be accessed over the Internet at www.gao.gov.

GAO Report No. GAO-04-911, "Army Reserve Soldiers Mobilized to Active Duty Experienced Significant Pay Problems," August 20, 2004

GAO Report No. GAO-04-89, "Army National Guard Personnel Mobilized to Active Duty Experienced Significant Pay Problems," November 13, 2003

GAO Report No. GAO-02-749, "Financial Management: Coordinated Approach Needed to Address the Government's Improper Payments Problems," August 9, 2002

GAO Report No. GAO-02-69G, "Strategies to Manage Improper Payments: Learning From Public and Private Sector Organizations," October 1, 2001

Appendix B. Report Distribution

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Office of the Under Secretary of Defense (Comptroller)/Chief Financial Officer Comments



COMPTROLLER

OFFICE OF THE UNDER SECRETARY OF DEFENSE
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WASHINGTON, DC 20301-1100

JUN 27 2005

MEMORANDUM FOR PROGRAM DIRECTOR, DEFENSE FINANCIAL AUDITING
SERVICE, OFFICE OF INSPECTOR GENERAL,
DEPARTMENT OF DEFENSE

SUBJECT: Office of the Inspector General, Department of Defense (OIG, DoD) Draft
Report on the Identification and Reporting of DoD Erroneous Payments
(Project No D2004FJ-0118)

This memorandum is in response to the subject April 27, 2005, draft report
provided to this office for review and comment. Our response to the audit findings and
recommendations directed to the Under Secretary of Defense (Comptroller)/Chief
Financial Officer is attached.

We appreciate the opportunity to respond to your draft audit report and look
forward to resolving the cited issues. My point of contact is Mr. Tom Summers. He can
be contacted by telephone at 703-697-3193 or e-mail at tom.summers@osd.mil.

Teresa McKay
Deputy Chief Financial Officer

Attachment:
As stated

cc:
ODGC(F)
DFAS

DRAFT REPORT DATED APRIL 27, 2005
PROJECT NO D2004FI-0150

"Office of the Inspector General, Department of Defense (OIG, DoD) Draft Report on the Identification and Reporting of DoD Erroneous Payments"

Recommendation 1: We recommend that Under Secretary of Defense (Comptroller)/Chief Financial Officer issue policy early in the fiscal year on the use of valid statistical methods to estimate erroneous payments. Specifically, those sampling techniques should focus on estimating the dollar amount of erroneous payments instead of the number. The policy should ensure that post-payment reviews support erroneous payment reporting and provide relief from pecuniary liability to accountable officials and certifying officers. The policy should include a process to obtain waivers from the requirements of the Office of Management and Budget if the work is too costly and complex.

Response: Concur. Agree that the policy guidance should be issued early in the fiscal year. Accordingly, the guidance for fiscal year (FY) 2005 was issued in October 2004. It is anticipated that the guidance for the FY 2006 Improper Payments Information Act (IPIA) survey will be forwarded in October 2005. With regard to the methods used to estimate improper payments, the "question and answer" section of the Office of Management and Budget (OMB) memorandum M-03-13, "Improper Payments Information Act of 2002 (Public Law No: 107-300)," dated May 21, 2003, states that improper payments may be measured by periodic study, judgmental sample, statistical sample, trend analysis and risk analysis/measurement. As a result, it would be inappropriate to limit our guidance to only one of these methods. As to the use of sampling techniques that focus on estimating the dollar amount of improper payments instead of the number, the Defense Finance and Accounting Service (DFAS) has already taken action and revised its methodology accordingly. The use of IPIA survey data will be explored as the source of post-payment reviews to provide relief from pecuniary liability to accountable officials and certifying officers as the Department estimating techniques improve.

Recommendation 2: We recommend that Under Secretary of Defense (Comptroller)/Chief Financial Officer report in the Performance and Accountability Report that the commercial and vendor pay activity group is at high risk for erroneous payments due to the high volume of erroneous payments and the lack of consistent procedures to identify erroneous payments.

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Finding
changed p.2
and results
changed
page 7.

Response: Partially concur. As outlined in the Office of Management and Budget (OMB) memorandum M-03-13, "Improper Payments Information Act of 2002 (Public Law No: 107-300)," dated May 21, 2003, the standard for significant improper payments is annual improper payments exceeding both 2.5 percent of program payments and \$10 million. Based on the most recent Improper Payments Information Act (IPIA) survey of commercial payments, overpayments and underpayments totaled \$460.1 million which represented 0.2237 percent of program payments—well below OMB criteria for reporting commercial payments as a high risk area.

Although the Department is confident that the amounts reflected in its IPIA survey are a fair representation of actual improper payments, it recognizes the need for a comprehensive, statistically sound methodology to estimate and baseline commercial payments. Accordingly, the Defense Finance and Accounting Service (DFAS) will declare a lack of a statistically valid method of estimating improper payments for commercial payments as a material weakness in its FY 2005 Performance and Accountability Report. The DFAS will, in turn, develop a process for estimating improper commercial payments that will provide reasonable assurance that it represents the actual amount of such payments. Concurrent with this methodology, the DFAS has established a database to capture actual improper commercial payment data. While methods for identifying and capturing data are still being refined, the database will assist in identifying, reporting, and ultimately reducing improper commercial payments by providing comprehensive data for analysis. This information will be used in making the determination of whether commercial payments should be identified as a high risk area.

Additional Comments:

Defense Travel System. The report identifies the Defense Travel System (DTS) element of Travel as a high risk area. It appears the auditors based their finding on a supporting schedule of the FY 2005 IPIA survey conducted in November 2004, which had incorrectly ranked DTS as a high risk area. Prior to issuance of the final IPIA survey results, the error was corrected.

Military and Civilian Pay. The Department recognizes that the initial post payment sampling and review plans established for military and civilian pay were not originally intended to capture or project improper payments (dollars or percentage of net pay) but rather were designed to project accuracy of net pay. However, substantial enhancements were implemented in FY 2004 with regard to additional statistics on overpayments and underpayments to estimate improper payment dollar values for military and civilian pay sampled accounts, as well as to generate a statistically valid estimate of improper

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payments for the Military Retirement Fund. Further enhancements will be implemented for FY 2005 to facilitate more accurate estimates of improper payments for military and civilian pay.

Military Health Benefits. The findings related to the Military Health Benefits program have been addressed separately by the Chief Financial Officer, TRICARE Management Activity (TMA), Office of the Assistant Secretary of Defense (Health Affairs). The TMA response, dated June 1, 2005, addresses the OIG, DoD, concerns regarding the methodology used to estimate the amount of improper payments. Specifically, the OIG, DoD, questions the validity of TMA's statistical sampling methodology citing the exclusion of medical claims less than \$100 from its audit sample. The TMA response cites a study performed in 2000 that (i) demonstrated that claims less than \$100 were at a low risk for errors, and (ii) the annual cost to review these claims (\$1 million) exceeded the expected return. No exception is taken to the TMA response.

Commercial Payments. Regarding the Commercial and Vendor Payments section of the report, the DFAS reported approximately \$24.1 million in improper contract and vendor payments for FY 2003 (reported as part of the FY 2004 IPIA survey conducted in October 2003). The Department of Defense reported \$30.9 million, which included improper payments made by other commercial payment activities—the Army Finance Command, Army Corps of Engineers and the Defense Threat Reduction Agency. The \$456.6 million in improper payments reported for FY 2004 (reported as part of the FY 2005 IPIA survey conducted in November 2004) also represents DFAS and other commercial payment activities. However, after submission of the FY 2005 IPIA survey results, the DFAS identified and reported an additional \$12.9 million in improper payments, which increased the DFAS total to \$460.1 million and the percentage of improper payments from 0.2174 percent to 0.2237 percent. The updated figures are not reflected in the draft report.

With respect to Table 2, "FY 2004 DFAS Management Reports," in the draft report, the Department disagrees with the assessment of \$1.1024 billion in potential improper payments as it is predicated on both Performance Measurement Indicators (PMI) data and IPIA survey data. There is duplicate information in the PMI and the IPIA survey data, not because of any reporting discrepancies, but because of the specific purpose and criteria for each reporting mechanism. Improper payments are considered to include payments made in excess of the net amount due the contractor, payments made to the wrong contractor, and payments made for less than the invoice amount that should have been for the full amount. On a broader scale, PMIs are designed to identify various categories of payments and/or actions, which result from proper as well as improper

payments. Therefore, certain information that was reported on the IPIA survey is a subset of PMI data. The chart below shows the source (PMI or IPIA survey) of figures shown in Table 2 of the report. Note that "Refunds Received" represents underpayments to contractors.

Table 2 Data (in millions)		Source
Interest Penalties on Late Payments	\$28.3	Performance Measurement Indicators (PMI)
Demands Issued	\$137.9	PMI
Underpayments	\$406.4	PMI
Overpayments	\$112.6	PMI
Refunds Received	\$306.8	IPIA survey
Discounts Lost	\$1.0	IPIA survey
Returned Funds	\$109.4	IPIA survey

The Department does not agree that interest penalties on late payments are improper payments. The IPIA defines improper payments as "any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements." Interest penalty payments are required by the Prompt Payment Act and, while undesirable, do not meet the IPIA definition.

Office of the Assistant Secretary of Defense (Health Affairs) Comments



TRICARE
MANAGEMENT
ACTIVITY

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JUN - 1 2005

MEMORANDUM FOR DEPARTMENT OF DEFENSE INSPECTOR GENERAL
DIRECTOR, DEFENSE FINANCIAL AUDITING SERVICE

SUBJECT: Report on the Identification and Reporting of DoD Erroneous Payments
(Project No D2004FJ-0118)

Thank you for the opportunity to review and provide comments on the proposed draft report, "Identification and Reporting of DoD Erroneous Payments" (D2004FJ-0118).

Overall, I nonconcur with the findings and conclusions detailed in the proposed draft report section addressing Military Health Benefits. The DoD IG has provided information that misrepresents the Defense Health Program (DHP) and fails to understand the Military Health System's (MHS's) compliance with Improper Payment Information Act (IPIA) reporting accomplished over the last several years.

Our comments (attached) will fully explain in further detail the methodology utilized to statistically estimate the amount of erroneous payments for the MHS. This process, we believe, identifies erroneous payments across the MHS at a rate better than the OMB guidelines. We demonstrate empirically that our audit methodology fully meets the intent of the Improper Payment Information Act (IPIA).

My points of contact on this audit are Mr. David H. Fisher (functional) and Mr. Gunther J. Zimmerman (GAO/IG Liaison), both of whom can be reached at (703) 681-3492.

A handwritten signature in black ink, appearing to read "John L. Kokulis", is written over the typed name and title.

John L. Kokulis
Chief Financial Officer

Attachment:
As stated

**DOD IG PROPOSED DRAFT REPORT
D2004FJ-0118**

**Agency Comments on Proposed Draft Report
“Identification and Reporting of DoD Erroneous Payments”**

TRICARE MANAGEMENT ACTIVITY COMMENTS

Agency comments are indicated below according to section in the proposed draft report.

Use of Statistically Valid Methods

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Military Health Benefits. The Assistant Secretary of Defense (Health Affairs) did not provide statistically valid estimates of the FY 2004 amount of erroneous payments made on health benefits. The TRICARE Management Activity did use statistical samples designed to contract compliance, and estimate the erroneous health benefit payments increased from \$53.5 million for FY 2003 to \$100.2 million for FY 2004. However, these procedures did not result in a statistically valid estimate.

In FY 2003 the TRICARE statistician reported to TRICARE management that the statistical methods used to test for contract compliance not appropriate to estimate dollar amounts of erroneous payments because of timing issues and because large amounts of information were not included. He stated that different methods would be needed to accurately estimate dollar amounts. However, the same methodology was used again to estimate FY 2004 erroneous payments. Therefore, the estimated amounts do not represent a statistically valid baseline of erroneous payments.

OMB determined that the Military Health Benefit activity group was susceptible to erroneous payments and it required the use of the OMB sampling formula (contained in step 2 of the Improper Payments Information Act (IPIA)) to estimate the amount of the erroneous payments. However, DoD officials stated the OMB verbally gave DoD approval to use the existing samples to estimate erroneous payments for FY 2004. We believe DoD needs to use statistically valid methods to establish a valid baseline of erroneous payments in the area of Military Health Benefits for FY 2005.

TMA Comment:

Nonconcur. We believe the DoD IG is using our exclusion of all medical claims less than \$100 from our audit sample as the basis for questioning statistical validity. We believe and will demonstrate empirically that our audit methodology fully meets the intent of the IPIA.

The DoD-IG suggestion fails to address cost, probability and the provisions of the IPIA. What may not have been understood is the basis for the statistical sample. The sample excludes claims under \$100 from the universe because significant government risk is not involved. The defined universe encompasses claims determined to be at risk for significant payment errors, the

elements for the statistical valid sampling as set by the IPIA. DoD's projections under the Improper Payment Information Act are based on the inappropriate expenditure of health care dollars in the TRICARE contract environment. In this environment, only allowable costs are paid by the Government. An allowable cost is one where the beneficiary is eligible, the provider (doctor, hospital, etc.) is authorized, the appropriate reimbursement methodology is used, and the service is a benefit. The eligibility determination is fully automated and is based on the response from the Government's eligibility system, reducing the chance of an error. The provider's authorized status is also automated and included in both the Government's system and the contractor's system. In addition, the provider is subjected to system-based audits by the Government when the claim is reported. The probability of an unidentified error in the provider determination is nearly zero. Pricing is also automated based on the location of care, health plan, beneficiary's status, and provider type. Again, nearly a zero probability for error. Finally, the only real probability for error is in the benefit determination. For claims of less than \$100 there is almost no probability of identifying an error because of system edits that automatically disallow non-covered services and procedures that do not match either the patient or the diagnosis. This leaves only those services that might be denied as not medically necessary. In an audit scenario, there is no way to determine if, for example, a runny nose office visit is not medically necessary even with the medical record. Because of this, the Department made the correct decision when it determined that our finite resources should be expended on auditing higher cost claims where there are more possibilities of an error occurring and where the error represents higher dollars. Since claims under \$100 are not determined to be a significant risk for payment errors, they are not subject to the statistical sample required by the IPIA. The contract design incentivizes the contractors to continuously improve accuracy and invest additional funds toward technology and edits that decrease payment errors until the point the investment costs exceed the savings, thereby meeting the goals of fiscal responsibility established by the IPIA. Please note that after the contractor's investment costs exceed savings the contractor is still financially responsible (at-risk) for the savings not pursued.

The stratified random sampling approach taken ensures that:

1. The Government is not paying an external contractor to re-adjudicate claims where the government is not at risk for health care dollars, such as under capitated plans and
2. The government is not paying an external contractor to re-adjudicate claims of such low value that the potential return outweighs the audit costs.

This stratified random sampling approach was validated in year 2000 through a separate audit of four random samples of claims under \$100. This study showed that the sample size increase needed to add a stratum for low dollar value claims would increase the annual cost for external audits by over \$1 million, which would outweigh the expected return to the Government. Additional costs would be incurred in imposing this extra requirement on the managed care contractors.

Maintaining audit focus on those higher dollar claims, i.e. claims with value over \$100, where the return to Government outweighs the cost to audit the sample is a fiscally prudent approach, is statistically valid for the "defined universe" and is an approach that conforms to the provisions of the IPIA.

Team Members

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