



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

Accounting and Information
Management Division

B-276232

April 24, 1997

Mr. James E. Reid
Deputy Controller
Department of Energy

Subject: Payment Processing: "Negative Confirmation" of Receipt

Dear Mr. Reid:

This letter responds to your request for an interpretation of the requirements of Title 7, "Fiscal Guidance," of the GAO Policy and Procedures Manual for Guidance of Federal Agencies. Specifically, you asked if you could, under predefined circumstances, implement a "negative confirmation" process for the receipt and acceptance of goods and services costing under \$25,000 ordered from vendors with whom an ongoing relationship exists. This would be in lieu of the written verification Title 7 requires in most instances prior to payment certification for invoices. In contrast, the negative confirmation approach you propose would require a written notification only if an invoice should not be paid or if a payment modification is necessary. In addition, in lieu of verifying receipt and acceptance on an after-the-fact basis for each payment, you propose a verification process on a statistical sampling basis.¹

As described in your letter, the Department of Energy is evaluating its existing payment system to streamline its operations and reduce costs. You stated that the process modifications would eliminate low value-added processes and achieve higher levels of operating efficiency, quality service, and customer satisfaction. Your staff explained that the modifications would greatly reduce the number of contacts made by Service Center employees to satellite offices to

¹Title 7 limits the use of statistical sampling to vouchers in amounts not exceeding \$2,500. However, although not specifically asked, we have addressed your questions to include a request to raise the limit to \$25,000 under the proposed negative confirmation process.

confirm the receipt and acceptance of goods, thus allowing the Center's employees to focus on more cost-effective work. Your staff estimated that your proposal would result in about \$123,300² annual savings or cost avoidance. We support initiatives to create a government that works better and costs less. At the same time, we believe that agencies have the responsibility to protect the government's interest.

We contacted your staff to discuss your questions in more detail. Since we did not test your process, our response only addresses your questions conceptually.

Although the negative confirmation procedure you propose increases the risks of overpayments to vendors, that risk could be acceptably mitigated if reasonable assurance of recovery of overpayments to vendors exists. Combining a negative confirmation process with a statistical sampling procedure to examine invoices under \$25,000 also increases risks. These risks would be acceptable provided (1) an assessment of the benefits of implementing the sampling plan compared to the additional risks associated with it reveals that the benefits exceed the projected costs, (2) the risk of errors and irregularities occurring and going undetected prior to payment is periodically assessed (through a statistical sample taken from all invoices subject to a negative confirmation) and kept within established thresholds, and (3) the agency has a continuing satisfactory relationship with the vendor, thus minimizing the risk of loss. Your proposal addresses these conditions; however, we have one observation and offer a control procedure to address it. Based on our understanding of your proposal, we do not object to its implementation provided that the control procedure we suggest is effectively implemented. Our assessment of your proposal is discussed in detail in the following sections.

ENERGY'S CURRENT SYSTEM

Energy's payment certification and processing occur at 3 main Financial Service Centers which currently support 11 satellite offices (16 are planned by September 30, 1997) where purchasing takes place. Each Service Center is assigned a number of satellite offices to service.

²Your staff emphasized that this estimate is provided as a basis for making an initial determination to implement system modifications and is based on certain assumptions believed to be valid at the time the estimate is compiled.

Your staff explained that satellite offices initiate purchase orders and obligate funds. The purchase orders contain the specific items and quantities ordered. The satellite offices forward a copy of each purchase order to the appropriate Service Center where it is filed awaiting receipt of the vendor's invoice. Vendors submit invoices to the cognizant Service Center where a daily Invoice Received Report listing each invoice by originating satellite office is prepared. The report contains the vendor's name, related purchase order number, invoice receipt date, invoice amount, discount information, and a special notation if obligated amounts were exceeded for each invoice. Daily reports are forwarded to the satellite office's responsible administrative officer with a cover memo stipulating that a 30-day limit is allowed for verifying receipt and acceptance of the goods/services ordered.

Administrative officers are responsible for recording receipt and acceptance of items ordered and for comparing quantities and items received and accepted with items ordered. If discrepancies exist, notations are required on the Invoice Received Report. For each invoice listed, the officer initials or signs indicating (1) approval for payment, (2) payment modification based on adjustments he or she made, or (3) disapproves payment by so noting. Also, if the invoice amount exceeds the related obligation, the officer must either (1) use available unobligated funds to cover the difference or (2) not approve payment for the excess amount. The report is then signed and forwarded to the Service Center for certification and payment. The signature of the administrative officer provides evidence that the aforementioned responsibilities have been appropriately discharged.

Your staff further explained that administrative officers discharge their responsibilities differently. In some offices, the administrative officer may verify mathematical accuracy, verify that the costs per invoice are consistent with the purchase order, and actually inspect the goods and/or services received. Others have staffs that perform these functions, and others may require written confirmation by program officials showing receipt and acceptance of goods and/or services. However these functions are performed, your staff stated that there must be an audit trail showing who is accountable for the discharge of each responsibility.

Service Center employees verify the administrative officers' initials or signature indicating receipt and acceptance for each line item invoice; compare amounts (quantities and dollars) on the invoice and the purchase order; and, if no discrepancies are found, schedule the invoice for certification and payment. If

discrepancies are found, the administrative officer is contacted to resolve questions.

ENERGY'S PROPOSED SYSTEM MODIFICATIONS

Energy proposes to switch to a "negative confirmation" procedure for invoices less than \$25,000. The primary difference between the existing procedures involving a positive confirmation and the proposal is that instead of the administrative officer notifying the Service Center of receipt and acceptance, the negative confirmation allows the Service Center to certify and process the payment without obtaining evidence of receipt and acceptance from the administrative officer.

Your staff explained that the \$25,000 limit for negative confirmation was selected because at the time of selection, amounts under \$25,000 were considered small or "simplified acquisitions"³ and Energy's invoice statistics indicate \$25,000 as an appropriate cut-off. Your staff further explained that based on invoices processed during fiscal year 1996, the number of invoices less than \$25,000 that would have been subject to the negative confirmation would have been about 40 percent of all invoices processed by Energy. However, the dollar amount of those invoices would have been less than 1 percent of the dollar amount of all invoices processed for payment.

Your staff stated that the negative confirmation process would apply to those vendors who have an ongoing satisfactory relationship with Energy and from whom recovery (or off-set) arising from overpayment is likely. Your staff also explained that the administrative officer at the satellite offices would continue to be responsible for documenting and ensuring receipt and acceptance on each invoice listed on the Invoice Received Report; however, the negative confirmation procedure would only require notification for those line item invoices on the Invoice Received Report if payment should not be made or should be different than the invoice amount or purchase order.

Under the proposal, the administrative officer would be sent the Invoice Received Report along with a memo explaining that positive confirmation (approval/rejection/modification) would be needed only for invoices listed on the

³Prior to the passage of the Federal Acquisition Streamlining Act of 1994, simplified acquisitions were defined as acquisitions less than \$25,000. That law raised the simplified acquisition threshold to \$100,000.

report that meet at least one of several criteria,⁴ and that these invoices would be highlighted on the Invoice Received Report. All other invoices on the report would be subject to negative confirmation.

Service Centers would initiate certification and payment processing on negative confirmation invoices 20 days after the report is sent unless the administrative officer notifies the Center that an invoice should not be processed for payment. To illustrate, this notification should occur if goods and/or services are not received or accepted, or description, quantities, and invoice total cost do not match those on the purchase order. Regarding vendors doing business with Energy for the first time, your staff stated that positive confirmation would be required initially to allow Energy to obtain evidence of the vendors' ability to supply acceptable goods or services promptly and to submit accurate billings, thus indicating Energy's confidence in the relationship with the vendor.

At the end of each month, the administrative officers would receive a Post Payment Report listing all invoices received during the month that were paid or rejected. The officers would be required to review the report and immediately contact their Service Centers if any discrepancies are identified so that, among other actions, recovery or off-set actions can be initiated, if necessary.

In addition, your letter stated that each quarter, Energy will closely monitor the changes once implemented. Each Service Center would be required to determine statistically projected error rates by analyzing a sample of payments made each quarter. A statistical sampling of all invoices paid from the negative confirmation procedure would be selected from the universe of all such payments to verify that the process is operating as intended.⁵ For each item selected in the sample, the Service Center would request evidence of receipt and acceptance from the applicable satellite office. Center staff would compare the items listed on the related purchase orders, invoices, and receiving evidence to ensure that the type of goods and/or service received was ordered and that quantities, costs, and math are accurate, complete, and proper.

⁴The primary criteria are: invoices for \$25,000 or more, partial payment invoices including contract payments for work in process, invoices where the risks of recovering overpayments exceed established thresholds (such as those from poor risk vendors and vendors doing business with Energy for the first time).

⁵Your staff stated that they plan to adopt the sampling procedures discussed in Title 7 that apply to payments under \$2,500 for the universe of negative confirmation payments less than \$25,000.

Your staff stated that if errors uncovered are within tolerable thresholds, now set at 5 percent of the number of invoices subject to negative confirmation, the process would not be adjusted, although the errors identified would be corrected. If however, the projected error rate exceeded this tolerance limit, the negative confirmation procedures would be adjusted to ensure that the rates do not breach the established thresholds. Each quarter, after the initial implementation period, the error rates would be assessed to determine if the thresholds are exceeded and procedures need to be adjusted.

Lastly, the Service Centers would be required to provide periodic training as needed by the satellite offices. Each quarter, the Service Centers would review the satellite offices' implementation of the new procedures to ensure adherence to the modified payment process. The scope and depth of the reviews to determine compliance with the procedures will be left to Service Center officials. The officials can visit the satellite offices, conduct telephone reviews, or use other methods to obtain evidence of compliance.

GAO'S ASSESSMENT OF THE PROPOSAL

The Federal Financial Management Improvement Act of 1996 mandated that agencies implement and maintain financial systems that comply with federal financial management system requirements. The Joint Financial Management Improvement Program (JFMIP) has issued a series of systems requirements documents generally accepted as the systems standards to be followed by agencies. In its "Framework for Federal Financial Management Systems," JFMIP envisioned systems with standardized information and electronic data exchange to eliminate manual processes, reduce the risks of data loss or errors, and eliminate manual reentry and interpretation.⁶ In discussing technology in payment systems, Title 7 states that agencies should endeavor to establish automated processing techniques (including data interchange) and controls whenever feasible so long as the interest of the government is protected. We believe that financial management systems will evolve to have the capabilities for automated data interchange between central offices and field offices. When the systems have evolved and are implemented, the information showing receipt and acceptance of goods recorded at the field offices would be available on-line to central offices' staff so that payment certification and processing can be facilitated promptly with limited subsequent contacts between offices. In the

⁶Framework for Federal Financial Management Systems, JFMIP, January 1995, pp. 8 and 9.

interim, until agency systems evolve to full electronic data interchange envisioned by JFMIP and alluded to in Title 7, other procedures such as the one you propose could be considered to achieve payment control objectives at less cost.

The type of process you propose to implement is referred to as "fast pay" in Title 7. You propose to combine fast pay with statistical sampling. Fast pay procedures permit invoices to be paid before verification of receipt and acceptance if there is a continuing relationship with the vendor and procedures allow the agency to take advantage of prompt payment discounts or effect other economies.⁷ Generally, to minimize the risks of overpayments, fast pay procedures are used with reliable vendors which have an ongoing relationship with an agency. Thus, if overpayment occurs, recovery is usually assured through a process of off-set on subsequent invoices. As we understand your proposal, such a continuing relationship would exist between Energy and the vendors whose invoices would be processed under a fast pay, or negative confirmation, arrangement. Conversely, under your proposal, vendors initially doing business with Energy and vendors identified as poor risks would require positive confirmation of receipt and acceptance prior to payment certification until they establish a reliable relationship with the agency. If effectively implemented, we believe that this fast pay arrangement may be used to pay your invoices provided that the cost savings resulting from implementing such process exceed potential losses.

Fast pay procedures normally require verification of receipt and acceptance of purchases after payment certification. Title 7 requires that when statistical sampling is combined with fast pay and used for verification of receipt and acceptance of purchases after certification as you propose, the plan must provide for (1) invoice examination to be commensurate with the risk to the

⁷The Office of Management and Budget Circular A-125, "Prompt Payment," December 12, 1989, and the Federal Acquisition Regulation, part 13.3, stipulate several criteria to be satisfied before implementing fast pay procedures. These criteria are designed to protect the interest of the government and to minimize the risk that overpayments may not be recovered.

government,⁸ (2) sampling of all invoices not subject to complete examination, (3) effective monitoring to ensure that the risks to the government remain within tolerable limits, and (4) a continuing relationship with the vendor such that the risk of loss is minimized.

Your staff stated that the proposal includes a sampling plan developed in accordance with these Title 7 requirements and that during the initial months of implementation and each quarter thereafter, your plan envisions a process to assess the risks of errors that occur as a result of implementing your proposal and, if needed, modifying the procedures to ensure that errors remain within tolerable thresholds. We have not tested your plan in operation to ensure that it follows these requirements. However, we believe it is acceptable if it follows the aforementioned Title 7 requirements and is effectively implemented for those specified invoices less than \$25,000.

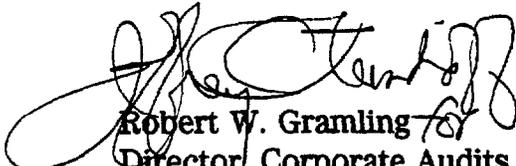
Also, we have one other observation regarding your proposal. Since the 1982 enactment of the Federal Managers' Financial Integrity Act (FMFIA), all agencies are required to review their systems of internal accounting and administrative controls and annually report material weaknesses. We believe that during the initial period and/or the first full year the payment system modifications are operational, Energy's FMFIA reviews should specifically emphasize testing the modifications by determining if the controls are effective and working as designed. Therefore, we suggest that Energy's FMFIA reviews specifically emphasize testing the controls in the proposal at the end of the year in which the implementation occurred if the modifications have been operational for most of the year and that the emphasis be extended through the following year if implementation occurred toward year-end.

⁸In developing a sample plan, agencies should ensure that the risk of loss incurred by the government because it has not audited each invoice is offset by the administrative cost savings achieved by using the sampling techniques. In order to achieve savings defined by Title 7, the costs of examining all vouchers would exceed the combined costs of (1) examining the sample and (2) projected losses due to undetected errors on invoices not examined. Through analysis, the plan must develop and identify a tolerable error rate (the point at which, or below which, savings should occur), the number of vouchers to select for examination, and the selection method.

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The contents of this letter were discussed with Wendy Miller and Jeffrey Payne of your staff. We hope our comments are helpful as you implement system modifications best suited to your needs. If you have any questions or would like to discuss these matters further, please contact me at (202) 512-9406 or Bruce Michelson, Assistant Director, at (202) 512-9366.

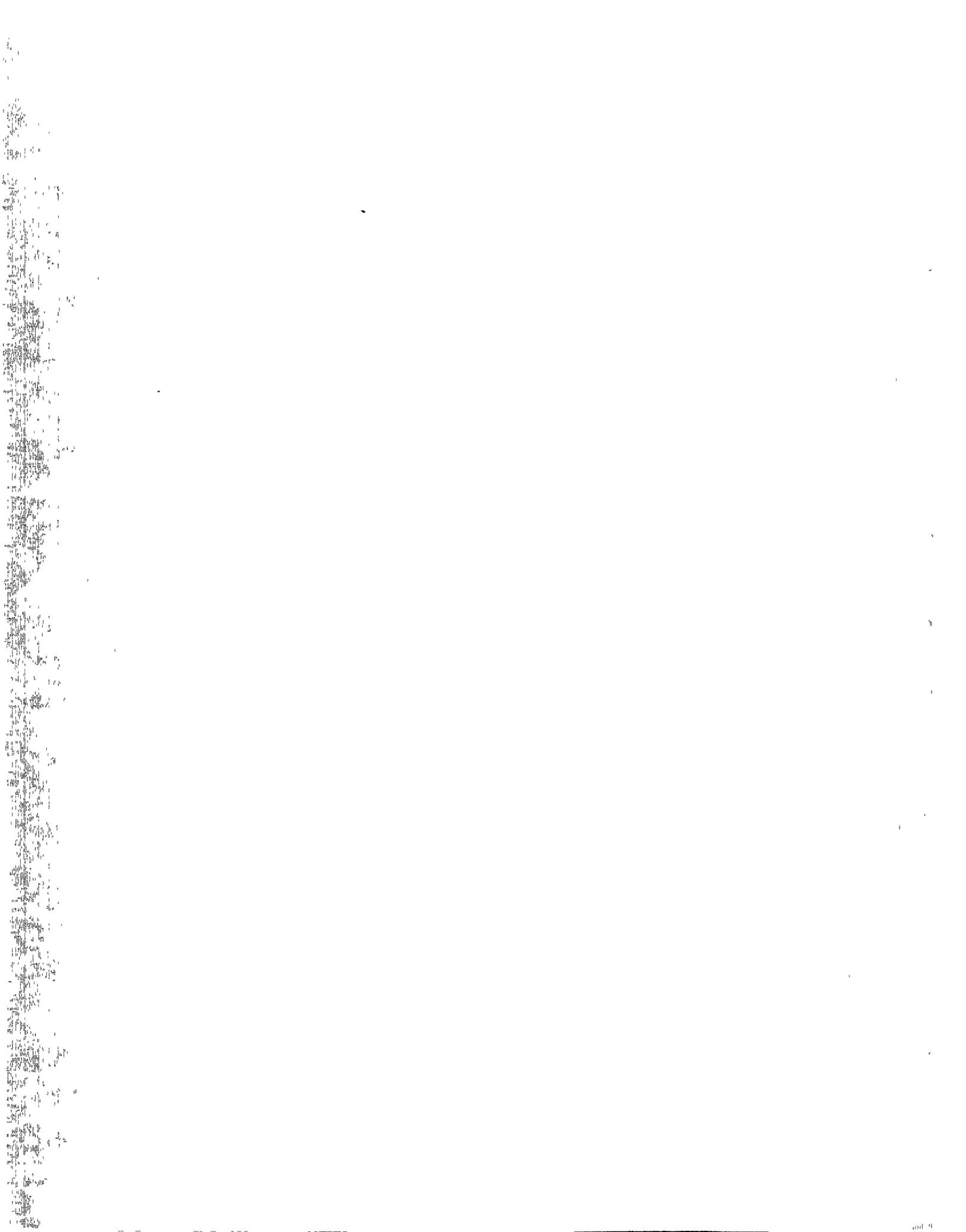
Sincerely yours,



Robert W. Gramling
Director, Corporate Audits
and Standards

(922233)

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