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

Accounting and Information  
Management Division

B-278123

October 21, 1997

Mr. William H. Eargle, Jr.  
Deputy Chief Financial Officer  
for Accounting  
U. S. Department of Housing and  
Urban Development

Subject: Payment Processing: Validation After Payment on a Sampling Basis

Dear Mr. Eargle:

This letter responds to your May 14, 1997, request for an interpretation of the requirements of Title 7, "Fiscal Procedures," of GAO's Policy and Procedures Manual for Guidance of Federal Agencies. Specifically, you asked if the Department of Housing and Urban Development (HUD) could implement a process, known as "fast-pay" under Title 7, which validates receipt and acceptance of goods and services ordered and the accuracy of invoices after payment certification for purchases costing \$2,500 or less. This process would be in lieu of the validation Title 7 requires in most instances prior to payment certification. In addition, in lieu of verifying receipt and acceptance and invoice accuracy for each payment, you propose a verification process performed on a statistical sampling basis.

As described in your letter and explained by your staff during subsequent discussions, HUD is evaluating its existing invoice examination program with the intention of streamlining its operations and reducing the cost of government. We support initiatives to create a government that works better and costs less. At the same time, agencies have the responsibility to protect the government's interest.

To supplement the information in your letter, we contacted your staff to discuss your question in more detail. Since we did not test your current system, our response only addresses your question conceptually.

Although payment certification prior to invoice validation increases the risk of overpayments to vendors, that risk could be acceptably mitigated if reasonable assurance of recovery of overpayments exists. Combining payment certification

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prior to invoice validation with a statistical sampling procedure performed after payment to examine invoices under \$2,500 also increases risks. These risks would be acceptable provided that (1) the agency has a continuing satisfactory relationship with vendors, (2) an assessment of the benefits of implementing the sampling plan compared to the additional risks associated with it reveals that the benefits exceed projected costs, and (3) the risk of errors and irregularities occurring and going undetected prior to payment is periodically assessed and kept within established thresholds. Your proposal addresses the second and third conditions; however, we have two concerns regarding the first condition and offer a control procedure to address it. In addition, we have another 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 procedures we suggest are effectively implemented as well. Our assessment of your proposal is discussed in detail in the following sections.

#### HUD'S CURRENT SYSTEM

HUD's payment certification and processing currently occurs at three main administrative accounting centers (located in Washington D.C.; Atlanta, Georgia; and Ft. Worth, Texas) which service 82 offices where the purchases take place. Each center is assigned a number of offices to service. Beginning in fiscal year 1998, HUD is planning on consolidating the three centers into the Ft. Worth center. The current payment processing system applied by the three centers would continue to apply to the single Ft. Worth center. The system modifications discussed in the following section would be implemented in Ft. Worth.

Your staff explained that under the current system, purchases are initiated at any of the 82 offices where contracts, purchase orders, and training requests are completed and funds are obligated. Invoices are then sent to the appropriate center for payment processing. All invoices are validated prior to payment certification and each is examined to determine, among other things, that a proper obligation was made, that the vendor is an approved vendor, that receipt and acceptance is documented, and that invoice footings and extensions are accurate. Verifying that the obligation is proper and the vendor is approved is done in an automated process.

#### HUD'S PROPOSED SYSTEM MODIFICATION

You propose to modify your existing system by making payment on a "fast-pay" basis, thus validating receipt and acceptance and invoice accuracy on a statistical sampling basis after payment is made. Under your proposal, the

center will continue to receive invoices. Each invoice of \$2,500 or less would be examined in an automated environment to determine that a proper related obligation was made and that the vendor is approved. The invoices would then be scheduled for payment certification and paid.

After payment, at the beginning of each month, all invoices subject to this procedure for the past month would be part of a universe from which a statistical sample would be selected.<sup>1</sup> All invoices selected in the sample would be validated by being examined to determine, among other items, that proper receipt and acceptance is documented and that invoice footings and extensions are accurate. This new process would be monitored each month to ensure that errors remain within tolerable limits. The results of the monthly samples from the center would be analyzed to ensure that errors are within a 5-percent tolerable limit or corrective action will be taken.

You propose these modifications because you believe them to be cost beneficial to HUD. In planning and designing the proposed modified procedures, your staff conducted tests and analyzed fiscal year 1997 data<sup>2</sup> to predict possible costs savings. Based on the tests and analysis and considering projected losses due to undetected errors or irregularities on invoices not examined, you estimate that the total annual savings for HUD would be about \$349,500.

#### OUR ASSESSMENT OF HUD'S PROPOSED SYSTEM MODIFICATIONS

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

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<sup>1</sup>Your staff explained that the sampling methodology would follow the requirements of Title 7 of the Policy and Procedures Manual.

<sup>2</sup>Fiscal year 1997 data projected by HUD included a total of 33,443 invoices for about \$231 million that will be processed for payment by HUD. Of these amounts, 23,170 invoices totaling about \$9 million were projected for invoices of \$2,500 or less. Invoices for \$2,500 or less subject to the proposed modified process were projected to be about 69.3 percent of the total number of invoices processed, but only comprised of about 3.9 percent of the total dollar amounts.

eliminate manual reentry and interpretation.<sup>3</sup> 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 interests of the government are protected.

We believe that financial management systems will continue to improve and evolve to have the capabilities for automated validating of invoices and data exchange between central and field offices. When the systems have evolved and are implemented, invoices that could be tested for accuracy and information showing receipt and acceptance of goods recorded at field offices would be available on-line to central office staff so that payment certification and processing could be facilitated promptly with limited subsequent contact between offices. Title 7 recognizes that in the interim, until agency systems evolve to full automation and full electronic data interchange envisioned by JFMIP, 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 and avoid penalties or effect other economies.<sup>4</sup> Your letter stated that the proposed modifications should enable HUD to realize an estimated savings, part of which would be attributable to late payment penalty avoidance or prompt payment discounts.

We have previously reported<sup>5</sup> that, generally, to minimize the risks of overpayments, fast pay procedures are used with reliable vendors who have an ongoing relationship with an agency. Thus, if overpayment occurs, recovery is usually assured through an off-set process on subsequent invoices. As we

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<sup>3</sup>Framework for Federal Financial Management Systems, JFMIP, January 1995, pp. 8-9.

<sup>4</sup>The 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.

<sup>5</sup>Payment Processing: "Negative Confirmation" of Receipt (GAO/AIMD-97-77R, April 24, 1997).

understand your proposal, such a continuing relationship would exist between HUD and nearly all vendors whose invoices would be processed under a fast pay arrangement. However, we have two concerns regarding the application of fast pay procedures as proposed.

First, vendors doing business with HUD for the first time would not have a prior relationship. Therefore, in order to determine the acceptability of vendors and to establish an ongoing relationship, we believe that HUD should verify receipt and acceptance and invoice accuracy prior to payment certification until such time as confidence is gained in the vendor's ability to provide timely and quality goods and services and accurate billings.<sup>6</sup> Second, for vendors identified as poor risks, HUD should confirm receipt and acceptance and verify invoice accuracy prior to payment certification until the vendor establishes a reliable relationship with HUD.<sup>7</sup> Therefore, we suggest that HUD implement a process to identify first time vendors and vendors that are poor risks and verify receipt and acceptance and invoice accuracy before payment certification until the vendors are considered reliable. If these two concerns are addressed and your proposal identifies these vendors and validates payment prior to certification, this fast pay arrangement may be used to pay your invoices.

Fast pay procedures normally require verification of receipt and acceptance and invoice accuracy on all purchases after payment certification. Title 7 requires that when statistical sampling is combined with fast pay, as you propose, the plan must provide for (1) invoice examination to be commensurate with the risk to the government,<sup>8</sup> (2) sampling of all invoices under \$2,500 not subject to

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<sup>6</sup>We believe that identification of first-time vendors can be made in an automated system where the system can be programmed to "flag" or highlight such vendors. Once identified, receipt and acceptance and invoice accuracy for those vendors can be verified a reasonable number of times until the vendors are believed to be reliable.

<sup>7</sup>We believe a cost-effective method, similar to the one identified in footnote 6, could be implemented to identify vendors who are poor risks so that receipt and acceptance and invoice accuracy can be verified prior to payment certification.

<sup>8</sup>In developing a sample plan, agencies should make sure that their proposed procedures will produce savings while adequately protecting the government's interests. Savings defined by Title 7, would be achieved where the combined costs of (1) examining the sample and (2) projected losses due to undetected errors on invoices not examined are less than the cost of examining all

(continued...)

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 letter contained a detailed description of HUD's estimated savings and risks as well as your sampling plan. Also, your staff stated that the sampling plan was developed in accordance with Title 7 requirements and that each month after implementation your plan envisions a process to assess the risks of errors that occur as a result of implementing your proposal and, if needed, to modify the procedures to ensure that errors remain within tolerable thresholds. We believe that, if properly implemented, your sampling and monitoring plans meet the requirements of Title 7.

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, HUD's FMFIA reviews should specifically emphasize testing the modifications by determining if the controls are effective and working as designed. Therefore, we suggest that HUD's FMFIA reviews specifically emphasize testing the controls contained 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.

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We appreciate the thoroughness of your written request and hope to provide it as an example to other agencies intending to make similar requests. The contents of this letter were discussed with Mr. Bill Humfleet, Field Comptroller, Atlanta Administrative Accounting Center and Ms. Doris Neubert of your staff.

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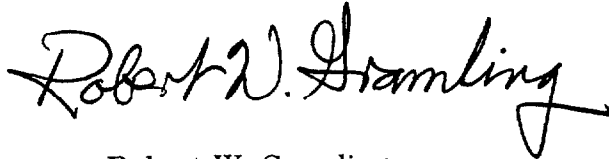
<sup>8</sup>(...continued)

vouchers. 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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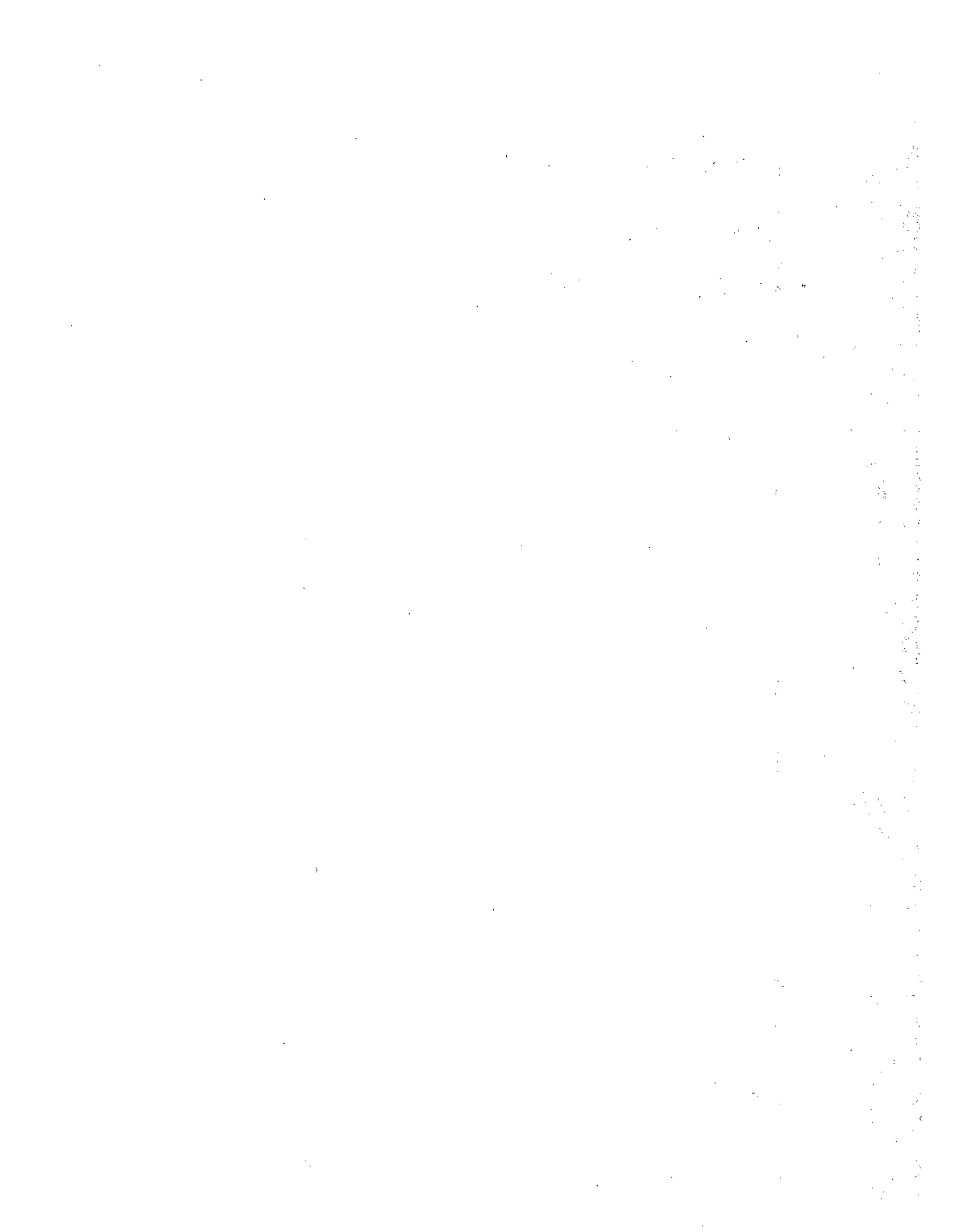
We hope our comments are helpful. If you have any questions or would like to discuss these matters further, please contact me or Bruce Michelson, Assistant Director, at (202) 512-9406.

Sincerely yours,

A handwritten signature in black ink that reads "Robert W. Gramling". The signature is written in a cursive style with a large, stylized initial "R".

Robert W. Gramling  
Director, Corporate Audits  
and Standards

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