



KPMG Peat Marwick LLP

A Review of Los Angeles County's

*Debt Tracking and
Collection Management*

Final Report

June 19, 1998

**COUNTY OF LOS ANGELES
CITIZENS' ECONOMY AND EFFICIENCY COMMISSION
DEBT TRACKING AND COLLECTION MANAGEMENT STUDY**

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I. Introduction

In March 1997, a study of Los Angeles County's Debt Tracking and Collections Management was commissioned by the Board of Supervisors of the Citizens' Economy and Efficiency Commission. The purpose of the study was to evaluate the County's individual and commercial debt tracking and collections and to maximize the collection of debts owed to Los Angeles County.

The project commenced in June of 1997, when the Commission hired Ken Pride, an independent consultant, to serve as Project Director and employed the CPA firm of Strabala Ramirez & Associates to perform a variety of support tasks for the study. For the next six months, Mr. Pride and the team began reviewing the County's current debt collection systems and processes for efficiency and effectiveness. The project was discontinued in December 1997 due to a lack of funding.

In February 1998, the Board of Supervisors approved a resumption of the study and in April 1998, engaged KPMG Peat Marwick LLP to assist Mr. Pride and the team with the following tasks:

- Review the major debt management and collection processes used by the County
- Review possible new or expanded federal and state government involvement
- Investigate and analyze the current government's interfaces of the County with all appropriate governments as they relate to debt tracking and collection systems

Mr. Phil Garland, KPMG's National Partner-In-Charge of Outsourcing Solutions, assigned Phil Brand and Teresa Boney as the lead consultants on the project.

Phil Brand, National Director of KPMG's Tax Controversy Services, has 26.5 years experience working in various technical, managerial and executive positions with the Internal Revenue Service. Mr. Brand was the former Chief Financial Officer and Chief Compliance Officer for the IRS. In both roles he was responsible for management and collection of IRS accounts receivable. Also included in his responsibilities was the IRS Office of Fed/State programs. This office is responsible for liaison and cooperation between the IRS and state and local government agencies. He has extensive experience advising federal, state and local government agencies in the area of debt management and collection.

Teresa Boney, Senior Consultant, has over 11 years experience in advising clients on business process re-engineering, strategic planning, financial management and organizational and operational analysis. She consults with federal, state and local governments on a variety of programs including debt management and collection operations. She has extensive experience in the area of privatization of various government operations.

Based on the available time frame and the County's limited budget, KPMG advised the Commission in a letter dated April 24, 1998 that KPMG could be most helpful by providing the following consulting services:

- Review and comment on the work already performed on the County's debt management and collection processes by consultants engaged to date, as well as provide recommendations for refinement, as appropriate.
- Identify agency best practices at the federal/state/local government levels.
- Investigate and analyze the current government interfaces of the County with appropriate governments as they relate to debt tracking and collection.
- Assist in the development and presentation of the report findings and recommendations.

On May 4 and 5, 1998, the KPMG team visited Los Angeles to meet with the current project team: Mr. Ken Pride, an independent consultant, Mr. Harry Hufford, independent consultant and former Chief Administrative Officer of Los Angeles County, and Strabala Ramirez & Associates, a CPA firm. The purpose of the visit was to gain an understanding of the current project status and KPMG's role in the development of the final report due on or before July 2, 1998.

This report provides more detailed information regarding KPMG's role, approach, and findings. It also provides the Commission with recommendations on an alternative approach to privatizing its debt collections.

II. Project Scope and Methodology

Based on the initial review of the project objectives, the KPMG team developed a three-phased approach designed to identify and implement a full range of alternatives for enhanced debt collection for the County of Los Angeles.

Phase I of the project scope involved an internal assessment of the current work-in-progress and any existing studies on the County's debt tracking and collection activities. In this phase, KPMG collected information from a variety of sources including:

- Previous project plans, objectives, and milestones
- Preliminary reports and recommendations (from current team)
- Public and Private Sector Best Practices Study

- Debt Tracking Process Flowcharts for Treasurer Tax Collector, D.A. Bureau of Family Support Operations, LA Municipal Court, LA Superior Court, BFSO, Probation Department, and Department of Health Services
- Reports on Total County Receivables and Delinquencies - 1995-1997

Phase II involved an external assessment primarily focused on possible partnering alternatives that could enhance the overall effectiveness of the County's current government interfaces with appropriate federal, state, and local governments as they relate to debt tracking and collection. In this phase, KPMG conducted research on California state laws, such as the Code of Civil Procedures -Section 1013, Vehicle Code-Section 15210, and Business & Professional Code-Section 101. Research of federal laws included the Federal Debt Collection Act of 1996, Executive Order 13019 and Internal Revenue Code Section 6103. Reviews were also made of ancillary federal regulations and pending legislation that could affect offsets and exchange of information between agencies.

The team also interviewed members of the County's Treasurer Tax Collector (TTC) Office, the Office of the Auditor-Controller, and the Department of Health Services. Additionally, team members interviewed officials of the Internal Revenue Service (Federal/State Relations Office) the California Franchise Tax Board, US Treasury Department (Financial Management Services and Government Wide Policy & Planning Divisions), staff of the Senate Finance Committee United States Senate, and employees of various State Revenue and Social Services Departments. Team members also met with a former Chief Administrative Officer for the County and representatives of private collection agencies.

Phase III included developing an alternative approach or template for privatizing debt collections. In this phase, KPMG suggests a systematic approach to contractor selection, setting performance incentives, and properly monitoring contractor performance. KPMG's template is based on years of experience in working with government agencies who have used private contractors to replace or augment debt collection. The template highlights the major characteristics of successful debt collection contracts between government agencies and private sector debt collection firms. This template may be used as new debt portfolios are privatized and when existing contracts on portfolios are renewed.

Figure 1, below, depicts the major components and interrelationships of KPMG's three-phased approach.

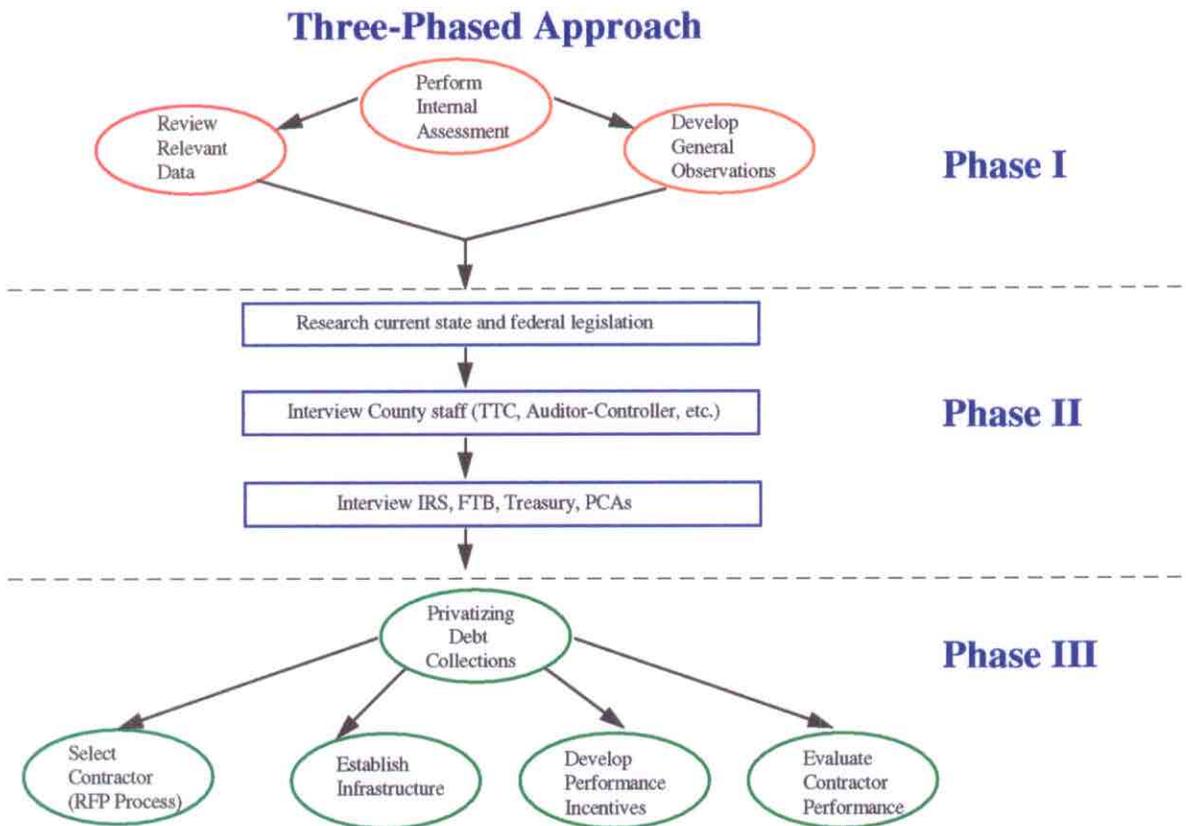


Figure 1 - Methodology for LA County Debt Tracking and Collection Project

III. Federal and State Interface Results

There are three levels of interface that are most frequently used as best practices by government agencies. These are interfaces with federal government agencies, state governments and local governments. Typical interfaces include authorization to administratively offset payments of tax refunds, some benefit payments or other payments to satisfy qualifying debt. A second type of interface is the exchange of information and access to data bases that contain information to assist in locating debtors or their assets. Lastly, there is the use of “holds” on certain types of licenses, non-emergency benefits or the ability to transact business with an agency until debt is satisfied. The KPMG team reviewed the current use of offsets and interfaces from three perspectives in that we looked at legislation and other authorities at the federal, state and local levels. A discussion on each follows.

A. Federal Interface and Liaison

The KPMG team met and interviewed a number of officials with the US Treasury Department's Financial Management Services and Government-Wide Policy and Planning and Financial Divisions. The team also interviewed management officials of the Internal Revenue Service, National Director of Federal State Relations, and the IRS Los Angeles District's Federal State Coordinator. Team members also spoke with representatives of the Federation of Tax Administrators and various state agencies. Lastly contacts were made with officials of the Social Security Administration and Department of Health and Human Services to explore possible liaison opportunities.

There are currently a number of opportunities for interface between States and in some instances other levels of government and Federal agencies. Included in these opportunities are the ability to use administrative offsets against eligible federal payments and in some instances even federal tax refunds. For example, states are able to certify delinquent child support payments to the Internal Revenue Service for offset of federal tax refunds. Los Angeles County is involved in this type of offset program. Also, some federal agencies can certify certain non-tax debts owed the federal governments to the IRS for offset. In order for a level of government other than a state to participate in any of the current federal refund offset programs, the debt must be defined as a obligation to the state.

Offsets of Federal Payments

The trend to utilize offsets has been greatly expanding. Most recently, federal legislation in the Debt Collection Improvement Act of 1996 and Executive order 13019 issued in September 1996 expanded the ability of designated agencies to use offsets.

The Debt Collection Improvement Act of 1996 at the federal level authorizes the Secretary of Treasury to offset certain types of federal payments other than tax refunds for other federal agencies and for some state debts. There is a required regimen of previous collection action, certification etc. Unfortunately, with the exception of some programs that local governments participate in with their state counterpart, local government debt cannot be administratively offset at the federal level.

Offset of IRS Refunds

Currently federal tax refunds cannot be offset for non-federal debt except in the areas of delinquent child support payments, student loans, and some similar quasi federal debts. This barrier may be eliminated when pending legislation HR 2676-IRS Restructuring and Reform Act introduced in 1997 is enacted. The Act authorizes the administrative offset of federal tax refunds to satisfy certain state tax debts. Legislative versions of this act have passed both the House and Senate and conferees are currently working to iron out the differences in the two bills.

Review of the legislative language and discussions with the Senate Finance Committee staff indicates that while this legislation will pass, the language is of little help to Los Angeles County. While federal refunds could be administratively offset by States, the type of debt involved is limited to “income taxes.” None of the types of debt owed to Los Angeles County will be covered by this legislation.

Access to IRS Held Information

Numerous states and some local governments are authorized access to IRS information and can exchange information that assists both in the administration of income taxes. Section 6103 (d) (1) of the Internal Revenue Code authorizes the disclosure of certain confidential taxpayer data for tax administration purposes. This authorization pertains to states. The definition of a state includes any municipality with a population in excess of 250,000. However the definition of tax administration purposes requires that the tax to be administered is either an income or wage based tax. IRS officials advised that in 1996 they attempted to get Treasury’s General Counsel to give them a broader definition of taxes and debt covered by this section of the Internal Revenue Code. The purpose was to allow access to IRS confidential tax information by local governments to assist in collecting a wider variety of debt. General Counsel’s opinion prohibited any such expansion. None of the debt owed Los Angeles County meets this definition thus, the IRS is prohibited under the Internal Revenue Code from disclosing confidential information to the County.

Access to Other Federal Agency Information

Federal privacy and disclosure statutes govern the exchange of personal and confidential information between the federal government and other government agencies. The KPMG team reviewed other federal statutes and made contact with other agencies including the Social Security Administration and Health and Human Services to gauge the availability and desirability of using data that agencies other than the IRS may possess. Based on our review, the type of debts owed LA County generally cannot be offset against federal payments and the exchange of information is also limited. More importantly, in reviewing the type of data maintained by various federal agencies, when it is updated, and the overall currency of such data, access would generally not be helpful to the current County collection effort. Lastly, the lack of common or missing identification numbers on some debt, the age of the debt, and the type of debt involved would also, in our judgement, make such an effort non-productive.

Summary

There are limited opportunities to use federal administrative offsets or federal information databases to assist in County debt collection. The County can make improvements in the other areas that would be more productive than the use of additional interface with federal agencies.

B. State of California Interface and Liaison

Many of Los Angeles County citizens owe delinquent sums of money to departments at all levels within the County. Ironically, at the same time these individuals owe the County monies, the State of California’s Franchise Tax Board (FTB) may owe the same individuals a tax refund.

The County of Los Angeles primarily interfaces with the FTB to help offset tax and non-tax debts owned by County residents. However, the FTB in turn liaisons with the State of California’s Department of Social Services and the State of California Lottery to exchange information on County debtors.

To gain a better understanding of these offset programs between LA County and the State of California, the KPMG team interviewed a number of personnel in the Collection Services Division of the County’s Treasurer Tax Collector’s Office and the State of California’s Controller’s Office, Franchise Tax Board, and Department of Social Services. The team also studied all relevant State of California Codes outlined in *Table 1* below.

State of California Code	Section
Government Code	<ul style="list-style-type: none"> • 12419.5 - Offsets and Deductions • 12419.8 - Offset of Amounts Due to a City or County ; Deduction of Costs • 12419.10 - Offset of Fine, Bail, Parking Penalty, or Reimbursement
Revenue and Taxation Code	19280 and 19551
Vehicle Code	15210
Code of Civil Procedure	1013
Business & Professions Code	101, 1000, and 3600

Table 1 - State of California Codes Researched

Franchise Tax Board (FTB)

In 1975, the FTB began intercepting the tax refunds of Californians who owe delinquent amounts to the state and counties agencies. In addition to collecting delinquent tax obligations, the FTB also intercepts a host of court-ordered debt (e.g., court fines, penalties, orders), child support obligations, and California State Lottery prizes. Once intercepted, the refunds and lottery prizes are redirected to the agencies to which the debts are owed.

The State of California’s FTB has established three programs for collecting such outstanding debt: 1) Interagency Intercept Collections Program; 2) Court-Ordered Debt Collections Program; and 3) Child Support Collections Program.

1. *Interagency Intercept Collections Program - Collection Process*

The County of Los Angeles, along with numerous other local agencies, has elected to participate in the State of California's Interagency Intercept Collections Program. Interagency Intercept Collections are governed by Sections 12419.5 and 12419.8 of the California Government Code.

On the 10th of each month, LA County's Treasurer Tax Collector's (TTC) Office sends delinquent accounts (90 days or older) via tape to the FTB for intercept only after avenues for collection have failed and the debtor has been sent a notification of the impending intercept. The FTB then loads the data into a mainframe file which is matched by social security number against taxpayer records. If the system matches a delinquent account to the taxpayers records, a "flag" is placed on the account to indicate that FTB will intercept any pending tax refund. Accounts that the system cannot match to the taxpayer records are held in a suspense file. If the debtor later files a return that matches an account, the mainframe system will pull the account from the suspense file and intercept the refund or flag the account if no refund is yet due. Flags remain on accounts until the end of the calendar year.

In addition to flagging accounts that match taxpayers' files, FTB matches accounts with winners of the California State Lottery. FTB receives a tape of prize winners from the California State Lottery to match against the intercept accounts before lottery winnings are distributed.

Interagency Intercept Collections is self-funded. FTB and the State Controller's Office calculate their administrative costs annually and the State Controller's Office bills and collects these amounts from LA County and other participating agencies. LA County and other participating agencies are billed approximately 11 cents for each case submitted on tape. Government Code Section 12419.2 allows LA County and other participating agencies to add this cost of collection to the amount the debtor owes the agency.

Table 2 below shows the Interagency Intercept Collections Program's latest collection totals for fiscal year 1996/1997.

**INTERAGENCY INTERCEPT COLLECTIONS PROGRAM
1996/1997 FISCAL YEAR COLLECTION TOTALS**

<i>CLIENTS</i>		<i>COLLECTED INTERCEPTS</i>		<i>PERCENT</i>
Type	# Participating	Number	Total Dollars	Of Total Collected
State agencies	89	286,040	\$50,210,221	57.3%
City agencies	32	9,369	992,336	1.1%
County agencies	51	61,770	7,672,087	8.8%
Federal (IRS)	1	94,912	28,702,303	32.8%
Total	173	452,091	\$87,576,947	100%

Table 2 - Interagency Intercept Collections Program Activity

2. Court-Ordered Debt Collection Program - Collection Process

In an effort to reduce the amount of court-ordered debt owed in the state, the California Legislature allowed the FTB and county superior, municipal, and justice courts to form partnerships to collect court-ordered debts. For those courts that volunteer to participate in the program, FTB collects certain criminal fines, penalties, forfeitures and restitution orders, as well as most Vehicle Code violations. FTB's Court-Ordered Debt Collections Program is authorized under Section 19280 of the California Revenue and Taxation Code.

However, not all courts under LA County jurisdiction participate in the FTB's Court-Ordered Debt Collections Program. At one time, LA County municipal and superior courts did participate in the Court-Ordered Debt Collection Program. However, these two LA County courts were recently consolidated and have since elected to submit delinquent debts to GC Services, a private collection agency, rather than to the FTB. On the other hand, LA County's Administrative Consolidated Municipal Courts (ACMC), which consists of about seven municipal courts and is based in Compton, just recently joined the FTB's Court-Ordered Debt Collections Program.

On the 10th of each month, all delinquent ACMC cases are submitted by the County's TTC Office via tape to the FTB to be processed. FTB first mails a Demand for Payment notice to the debtor. If the debtor does not resolve the debt within 10 days, the FTB then issues a levy against the debtor's bank accounts, wages, or other sources of income. When a levy attaches a bank account, the debtor has 10 days to pay his/her debt, or the bank forwards the funds to FTB. When a levy attaches wages, the debtor has at least 10 days to pay voluntarily before the employer begins withholding up the 25% of his/her disposable income.

Any monies collected by the FTB for the courts are deposited into a Court Collection Fund--an account created for Court-Ordered Debt Collections. The balance, minus FTB's administrative costs (not to exceed 15% of collections), is transferred to the court, county, or state fund to which the debt is owed.

Table 3 below shows the Court-Ordered Debt Collections Program's latest collection totals for fiscal year 1996/1997.

**COURT-ORDERED DEBT COLLECTIONS PROGRAM
1996/1997 FISCAL YEAR COLLECTION TOTALS**

<i>CASE INVENTORY</i>		<i>COLLECTION ACTIVITY</i>	
Cases submitted by courts	106,581	Demand notices	74,668
Cases returned before FTB action	(27,484)	Bank levies	2,242
Cases returned after FTB action	<u>(10,068)</u>	Wage levies	<u>37,228</u>
Net change in inventory	69,029	Total collection activities	114,138
Fiscal year-end inventory	107,140	Total collected (rounded)	\$3,762,500

Table 3 - Court-Ordered Debt Collections Program Activity

3. Child Support Collections Program - Collection Process

On January 1, 1998, the State of California issued a mandate that county and city District Attorneys (DA) refer all child support obligations which are at least 90 days delinquent to the FTB for collection in the same manner the FTB collects delinquent tax obligations.

The Child Support Management Bureau of the California Department of Social Services works closely with the FTB and the DAs to manage, track, and process delinquent child support cases. The California Department of Social Services also refers all overpayments and over-issuances to welfare and food stamp recipients to the FTB for collection.

At the time of our interview, no statistics on collection totals of the Child Support Collections Program was available.

Summary

Based on our review of the legislation, authorizations, and current practices, the County is making adequate use of the various interfaces available at the state and local level. However, KPMG believes that the County could benefit more from these interfaces if the type of debt that may be referred to the FTB is expanded to include debts owed to the Department of Health Services. We recognize that this would require legislation by the state. More detailed information on this proposal can be found in the Recommendations section at the end of this report.

IV. An Approach To Privatizing Debt Collection

While recognizing that some County Departments and the Treasurer Tax Collector (TTC) currently use private collection agencies (PCAs) to support their efforts, KPMG finds that a increasing number of federal agencies, states and local governments are turning to the private sector for assistance in collecting government managed debt.

If the County greatly expands its approach to use of PCAs or when existing contracts with PCAs are renegotiated or put up for bid, the following template will assist in improving the outcomes of the use of PCAs.

Government agencies are increasingly turning to the private sector for assistance in collecting government managed debt. Forty state governments now use private collection agencies to augment their own tax collection operations. Debts for student loans, delinquent child support payments, fines, and taxes are now commonly referred to the private sector from agencies at the local, state, and the federal level. The downsizing of government, the need for revenue, and government reinvention efforts have heightened the use of private debt collection to replace or supplement the government's own debt collection processes.

Despite the increasing privatization the results have been mixed. This is caused in part by: (1) the resistance in the bureaucracy to the idea of privatizing; (2) philosophical disagreement with the concept of transfer of what some see as an "inherent governmental responsibility"; (3) the constraints government regulations place on the procurement process in general; and primarily (4) because of poorly designed plans to select, motivate and monitor the performance of the private collection agencies hired.

KPMG believes that by using a systematic approach to contractor selection, setting performance incentives, and properly monitoring contractor performance, government will ensure that results from this form of privatization are maximized.

The following template is based on KPMG's experience in working with government agencies who have used private contractors to replace or augment debt collection, the input of private sector debt collectors, and the expertise of KPMG employees who have assisted in "privatizing" debt collection while previously working in government. The template highlights the major

characteristics of successful debt collection contracts between government agencies and private sector debt collection firms.

Table 4 below provides a quick overview of the **key elements** KPMG believes should be included when contracting for collection services. A more in-depth discussion of the key elements follows the table.

KEY ELEMENTS OF CONTRACTING OUT COLLECTION SERVICES

RFP/Contract Activity	Recommendation	Outcome
Number of Contractors	<ul style="list-style-type: none"> • Select more than one contractor. The number is dependent on the size of the portfolio. • Select an alternate as standby. 	<ul style="list-style-type: none"> • Ensures healthy competition. • Allows easy replacement for poor performing contractor(s).
Length of Contract	<ul style="list-style-type: none"> • Two to three years with additional two (1) one year extensions. 	<ul style="list-style-type: none"> • Allows vendors to invest in and recoup costs.
Allowable Work Period	<ul style="list-style-type: none"> • Upon expiration or non-renewal of a contract, a contractor should be allowed to retain accounts placed for collection a minimum of 12 months from date of placement. 	<ul style="list-style-type: none"> • Ensures all accounts will be worked thoroughly up to the contract termination date.
Retention of Payfile	<ul style="list-style-type: none"> • Contractor should be allowed to retain all accounts in repayment status for some minimum period from the date of contract expiration or termination for convenience. • Period of retention should be equal to the term for an average balance account to pay off through monthly payments such as thirty-six months. 	<ul style="list-style-type: none"> • Encourages vendors to initially invest funds necessary for a thorough collection effort. • Avoids “creaming” account listings. • Provides more negotiation options to settle cases. • Avoids pressure tactics. • Results in fewer complaints. • Allows vendors to recoup up-front costs.

RFP/Contract Activity	Recommendation	Outcome
Initial Placement of Accounts	<ul style="list-style-type: none"> • Each contractor initially should receive a placement of which is based on a random selection. • Accounts should have equal quality and same appropriate average balance. 	<ul style="list-style-type: none"> • Creates a fair and level playing field for contractor performance evaluation.
Pre-Qualifying Experience	<ul style="list-style-type: none"> • Contractors should have a minimum of 3-5 years of government debt collection experience (local, state or federal). • Contractors should have a proven track record of handling contracts similar in size to the portfolio that is being placed. • Contractor references should also be representative of similar portfolio size. 	<ul style="list-style-type: none"> • Ensures proven track record of performance handling similar sized accounts and volumes. • Understands government requirements and expectations. • Assures resources availability-systems, technology, reporting capability, etc.
Fees, Incentives, and Placement Distribution	<ul style="list-style-type: none"> • Use multiple contractors in competition with each other. • If using three or more contractors, provide a bonus of two percent (2%) on top of the base fee for the top performer and one percent (1%) to the second place performer. • Larger future placements should be awarded to top performers. Distribution of 50/30/20% if using three contractors. • Evaluations should take place every three months Base collection fee should be fixed to ensure that all contractors are on the 	<ul style="list-style-type: none"> • Creates competitive environment between contractors. • Rewards performance. • Increases net collection return. • Allows contractors to invest the required resources to provide the optimal return. • Avoids “creaming” of accounts.

RFP/Contract Activity	Recommendation	Outcome
	same competitive level ⇒25% contingency fee.	
Performance Evaluation	<ul style="list-style-type: none"> • Recovery should be calculated using total dollars collected divided by total dollars placed for the entire contract to date. 	<ul style="list-style-type: none"> • Provide a fair and equitable way of evaluating contract performance. • Focuses on what is important, revenue collected.
Request for Industry Comments	<ul style="list-style-type: none"> • Final draft of the RFP should be provided to the prospective bidders for comments. • Offers no competitive advantage to any bidders as all have the opportunity to comment. 	<ul style="list-style-type: none"> • Ensures clarity and offers opportunity to improve the final product. • Reduces questions and speeds the RFP process. • Reduces opportunity for a protest.

Table 4 - Key Elements Of Contracting Out Collection Services

(1) Number of Contractors

KPMG recommends using a minimum of two or three contractors for most debt portfolios e.g. one contractor per \$50 million of annual placements but seldom less than two. This number can be larger depending upon the size of the debt and number of accounts assigned to contractors; however, the number must remain manageable. The use of multiple contractors ensures competition and allows the client to provide incentives to all by offering rewards to the highest performing contractors.

Additionally, the agency should select an alternate contractor as a “standby”, in case one or more of the original contractors defaults or does not otherwise perform. This alternate then would automatically move into the defaulting contractor’s slot. This strategy would allow the government agency to use the term of the contract as an incentive to encourage contractor performance.

(2) Length of Contract

The investment required by both the government agency and the collection contractors to ensure the contract’s success requires significant up-front expenditures. The government agency must establish proper coordination, build interfaces and arrange for facilities and staffing to ensure the contractors have what they need to perform at peak efficiency. Contractors must likewise make similar investments. They may be required to make up-front expenditures for facilities, staffing, computer, and telecommunications equipment. In order to ensure that the contractor is willing

to make the required up-front investments, the base term of any contract should be for a period of at least three (3) years. The contract should also allow for an additional two [one (1) year] options to renew the contract without further competition based on satisfactory performance. The length of the contract serves as a compliment to the item, retention of payfile in encouraging contractors to adopt a long-term view on investment and performance. This extended contract term allows the collection contractors to invest more heavily in the collection effort and make meaningful commitments on facilities, personnel, and equipment. These are required investments in order to deliver high recovery rates. This stimulates long-term thinking, planning, and a thorough collection approach.

(3) Increasing Contract Term By Using Standby Awards

Many government agencies have experienced the problem of being dissatisfied with one or more collection contractors midway through a contract. However, when faced with issuing a new RFP or continuing the contract, some chose the easiest path; they continue with a poor performing contractor. To guard against this, some clients shorten the contract life to give themselves an easy exit strategy.

KPMG suggests another solution, the award of standby or inactive contracts as part of the RFP process. The “standbys” do not receive work initially, but are available as backup if one of the initial contractors does not perform. The standby contracts are at no cost to the client unless activated. Thus, poor performers can be placed on notice and if results do not improve, they can be readily replaced. Additionally, this ensures continued competition if an original contractor defaults. Having a contingency plan by using standby contractors eliminates the need to shorten the contract term and to rebid contracts more frequently.

(4) Retention of Installment Agreement (Payfile) Accounts

Allowing a contractor to retain accounts in repayment status after the expiration of a contract is **essential** to ensure an all-out quality collection effort. It is a reality in the collection business, that if collection contractors are not allowed to retain accounts in repayment status (i.e., installment agreements) after expiration or termination for convenience of a contract, they will concentrate their efforts on short-term results.

It is costly and time consuming to properly negotiate and implement a repayment program where the debtor does not default and pays regularly until an account is paid-in- full. In order to generate maximum results, collection contractors incur significant up-front collection costs in skiptracing, salaries, bonuses, etc. The majority of these costs are expended on all debtors, even those who cannot be located or who cannot pay. It is unrealistic to expect contractors to focus on long-term efforts at recovery if they cannot retain the earnings from such accounts after the contract term is completed. Failure to allow this retention will encourage short-term creaming and concentration on balance-in-full collections and substantial down payments. This creates a lack of sensitivity to the debtor’s current financial situation. It also ignores the revenue available from using longer-term installment agreements for individuals otherwise unable to pay.

The percent of accounts that pay-in-full, immediately, is three percent for the average collector and five percent for the industry leaders. Collectors usually do not generate enough collections from up-front payments to offset their initial expenses let alone make a profit. Profits come from the last few months of longer term payouts. Therefore, if accounts are placed at month thirty of a thirty-six month contract, retention provides an incentive for the collector to properly work all accounts to the end of the contract period by attempting to negotiate acceptable repayment terms. Without retention, the collector is motivated to focus only on very short term results which reduces recovery and promotes adverse debtor reaction.

In summary, for any collection contractor to achieve the highest level of performance for the client, it is essential that the retention of paying accounts be permitted beyond the expiration or termination of the contract, for convenience of the contract. The term beyond the conclusion of the contract should be equal to the time necessary for an average balance account to pay in full through monthly installments. The collector should know an account will be retained if it is kept in current repayment status for the retention period. In most cases, this period will be approximately thirty-six months.

Note: If a contract is terminated for cause, all accounts should be returned within sixty (60) days of the date of termination.

(5) Initial Placement of Accounts

In order to properly compare and monitor performance, contractors must be judged in an environment that creates a relatively level playing field. The process of assigning accounts to the various contractors should be on a random basis from the portfolio of accounts to be assigned. Each contractor should receive an initial placement of accounts which is equal and based on random selection. Accounts assigned should be of similar size, age and condition. This inventory becomes the baseline against which to measure contractor success is measured. Therefore, to ensure fair comparisons the inventory should be of equal nature.

(6) Pre-Qualifying Experience

Past history is predictive of future results. **No other factor in predicting successful contractor performance is more important than experience.** If a collection contractor has a history of performance they are likely to perform well in the future. Establishing minimum experience standards pre-qualifies all prospective collection contractors for the government agency. It also eliminates the enormous amount of time wasted reviewing bids received from firms who are unable to adequately provide the services necessary to achieve maximum results. Using such pre-qualifying experience ensures that the government will use collection contractors who have a track record of superior performance.

Some contractors can provide satisfactory results on a \$10 million dollar portfolio but cannot provide the same results on a larger portfolio. The government must be assured that the bidders have the resources to accommodate the contractual requirements, complex reporting, and electronic communications required for the amount of money in the portfolio. On large

portfolios we recommend establishing minimum experience criteria for contractors of three to five years experience of government debt collection handling portfolios of equal size to the portfolio being placed. Further, we suggest the contractors be required to provide information on their performance provided by their clients for all their contracts within the three-to-five year period. Particular attention should be given to contracts with similar size and reference information should be obtained.

NOTE: CONTRACTORS SHOULD NOT BE SELECTED IF THEY ARE OWNED BY THE SAME PARENT OR HOLDING COMPANY TO AVOID A CONFLICT OF INTEREST.

(7) Fees, Incentives and Placement Distribution

Many of the unsuccessful efforts feature contracts that focus on requirements and activities that do not directly correlate to results. It is virtually impossible to pre-establish a rate of recovery for most portfolios of delinquent debt. There are simply too many variables affecting a debtor's ability to pay. Since it is virtually impossible to pre-establish a rate of recovery for any portfolio of delinquent debt, governments often believe the fee should be the primary determining factor when selecting a private collection agency. What often happens is that the emphasis on the fee causes some bidders to bid low to "buy" the contract with the intention of "creaming the accounts." Statistics have proven that low bid usually equals low effort and low recovery.

Use of Fixed Fee

One solution to this dilemma is to pre-establish a fixed contingency collection fee and then add performance incentives for contractors who excel at recovery. All contracts should be based exclusively on what is collected. **The basis for the contingency fee structure is that a contractor is only paid for what is collected.** The adoption of a fixed contingency commission percentage rate coupled with performance incentives eliminates the confusion and uncertainty in selecting contractors based solely on commission rates. Neither the lowest nor highest rate always guarantees the best results.

It is essential that a reasonable fixed commission rate be established which allows contractors to invest the necessary resources to provide the optimal return for the client. Any "low bid" type award may force the winning contractor to curb costs and allocate minimal resources in order to provide the minimum services required by the RFP. The end result is a creaming collection effort and a significant loss to the client.

A competitive rate increases the value of the contract when compared to other potential clients with comparable portfolios. Opponents of fixed commission rates argue that it removes the competitive nature of the bidding process. To the contrary, in addition to key factors such as experience, staffing, systems, and financial stability, contractors would state what activities and level of service they would provide for the fee established in the RFP. Importantly, it also allows the agency to concentrate on qualitative factors such as experience, demonstrated performance, and proposed workplans in selecting a contractor.

Add Performance Incentives to the Fixed Fee Concept

While KPMG recommends that the RFP solicit bids based on a fixed fee contingency for all successful contractors, we also believe that offering bonus incentives to the top performing contractors based on their long-term performance ensures a competitive environment and a payback from contracting out. Bonuses are only paid to top performers. The objective of performance incentives is to motivate contractors to compete against each other for financial and placement volume rewards. The concept is simple. The top performer gets a larger share of the recovery amounts and a larger share of future portfolio placements.

Performance incentives can usually be separated into two categories; (1) fee incentives and (2) placement incentives. The value of implementing these performance incentives can be measured by the bottom line results, **more revenue collected**.

Contractor performance should be compared (netback results) over a set period of time (e.g., a period of six months). Performance bonuses such as 2% of collections to the top performer and 1% to the second place performer are used as incentives to increase performance. Additionally, the high performing companies should receive a larger portion of future placements as an added incentive. In a three contractor situation the initial placements might be 33.3% of the portfolio each to start. However, future placements should be awarded to the top performers so that after the initial period of performance comparison, the distribution pattern would change to 50/30/20%. This percentage is adjusted periodically based on performance.

In summary, while government contracting has historically focused on one determining factor in selecting firms to collect government debt, “**low cost or fee,**” KPMG’s experience is that a competitive environment created by the use of performance incentives, with significant rewards and penalties is much more effective in motivating contractors and achieving results. Under such circumstances contractors will focus on achieving the highest returns while the compensation paid by the agency is in direct proportion to the results achieved by each collection contractor. Those who produce the most results are paid the most.

(8) Evaluating Prospective Vendors

The main focus of the evaluation process should be based upon a collection contractor’s ability to perform. Establishing a weighted scoring system that focuses on experience, dependability and history of performance in government debt collections, combined with the ability to provide the staffing, management, equipment, and facilities are the primary factors that are indicative of success. The ability to properly staff the contract with experienced senior management and front line personnel will make a significant difference in a contractor’s ability to implement the work plan for the client.

The workplan (specific collection activities that will be undertaken and client support) also deserves important consideration in the evaluation process. However, while technical capability is important, the primary focus of the evaluation should be based upon fact not speculation. The client should rely on the past demonstrated performance and capabilities of the prospective contractors.

KPMG recommends the following weighting factors or points for the evaluation of the technical proposal.

Management/Staffing/Scheduling	20 percent
Contractor Experience	40 percent
Workplan and Information Systems	30 percent
Financial Stability	10 percent

This lack of emphasis on low cost or low fee as a major determining factor is because of the standard fee-based plus incentives approach outlined above. KPMG recommends that the emphasis be primarily on quality of the contractors and, hence, results, rather than fee. If cost cannot be removed as a factor, it should be included as a minor factor (e.g., 15 percent of the total score).

Evaluation of Contractor Performance

The recommended method of measuring contractor performance is the concept “net back performance.” This concept may be adjusted by other factors such as the number of legitimate customer complaints; however, in the final analysis, the basic test of performance should be the amount of assets recovered while using proper collection techniques. The value of “net back” lies in the concept of measuring the client’s share of dollars recovered by the collection agency in relation to the opportunity of the amount they had to collect and less fees charged.

KPMG’s experience confirms that the collection effort extended by a collection firm depends on the profitability of the accounts being worked. The variables that affect profitability are:

- The cost of setting up and loading the accounts on the contractors’ database;
- The difficulty of working the accounts (how thoroughly they were worked before the referral is made to the contractors);
- The collectability of the account (likelihood of getting paid once contact is made);
- The average balance of accounts; and
- The fee for service charged.

A collection firm offering low rates is typically forced to reduce the level of effort it conducts on each account, relying on a skimming or creaming method on only high balance accounts to make a profit. In other words, they concentrate on easy to locate, easy to contact accounts leaving the more difficult accounts untouched. The less favorable accounts for which government expects collections to be performed typically become secondary placements. The agency then receives a low price but at a high cost. **Seasoned creditors who use contractors, consider performance not price, as the base underlying tenet.**

“Net back” refers to the client’s share of the dollars recovered by the collection contractor. In other words, if a collection firm is paid a 20% fee on monies collected, and collects \$1,000,000 for the year, the “net back” is \$800,000. When comparing two collection firms with equal

volume of placements, determining which firm is yielding the greatest net back is easy. The agency returning the most money to the client is the better performer.

However, when comparing different volumes accounts (contract and amounts) to collection firms which are paid different fees, (i.e., base fee plus bonus or incentive), one needs to examine the net back percentage to determine which firm is providing the client with the greatest return. An example follows in *Table 5*:

Example:

Performance Indicator	Collection Firm A	Collection Firm B
1997 Dollars Referred	\$ 1,000,000	\$ 2,000,000
Recovery Rate	15%	10%
Gross Dollars Collected	\$ 150,000	\$ 200,000
Collection Contingency Fee	\$ 25%	20%
Fee Paid to Vendor	\$ 37,500	\$ 40,000
Net back to Agency	\$ 112,500	\$ 160,000
Net Back Percentage	11.15%	8%

Table 5 - Example: Evaluating Contractor Performance

Collection Firm A's net back to the client per dollar referred is greater than Collection Firm B's even though Firm B is charging a lower fee and was given twice the volume of accounts.

This evaluation method should include controls to ensure fair and equitable competition. First, each firm should receive a random selection of like accounts. Second, the time frame used for comparative results should be structured over an interval long enough to prevent firms from altering their normal procedures and to accurately reflect the agency's usual recovery rates. Third, a significant volume should be given to each firm at the start of the competition. This volume will dictate that the firms distribute these accounts among all of their collectors designated for this contract in their usual manner in order to be able to work on all accounts during the evaluation period. Finally, a reward and penalty system should be implemented to reward firms providing the best results and to penalize the least effective company. This system gives firms an incentive to produce the best results. It also ensures the greatest percentage of the clients accounts are with the firm that provides the best return.

Government owes it to taxpayers to vigorously pursue delinquent debt to ensure that everyone pays their fair share of taxes, gets their child support or repays their other obligations to government. The traditional approach of selecting the lowest bidder(s) needs to be rethought. The emphasis should shift to qualitative factors in selecting contractors and provide incentives for high performance to encourage optimum contractor productivity.

V. Recommendations

Based on its review of previous studies and materials, state and federal laws, and interviews with key personnel, the team has a number of first impression observations and recommendations. Because of the time-frame involved and the limitation of funding for a longer-term analysis, the comments and recommendations could not be fully developed, or subjected to in-depth analysis and costing. However, KPMG believes each is worthy of consideration or further development as appropriate.

1) The definition of accounts receivable varies between the various departments. As a result, we recommend establishing a common definition, understanding or process to accurately project accounts receivable.

There have been a series of attempts during this study to define accounts receivable and estimate the total recovery value of the accounts receivable. Establishing a viable baseline against which to measure future performance is paramount. Until an amount of projected recovery is firmly established, it is premature and potentially counter productive to launch major initiatives to change debt collection management and collection procedures.

The starting point should be the figures in the audited financial statements of the County. This should then be supplemented with information from the various other departments that is not included as part of the audited financial statements. Once a baseline is established, it can be used as the basis for another measure, a projection of the amount of debt that may actually be recoverable. For purposes of debt collection management and to measure collection performance, establishment of projected recovery would be extremely helpful.

Many private collection agencies (PCAs) screen debt through pre-collection analysis. Originally developed to help identify those accounts most likely to yield results, these models also help PCAs decide the value of debt portfolios. These predictive analysis models use sampling techniques to project the recovery value of accounts receivable portfolios before they commence collection actions. In general terms these predictive models require the name, last known address and social security number of the sampled accounts. Using this information, the collection company runs various diagnostics, including credit bureau checks, employment analysis and demographic data. This data is coupled with the age, type and average amount of debt outstanding. This information is then joined with previous recovery experience rates to predict the “recovery value” of the debt portfolio.

Such projections are then used to allow the collection company to zero in on those accounts that are most likely collectible. The County might find that such an analysis on existing accounts receivable could assist in determining the probable recovery rate of the various types of debt it collects.

Whether a method like this is used periodically, or simply as a one time effort, adherence to a better definition of debt and establishment of projected collectability is paramount to establishment of a baseline against which to measure results. Failure to do so will result in wide

variances in what individuals may believe to be the recovery value of accounts receivable. This in turn could cause adverse publicity, budget miscalculations, and poorly informed judgments on the performance of the County's debt collection operations.

Another phase of defining the accounts receivable is to establish and enforce firm guidelines on debt write-off. Our review indicates that many departments have large amounts of old debt on the books. Unless such debt is the subject of installment agreements or other anticipated collection the debt should be written-off. This will also assist County Supervisors in determining the value of County accounts receivable.

2) Action to collect debt should commence sooner and private collection agencies should play a broader role much earlier in the process.

The problem here is twofold. First, there is a lack of consistency and wide variety of approaches used in the collection activities of the various departments within the County. Departments have important basic functions so that debt collection actions prior to referral to the Treasurer Tax Collector's (TTC) Office are not often a high priority. Second, TTC has insufficient resources assigned to debt collection. At the time of our review, approximately eight collectors are assigned an average of over 2,400 accounts each for collection and follow-up. Thus, the delay also comes from lack of resources.

Accordingly, the actions within many departments and subsequently within TTC are focused on creaming accounts. This is done by sending out multiple notices prior to using other intervention techniques. Due to the wide variety of techniques and timelines used in the departments prior to referral to TTC, more in-depth actions often come months after the original debt is incurred. The inconsistency in when and how frequently accounts are assigned from the various departments to TTC contributes to such delay. There are guidelines as to when such accounts are to be transferred to the Treasurer Tax Collector's Office however, compliance with the guidelines vary.

Failure to work accounts in a timely manner has a two-fold negative impact. First, the longer an account goes without contact the less likelihood there is of any recovery. Different types of debt and debtors respond to varying types of approaches. Some pay based on notices, while others require personal contact. Second, failure to attempt to collect on such accounts sets up an expectation among future customers that accounts do not have to be paid.

The increased use of private collection agencies (PCAs) could greatly enhance County collection operations. While the TTC utilizes PCAs, it does so too late in the process. Secondly, the research capabilities, employee incentives and technology available to a top rate PCAs will most likely be superior to those available to County debt collection operations. This is not about the individual capabilities of the County employees but is a statement of the advantages PCAs often enjoy. These advantages may be summarized as follows:

- Major PCAs maintain and routinely improve their telecommunications, information systems support, on-line research and debt collection modeling systems based on operational needs;

- PCAs are not restricted by procurement regulations like those in the public sector. They are able to continually upgrade equipment, software, research capabilities and collection techniques;
- The successful collection agency is more advanced than most government agencies and has the ability to stay technologically current. Modern telephone systems, predictive modeling, on-line research including tie-in with credit bureaus, telephone company data bases and similar skip tracing automation are features of modern PCA operations; and
- The actions of private collection agencies are governed by the Fair Debt Collection Practices Act. This law contains multiple provisions, constraints, obligations and opportunities to collect damages to protect consumers from unfair debt collection practices.

The use of private collection agencies earlier in the process is now a best practice within private industry and within all levels of governments. Federal, state and local government agencies now routinely use PCAs for all debt collection or to assist in the collection of debt, taxes, loans and other obligations. PCAs are now evolving into a vital part of the government's debt recovery process. In fact, Los Angeles County's Department of Health Services is a prime case study example of how PCAs can improve debt collections.

The Department of Health Services has an on-going initiative to improve its collection of accounts receivable. This initiative involves an in-depth look at its processes, workflows, notices, and use of privatization. One recommendation pending as a result of this study is to change the sequence of actions on in-patient accounts receivable. Currently, the self pay accounts receive notices from the healthcare facility, unpaid accounts then go to an outside vendor who attempts to determine if the debtor may in fact qualify or have for third party coverage for the amount owed. Accounts that remain unpaid are next sent to the Treasury Tax Collection Department for another round of collection attempts. Finally the remaining unpaid accounts are referred to an private collection agency. ***Results of a study conducted by the Department indicate that sending accounts directly to the outside collection agency before sending them to TTC resulted in double the amount of collections on accounts so routed.*** The results of this study known as the Harbor Pilot have been concurred with by the Auditor Controllers office. Accordingly, a change in the sequence of routing such accounts should be considered.

To capitalize on the success of the Harbor Pilot, the County should consider using PCAs to accomplish almost all debt collection actions currently assigned to the TTC. Review of departmental operations should also be made to consider whether the role of PCAs could expand to the departmental responsibilities. While the TTC might retain some responsibilities for debtor contacts, given the available resources and level of accounts, referral to PCAs earlier in the process is warranted. TTC staffing could then focus on contract administration and resolving disputed accounts.

This would allow for a less routinized approach to collection actions on accounts assigned to TTC. By virtue of the staffing levels available to the TTC, most actions are limited to either identification of third party responsibility for such debt or notice issuance. Accordingly, absent additional resources for TTC, greatly increased privatization is a pragmatic solution.

3) In terms of the use of privatization, the focus should be on management and collection of debts other than secured real estate taxes.

In KPMG's experience, there is generally a high degree of compliance with real estate taxes. Even when such taxes are not immediately paid, the eventual sale or turn-over of real estate properties generally results in the payment of such taxes at some point in time. Los Angeles County's experience is typical in that most real estate taxes are eventually collected. Accordingly, we do not believe that this is an area that should be subjected to focus during this review except for real estate tax debt that is no longer secured. Secured real estate tax debt is that debt where the property taxed is still owned by the debtor. In some instances real estate tax debt is owed but the debtor no longer owns the property. This unsecured debt is not as likely to be collected and could be subjected to privatization as part of the overall use of private debt collectors.

4) The County should test new strategies to prevent and collect delinquencies that are used as best practices in a variety of jurisdictions.

There are a number of best practices used by government agencies in prevention and collection of delinquent debt. Examples of such best practices are:

- **Early Intervention:** Payment arrangements, full financial information, and identifying information is gathered at the time the service or debt is established. One best practice is the use of collection personnel or PCAs at this point in the process. When the debt is being established at the point of delivery of services or when fines are imposed, financial advisors and collectors are assigned to work with recipients. While it may be difficult to convince a health care professional to concentrate on debt recovery at the point of service, referring the customer to a collection professional to arrange for payment is more easily implemented.
- **Business Licensing Strategy:** Another tool is the denial of certain non-emergency benefits, employment, business licenses, or the ability to compete for County business if there is delinquent debt outstanding or until satisfactory arrangements are made to resolve such debt. Potential contractors or vendors who provide services to the County should be required to be current on debt obligations to the County. The presence of delinquent debt could be used as a disqualifier to participate in bids or as a part of the evaluation scoring on competitive bids.

In order to implement such a strategy, departments must have the ability to check TTC records on outstanding debt and such information must be accurate and current. Generally, some dollar threshold is established before checks against a central data base of delinquent debt is required.

- **Intra-County Offsets:** Coupled with the business licensing strategy is the concept of offsetting County payments to vendors or individuals who owe the County money. This best practice is one where all payments over a certain dollar threshold are matched against a listing of debt over a certain threshold. These payments are subject to offset to satisfy delinquent debt. In order to make this process effective it is necessary to ensure the database of delinquent debt is accurate and current. There must also be a quick resolution process to resolve disputes.
- **Use of a Common Debtor Master File and Identifying Numbers:** In order to use either a Business Licensing Strategy or Intra-County offsets the County must use a common identifying numbering system on all debt, so that multiple debt owed to various departments can be identified as being owed by the same individual or business. Other jurisdictions often use the SSN for individuals or the Federal Employers Identification Number (EIN) for business taxpayers. Obviously, consideration must be given to the cost of setting up such a system however in order to properly administer debt owed the County some form of such a system must be used. Accordingly, the County may wish to establish such a system for certain types and amounts of debt as a prototype for such a system. Once a master file and common identification numbering system is in place, payments, refunds, license applications and business proposals can be routinely screened against the master file to offset debt or to otherwise aid in collecting amounts due.

5) The County should pursue legislation to expand the type of debt that may be referred to the California Franchise Tax Board and other agencies for offset against tax refunds or other payments to include debts owed to the Department of Health Services.

The Department of Health Services currently cannot refer there delinquent accounts to the California Franchise Tax Board or other State agencies for offset of State Income Tax refunds or other payouts. This type of debt is not authorized for offset by the existing statute. The County should consider requesting legislation that would permit the referral of such debt to the State for offset. In order to determine if such a program would be beneficial, the County should request the California Franchise Tax Board to run a “simulated offset program” against a sampling of past due debt. This would provide the County and State with data as to whether such a program would be beneficial and cost effective and provide the basis for any recommendation if the simulation indicates the success for such offsets.

6) Move the authority to accept “compromise or settlement” of debt owed to the County down to the Department level. Allow Department Heads or appropriate designees to accept settlements of debt.

The current process within the Department of Health Services requires referral outside the Department whenever a settlement offer is made for less than the full amount of the debt by a citizen or a third party insurer. This approval process is time consuming and cumbersome. Additionally, such approvals are usually routinely granted however, the approval takes several weeks. In some instances the lack of “on the spot” authority prevents settlements. This authority could be coupled with periodic reports to and reviews by the Auditor-Controller to alleviate concerns about improper judgments on settlements. Frequently such settlement offers are made

by third party insurers who use short deadlines for acceptance of such offers as a settlement technique. Legislative changes to the County ordinances or procedures to delegate such authority to various department heads would be a positive step in streamlining decision making in this area.

7) The County should commend and publicize the business re-engineering efforts underway within the Department of Health Services on debt management and collection as a best practice for other County Departments who manage accounts receivable.

The Department of Health Services has been engaged in a long-term review of its processes, systems and the workflow related to debt management and collections. A number of process changes, recommendations and improvements have been made due to this effort. Outside consultants are used, however, they primarily serve in a facilitator role. In other words, the ideas for improvements and modifications come from the employees within the Department engaged in the work. The Department has shown a willingness to use a variety of techniques to improve its debt collection performance. For example it is currently considering the feasibility of privatizing the submission and management of claims made to commercial insurance companies. Similar efforts could produce improvements in other departments. The key is the involvement of employees and manager who understand the current system coupled with encouragement to seek new solutions. Not all ideas that surface will work however, the day-to-day emphasis on process improvement will yield results.