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Office of Inspector General
Western Region

Audit Report

Food and Nutrition Service Food Stamp Program ALERT Watch List

Report No. 27099-32-SF
July 2006



UNITED STATES DEPARTMENT OF AGRICULTURE

OFFICE OF INSPECTOR GENERAL

Washington D.C. 20250



DATE: July 28, 2006

REPLY TO
ATTN OF: 27099-32-SF

TO: Roberto Salazar
Administrator
Food and Nutrition Service

ATTN: Lael Lubing
Director
Grants Management Division

FROM: Robert W. Young
Assistant Inspector General \s\
for Audit

SUBJECT: ALERT Watch List

This report presents the results of our audit of the Food and Nutrition Service's Anti-Fraud Locator using EBT Retailer Transactions (ALERT) Watch List. Your July 12, 2006, response to the draft audit report is included as exhibit A to the report. Excerpts from your response and the Office of Inspector General's positions have been incorporated into the relevant sections of the report.

We agree with your management decisions on all recommendations. Please follow your internal agency procedures in forwarding final action correspondence to the Office of the Chief Financial Officer.

We appreciate the cooperation and assistance provided by your staff during the audit.

Executive Summary

Food and Nutrition Service, Food Stamp Program, ALERT Watch List (Audit Report No. 27099-32-SF)

Results in Brief

In part to address fraud in the Food Stamp Program, the Food and Nutrition Service (FNS) replaced paper coupons with electronic benefits transfer (EBT) cards. With EBT systems, benefits are transacted electronically, so FNS has access to information about every transaction. FNS' ALERT¹ system analyzes this data to detect patterns that indicate fraud, then assigns each store a score reflecting the likelihood that the store is engaging in fraud. FNS officials and staff we interviewed considered ALERT to be a highly valuable tool for identifying potential fraud.

In 2002, FNS implemented a subsystem of ALERT, called the Watch List, which targets specific stores for review. The Watch List is a compilation of stores which generally have the highest ALERT scores. Our overall objective was to evaluate the Watch List as a tool for identifying fraud. We could not make this assessment because the information necessary to do so was not available in ALERT. The unavailability of this information also precluded FNS from assessing the Watch List's effectiveness, including evaluating whether stores with high ALERT scores were determined to be violating program requirements.

FNS field office staff are required to review each new Watch List store, assess the data that caused it to be flagged by ALERT, and take the appropriate action. If the data do not indicate potential trafficking, the store will not require any further review, and FNS will place it into a suspense status in the Watch List system. However, if the data do indicate potential violations, further action is required. This may include field office staff collecting and analyzing additional transaction data for the store. FNS has the authority to impose sanctions (such as disqualifying the store from the program or assessing it a monetary penalty) based on suspicious transaction patterns that the store owner is unable to satisfactorily explain. In other cases, field office staff will refer stores to FNS' Retailer Investigations Branch to gather additional evidence before making a determination on the store.

FNS does not record all information about actions taken (i.e., disposition data) on individual Watch List stores in ALERT. The details of specific compliance actions taken are recorded in the Store Tracking and Redemption System (STARS). However, STARS does not contain information on ALERT rankings, and the ALERT system was not capable of providing a universe of Watch List stores for a prior point in time which could be

¹ Anti-Fraud Locator Using EBT Retailer Transactions

validated to STARS data. We believe FNS needs this information in ALERT to assess the Watch List's effectiveness in identifying fraud. For example, we believe that FNS should be able to determine how many of the stores appearing on the Watch List were ultimately found to have violated program requirements, and for those stores, what specific actions were taken on them.

We found that FNS staff was expending resources reviewing stores that did not merit it. During interviews, FNS staff expressed concerns that too many "false hits" were appearing on the Watch List, and provided us specific examples to substantiate their concerns. (False hits are stores appearing on the Watch List that do not warrant review because their transaction patterns represent the normal, legitimate practices of the store.) By analyzing data on the disposition of Watch List stores, FNS could also gauge the extent of this problem, and then develop measures to minimize it.

Disposition data could also help FNS assess the reliability of ALERT ranks. Higher ALERT scores are intended to indicate a greater potential that the store is trafficking, but FNS does not currently have the data to confirm whether this is actually the case. By analyzing the outcomes of Watch List stores, sorted according to ALERT ranks, FNS could assess the correlation between rank and outcome, potentially helping it to improve the ranking process. We had planned on conducting this type of analysis during the audit but were unable to do so due to the unavailability of data on the disposition of Watch List stores.

We also determined that categories used by FNS to classify stores in its systems did not always group similar stores together. This impacts ALERT and the Watch List because some of the analyses compare an individual store's transactions to the averages for other stores in the same category. The store's transactions may appear normal when included in a category that contains too many dissimilar stores, but indicate fraud when compared only to the transactions of similar stores. As a result, FNS has reduced assurance that the Watch List identified all the stores it should have. In addition, FNS had not developed standard definitions for the categories, which caused FNS staff either to miscategorize stores or to categorize them inconsistently. Together, these conditions impacted the reliability of the ALERT scans, and therefore FNS' ability to identify noncomplying stores.

Prior to our audit, FNS had addressed these concerns by developing revised store categories and definitions. However, because many of the approximately 160,000 participating stores will have to be manually converted to the new categories, a highly labor-intensive process, conversion will require significant time and staff resources to accomplish. For this reason, FNS has not yet put the revisions in place.

**Recommendations
in Brief**

We recommend that FNS:

- Program the ALERT system to provide data on the disposition of stores appearing on the Watch List, to allow an analysis of the Watch List's effectiveness.
- Develop a plan and timeframe for implementing the new store type categories, and distribute guidance which defines store type categories to all field office staff.

Agency Response

In its July 12, 2006, written response to the draft report, FNS agreed with the report's findings and recommendations. FNS is currently working on enhancements to the ALERT system which are intended to reduce the number of false hits and allow system effectiveness to be measured. FNS expects to have the capability to generate reports on system effectiveness by January, 2007, and to make system adjustments based on the enhancements by February 2007.

FNS is also in the process of developing firm (store) type definitions, which it intends to implement by June, 2007.

OIG Position

We accept FNS' management decision on all recommendations.

Abbreviations Used in This Report

ALERT	Anti-fraud Locator using EBT Retailer Transactions
EBT	Electronic Benefits Transfer
ESSRA	Extract System for STARS, REDE, and ALERT
FNS	Food and Nutrition Service
OIG	Office of Inspector General
OMB	Office of Management and Budget
REDE	Retailer Electronic Data Exchange
STARS	Store Tracking and Redemptions System

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Background and Objectives

Background

The Food and Nutrition Service's (FNS) Food Stamp Program helps low-income families buy nutritious foods by providing them benefits that can be redeemed at authorized stores.² Unfortunately, some recipients and stores collude to defraud the program by trading benefits for cash instead of food. For example, a retailer may charge the recipient's account for \$50 in benefits, give the recipient \$25 in cash, and keep the difference.

In part to address this problem, FNS replaced paper benefits (i.e., food stamp coupons) with electronic benefits transfer (EBT) cards, which work like bank cards. Each State has an EBT system to which terminals in stores are connected. The system verifies that benefits are available before authorizing a transaction and debits the recipient's account for each completed transaction. Because benefits are transacted electronically, these systems provide FNS with detailed data on every food stamp transaction. FNS then analyzes this data to uncover patterns indicative of fraud.

FNS implemented the Anti-Fraud Locator Using EBT Retailer Transactions (ALERT) system in 1996 to perform this fraud analysis. Each State regularly sends data from its EBT system to ALERT, which subjects the data to a number of scans to identify suspicious patterns. Each store is assigned a score—an ALERT rank—based on the scans. FNS regions have the ability to adjust the scans to suit local conditions since patterns of abuse vary relative to local conditions (i.e., patterns indicating fraud in one location may not in another).

In 2002, FNS implemented a subsystem of ALERT called the Watch List. The Watch List compiles all the stores meeting predefined parameters (generally, those with the highest ALERT ranks), called pending stores, into a single list for each FNS field office.³

The Watch List utilizes data from both the ALERT system and another FNS system called the Store Tracking and Redemptions System (STARS). STARS is used by FNS to manage retailer participation in the program. It includes administrative information about the store, such as the name of the owner, the store's location and hours, sales data, and so on. If compliance activities are conducted on a store, a compliance "case" will be opened in STARS. While this frequently results because a store appeared on the Watch List, there are other reasons for opening a case (for example, FNS might have received a whistleblower complaint or a referral from a local

² Although we use the terms "store" and "retailer" in this report, other types of organizations, such as wholesalers, meal services, group living arrangements, and trade routes, may participate. For brevity, we will consider "store" to encompass all authorized firms.

³ FNS' 44 field offices (and 1 area office) nationwide are responsible for authorizing stores and monitoring their compliance with program requirements.

agency). The details of the specific compliance actions taken are recorded in STARS. If FNS determines it unnecessary to open a case on a store appearing on the Watch List, the reason for not opening a case is recorded in the Watch List system rather than STARS.

Field offices are required to review their pending stores to determine what additional action is warranted. Some stores may need no further review and can be immediately placed into a suspense category in the system.⁴ In other cases, the field office may continue to monitor a store's transactions, or gather additional information, before making a decision. Sometimes, the field office refers a store to FNS' Retailer Investigations Branch for investigation. If the store is found to have violated program requirements, the field office can issue a warning letter to the store, assess it a monetary penalty, or disqualify it from the program. After all necessary actions have been taken, FNS will place the store in a closed status for a set time period so that it does not immediately reappear on the Watch List.

FNS contracts with a private firm to administer the ALERT system. The contractor provides services including system design and coding, maintenance, training, technical support, and so on. The contract with this firm was renewed in late 2004, at which time a second private firm was contracted with to develop enhancements to the system such as more sophisticated fraud analyses and expansion of the types of data analyzed.

Objectives

Our overall objective was to evaluate the effectiveness of the Watch List as a tool to identify fraud. To accomplish this, we evaluated (1) whether FNS field offices were processing Watch List cases in accordance with program requirements, (2) the adequacy of store type definitions, (3) FNS' policies regarding whether supermarkets would be included in or excluded from the Watch List, and (4) the usefulness of Watch List reports.

We had planned to evaluate whether ALERT store rankings reasonably reflected the potential risk of fraudulent activity (i.e., whether stores with high ALERT scores were determined to be violating program requirements). However, we found that the data necessary to make this assessment was not available. The impact of FNS not having this information is addressed in Finding 1.

⁴ Moved from "pending" status to "closed" status in the Watch List system.

Findings and Recommendations

Section 1. Watch List

Federal agencies are required, by Office of Management and Budget (OMB) Circular A-123, “Management Accountability and Control,” to ensure that Government resources are used efficiently and effectively. To accomplish this, they are required to implement and assess management controls.⁵ Management controls are defined as the “tools to help program and financial managers achieve results and safeguard the integrity of their programs.”⁶

The process of monitoring retailer compliance is a management control intended to safeguard the integrity of the Food Stamp program. Both ALERT and Watch List were developed by FNS to assist in achieving that goal.

FNS’ ALERT system analyzes EBT transactions for patterns indicative of fraud and then assigns each store a score—an ALERT rank. FNS officials and staff we interviewed considered ALERT to be a highly valuable tool for identifying potentially fraudulent retailers. Through the processing of vast amounts of transaction data, the system is able to provide a level of fraud-detection analysis that staff could not otherwise accomplish. The Watch List is a compilation of stores meeting predefined parameters, which generally have the highest ALERT ranks.

Finding 1 FNS Has Not Assessed the Effectiveness of the Watch List

FNS could not assess whether the Watch List was an effective tool for identifying fraud because it did not have the data available in ALERT to make that assessment, including whether stores with high ALERT ranks were determined to be violating program requirements. FNS plans to program the ALERT system to provide the data necessary to conduct this type of analysis. However, FNS needs to complete certain upgrades of its data systems, which are in process.

FNS implemented the Watch List in 2002. FNS field offices are required to review the data that caused ALERT to flag each store on the Watch List and take the appropriate action, such as:

- Suspending the store in the Watch List system because the data patterns do not indicate trafficking is occurring;

⁵ OMB Circular A-123, transmittal letter, item 2 (Policy) (dated June 1995). A revised version of Circular A-123 that was issued on December 21, 2004 and took effect on October 1, 2005 includes similar requirements.

⁶ OMB Circular A-123, Introduction (dated June 1995).

- Gathering and analyzing additional data on the store because the initial data is inconclusive; or
- Referring the store for investigation.

If violations are found, the store may be sanctioned (for example, disqualified from the program or assessed a monetary penalty).

FNS does not record all information about actions taken (i.e., disposition data) on individual Watch List stores in ALERT. The details of specific compliance actions taken are recorded in STARS. However, STARS does not contain information on ALERT rankings, and the ALERT system was not capable of providing a universe of Watch List stores for a prior point in time which could be validated to STARS data. Accordingly, FNS did not have the data in ALERT to evaluate the Watch List's effectiveness, and specifically whether stores with high ALERT ranks were determined to be violating program requirements. The agency told us that that it intends to perform this type of analysis, but upgrades to STARS and the ALERT system are needed before it can begin programming ALERT to provide this data. The upgrades to STARS were implemented in late 2004. The process of upgrading ALERT began around the same time, but is still ongoing. FNS projects that it may be ready to begin the recommended programming in late 2006.

FNS needs the information on the actions taken on individual stores to assess the Watch List's effectiveness in identifying fraud. With this information, FNS should be able to determine:

- How many Watch List pending stores received a detailed review, and what specific actions were taken on them;
- How many of the reviews were performed by field office staff, and how many were referred to other entities for investigation;
- How many of the reviewed stores were ultimately determined to be violating program requirements, and what actions were taken on them; and
- Of the stores determined to be violating program requirements, how many cases originated as Watch List pending stores, and how many came from other sources.

Our audit found that, in fact, the Watch List was not operating as effectively as it could have been. It was including stores that did not merit review. FNS staff referred to these stores as "false hits," meaning the stores appeared on the Watch List because their transaction patterns resulted in high ranks on certain ALERT scans, but actually represented the normal, legitimate practices of the store. Concerns about false hits were widespread among the FNS staff we interviewed, who believed that dealing with false hits was taking up time that could be used more productively. FNS staff identified to us a number of types of stores, or specific store chains, that regularly showed up as false hits.⁷

⁷ Details of the specific examples given us are not cited in this report, to prevent disclosure of information about how the ALERT scans operate.

Having the answers to the above questions would allow FNS to better gauge the extent to which false hits are a problem, and then develop measures to minimize them. For example, FNS might be able to create special categories for certain types of stores, and then adjust how the scans operate to prevent their unique but legitimate transaction patterns from causing them to appear on the Watch List.

Information on the actions taken on individual Watch List stores would also help FNS assess the overall effectiveness of the Watch List. This information could also help FNS assess the reliability of ALERT ranks. Higher ALERT rankings are intended to indicate a greater potential that the store is trafficking. By expanding the analysis described above to correlate the ALERT ranks of stores on the Watch List with the various outcomes, FNS may be able to improve the ranking process.

Recommendation 1

Program the ALERT system to provide data on the disposition of stores appearing on the Watch List, to allow an analysis of the Watch List's effectiveness in identifying fraud.

Agency Response. In its written response to the draft audit report, dated July 12, 2007, FNS stated it was in agreement with the finding and recommendation. Under the current ALERT contract, FNS is constructing a "data warehouse" utilizing a Statistical Analysis System tool, which will be capable of analyzing large volumes of data. The purpose of the data warehouse is to refine ALERT analysis to identify stores that may be overlooked and reduce the number of false hits. FNS expects that conclusions based on data warehouse analyses will be available in October, 2006, and that system adjustments will be made by February, 2007. FNS also expects to deploy reports to measure system effectiveness by January 2007.

OIG Position. We accept FNS' management decision on the recommendation.

Finding 2 FNS Needs to Implement Revised and Well-Defined Store Categories

FNS field office staff did not always categorize stores in the STARS system in a logical and consistent manner because FNS (1) had established store-type categories that did not always group similar stores together and (2) had not provided guidance to staff to define the categories. To the extent that stores have been improperly categorized, ALERT will compare dissimilar stores' transaction patterns, resulting in less reliable ALERT ranks and diminishing FNS' ability to identify noncomplying stores.

Prior to our audit, FNS had recognized these concerns and developed revised store categories and definitions. However, because conversion will require significant time and staff resources to accomplish, FNS has not yet put the revisions in place.

Prior to authorization, FNS assigns each store one of 31 store-type categories, such as supermarket or convenience store. FNS records this and other information about the store in STARS. In determining store type, field office staff consider information from various sources, such as the application and pre-authorization store visits. Reports on these visits, which are conducted by private contractors, include photographs of the store, a sketch of its layout, and information from a questionnaire describing its operations and characteristics.

FNS' compliance monitoring activities are directly impacted by how FNS staff categorizes a store. One approach used in some of the ALERT scans is to compare a specific store's transactions to those of other stores in its category. Deviations from category averages can form the basis for charging a store with program violations, and are generally cited in charge letters. Therefore, correct and consistent classification of stores is important to the integrity of the process.

FNS does not provide its staff with store definitions, or guidance on how to categorize a store. In general, staff learns how to categorize a store from co-workers in the field office. The only written guidance available to field office staff came from a previous version of the retailer application form, which provided limited definitions of supermarkets (i.e., a store with annual gross sales of \$2 million or more) and specialty food stores ("meat store, fish store, bakery, etc."). However, the current application (September 2004 revision) eliminates these definitions.

To compare how different regions and field offices categorize stores, we interviewed field office staff in each FNS region, and reviewed store listings for each of the sampled field offices. We identified significant variations in how similar stores were categorized. Examples of the inconsistencies we found include the following.

- While "super" versions of major discounters, such as Wal-Mart SuperCenters and Super Targets, were consistently classified as supermarkets, standard size versions of the chains were not. For example, Big K-Marts (standard-size stores) were categorized as general stores, other grocery combination stores, or supermarkets, depending on the field office.
- Some field offices categorized chain convenience stores with gas pumps, such as 7-Elevens and Circle K's, as grocery/gas combinations, while others categorized them as convenience stores.
- Some regions classified ethnic stores (for example, those specializing in Asian food) using the standard small/medium grocery or supermarket categories, but other regions considered them specialty food or other food stores.⁸

⁸ We also noted that the contractor store visit handbook states ethnic stores are a type of specialty food store.

As of mid-2003, FNS had established a working group to revise and define store-type categories. As of the time of our audit, it had drafted new categories and corresponding definitions. The proposed definitions eliminated or combined some store types, split others into multiple store types, and added some new store types. For the most part, the new categories appeared to address the issues raised to us by field office staff. However, because many of the approximately 160,000 participating stores will have to be manually converted to the new categories, a highly labor-intensive process, conversion will require significant time and staff resources to accomplish. For this reason, FNS has not yet put the revisions in place.

Recommendation 2

Develop a plan and timeframe for implementing the revised store type categories.

Agency Response. See response to Recommendation 3.

OIG Position. See position on Recommendation 3.

Recommendation 3

Develop written guidance which defines store type categories and distribute it to all field office staff.

Agency Response. In its written response to the draft audit report, dated July 12, 2007, FNS stated it was in agreement with the findings and recommendations. FNS is currently developing firm (store) type definitions, which will be tested and built into the STARS system. FNS expects to implement the definitions in June, 2007.

OIG Position. We accept FNS' management decision on the recommendations.

Scope and Methodology

This audit was conducted to review the ALERT and Watch List systems, which are management controls over FNS' Food Stamp Program. The scope of the audit included Federal Fiscal Year 2005, the current year at the time fieldwork was conducted. During the audit, we conducted fieldwork at the FNS National Office in Alexandria, Virginia; FNS' Southeast Regional Office in Atlanta, Georgia; and FNS field offices in Atlanta, Georgia; Montgomery, Alabama; and Tallahassee, Florida. Audit field work was conducted between January and August 2005.

This audit was performed in accordance with generally accepted government auditing standards. To accomplish our audit objectives, we performed the following audit steps and procedures:

- We reviewed regulations, policies, and background information relating to Food Stamp Program retailer compliance.
- We interviewed FNS officials and staff, and obtained and reviewed various records, during our visits to FNS' national, regional, and field offices.
- We interviewed by telephone FNS personnel at the regional and field office level in FNS' six other regions.
- We reviewed reports and data extracted from various FNS data systems, including STARS, ESSRA,⁹ ALERT, and Watch List.

⁹ Extract System for STARS, REDE, and ALERT (REDE, or Retailer Electronic Data Exchange, is another FNS data system.)

Exhibit A – Agency Response



United States
Department of
Agriculture

JUL 12 2006

Food and
Nutrition
Service

SUBJECT: OIG Audit 27099-32-SF: ALERT Watch List

3101 Park
Center Drive

TO: Robert W. Young
Assistant Inspector General for Audit
Office of Inspector General

Alexandria, VA
22302-1500

This memorandum is in response to the subject audit's findings and three recommendations. We concur with the findings and offer the following responses:

Recommendation 1: Program the Anti-Fraud Locator using Electronic Benefits Transfer Retailer Transactions (ALERT) system to provide data on the disposition of stores appearing on the Watch List, to allow an analysis of the Watch List's effectiveness in identifying fraud.

Response: The Food and Nutrition Service (FNS) agrees it needs to statistically analyze the outcomes of the Watch List to assess its reliability in identifying suspect stores.

Part of the current contract for ALERT has been to construct a data warehouse utilizing a Statistical Analysis System (SAS) software analysis tool. This software is particularly capable of analyzing large volumes of data. The purpose of the data warehouse is to refine ALERT analysis to identify stores that may be overlooked and reduce the number of "false hits." The goal is to have an ongoing process of analysis and enhancements.

The analysis will be improved by performance related reports to measure effectiveness. These performance reports will tie investigative outcomes back to the reasons a store was assigned to the Watch List in the first place. The functional design of these reports should be completed by September, 2006 and deployed by January, 2007. Further analytic conclusions based on SAS data warehouse analyses will be available in October of this year and relevant adjustments will be made to ALERT by February of 2007.

Recommendation 2: Develop a plan and timeframe for implementing the revised store type categories.

Recommendation 2 is addressed as part of the response to Recommendation 3.

Recommendation 3: Written guidance which defines store type categories and distribute to all field office staff.

Response: FNS is in the final stages of developing firm type definitions that are based on information that is routinely collected, such as the number of cash registers, product information and store sales information. As a result, firm type definitions will be

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Exhibit A – Agency Response

Robert W. Young
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dependent upon store characteristics that are part of the data maintained in the Store Tracking and Redemption System (STARS). This approach will be tested and any adjustments will be built into the STARS system. Final implementation is planned for June, 2007.

Please feel free to contact me at 703-305-2062 or Jeff Cohen, Director, Benefit Redemption Division at 703-305-2434 if you wish to discuss our response.


Roberto Salazar
Administrator

Informational copies of this report have been distributed to:

Office of the Chief Financial Officer

Director, Planning and Accountability Division (1)

Administrator, FNS (8)

Attn: Agency Liaison Officer

Government Accountability Office (1)

Office of Management and Budget (1)