

M-03-07, Programs to Identify and Recover Erroneous Payments to Contractors

January 16, 2003

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MEMORANDUM FOR HEADS OF EXECUTIVE DEPARTMENTS AND AGENCIES

FROM: Mitchell E. Daniels, Jr.
Director

SUBJECT: Programs to Identify and Recover Erroneous Payments to Contractors

The Administration's Improved Financial Performance initiative, part of the President's Management Agenda, includes an initiative to reduce erroneous payments made by the federal government. Erroneous payments waste taxpayer dollars and divert resources from their intended beneficiaries. The attached guidance provides agencies with a tool that can help recover and, more importantly, prevent erroneous contract payments.

Section 831 of the Defense Authorization Act for Fiscal Year 2002 added a new subchapter to the U.S. Code (31 USC §§3561-3567) that requires agencies that enter into contracts with a total value in excess of \$500,000,000 in a fiscal year to carry out a cost-effective program for identifying errors made in paying contractors and for recovering amounts erroneously paid to the contractors. A required element of such a program is the use of recovery audits and recovery activities.

Federal agencies have tested the use of recovery auditing with success. Congress enacted the government-wide requirement to implement recovery auditing as a result of such testing. Recovery auditing is viewed by Congress and the Administration as a cost-effective way to identify and recover erroneous contract and other payments.

The guidance in the attachment to this memorandum is intended to assist agencies to successfully implement recovery auditing and recovery activity as part of an overall program of effective internal control over contract payments.

Reporting: The statute requires that by December 31, 2004, agencies which are required to undertake a recovery audit program shall provide a report to the Office of Management and Budget (OMB) that shall include the following information for programs conducted under this guidance during FY 2003¹:

- A general description and evaluation of the steps taken to carry out a recovery auditing program;
- The total cost of the agency's recovery auditing program. Report separately the costs of the agency's recovery audit program activities (agency salaries and expenses) and contracted recovery audit services (amounts paid and payable to recovery audit contractors);
- The total amount of payment errors identified under the recovery auditing program, the total amount subsequently deemed not recoverable, the total amount recovered, and the total amount outstanding pending final resolution or collection. Report separate totals from amounts attributable to internal agency activities and to recovery audit contractors;
- A general description and evaluation of any management improvement program carried out pursuant to this memorandum;
- A description of the classes of contracts excluded by the agency head.

A similar report is due December 31, 2005, and 2006, covering the fiscal year ending the preceding September 30.

To the extent that agencies believe the guidance does not clarify questions relating to recovery auditing activities or they have questions about the application of this guidance, they should contact their Resource Management Office at OMB.

Attachment

1 At its discretion, an agency can also include information concerning its recovery audit program established pursuant to P.L. 107-107 and conducted prior to FY 2003.

Attachment

Guidance on Implementing a Recovery Audit Program

1. I. **General:** Agencies shall have a cost effective program of internal control to prevent, detect, and recover overpayments to contractors resulting from payment errors. A program of internal control may include policies and activities such as prepayment reviews, a requirement that all relevant documents be made available before making payment (e.g., invoice, packing list, receiving report, inspection report, etc.),

payment of only original invoices (as opposed to photocopies), and performance of contract audits. For agencies that enter into contracts with a total value of more than \$500,000,000 in a fiscal year, a recovery audit program is a required element of their internal controls over contractor payments.

2. **Definitions:** For purposes of this guidance:

- a. A *Contract Audit* refers to a post-award examination of the books and records of a Federal contractor that is performed by the contracting officer, or an authorized representative of the contracting officer, pursuant to the audit and records clause incorporated in the contract. A contract audit is normally performed by an auditor that serves in an advisory capacity to the contracting officer. A post-award contract audit, as distinguished from a recovery audit, is normally performed for the purpose of determining if amounts claimed by the contractor are in compliance with the terms of the contract and applicable laws and regulations. For example, the scope of a post-award contract audit may include a review of the direct and indirect costs claimed to have been incurred or anticipated to be incurred under a negotiated contract. Such reviews involve the contractor's accounting records, including the contractor's internal control systems. A post-award contract audit may also include a review of other pertinent contractor records, e.g., reviews to determine if a contractor's proposal was complete, accurate, and current; reviews of contractor prices charged for commercial items sold to other Federal and non-Federal customers; reviews of the contractor's systems established for identifying and returning any erroneous payments received under its Federal contracts.
- b. A *Recovery Audit Contingency Contract* is a contract for recovery audit services in which the recovery audit contractor is paid a portion of the amount recovered. The amount the contractor is paid, generally a percentage of the recoveries, is based on the amount actually collected based on the evidence discovered and reported by the recovery audit contractor to the appropriate agency official.
- c. A *Management Improvement Program* is an agency-wide program to address the flaws in an agency's internal controls over contractor payments discovered during the course of implementing a recovery audit program or other control activities over contractor payments.
- d. *Payment Errors* are errors resulting from duplicate payments; errors on invoices or financing requests; failure to reduce payments by applicable sales discounts, cash discounts, rebates, or other allowances; payments for items not received; mathematical or other errors in determining payment amounts and executing payments; and the failure to obtain credit for returned merchandise.

- e. *Recovery Activity* is any activity by an executive agency to attempt to recover overpayments identified by a recovery audit.
- f. A *Recovery Audit* is a review and analysis of the agency's books, supporting documents, and other available information supporting its payments that is specifically designed to identify overpayments to contractors that are due to payment errors. It is not an audit in the traditional sense. Rather it is a control activity designed to assure the integrity of contract payments, and as such, it is a management function and responsibility.
- g. A *Recovery Audit Program* is an agency's overall plan for the performance of recovery audits and recovery activities. The head of the agency will determine the manner and combination of recovery audits and activities that are expected to yield the most cost-effective recovery audit program for the agency. This program should include a management improvement program as defined above and discussed in Section IX.

3. Scope of Recovery Audits

- a. All classes of contracts and contract payments should be considered for recovery audits. Agencies should review their different types of contracting categories and identify those classes of contracts that have a higher potential for payment errors, i.e., contract categories where the benefits would likely exceed the agency's costs of the recovery audits and recovery activities.
- b. Agency heads may exclude classes of contracts and contract payments from recovery audit activities if the agency head determines that recovery audits are inappropriate or are not a cost-effective method for identifying and recovering erroneous payments. The following are examples of classes of contracts and contract payments that may be so excluded:
 - 1. Cost-type contracts that have not been completed where payments are interim, provisional, or otherwise subject to further adjustment by the Government in accordance with the terms and conditions of the contract.
 - 2. Cost-type contracts that were completed, subjected to a final contract audit and, prior to final payment of the contractor's final voucher, all prior interim payments made under the contract were accounted for and reconciled.

3. Other contracts that provide for contract financing payments or other payments that are interim, provisional, or otherwise subject to further adjustment by the Government in accordance with the terms and conditions of the contract.
 4. Recent payments may be excluded for a reasonable period of time in order to allow the agency's normal post-payment processes to identify and correct any overpayments.
- c. Recovery auditing contractors may, with the consent of the employing agency, communicate with the agency's contractors for the purpose of verifying the validity of potential payment errors they have identified. A recovery auditing contractor shall not maintain a presence on the property of the contractors that are the subject of recovery auditing.
 - d. Agency heads shall take steps to ensure that the implementation of their recovery audit program does not result in duplicative audits of contractor records. In this regard, actions to follow-up with contractors on potential overpayments identified through recovery audits of agency records do not constitute audits of contractor records. However, recovery auditing activities should not duplicate other audits of the same (contractor or agency) records that specifically employ recovery audit techniques to identify and recover payment errors. At a minimum, agency heads should coordinate with the agency Inspector General and other organizations with audit jurisdiction over agency contracts.
 - e. In addition to identifying and documenting specific overpayments resulting from payment errors, recovery auditors should also analyze the reasons why payment errors occurred and, where appropriate, recommend cost-effective controls to prevent such overpayments in the future. The results of such analysis and related recommendations should be considered by the agency as part of its management improvement program. If requested, the agency should provide such information to its Office of Inspector General.
 - f. Instances of potential fraud discovered through recovery audits and recovery activities shall be reported immediately to the agency Inspector General.
4. Sources of Recovery Audits: Recovery audits may be performed by employees of the executive agency, by any other department or agency of the United States Government acting on behalf of the executive agency, or by contractors performing recovery audit services under contracts awarded by the executive agency.

5. Role and Authority of Inspectors General

- a. Nothing in this guidance should be construed to impair the authority of an Inspector General under the Inspector General Act of 1978 or any other law. However, because the recovery audit program required by this guidance is an integral part of the agency's internal control over contract payments, and therefore a management function, independence considerations would normally preclude the Inspector General and other agency external auditors from carrying out management's recovery audit program.
- b. Agency Inspectors General and other external agency auditors are encouraged to assess the effectiveness of agencies' recovery audit programs as part of their internal control work on existing audits, e.g., the annual financial statement audit, or as a separate audit.

6. Recovery Audit Services Performed by Contractors

- a. Agency heads may enter into any appropriate type of contract, including a contingency contract for recovery audit services. However, amounts recovered due to interim payment errors made under ongoing contracts, i.e., duplicate progress payments or cost reimbursement claims, may not be available to pay the recovery audit fee if these amounts are still needed to make subsequent payments under the contract. Agencies need to establish other funding arrangements when making payments to recovery audit contractors in such cases.
- b. In addition to provisions that describe the scope of recovery audits (and any other provisions required by law, regulation, or agency policy), any contract with a private sector firm for recovery audit services shall include contract provisions that:
 - 1. Prohibit the recovery audit contractor from:
 - 1. requiring production of any records or information by the agency's contractors. Only duly authorized employees of the agency can compel the production of information or records from the agency's contractors, in accordance with applicable contract terms and agency regulations;
 - 2. establishing or otherwise having a physical presence on the property or premises of any other agency contractor for the purpose of performing the contract;
 - 3. acting as an agent for the Federal Government in the recovery of funds erroneously paid to contractors;

4. using or sharing sensitive financial information with any individual or organization, whether associated with the Federal Government or not, that has not been released for use by the general public, except for the purpose of fulfilling the recovery audit contract; and
5. disclosing any information that identifies an individual, or reasonably can be used to identify an individual, for any purpose other than performing the recovery audit.
2. Require the recovery audit contractor to take steps to safeguard the confidentiality of sensitive financial information that has not been released for use by the general public and any information that could be used to identify a person.
7. Recovery Activity - Recovery activity shall be carried out by Federal employees. Agencies shall follow applicable laws and regulations governing collection of amounts owed to the Federal Government.
8. Disposition of Recovered Amounts
 - a. A. Funds collected under a recovery audit program less any amounts needed to make payments under the related contract(s) shall be available to the executive agency for the following purposes:
 1. To reimburse the actual expenses incurred by the executive agency for the administration of the program (including payments made to other agencies that carry out recovery audit services on behalf of the executive agency).
 2. To pay contractors for recovery audit services.
 - b. Except as provided in paragraph C., any amounts erroneously paid by an executive agency that are recovered under a recovery audit program that are not used to reimburse expenses of the executive agency or pay recovery audit contractors under paragraph A:
 1. shall be credited to the appropriations from which the erroneous payments were made, shall be merged with other amounts in those appropriations, and shall be available for the purposes and period for which such appropriations are available; or
 2. if no such appropriations remain available, shall be deposited in the Treasury as miscellaneous receipts.

- c. When required or authorized by other provisions of law, any funds remaining after reimbursing expenses of the executive agency and paying recovery audit contractors, shall be credited to a non-appropriated fund instrumentality, revolving fund, working-capital fund, trust fund, or other fund or account.
- d. Contingent fee contracts shall preclude any payment to the recovery contractor until the recoveries are actually collected by the agency.
- e. All funds collected and all direct expenses incurred as part of the recovery audit program shall be accounted for specifically. The identity of all funds recovered shall be maintained as necessary to facilitate the crediting of recovered funds to the correct appropriations and identify applicable time limitations associated with the appropriated funds recovered.

9. Management Improvement Programs

Section 3564 of title 31, U.S. Code, also authorizes agencies to implement "management improvement programs." Such programs shall take the information gleaned from the recovery audit program, as well as other audits, reviews, or information that identify weaknesses in an agency's internal controls, and ensure that actions are undertaken to improve the agency's internal controls governing contract payments.

10. Grant Programs - Agencies whose grant programs fund significant contract activity by grant recipients may consider including contracts at the grant recipient level in their recovery audit program. Agencies can engage contractors on a contingency basis to the extent otherwise authorized by law.