United States Department of the Interior

OFFICE OF THE SECRETARY
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To: Director, Office of Acquisition and Property Management
Bureau Assistant Directors, Administration
Chief Executive Officer, National Business Center
Bureau Finance Officers
Bureau Procurement Officers

From: Mona S. Williams
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Subject: Risk Assessments and Recovery Audits for Improper Payments

The purpose of this Financial Administration Memorandum (FAM) is to establish the requirements for conducting risk assessments and recovery audits for improper payments.

Appendix C to OMB Circular A-123 provides guidance for conducting recovery audits and risk assessments to fulfill the requirements under the Improper Payments Information Act of 2002 (IPIA) and the National Defense Authorization Act for FY 2002, Subchapter VI – Recovery Audits. The laws require each agency to annually identify programs and activities susceptible to improper payments, estimate the amount of improper payments, report that estimate to Congress, and for agencies that enter into contracts totaling more than $500 million in a fiscal year, to carry out a cost effective program to identify errors in payments and recover amounts erroneously paid.

Risk Assessments:

Appendix C to OMB Circular A-123 states that annual risk assessments are required for all agency programs where the level of risk is unknown until the risk level is determined and the baseline estimates are established (if applicable). It also states that for agency programs deemed not risk susceptible, risk assessments are required every three years unless the programs experience a significant change in legislation and/or significant increases in funding level. Programs experiencing significant changes must undergo a risk assessment during the next annual cycle.

The Department has been conducting annual risk assessments of programs exceeding $100 million in annual outlays. These risk assessments have shown that the Department is at low risk for improper payments. Therefore, the Department's annual risk assessment requirement is now converted to a three-year risk assessment. The next Departmental risk assessment will be for FY2009 and will be conducted every three years hence. Programs requiring a more frequent risk assessment will be identified separately, and notification of such risk assessments will be issued under a separate data call.

Guidance on conducting risk assessments is included at Attachment 1.

Recovery Audits:

Appendix C to OMB Circular A-123 requires agencies to have a cost effective program of internal control to prevent, detect, and recover overpayments to contractors resulting from payment errors. A required element of such a program is the use of recovery audits and recovery activities. A recovery audit is a review and analysis of the agency's books, contracts and modifications, vendor correspondence, payment transaction records, vendor master files, paid history files, purchase orders, invoice files, and other available information supporting payments that is specifically designed to identify overpayments to contractors due to payment errors. It is not an audit in the traditional sense.

Recovery audits may be performed by agency employees, by other departments or agencies of the U.S. Government acting on behalf of the agency, or by contractors performing recovery audit services under contracts awarded by the agency. It cannot be performed by the Inspector General and other agency external auditors that carry out management's recovery audit program.

The Department requires annual recovery audits of all payments made to vendors and reports on recovery auditing activities annually in the IPIA portion of the Management's Discussion and Analysis section of the PAR. The Department currently outsources recovery audit services but does not preclude bureaus from performing recovery audits with in-house resources. Bureaus and Departmental offices have negotiated their own task orders with a Federal government contracting agent. Any appropriate type of contract, including contingency contracts, may be used to obtain the services of recovery audit contractors. A recovery audit contingency contract is a contract in which the recovery audit contractor is paid a portion of the amount recovered. The amount the contractor is paid is generally a percentage of the recoveries and is based on the amount actually collected, based on the evidence discovered and reported by the recovery audit contractor to the appropriate agency official. Contingency fee contracts preclude payment to the contractor until the recoveries are collected.

Recovery audit contractors may review payments/payment data and contracts to determine improper payments, and they may communicate with vendors to verify the validity of potential payment errors. They also analyze the reasons for erroneous payments and recommend cost effective controls to prevent such future erroneous payments. Contractors are prohibited from using or sharing sensitive information that has not been released for use by the general public except for the purpose of fulfilling the recovery audit contract. In addition, recovery audit contractors are required to take steps to safeguard the confidentiality of sensitive information that has not been released for use by the general public. All recovery audit contractor personnel sign non-disclosure agreements prior to being assigned to do recovery audit work for the Department.

Attachment 2 contains a description of the Department's current recovery audit contractor's activities.

Questions on risk assessments or recovery audits should be directed to Dorothy Sugiyama at (202) 208-5789.

Prior Financial Administration Memoranda on this subject: None

Attachments

Overview of PRG–Schultz Recovery Audit Services

Through the requirements outlined in Section 831 of the Defense Authorization Act of 2002, PRG-Schultz (PRG-S) has been contracted by the Department of the Interior to perform recovery review services. Agencies that enter into contracts with a total value in excess of five hundred million dollars ($500,000,000) in a fiscal year are required to carry out a cost effective program for identifying errors made in paying contractors and for recovering amounts erroneously paid to the contractors. We are providing brief descriptions and logistics requirements of the various audit projects (Statement/Aged Accounts Receivable Review, Duplicate Payment, and Contract Compliance/Terms and Conditions Review) PRG-S will undertake, and the transaction aging requirements to successfully engage these projects.

Statement/Aged Accounts Receivable Review Project

Statement Review Summary
The purpose of this project is to identify monies (overpayments/erroneous payments/credits) that may be known to contractors as being owed to the Department of the Interior. This project also provides PRG-S with the opportunity to development of a better knowledge base regarding the activities of the Department of the Interior. In many cases, this project will uncover other problem areas that PRG-S will then review on a more global level to determine if the problem is isolated or occurring with numerous contractors or contract types.

It has been PRG-S' experience that the errors uncovered from this project are far reaching and include some of the following disbursing type errors:

- Duplicate payment of an invoice
- Erroneous payment of an invoice
- Payment of an invoice to the wrong vendor
- Earned cash discounts not taken
- Cash discounts taken at the wrong rate
- Outstanding credit memos not taken at time of payment
- Overpayments due to government furnished materials or equipment not properly being deducted

There are also instances when monies are outstanding due to contractual errors. Some of these types of errors that PRG-S has encountered include:

- Uncollected reducing modifications to contracts
- Volume discounts clearly identified in a contract, but which are not known to the payment office
- Unit price changes (very common on contracts where an option has been exercised and the unit price might change, or not, but the vendor inadvertently charges the "market" price instead of the contracted price)
- Unauthorized quantity variances for contracts with 0% authorized variances
- Overpayments due to progress payments not being liquidated
- Open credits from refunds due to Industrial Based Maintenance clauses within contracts

Statement Audit Review Processes

- The first step of this project is to obtain a Department of the Interior generated and approved Vendor Master File (already received) and submit statement request letters to all the vendors on the list (already submitted). The vendor master file should not be derived from the A/P data set as it will likely provide remit to addresses, and the statement letter request may not reach the individual within the vendor's organization who is most capable of responding.
- As statements are received from the Department of the Interior vendors, they are reviewed for any monies (credits) that may be due the Department of the Interior. Statement auditors communicate with the vendors having potential monies due the Department of the Interior, in an effort to ascertain the cause of the error. They obtain all the necessary documentation from the Department of the Interior vendors, and submit the potential claim package to the Department of the Interior field auditors for further research, validation and documentation collection.
- The field auditor reviews historical and "real-time" electronic data to research the validity of the vendor's records.
- Once the field auditor has determined that the monies are likely due Department of the Interior, they pull the necessary documentation that might have been missing from the vendor's submission.
- Potential claims and supporting documentation will be submitted to Department of the Interior's POC for validation and collection.
- Statement credits discovered and validated through this process will be "aged" 90 days to allow current bureau internal controls to take affect.

Duplicate Payment Audit Project

Duplicate Payment Review Summary

Past experience has consistently identified several reasons why an invoice might be paid twice or paid erroneously. Some of the reasons include:

- Manual mistakes when inputting an invoice number, invoice amount, or invoice date
- Payments made to the wrong vendor, with a subsequent payment made to the correct vendor
- Intentional attempts to over-ride system controls by the inclusion of alpha or numeric characters to a vendor invoice number
- Submission of duplicate or revised invoices by the vendor whereby both get paid
- Purged files that make it cumbersome, or impossible to determine if older invoices were previously submitted and paid
- Payments made by multiple payment center
- Payments made to separate divisions of the same vendor

These reasons have been developed into "criteria" which can be "mined" utilizing the data sets that will be provided by the Department of the Interior on a periodic basis. From the first data set provided seventeen (17) standard PRG-S duplicate/erroneous payment reports will be generated to "flag" invoices that meet the criteria. Once a knowledge base has been developed for

Department of the Interior's data set, additional exception reports will be generated that are Department of the Interior specific.

Duplicate / Erroneous Payment Review Process

- Generate the standard PRG-S duplicate/erroneous payment reports and provide to field auditors
- Field auditors will review each transaction of a report to develop a pull list of transactions that will likely prove to be duplicates or erroneous payments. To develop the initial pull list, the field auditor must:
    - Review electronic and "real time" payment history for each vendor to see if the transaction is consistent with payment trends
    - Check for possible voided payments or offsets previously generated by the Department of the Interior
    - Generate a pull list for all transactions that still appear to be erroneous or duplicated
- Utilizing the pull list, the field auditor must obtain an electronic or hard copy of the invoice and receiving documents to determine, if in fact, the 2 payments are for the same invoice, or revised invoice
- Prepare a potential claim, and pull the necessary documentation to validate claim.
- Submit potential claim to Department of the Interior's POC for validation and collection.
- Claims discovered during this process will be "aged" within the fiscal year scope allowed by the bureau task order.

Contract Compliance/Terms and Conditions Review

Contract Compliance/Terms and Conditions Review

The general perception is that most payment errors occur from payables. The reality is that even with today's integrated systems, collaborating for 100% pricing and payment accuracy is a tremendous challenge. Historically 75-80 % of recoveries are discovered during this review.

Orders can be accomplished by:

- Phone / Fax
- Web / Auction
- Private Network
- Salesperson

Receipts can occur:

- Centrally
- Remotely
- Drop Ship

Validation may require:

- "3 way" matching
- System matching
- Manually

Payment can occur through:

- Check
- ACH

- EDI
- Wire Transfer

Factors used to identify contracts to be reviewed

- There are several factors that PRG-S will use to determine which contracts will be selected for Contract Compliance/Terms and Conditions Review, including:
    - Large dollar volume contracts
    - Contracts with numerous changes / modifications to original obligation
    - Known contractual clauses specific to certain types of obligations which typically create errors in interpretation
    - Contract types identified by the Department of the Interior as being areas of concern
    - Through electronic data manipulation, identification of "trends" which may indicate problem contract types or potential vendor problems

Contract Compliance/Terms and Conditions Recovery Review Processes

This is not an examination of the appropriateness of the contract. The purpose of this audit is to review payment actions as they relate to procurement actions, in an effort to determine "leakage" between procurement and paying offices. The processes are as follows:

- Obtain Electronic or Hard copy procurement documents, as available, including:
    - Contracts
    - Modifications
    - Buyer Files
    - E-mail files
    - Solicitations
    - Vendor / Client correspondence
- Review available documentation and develop a summation of the terms and conditions, including all subsequent modifications, to develop an overall intent of the contract. Summation will include conditions such as:
    - Unit price changes and timing
    - Required delivery schedules
    - "Option" terms and any subsequent changes price guarantees
    - Acceptable G & A expenses, with corresponding OH & P. percentages
    - Approved labor hour quantities and charges
    - Government furnished material or equipment provided
    - Government financing (progress payments)
    - Payment terms
    - Volume discounts
    - Other allowances
    - Authorized quantity variances
    - Penalty clauses that may apply, including:
        - Late or non-delivery
        - Non-conformity of quantity or quality
        - Liquidating damages
        - Price warranty

    - Product warranty

- Obtain all electronic or hardcopy documentation pertaining to receipt of goods, vendor invoices and payment documents.
- Utilizing receipt, invoice and payment documents:
    - Identify, from the receipts documents, any discrepancy in delivery requirements, including both the timing of the delivery and the quantity required for each delivery
    - Match receipts to invoices to identify any discrepancies in quantities charged, or possible back ordered goods erroneously charged on an invoice
    - Compare invoices to payment documents to ensure all discounts and allowances have been taken and/or taken at the correct rate
    - Identify any pricing discrepancies
- Prepare a summation of the receipt, invoice and payment history, noting any discrepancies indicative of monies being owed to client.
- Prepare a potential claim that is well documented and identifies monies owed Department of the Interior.
- Present findings to Department of the Interior's POC for validation and submission to vendor for review and collection.
- Potential claims discovered during this review will be "aged" in accordance with the fiscal year scope of the bureau task order.

Four Step Risk Assessment Process:

Step 1: Review all programs exceeding $100 million in annual outlays, and identify those which are susceptible to significant improper payments. Significant improper payments are defined by OMB as annual improper payments in the program exceeding both 2.5 % of program payments and $10 million.

Step 2: For the programs determined to be susceptible to significant improper payments, perform a statistically valid estimate of the annual amount of improper payments in programs and activities.

Step 3: For the programs determined to be susceptible to significant improper payments, prepare and implement a plan to reduce improper payments.

Step 4: For the programs determined to be susceptible to significant improper payments, report estimates of the annual amount of improper payments in these programs and activities and progress in reducing them in annual Performance and Accountability Reports.

In performing Step 1, managers or evaluators should focus on internal control processes and the inherent risks of each program. Listed below are some of the key factors to be considered when performing assessments. The key factors provided below are neither intended to be all-inclusive nor apply to all programs/activities within a bureau. Some of the factors are subjective in nature and must rely on the manager's judgment and experience in the program assessed. The Risk Rating Worksheet (Attachment 3) is to be completed for each program reviewed. It is each Bureau's responsibility to prepare a Summary Risk Rating Sheet Worksheet for Programs that have multiple field offices that would require separate inputs related to the overall program's assessment. It is very important to retain the risk assessment worksheets for all programs reviewed (including those determined to be medium or low risk). This documentation should be retained by the bureau's management control official to be made available for audit or other review should that be necessary.

Risk Identification

1. Does management identify risk factors using various methodologies as appropriate?

A. Are qualitative and quantitative methods used to identify improper payments and determine relative risk rankings on a scheduled and periodic basis?

B. Have the risk of improper payments been identified, ranked, analyzed, mitigated, and communicated to appropriate staff?

C. Has the topic of improper payments been discussed at senior-level management meetings?

D. Have improper payments been identified as a result of findings from audits, evaluations, or other assessments?

2. Do adequate mechanisms exist to identify the risk of improper payments arising from <u>external</u> factors?

A. Technological advances?
B. Changing expectations/requirements of Congress or other regulatory bodies?
C. Possible natural catastrophes, criminal or terrorist actions?
D. Business or economic changes?
E. Major suppliers or contractors?

3. Do adequate mechanisms exist to identify the risk of improper payments arising from <u>internal</u> factors?

A. Recent downsizing or reorganization of bureau operations or personnel?
B. Business process re-engineering or redesign of operating processes?
C. Disruption of information systems and the extent to which backup systems are available?
D. Decentralized program operations?
E. Lack of qualified personnel or the extent to which they have been trained?
F. Heavy reliance on contractors or other sources (such as volunteers) to perform critical agency operations?
G. Unusual employee access to vulnerable assets?
H. Human capital-related matters, such as succession planning, retention of key personnel who can affect the ability of the program/activity to function effectively, and the adequacy of compensation programs to keep the program competitive with the private sector for labor?

4. Does management assess other factors that may contribute to or increase the risk exposure to improper payments?

A. Past failures to meet program missions or objectives?
B. A history of improper program expenditures, violations of funds control, or other statutory noncompliance?
C. The inherent nature of a program, its significance and/or complexity?

<u>Risk Analysis</u>

1. After identification of the risk of improper payments by program/activity, has management undertaken a thorough analysis of their possible effect?

A. Has management established a formal process to analyze improper payments?
B. Have criteria been established for determining low, medium, and high risks?
C. Are appropriate levels of management and employees involved in the risk analysis?
D. Are the improper payments identified and analyzed objectively relative to the corresponding program/activity?
E. Does the risk analysis include estimating the risk significance?
F. Does the risk analysis include estimating the likelihood and frequency of occurrence of each risk and determining whether it falls into the low, medium, or high-risk category?

G. Has a determination been made on how best to manage or mitigate the risk, and what specific actions should be taken?

2. Has an approach for management control over improper payments been developed based on the amount of risk that can be prudently accepted?

A. Is the approach designed to keep improper payments within levels judged to be appropriate and does management take responsibility for setting the tolerable risk level?

B. Are specific control activities decided upon to manage or mitigate specific improper payments bureau-wide and at each activity level, and is their implementation monitored?

Risk Rating Worksheet - Improper Payments

PROGRAM TITLE____

ANNUAL PROGRAM OUTLAYS $ __________

ESTIMATED ANNUAL NUMBER OF PROGRAM PAYMENTS ______________

ANNUAL ESTIMATED AMOUNT OF IMPROPER PAYMENTS $_____________

% OF ANNUAL NUMBER OF PAYMENTS MADE IMPROPERLY ___________

RISK RATING: High______ Medium______ Low _______

Use separate sheets of paper as necessary to respond to each of the following:

1) PROVIDE THE CRITERIA USED TO DETERMINE THE RISK RATING.

2) LIST SIGNIFICANT WEAKNESSES.

3) SUMMARIZE THE RATIONALE/DECISIONS SUPPORTING THIS ASSESSMENT.

4) PROVIDE THE NAMES AND TITLES OF THE PRIMARY CONTRIBUTORS PREPARING THIS RISK ASSESSMENT.

5) BUREAU PROGRAM/ACTIVITY CONTACT: _____________________________

Phone Number: