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OFFICE OF MANAGEMENT AND BUDGET
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THE DIRECTOR

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MEMORANDUM FOR HEADS OF EXECUTIVE DEPARTMENTS AND AGENCIES

FROM: Rob Portman 

SUBJECT: Issuance of Appendix C to OMB Circular A-123

Congress has enacted several provisions of law aimed at improving the integrity of the government's payments and the efficiency of its programs and activities, including the Improper Payments Information Act of 2002 (IPIA) (Pub. L. No. 107-300), and section 831 of the Defense Authorization Act for Fiscal Year 2002 (Pub. L. No. 107-107, codified at 31 U.S.C. §§ 3561-3567), also known as the Recovery Auditing Act.

OMB has issued memoranda to carry out these laws and provide guidance to agencies on their implementation. These memoranda include M-03-07 of January 16, 2003 ("Programs to Identify and Recover Erroneous Payments to Contractors"); M-03-12 of May 8, 2003 ("Allowability of Contingency Fee Contracts for Recovery Audits"); and M-03-13 of May 21, 2003 ("Improper Payments Information Act of 2002 (Public Law No: 107-300)"). In addition, OMB has been routinely working with agencies in clarifying this guidance to best reflect current policy and legislative intent.

This Appendix C to OMB Circular A-123 consolidates these three memoranda (M-03-13 is encompassed in Part I of Appendix C, and M-03-07 and M-03-12 are encompassed in Part II of Appendix C). In addition, this Appendix clarifies and updates requirements in order to support government-wide IPIA compliance.

Significant updates to OMB's IPIA guidance include:

- New language clarifying the definition of an improper payment;
- Provisions for alternative sampling methodologies;
- Reporting requirements for certain low risk programs;
- Guidance for Federal agencies that fund State-administered programs;
- List of best practices for preventing, identifying, detecting, and recovering improper payments; and
- Clarification of OMB's authority to require agencies to track programs under the IPIA with low error rates (i.e., less than 2.5 percent), but significant improper payment amounts.

This revised guidance is effective for agencies to use immediately and for the fiscal year 2006 Performance and Accountability Report reporting. Please contact Sally Clark Beecroft, Office of Federal Financial Management, telephone (202) 395-1040, with any questions regarding this guidance.

APPENDIX C

Requirements for Effective Measurement and Remediation of Improper Payments

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Part I. Improper Payments Information Act Reporting

This Guidance implements the requirements of the Improper Payments Information Act of 2002 (IPIA) (Pub. L. No. 107-300). OMB Memorandum M-03-13, “Improper Payments Information Act of 2002 (Public Law No: 107-300),” issued May 21, 2003, is hereby modified and incorporated as Appendix C, Part I. to OMB Circular A-123, *Management’s Responsibility for Internal Controls*.

A. What is an erroneous or improper payment? (The term "erroneous payment" and "improper payment" have the same meaning in this Guidance)

An improper payment is any payment that should not have been made or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirements. Incorrect amounts are overpayments and underpayments (including inappropriate denials of payment or service). An improper payment includes any payment that was made to an ineligible recipient or for an ineligible service, duplicate payments, payments for services not received, and payments that are for the incorrect amount. In addition, when an agency’s review is unable to discern whether a payment was proper as a result of insufficient or lack of documentation, this payment must also be considered an error.¹

The term “payment” in this Guidance means any payment (including a commitment for future payment, such as a loan guarantee) that is

- derived from Federal funds or other Federal sources;
- ultimately reimbursed from Federal funds or resources; or
- made by a Federal agency, a Federal contractor, a governmental or other organization administering a Federal program or activity.

This includes Federal awards subject to the Single Audit Act Amendments of 1996 (SAA) (Pub. L. No. 104-156) that are expended by both recipients and sub-recipients. In limited cases, and with prior approval from OMB, an agency may implement a measurement approach that excludes improper payments that have been subsequently corrected and recovered from the annual total reported in its Performance and Accountability Report (PAR).

B. What agencies are required to comply with the requirements of the Improper Payments Information Act of 2002 (IPIA) (Pub. L. No. 107-300)?

The agencies required to comply with IPIA are defined broadly as “a[ny] department, agency, or instrumentality in the executive branch of the United States” as defined in title 31, section 102 of the United States Code.

¹ Agencies that use a different method for reporting errors that result from documentation issues must present their proposal to OMB for review. Any deviation from the methodology described above must be approved in advance by OMB.

C. What is a program or activity? (The term “program and activity” is referred to in this Guidance as “program.”)

The Act anticipates that agencies will examine the risk of erroneous payments in all programs and activities they administer, beyond those listed in the former Section 57 of OMB Circular A-11. The term program includes activities or sets of activities recognized as programs by the public, OMB, or Congress, as well as those that entail program management or policy direction. This definition includes, but is not limited to, all grants including competitive grant programs and block/formula grant programs, regulatory activities, research and development activities, direct Federal programs, procurements including capital assets and service acquisition, and credit programs. It also includes the activities engaged in by the agency in support of its programs.

For Federal awards subject to the SAA or otherwise listed in the Catalog of Federal Domestic Assistance (CFDA), Federal agencies should consider using the groupings in the OMB Circular A-133 Compliance Supplement and the CFDA. However, unless otherwise specified in OMB Circular A-11, each Federal agency, after consultation with OMB, is authorized to determine the grouping of programs which most clearly identifies and reports erroneous payments for their agency. Agencies must not put programs into groupings that result in significant error rates being masked by the large size or scope of such a grouping. For transparency, the basis for these groupings must be reported in the agency’s annual PAR.

D. What constitutes an improper loan or loan guarantee payment?

Direct loans:

Under a direct loan program, improper payments may include disbursements to borrowers or other third-party payments that are based on incomplete, inaccurate, or fraudulent information. They may also include duplicate disbursements, disbursements in the incorrect amount, or loan funds used for purposes other than those allowed by law, program regulations, or agency policy.

Loan guarantee:

Under a loan guarantee program, an improper payment may include disbursements to intermediaries, third-parties for defaults, delinquencies, interest and other subsidies, or other payments that are based on incomplete, inaccurate, or fraudulent information. They may also include duplicate disbursements, disbursements in the incorrect amount, or any disbursements that are not in compliance with law, program regulations, or agency policy.

E. What are agencies required to do?

Agencies are required to review all programs and activities they administer and identify those which may be susceptible to significant erroneous payments. This includes payments from Federal awards subject to the SAA made by recipients and sub-recipients. 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). For agency programs deemed not risk susceptible risk assessments are required every three years. Agencies need not conduct formal risk assessments for those programs in which improper payment baselines are already established, are in the process of being measured, or will be measured by an

established date. However, if a program experiences a significant change in legislation and/or a significant increase in funding level, agencies are required to re-assess the program's risk susceptibility during the next annual cycle, even if it is less than three years from the last risk assessment. For all programs and activities in which the risk of erroneous payments is significant, agencies shall estimate the annual amount of erroneous payments and report the estimates in their annual PARs to OMB as set forth in OMB Circular A-136, *Financial Reporting Requirements*, for IPIA and Recovery Auditing Act reporting.

Unless an agency has specific written approval from OMB for a deviation to the steps explained below, agencies are required to follow these steps to determine whether the risk of erroneous payments is significant and to provide valid annual estimates of erroneous payments. (Also, refer to Section E which describes some of the possible acceptable alternative methodologies for error measurement.)

Step 1: Review all programs and activities and identify those which are susceptible to significant erroneous payments.

- a. Definition. For the purposes of this Guidance, "significant erroneous payments" are defined as annual erroneous payments in the program exceeding both 2.5 percent of program payments and \$10 million.
- b. Systematic Method. Many agencies already know which programs and activities are at the highest risk of erroneous payments. Agencies shall institute a systematic method of reviewing all programs and identifying those which they believe to be susceptible to significant erroneous payments. The agency shall maintain documentation to support this review and the results.
- c. Other high risk programs. However, OMB may determine on a case-by-case basis that certain programs that do not meet the threshold requirements described above, may still be subject to the annual PAR reporting requirement. This would most likely occur in programs with relatively high annual outlays. For example, a program with \$10 billion in annual outlays and a 1 percent error rate (i.e., \$100 million improper payment amount) may be required by OMB to be included in an agency's annual IPIA reporting as a high risk program or activity.
- d. Examples. To further clarify this step, we provide three examples assuming that no exceptions have been made:

Example 1: Under the analysis in Step 1 a program has a potential error rate of 2.25 percent or \$14 million. Under this Guidance an agency need not perform Step 2, making a statistically valid estimate of erroneous payments in the program, because the potential error rate does not exceed 2.5 percent.

Example 2: Under the analysis in Step 1 a program has a potential error rate of 2.75 percent or \$9 million. Under this Guidance, an agency need not perform Step 2, making a statistically valid estimate of erroneous payments in the program, because the potential amount of erroneous payments in the program does not exceed \$10 million.

Example 3: Under the analysis in Step 1, a program has a potential error rate of 2.75 percent and \$11 million. Under this Guidance, an agency must perform Step 2, obtaining a statistically valid estimate of erroneous payments in the program, because the potential error rate exceeds 2.5 percent and the potential amount of erroneous payments exceeds \$10 million. The agency must report a statistically valid error rate for the program in its annual PAR.

Step 2: Obtain a statistically valid estimate of the annual amount of improper payments in programs and activities (unless otherwise noted in this Guidance).

- a. Annual Estimated Amount. For all programs and activities susceptible to significant improper payments, agencies shall determine an annual estimated amount of improper payments made in those programs and activities. This estimate is a gross total of both over and under payments (i.e., not the net of over and under payments).
- b. Random Sample. The estimates shall be based on the equivalent of a statistically random sample of sufficient size to yield an estimate with a 90 percent confidence interval of plus or minus 2.5 percentage points around the estimate of the percentage of erroneous payments.²
- c. Validity. The agency may use their initial determination of the *potential* error in Step 1 and the examples below to aid in determining their sample size; however, agencies must consult with a statistician to ensure the validity of their sample design, sample size, and measurement methodology.
- d. Examples. To clarify this step, we provide two examples below.
 - The examples illustrate the least complicated scenario in which an agency’s payments are either correct or incorrect with the error rate expressed as a simple percentage of the number of payments that were incorrect (attribute sample).
 - The examples also assume that a simple random sample of cases is drawn for review from a very large universe of payments.³
 - However, it is important to note that the examples below (and the formula in the footnote) provide for an error rate estimate, but not an estimate of improperly paid dollars. Furthermore, many agency programs will need to utilize more complex sample designs because their payment universe contains divergent dollar amounts and/or types of payments.
 - Therefore, most agencies will need to consult with a statistician to design an appropriate sample that may involve estimates of improperly paid dollars or

² Agencies may alternatively use a 95 percent confidence interval of plus or minus 3 percentage points around the estimate of the percentage of improper payments.

³ Under these assumptions, the minimum sample size needed to meet the precision requirements can be approximated by the following formula, which is used in the examples:

$$n \geq \frac{2.706(1 - P)}{\left(\frac{.025}{P}\right)^2}$$

Where n is the required minimum sample size and P is the estimated percentage of erroneous payments (Note: This sample size formula is derived from *Sampling of Populations: Methods and Applications* (3rd edition); Levy, P. S. & Lemeshow, S. (1999); New York: John Wiley & Sons; at page 74. The constant 2.706 is 1.645²)

multiple stages of selection or stratification (rather than a simple random sample), and to ensure that their sample design and size will meet the minimum required precision level in this guidance.

Example 1: Under the analysis in Step 1, the program has a potential error rate of 3 percent (and at least \$10 million). Under this Guidance the agency needs to draw a random sample of payments from the program that will yield a statistical estimate of the erroneous payment rate. The 90 percent confidence interval around this estimate should be no more than plus or minus 2.5 percentage points. Using the initial determination of a three percent error rate yields a minimum sample size of approximately 126 cases.

Example 2: Under the analysis in Step 1, the program has a potential error rate of 4.5 percent (and at least \$10 million). The required minimum sample size to achieve a 90 percent confidence interval around this estimate of 4.5 percent of plus or minus 2.5 percentage points is approximately 186 cases.

- a. Use Large Sample Sizes. Because of the imprecision of the risk assessment performed in Step 1, agencies should ensure that they do not select too small of a sample. Because, for a given sample size, the standard error of a percentage estimate increases as the point estimate of the error rate approaches 50 percent, agencies should be conservative and use a higher estimated error rate in their sample size calculations to ensure that they will meet the precision targets.
- b. Greater Precision. Furthermore, these guidelines for precision should be taken as the minimum, and agencies are encouraged to increase samples above the minimum to achieve greater precision in their estimates. The agency shall maintain documentation to support the calculation of these estimates.
- c. Working with other Entities. In addition, agencies should consider working with entities (i.e., grant recipients) that are subject to A-133 audits to use ongoing audits to assist in the process to estimate an erroneous payment rate and amount.

Step 3: Implement a plan to reduce erroneous payments.

- a. Root Causes. For all programs and activities as determined under Step 2 with erroneous payments exceeding \$10 million, agencies shall identify the reasons their programs and activities are at risk of erroneous payments and put in place a corrective action plan to reduce them. To determine the root causes for improper payments, agencies may be required to conduct an analysis of improper payments which produces an error rate at higher levels of confidence and precision than that prescribed by this Guidance.
- b. Reduction Targets. When compiling its plan to reduce improper payments, agencies shall set reduction targets for future improper payment levels and a timeline within which the targets will be reached.
- c. Accountability. In addition, agencies must ensure that their managers and accountable officers (including the agency head) are held accountable for reducing improper payments. Agencies shall assess whether they have the information systems and other infrastructure needed to reduce improper payments to minimal cost-

effective levels, and identify any statutory or regulatory barriers which may limit the agencies' corrective actions in reducing improper payments.

Step 4: Report estimates of the annual amount of improper payments in programs and activities and progress in reducing them.

- a. Reporting. Agencies shall report to the President and Congress (through their annual PARs in the format required by OMB Circular A-136 for IPIA reporting) an estimate of the annual amount of improper payments for all programs and activities, regardless of the dollar amount of the estimate, as further explained below. Information from agency PARs is subsequently analyzed for inclusion in OMB's government-wide report on improper payments entitled, "Improving the Accuracy and Integrity of Federal Payments," which is published annually during the first quarter of each calendar year.
- b. Estimates greater than \$10 million. For improper payment estimates that exceed \$10 million agencies shall include the following in their annual PARs to OMB:
 - i. The estimate of the annual amount of improper payments (gross over and underpayments) made in the program and the methodology used to arrive at that estimate.
 - ii. A discussion of the causes of the improper payments identified, actions taken to correct those causes, and the results of the actions taken to address those causes. Part of this discussion shall include the portion of payment errors attributable to insufficient or lack of documentation, if applicable.
 - iii. A discussion of the amount of actual improper payments the agency expects to recover and how it will go about recovering them.
 - iv. A statement of whether the agency has the information systems and other infrastructure it needs in order to reduce improper payments to the levels the agency has targeted.
 - v. If the agency does not have such systems and infrastructure, a description of the resources the agency has requested in its most recent budget submission to Congress to obtain the necessary information systems and infrastructure.
 - vi. A description of the steps (including timeline) the agency has taken and plans to take to ensure that agency managers and accountable officers (including the agency head) are held accountable for reducing and recovering improper payments.
 - vii. A description of any statutory or regulatory barriers which may limit the agencies' corrective actions in reducing improper payments.
 - viii. A statement of how the agency plans to reduce improper payments from the baseline rate over the next three fiscal years provided the agency has estimated a baseline improper payment rate for the program.
- c. Estimates less than \$10 million. If the improper payment measurement estimate yields less than \$10 million, agencies are still required to report the total in their annual PARs to OMB.

F. May agencies use alternative sampling methods?

Yes. Agencies may utilize an alternative sampling approach provided they obtain OMB approval prior to implementation. The scenarios described below are examples of the types of approaches that may be approved by OMB as alternatives to the steps provided in Section E, Part I, of this Guidance. However, agencies are still required to obtain OMB approval prior to implementation. Use of alternatives should not preclude agencies from performing their risk assessments as required by this Guidance in Part I, Paragraph E. In addition, if agencies are approved to use either Scenario 1 or 2, all steps within the scenario are required to be completed, and the use of, and justification for, using an alternative sampling method must be reported in the agency's annual PAR.

Scenario 1. An agency has a previous (less than five years old) baseline improper payment rate, and has a plan in place to obtain another full program improper payment rate within five years from the baseline year.

Step 1: Aging the baseline rate. The agency should use statistical methods to update or “age” the baseline improper payment rate in the intervening years, until the next program rate is established. Specifically, the agency should use available data to extrapolate updates of the baseline rate. At a minimum, the analysis should conclude whether the baseline rate is trending upward, downward, or remaining static.

Step 2: Program component annual measurement. The agency should develop an annual error rate for a component of the program. The component can be defined based on population, program area, or known problem area. To the extent possible, the component chosen for analysis should be based on risk so that the agency is targeting an area of the program in which a significant amount of improper payments is expected to occur. This could mean choosing an area because of overall financial exposure, or in the case of State-administered programs, possibly selecting larger states to cover more of the risk. This program component should be statistically sampled annually to obtain an error rate consistent with the statistical rigor requirements of this Guidance in Part I, Paragraph E. The goal for the component study is not to extrapolate an improper payment rate for the program as a whole. Rather, the goal is only to estimate an improper payment amount for the relevant program component being studied. Component-specific baseline and target rates, as well as corrective action plans, should be developed to measure and assess agency progress in reducing improper payments in the program component.

Please note, that both Steps 1 and 2 in Scenario 1 are required if this alternative is chosen by the agency and approved by OMB.

Scenario 2. No baseline comprehensive improper payment rate is established and no statistically valid methodology is yet developed to obtain one.

Step 1: Plan for comprehensive baseline measure. A methodology to obtain a comprehensive baseline improper rate must be developed with a timeline that would allow for the first measurement to occur within three years of when the plan was

approved by OMB. Statistical rigor must meet, at a minimum, the requirements previously stated in this Guidance in Part I, Paragraph E.

Step 2: Program component annual measurement. While the agency is working toward a comprehensive baseline rate, the agency should annually identify a component to measure, and begin to report on this measurement within one year of the plan's approval by OMB. (See Step 2 in Scenario 1 above.)

Step 3: Determine rate. Once the baseline rate is established, and if the rate cannot be re-measured annually, the agency should perform both Steps 1 and 2 of Scenario 1 above to ensure that adequate information on improper payments is obtained on an annual basis. If an agency decides to utilize one of the scenarios listed above, it must complete all of the steps for the scenario selected. It is important to note that agencies are not restricted to using only these two approaches; different strategies may be necessary because of pre-existing legislative requirements and/or prohibitions, or because a different method may be more appropriate in providing results for a particular program. Agencies may also consider non-probabilistic sampling approaches, such as purposive sampling or cut-off samples, when legislative requirements make probabilistic samples untenable (for examples see paragraph H).

As detailed above, whether an agency decides to use one of these two scenarios, or proposes a different process, all deviations from Appendix C, Part I, Paragraph E must be approved in advance by OMB.

G. Are agencies required to subject the entire lifecycle of a payment to sampling and/or testing, or may agencies determine the transaction points that have the highest risk of error, and focus their sampling and/or testing accordingly?

Agencies may focus their sampling and/or testing on individual components or transaction points of their programs for the areas posing the highest risk of improper payments. For example, an agency may have a program where payments involve five transaction steps before funds reach the ultimate recipient. However, the agency may determine that only two of the transaction steps are high risk. Therefore, only these two transaction steps need sampling, detailed review, and reporting. This decision and subsequent actions should be documented by agencies in their annual PAR and discussed with, and approved by, OMB prior to implementation.

H. What are Federally-funded, State-administered programs, and may agencies consider other approaches for this these types of programs?

Federally-funded, State-administered programs (e.g., Medicaid, TANF, Title I Grants to States, Child and Adult Care Food Program) receive at least part of their funding from the Federal Government, but are administered, managed, and operated at the State or local level. Where programs are administered at the State level, statistically valid estimates of improper payments may be provided at the State level either for all States or for all sampled States annually. If the improper payment estimates are provided at the State level, these State-level estimates should then be used to generate a national improper payment dollar estimate and rate. However,

agencies may submit a plan to OMB for approval to provide national level estimates for State-administered programs based on a purposive or systematic selection of such programs each year.

One example of this type of approach can be seen in the Title IV-E Foster Care Program, wherein current regulations require that programs be reviewed every three years for compliance. With prior OMB approval, this program has taken the review cycle already in place and leveraged it for IPIA measurement, providing a rolling three-year average error rate.

Alternate methodologies, such as those described above, must be approved by OMB in advance of implementation. The justification to use this type of approach must include a description of the States to be selected each year, the methodology for generating annual national estimates, and a justification for using the proposed plan rather than an estimate based on a random statistical sample.

I. Where and when should agencies report the information required by the Act?

Agencies shall, following the format included in OMB Circular A-136, include a summary of their progress of completing these reporting requirements in the Management Discussion and Analysis (MD&A) section of their PARs. However, the detailed portion of the reporting required by this Guidance is to be included as an appendix to the PAR. The annual estimate of improper payments reported in the PAR should coincide with the fiscal year being reported. However, in limited cases, agencies may report based on the previous fiscal year's data. For example, for the fiscal year (FY) 2006 PAR reporting, agencies may report on FY 2005 data. Agencies may choose a different 12-month reporting period as long as it does not extend beyond the previous fiscal year.

J. How does this Guidance affect recovery auditing activities?

Agencies are to report on their recovery auditing activities annually in the appropriate section of the IPIA portion of their PARs, as required by OMB Circular A-136. If appropriate, agencies should also include a summary of their efforts with the IPIA discussion in the MD&A. There may be instances when an agency makes substantial commercial payments, yet the sum of these payments falls below the Recovery Auditing Act reporting threshold of \$500 million. In these cases, the agency should review its commercial payment universe as a "program" during its annual program inventory and risk assessment. If the agency determines this "program" to be risk susceptible, then the area of commercial payments will be subject to routine IPIA reporting. (See also Section II of this Guidance.)

K. Are programs listed in the former Section 57 of OMB Circular A-11 for FY 2001 (see list of these programs attached at the end of Part II) permanently subject to IPIA reporting requirements?

No. If an agency program has documented a minimum of two consecutive years of improper payments that are less than \$10 million annually, this agency may request relief from the annual reporting requirements for this program. This request must be submitted in writing to OMB. However, if significant legislative changes occur, if program funding is significantly increased,

or if any change results in substantial program impact, agencies must perform a risk assessment of this program as part of its next reporting cycle. If the risk assessment indicates that the program is again susceptible to significant improper payments, the agency will return to the full measurement and reporting process as required by IPIA. Agencies must continue to report improper payment rates, amounts, and remediation efforts as long as annual improper payments for a program exceed \$10 million.

L. What activities may be used to identify, eliminate and recover improper payments?

Federal agencies should take all necessary steps to ensure the accuracy and integrity of Federal payments. Generally speaking, program integrity activities fall into three basic categories: prevention, detection, and recovery.

- a. Prevention. Prevention activities are by definition proactive. These are actions performed prior to payment issuance to assure that the payment is accurate when made. Examples of this type of activity include pre-payment audits, due diligence based on risk prioritization, and predictive modeling. (This is a process whereby transactions that have pre-established criteria or characteristics may be automatically assessed as high risk or not. The high risk transactions then receive increased focus during pre- and post-payment audits.)
- b. Detection. Detection activities occur subsequent to payment. These are actions that test the accuracy of payment processes and identify errors made during those processes. For example, routine payment verification or quality control would review a universe of payments using different criteria than used on the front-end to detect potential payment errors. Data matching compares two or more data fields or sets to confirm consistent input. Use of data mining techniques allows payment patterns or anomalies to be isolated and subjected to further review.
- c. Recovery. Recovery or collection activities refer to efforts directed toward recapturing improperly made payments. For example, the Treasury Offset Program is frequently used to recoup overpayments. In addition, the recovery auditing concept has been shown to be effective when either an internal or external organization reviews payments to determine correctness. (See Part II of this Guidance for additional details regarding this subject.) An innovative direction that some Federal agencies have begun utilizing is risk sharing with its contractors. For example, one large agency has its contractors assume financial responsibility for any payment errors as unallowable contract costs. In addition, this agency financially penalizes its contractor when the amount of payment errors payments exceeds two percent of total contract payments. As a result, this program has virtually no improper payments. (This practice in no way delegates legal responsibility.)
- d. Possible Approaches to Consider. Current practices that are yielding positive results in certain Federal agencies include:
 - Predictive modeling – an automated process whereby transactions that have pre-established criteria or characteristics are automatically deemed high risk and therefore receive increased focus both pre- and post-payment. For State-administered programs, in

which States are utilizing unique predictive models, Federal agencies should evaluate which States have the most effective methods and ensure that best practices in this area are disseminated to other States.

- Data mining – an automated process used to scan data bases to detect patterns, trends, and/or anomalies for use in risk management or other areas of analysis. This technique can be used to build more effective predictive modeling criteria, identify control weaknesses that are leading to improper payments, and/or inform on the most effective oversight and due diligence activities.
- Alignment of due diligence and risk oversight – Federal agencies should structure due diligence and oversight activities so that higher risk transactions generate additional due diligence/review and lower risk transactions generate limited or no due diligence/review.
- Prioritization of verification activities based on effectiveness – Federal agencies should evaluate the return on investment of various outreach efforts (e.g., in-person audits, written notices, phone calls) and utilize those efforts with the greatest return on investment.
- Data matches – Federal agencies should be evaluating Federal, State, local, and private databases to assess whether data matches can help strengthen pre- and post-payment reviews.

M. Where can agencies go to find additional information about estimating and reducing improper payments?

The Government Accountability Office surveyed public and private sector organizations and issued a report on the practices to use in measuring and preventing erroneous payments. That report, “Strategies to Manage Improper Payments: Learning from Public and Private Sector Organizations” (GAO-02-69G, October 2001). This document may also be found on the Internet at www.gao.gov/cgi-bin/getrpt?gao-02-69-G. In addition, there are documents on the Chief Financial Officers Council web site (www.cfoc.gov) that discuss methods, practices and processes, for identifying, preventing, and recovering improper payments.

Part II. Recovery Auditing

This section of the guidance implements the requirements of section 831 of the Defense Authorization Act for Fiscal Year 2002 (Pub. L. No. 107-107, codified at 31 U.S.C. §§ 3561-3567) (section 831), also known as the Recovery Auditing Act. Section 831 added a new subchapter to the U.S. Code (Title 31, §§ 3561-3567) that requires agencies that enter into contracts with a total value in excess of \$500 million 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. As previously mentioned in Part I, Section J of this Guidance, for agencies that use internal review for monitoring accuracy of commercial payments, this payment category is to be included in the agency's program inventory and risk assessment process. However, agencies that use internal staff to perform recovery auditing must report these activities under the same conventions as required when contracting with private sector recovery auditing firms.

OMB previously issued two memoranda to implement section 831. Memoranda M-03-07, "Programs to Identify and Recover Erroneous Payments to Contractors," of January 16, 2003, and M-03-12, "Allowability of Contingency Fee Contracts for Recovery Audits," of May 8, 2003, are hereby modified and incorporated as Appendix C, Part II to OMB Circular A-123, Management's Responsibility for Internal Controls.

This Guidance is intended to assist agencies in successfully implementing recovery auditing and recovery activity as part of an overall program of effective internal control over contract payments.

A. What are agencies generally required to do when implementing a recovery auditing program?

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

B. What are the reporting requirements for recovery auditing?

In accordance with OMB Circular A-136, agencies must report annually on their recovery auditing program in their PARs. The report shall include the following information:

- a. A general description and evaluation of the steps taken to carry out a recovery auditing program;

- b. 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);
- c. The total amount of contracts subject to review, the actual amount of contracts reviewed, the amounts identified for recovery, and the amounts actually recovered in the current year. Report separate totals from amounts attributable to internal agency activities from recovery audit contractors;
- d. A corrective action plan to address the root causes of payment error;
- e. A general description and evaluation of any management improvement program carried out pursuant to this Guidance; and
- f. A description and justification of the classes of contracts excluded from recovery auditing review by the agency head.

C. What are the definitions used for recovery auditing in this Guidance?

For purposes of this Guidance the following terms and definitions are used:

1. 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; and reviews of the contractor's systems established for identifying and returning any erroneous payments received under its Federal contracts.
2. 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.
3. 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.

4. *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.
5. *Recovery Activity* is any activity by an executive agency to attempt to recover overpayments identified by a recovery audit.
6. 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, is a management function and responsibility.
7. 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 Part II, Section K.

D. What is the scope for Recovery Audit Programs?

1. 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).
2. 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 excluded:
 - i. 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.
 - ii. 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.

- iii. Other contracts that provide for contract financing payments or other payments that is interim, provisional, or otherwise subject to further adjustment by the Government in accordance with the terms and conditions of the contract.
3. Recent payments may be excluded for a reasonable (as defined by the agency) period of time, in order to allow the agency's normal post-payment processes to identify and correct any overpayments.
4. 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.
5. 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 their Inspectors General and other organizations with audit jurisdiction over agency contracts.
6. In addition to identifying and documenting specific overpayments resulting from payment errors, and where appropriate as determined by the agency, recovery auditors must also analyze the reasons why payment errors occurred, and recommend cost-effective controls to prevent such overpayments in the future, as a normal part of their contract work. The results of such analyses and related recommendations will be considered by the agency as part of its management improvement program. (For more information on this point, see also Part II, Section F.) If requested, the agency should provide such information to its Office of Inspector General.
7. Instances of potential fraud discovered through recovery audits and recovery activities shall be reported immediately to the agency Office of Inspector General.

E. Who may perform recovery audits?

Recovery audits may be performed by employees of the 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.

F. What is the role and authority of Inspectors General?

1. 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.

2. Agencies' 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).

G. May recovery audit services be performed by contractors?

Yes. 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. Therefore, agencies would need to establish other funding arrangements when making payments to recovery audit contractors in such cases.

H. Are there any prohibitions when using a contracted auditing firm?

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 provisions that:

1. Prohibit the recovery audit contractor from:
 - i. 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;
 - ii. establishing or otherwise having a physical presence on the property or premises of any other agency contractor for the purpose of performing the contract;
 - iii. acting as an agent for the Federal Government in the recovery of funds erroneously paid to contractors;
 - iv. 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
 - v. 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.

I. Who performs recovery activities once the improper payments are discovered and verified?

The actual collection activity may be carried out by Federal employees. However, agencies may use another private sector entity, such as a private collection agency, to perform this function, if this practice is permitted by statute. As noted above in section H.1.iii. above, the recovery auditing contractor itself may not perform the collection activity, unless it meets the definition of a private collection agency, and the agency involved has statutory authority to utilize private collection agencies. Agencies shall follow applicable laws and regulations governing collection of amounts owed to the Federal Government.

J. What is the proper disposition of recovered amounts?

1. 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 to reimburse the actual expenses incurred by the executive agency for the following purposes:
 - i. 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 agency);
 - ii. To pay contractors for recovery audit services.
2. Except as provided in paragraph 3 below, 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 1:
 - i. 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
 - ii. If no such appropriations remain available, the funds recovered shall be deposited in the Treasury as miscellaneous receipts.
3. 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.
4. Contingency fee contracts shall preclude any payment to the recovery audit contractor until the recoveries are actually collected by the agency.
5. 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 to identify applicable time limitations associated with the appropriated funds recovered.

K. Are agencies authorized to implement Management Improvement Programs?

Yes. Section 3564 of title 31, U.S. Code, authorizes agencies to implement “management improvement programs.” Such programs shall take the information obtained 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.

L. May agencies with grant programs employ recovery auditing?

Agencies whose grant programs fund significant contract activity by grant recipients may consider encouraging recovery auditing contracts at the grant recipient level. Costs of contingency fee contracts incurred by State and local governments for the recovery of improper payments charged against Federal programs are allowable costs under OMB Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments*, Attachment A, Section C.3. State and local governments may use a portion of recovered improper or fraudulent payments from Federal programs to pay the contingency fees involved with recovery auditing contracts. The portion used to pay contingency fees, as well as the actual expenses incurred by the Grantee for program administration, should be claimed as administrative costs.

SECTION 57—INFORMATION ON ERRONEOUS PAYMENTS

EXHIBIT 57B

PROGRAMS FOR WHICH ERRONEOUS PAYMENT INFORMATION IS REQUESTED

Erroneous payment information is requested for the following:

Department of Agriculture	Federal Transit—Capital Investment Grants
Food Stamps	Federal Transit—Formula Grants
Commodity Loan Program	
National School Lunch and Breakfast	Department of Veterans Affairs
Women, Infants, and Children	Compensation
Department of Defense	Dependency and Indemnity Compensation
Military Retirement	Pension
Military Health Benefits	Insurance Programs
Department of Education	Environmental Protection Agency
Student Financial Assistance	Clean Water State Revolving Funds
Title I	Drinking Water State Revolving Funds
Special Education—Grants to States	National Science Foundation
Vocational Rehabilitation Grants to States	Research and Education Grants and
Department of Health and Human Services	Cooperative Agreements
Head Start	Office of Personnel Management
Medicare	Retirement Program (CSRS and FERS)
Medicaid	Federal Employees Health Benefits Program
TANF	(FEHBP)
Foster Care—Title IV-E	Federal Employees' Group Life Insurance
State Children's Insurance Program	(FEGLI)
Child Care and Development Fund	Railroad Retirement Board
Department of Housing and Urban Development	Retirement and Survivors Benefits
Low Income Public Housing	Railroad Unemployment Insurance Benefits
Section 8 Tenant-Based	Small Business Administration
Section 8 Project Based	(7a) Business Loan Program
Community Development Block Grants	(504) Certified Development Companies
(Entitlement Grants, States/Small Cities)	Disaster Assistance
Department of Labor	Small Business Investment Companies
Unemployment Insurance	Social Security Administration
Federal Employee Compensation Act	Old Age and Survivors' Insurance
Workforce Investment Act	Disability Insurance
Department of Treasury	Supplemental Security Income Program
Earned Income Tax Credit	
Department of Transportation	
Airport Improvement Program	
Highway Planning and Construction	