



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

IN REPLY REFER TO

PPD 730.5.70.1

January 3, 2003
03-PPD-002(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Special Purpose Audits of Contract Overpayments and Progress Payments for FY 2003

Summary

During FY 2003, DCAA will continue to team with the Defense Finance and Accounting Service (DFAS) to improve the Department's financial management of DoD contracts. During FY 2002, Field Audit Offices (FAOs) performed special purpose audits of contract overpayments and progress payments for (i) all major contractors, (ii) contractors receiving significant contract payments, and (iii) other contractors that FAOs deemed appropriate based on documented risk. At each contractor where we performed a special purpose audit of overpayments in FY 2002, FAOs will perform another audit in FY 2003 to:

- perform audit steps in the attached audit program that were not performed during FY 2002;
- follow-up on FY 2002 outstanding overpayments, system deficiencies, and suggestions for improvement;
- identify any current overpayments; and
- perform an analysis of significant refunds.

During FY 2003, FAOs will also:

- identify any new major contractor or other contractor with a high risk billing system where a special purpose audit was not performed in FY 2002,
- perform the full special purpose audits of these new/high risk contractors, as outlined in the attached audit program, and
- exclude contractors selected in FY 2002 for audits based solely on high risk, if the FAO has documented that the identified risk no longer exists.

At contractors where we are performing a special purpose audit of overpayments, the FAO should coordinate with the contracting officer to perform at least one progress payment audit on progress payment requests based on costs on fixed price (e.g., firm fixed price or fixed price incentive) contracts that meet any of the following criteria:

- contracts over \$100 million,
- contracts in a loss position, or
- contracts with alternate liquidation rates (ALRs).

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Performance of the special purpose audits of contract overpayments and progress payments should be initiated immediately. FAOs must complete at least 50 percent of the audits by April 30, 2003, 75 percent by July 31, 2003, and the remainder by the end of the fiscal year.

Background

As a result of the FY 2002 programmed audits, our FAOs found over \$200 million of overpayments. The overpayments were the result of (i) contractor internal control problems (52 percent), (ii) contract administration adjustments (37 percent), and (iii) payment office errors (11 percent). Major causes of the overpayments were:

- contractor not performing periodic reconciliations of billed to booked amounts (Audit Alert issued May 23, 2002 – MRD-02-PPD-044(R));
- contractor not resolving overpayments related to differences in liquidation on delivery invoices in a timely manner;
- contractor not processing contract administration adjustments impacting billings in a timely manner;
- contractor not updating alternate liquidation rates to reflect current contract profit position;
- contractor not updating the estimate-at-complete (EAC) on contracts in a loss position; and
- other contractor internal control deficiencies.

This updated guidance includes enhanced audit procedures as a result of lessons learned during FY 2002.

Audit Guidance

Special Purpose Audits of Contract Overpayments. The attached updated audit program includes the audit steps required to perform the special purpose audits of overpayments. The audit program covers the following major areas:

- comparison of billed and paid amounts, including accounting for progress payment liquidations,
- reconciliation of recorded to billed costs,
- processing of contract administration adjustments,
- processing of demand letters,
- management of subcontractor billings,
- offsets, and
- refunds.

During FY 2003, FAOs will perform updated special purpose audits at all contractors where special purpose audits were performed during FY 2002. The only exception is if the FY 2002 audit was performed because it was identified solely as high risk and the audit documented and concluded

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low risk. These updated audits will cover the following areas:

- audit steps included in the attached audit program that were not performed/completed during the FY 2002 special purpose audits (e.g., accounting for liquidation differences – See Audit Program Steps E.1.a.(5) and E.1.b.(3), and review of subcontractor billings – See Audit Program Steps D.1.f and E.5.);
- follow-up on FY 2002 reported deficiencies and suggestions for improvement;
- determine status of outstanding overpayments identified in FY 2002 audit, including documentation of the resolution of those overpayments (including those reported by contractors to the GAO);
- identify and review outstanding overpayments. Update the following areas and identify any significant overpayments since the date of our last review:
 - comparison of billed and paid amounts (See Audit Program Step E.1.) and
 - reconciliation of recorded to billed costs (See Audit Program Step E.2.); and
- obtain and review a list of refunds for the last 12-month period and determine whether significant refunds were processed timely (See Audit Program Steps D.1.h and E.7.).

During FY 2003, FAOs will also identify any new major contractor or other contractor with a high risk billing system where a special purpose audit was not performed in FY 2002. The FAO will perform the full special purpose audit at these new contractors as outlined in the attached audit program.

Coordination with Field Detachment. FAOs that have cognizance of contractors with significant classified contracts should coordinate with the Field Detachment to determine the DCAA office with responsibility for identifying and reviewing overpayments on classified contracts. This coordination should be documented in the special purpose audit working papers. FAOs should also coordinate with the Field Detachment on any significant overpayments found on classified contracts during FY 2003.

Coordination at Contractors with Centralized Accounts Receivable Functions (often referred to as Shared Services). During FY 2002, we found that some major contractors have centralized their accounts receivable functions. The significant centralized accounts receivable functions reviewed during FY 2002 included Honeywell Shared Services in Tempe, Arizona and Lockheed Martin Shared Services in Gaithersburg, Maryland. Other major contractors may have plans to centralize accounts receivable functions during FY 2003. Close coordination is required during the planning stages of the special purpose audits at FAOs cognizant of the shared services location and the FAOs cognizant of the segments serviced by the shared services.

The audit objectives at centralized accounts receivable (shared services) locations generally include:

- comparison of billed to paid amounts,
- resolution of overpayments as a result of comparison of billed to paid amounts (including differences in application of liquidation rates),
- review processing of demand letters, and

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- review processing of refunds/offsets.

The audit objectives at segments serviced by shared services generally include:

- reconciliation of billed to booked amounts (especially physically complete contracts),
- review of contract administration adjustments,
- review of management of subcontract billings, and
- review refunds/offsets to the government.

Early in FY 2003, FAOs cognizant of centralized accounts receivable functions should coordinate with FAOs cognizant of the segments serviced by the shared services to develop documented audit objectives and audit plans for performing the special purpose audits.

Assist Audits of Major Subcontractors (See Audit Program Step E.5.). FAOs cognizant of contractors with significant subcontractor billings should determine early in FY 2003 if assist audits are required to determine if there are overpayments at the subcontractor location. Assist audits are generally required on subcontracts when the prime contractor does not have visibility over payment variances in the subcontractors' accounting records. The assist audit request should identify the subcontractor name and pertinent information on the subcontracts to be reviewed (e.g., subcontract number, period of performance, subcontract price, and subcontract type.) After receipt of the assist audit request, FAOs cognizant of the subcontractor should include the subcontracts in the special purpose audit at the subcontractor location. At subcontractor locations where a special purpose audit is not otherwise planned for FY 2003, FAOs cognizant of the subcontractor should coordinate the assist audit with the regional Task Force member before doing any work on the request.

Reimbursable Contracts. At contractors with significant reimbursable (non-DoD) contracts, FAOs should contact the regional Task Force member before beginning the audit to determine if the reimbursable contracts should be included in the audit. The regional Task Force member will coordinate, as appropriate, with Headquarters, Operations Directorate.

Special Purpose Audits of Progress Payments. During FY 2002, we continued to find significant issues on progress payment requests on contracts in a loss position and contracts using an alternate liquidation rate (ALR). As a result, during FY 2003, at all contractors where we are performing the special purpose audits on contract overpayments, we should perform at least one review of progress payment requests based on costs for **fixed-price** (firm fixed price or fixed priced incentive) contracts that meet any of the following criteria:

- contracts over \$100 million,
- contracts in a loss position, or
- contracts with ALRs.

Each FAO must document its selection of these contracts. At a minimum, the documentation must include the contractor name, contract number, and basis for inclusion (i.e., contract over \$100 million, contract in loss position, or contract with an ALR). To develop this list, the FAO should first request from the contractor a listing of fixed-priced contracts that meet the above criteria. The

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FAOs should then coordinate the contract listing with the local DCMA. For a final verification, the auditor should scan recent requests for progress payments from the contractor's billing department to ensure the list of contracts and related program plan for special purpose audits of progress payments is complete.

FAOs should also coordinate with DCMA on the specific contracts selected for the special purpose audits of progress payments. This coordination should include a discussion on the criteria used to select the contracts.

The standard audit program, APPAYCOST, Audit Program for Progress Payments Based on Cost, should be used to perform the special purpose audit of progress payments. Based on lessons learned in FY 2002, FAOs should pay close attention to ensuring that the steps in APPAYCOST relating to reviewing EACs and ALRs; and making recommendations relating to application of the loss ratio factor are performed and documented during the special purpose audit. These special purpose audits should be performed on contractors' current progress payment requests (requests issued in the last 30-60 days). FAOs should coordinate with the regional Task Force member on any special purpose audit of progress payments prior to closing an assignment where an audit report will not be issued.

Closing Remarks

Field office personnel should direct any questions regarding this memorandum to the regional Task Force member. The following are the task force members and contact numbers:

Central Region	Jody Niebruegge	(314) 233-6712
Eastern Region	Daphne Cable	(770) 319-4453
Mid-Atlantic Region	Art Ruggia	(856) 727-5795
Northeastern Region	Paul Catanzano	(978) 551-9811
Western Region	Bill French	(626) 918-5922
Field Detachment	David White	(703) 227-9065
DFAS Financial Advisor	Joe Beaumariage	(614) 693-7987

/Signed/
Robert DiMucci
Assistant Director
Policy and Plans

Enclosure:

Audit Program for Review of Contract Overpayments (*not included see 03-PAS-014(R)*)

DISTRIBUTION: C