



# COMMONWEALTH of VIRGINIA

DAVID A. VON MOLL, CPA  
COMPTROLLER

*Office of the Comptroller*

P. O. BOX 1971  
RICHMOND, VIRGINIA 23218-1971

December 29, 2006

The Honorable John H. Chichester, Chair  
Senate Finance Committee  
General Assembly Building, Room 626  
Capitol Square  
Richmond, Virginia 23219

The Honorable Vincent F. Callahan, Jr., Chair  
House Appropriations Committee  
General Assembly Building, Room 947  
Capitol Square  
Richmond, Virginia 23219

Dear Messrs Chairmen:

Pursuant to § 2.2-1822.1 of the *Code of Virginia*, I hereby report on the status of the Commonwealth's recovery audit program. This code section directed the Department of Accounts to procure the services of one or more private contractors to conduct systematic recovery audits of state agencies. It further required that a report on such activities be submitted to the two money committees by January 1 of each year.

If I can provide any additional information, please contact me at 804.225.2109 or [david.vonmoll@doa.virginia.gov](mailto:david.vonmoll@doa.virginia.gov).

Sincerely,

A handwritten signature in black ink that reads 'David A. Von Moll'.

David A. Von Moll

Copy: The Honorable Jody M. Wagner  
Robert Vaughn, Staff Director, House Appropriations  
Betsy Daley, Staff Director, Senate Finance

DAV/mjm

Attachment



**ANNUAL REPORT ON THE  
COMMONWEALTH'S RECOVERY AUDIT  
PROGRAM**

As required by § 2.2-1822.1 of the Code of Virginia (1950, as amended)

Presented to  
The Honorable John H. Chichester, Chair  
Senate Finance Committee  
and  
The Honorable Vincent F. Callahan, Jr., Chair  
House Appropriation Committee

Presented by  
David A. Von Moll, State Comptroller  
December 29, 2006

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## **Executive Summary**

In accordance with section 2.2-1822.1 of the Code of Virginia the Department of Accounts entered into a contract with PRG-Schultz USA, Inc. in early 2005 for recovery audit services. On December 30, 2005 a report regarding the status of these services as of that date was presented to the respective Chairs of the Senate Finance and House Appropriation Committees.

In December, 2005, the PRG-Schultz auditors were primarily involved in the beginning stages of audit field work for fiscal years 2002 through 2004. At that time approximately \$280,000 in potential duplicate payments were identified and in various stages of validation. A minor amount was at the point of actual presentation to a vendor with the request to repay the Commonwealth, and the Department of Accounts had not received any repayments. Actual receipt of the repayments began in January, 2006.

As of December, 2006 the auditors have largely completed their field work and have presented the claims to most vendors for repayment to the Commonwealth. As of December, 2006 collections total \$454,892. The majority of these recoveries represent duplicate payment claims. Approximately \$130,000 of these collections represent payments originally made from the general fund. The remaining amount of collections approximating \$325,000 represent disbursements originally made from various nongeneral funds including federal funds. Net of the auditor contingency fee of 20% all collections with the exception of general funds will be returned to the agencies. Agencies receiving a return of federal funds will coordinate the proper disposition of these funds with their federal cognizant agency.

The auditors remain involved in the review of payments executed under contracts between state agencies and vendors and will continue these efforts until all payments have been evaluated. Efforts to collect claims identified and validated are ongoing. The disposition of disbursements approximating \$420,000 that have been identified as potentially erroneous remains unresolved. Validation efforts regarding these potential claims are continuing.

The PRG Schultz USA, Inc. contract provided for an optional extension of fiscal years to be audited. Accordingly, DOA has entered into an agreement with PRG Schultz to audit fiscal years 2005 and 2006. The payment files for these fiscal years have been provided to the auditors who have begun the preliminary analysis of this data. Communication from DOA regarding the continuation of this audit process will be sent to state agencies in early 2007 at which time the auditors will commence contacting agencies to begin the validation process for potential erroneous payments.

## **Background**

### ***Statutory Authority***

Code of Virginia § 2.2-1822.1, entitled “Recovery audits of state contracts,” requires the Department of Accounts to contract for and report on the status and effectiveness of recovery audits, including any savings realized, to the Chairs of the House Committee on Appropriations and the Senate Committee on Finance by January 1 of each year. This report fulfills that statutory requirement.

### ***Contract Award***

Following the standard State procurement process, the Department of Accounts (DOA) issued a Request for Proposals (RFP) for recovery audit services in December 2004. The RFP contained evaluative criteria for scoring each response such as the contingency fee and the bidders experience in conducting recovery audits. DOA received responses from nine qualified audit companies and ultimately awarded the contract to PRG-Schultz USA, Inc. (sometimes referred to in this report as “the auditor”).

Several other responding audit companies provided competitive proposals; however, none could cite a breadth of experience in auditing state governments commensurate with that of PRG-Schultz. Founded in 1972, PRG-Schultz has performed over 6,700 recovery audits in a wide variety of audit environments and industries. Other state governments that have hired or currently employ PRG-Schultz for recovery audits include Arizona, Delaware, Florida, Maryland, Missouri, Indiana, New York, North Carolina, Oregon, and Tennessee. PRG-Schultz has also provided recovery audit services for a number of federal government agencies.

### ***Contingency Fee***

Code § 2.2-1822.1 (Appendix A) states that recovery audit contracts shall be performance-based. DOA research confirmed that it is standard industry practice for recovery audits to be performed on a contingency fee basis. The contingency fees quoted to the Commonwealth during the competitive bid process ranged from a low of 13.5% to a high of 40%. Some proposals also quoted a tiered fee structure, based upon the total amount of recoveries, with the fee rate becoming lower as the amount of recoveries increased. As the successful bidder, PRG-Schultz offered a 20% flat fee, which was competitive with the fees offered by the other bidders.

## **Audit Scope and General Results**

This review involved all agencies and institutions of the Commonwealth, including universities with decentralized check writing authority, and consisted of approximately \$22.3 billion dollars in transactions. Cost recovery auditors primarily examine payments to vendors, excluding other major categories such as personnel, employee health benefits, and employee retirement contributions. During the review no significant trends were reported pertaining to specific agency or secretarial performance or in such areas as year-to-year comparisons or repetitive vendors. To date, this program has generated collections of \$454,892 with an additional \$420,000 still in the validation process. In total this represents .004% of the \$22.3 billion transaction total examined.

PRG-Schultz reports this percentage is at the lower end of the range typically found in governmental entities. In comparison to other Federal and State recovery reviews PRG-Schultz states in their final report *“the Commonwealth of Virginia is to be complimented for several procedures which support the minimal overpayment of disbursements.”* PRG-Schultz reports experiencing recovery review overpayment identification rates as high as .3% of the auditable disbursement base with a recognized benchmark of .1% for a broad scope review. For the fiscal years reviewed, the Commonwealth of Virginia appears to have sufficient procedures and processes in place to identify overpayments and to limit overpayment errors.

### **Medicaid Payments**

As indicated above approximately \$22.3 billion in expenditures were initially audited. That estimate excluded certain state expenditures such as payroll costs, health benefit payments, insurance payments and payments made under the Medicaid Program administered by Virginia’s Department of Medical Assistance Services (DMAS).

Extensive efforts were made to fully research the cost recovery industry, the audit processes commonly used, the experiences of other states and DMAS’s existing Medicaid control structure in order to focus initial cost recovery audit efforts on expenditure categories with higher recovery potential. Whether to include the Medicaid program as part of initial recovery audit efforts was carefully considered. As discussed in the December 30, 2005 report, due to its extensive existing control structure and unique funding environment, the DMAS Medicaid Program has been excluded from the cost recovery audit program to-date. This exclusion will be reexamined as appropriate during future reviews.



## **VDOT Open Contracts**

VDOT presents a somewhat unique audit environment in that road construction, design, and maintenance often involves a large number of contractual agreements, which can be in an active status for extended periods of time, often spanning several years. As a normal business practice, the progress of the construction is subject to audit by VDOT staff throughout the course of the construction. Final reviews are performed to ultimately ensure accuracy of the billings and payments and the products and services delivered throughout the contract term. In some cases the final review of a closed contract may occur three years after completion of the project.

The audit of open contracts was deferred in order to allow VDOT staff to complete the existing internal contractual review process prior to opening the contracts up for review by PRG-Schultz. As part of the continuing cost recovery audit program, currently open contracts will be subject to recovery audit in the fiscal year in which those contracts close.

## **The Audit Process**

The PRG-Schultz audit process consists of three main components; duplicate payment analysis, statement letter analysis, and contract review.

### ***Automated Duplicate Payment Analysis***

The automated duplicate payment analysis is conducted by PRG-Schultz against Commonwealth payment files using proprietary applications software, which performs a number of transaction analyses using comparative logic, algorithms, and other analytical tools and methodologies. DOA provides CARS expenditure files and record layout information to PRG-Schultz data acquisition specialists. Colleges and universities which are decentralized for the accounts payable function also provide their expenditure files directly to PRG-Schultz.

Output from this “data-scrubbing” process takes the form of special reports that are used by the auditors as tools to further examine the transactions. These reports identify payments that appear to be duplicates. PRG-Schultz interprets these reports and eliminates certain payments that, upon individual review, are determined to not be duplicate. This detailed report review condenses the potential duplicate payments list to only those duplicates that, in an experienced auditor’s judgment, merit further examination. PRG-Schultz then examines original payment vouchers from the disbursing agency to further authenticate the erroneous payment. The list of potential duplicate

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payments is then presented to the agency fiscal staff to validate the auditor's findings or to provide evidence that invalidates the finding. All findings that have passed the agency validation step are presented to each vendor with a request for a refund check made payable to the Commonwealth and sent to DOA for deposit in a special fund to collect and account for cost recovery payments.

## **Current Status**

The automated analysis and field work for duplicate payment review is complete for fiscal years 2002 through 2004. To-date \$354,000 has been collected and approximately \$418,000 in additional potential duplicate payment claims are in the validation process and remain unresolved. While additional collections are likely, a portion of these remaining claims are expected to be invalidated.

## ***Statement Letters and Contract Review***

### **Statement Letters**

The second component of the cost recovery audit process involves the mass mailing of statement letters by PRG-Schultz to vendors that provide a significant amount of goods and services to agencies and institutions. PRG-Schultz generates the vendor mailing list from agency and institution vendor files. The statement letter process was performed concurrently with the duplicate payment review.

The statement letter requests that the vendor provide a statement of account (or aging for accounts) for each agency or institution in order to identify uncollected credits on accounts. The statement letter includes a list of agencies and institutions since vendors may not associate all of the appropriate governmental customers' names with the Commonwealth of Virginia.

If a vendor responds to PRG-Schultz that the vendor holds open credits or excess payments from an agency customer, PRG-Schultz auditors confirm each item with the vendor and sends a payment request to the vendor. The payment request instructs the vendor to mail a refund check to the Commonwealth.

The first statement letter mailing was sent to CARS vendors in October 2005 and a second mailing was issued in late January 2006. Two mailings were also performed for university vendor listings, in June 2006 and again in August 2006. In total, statement letter requests were sent to over 11,000 vendors. The response rate to this request for

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account information was approximately 52%, and follow-up on selected non-responsive vendors continues.

## **Current Status**

PRG-Schultz has found through experience that the statement letter process often yields significant results. PRG-Schultz bears the entire costs of postage and administrative handling. As the auditors received vendor responses to the statement letters each response was analyzed, agency personnel confirmed the available credit if it was less than six months old and the auditor mailed payment requests to the vendors. The vendors are specifically instructed to issue a refund to the Commonwealth and not issue a credit memo.

Certain situations revealed an accumulation of items that vendors reported as still owed to them and other situations where an agency had issued payments that were not applied to an outstanding balance. An analysis of the account revealed these facts and provided the agencies the opportunity to rectify incorrect postings by the vendor of agency payments.

The analysis and field work for statement letter reviews are complete for fiscal years 2002 through 2004. To-date nearly \$99,000 has been collected by the Commonwealth from this statement review process with \$2,000 more identified for potential validation and collection.

## **Contract Review**

During the contract review phase of the recovery audit process, the auditors examine statewide and agency-issued contracts. The payments made to vendors under the terms and conditions of the contracts are audited to ensure compliance with those terms regarding pricing, discounts, labor rates, and other allowable charges identified in the contract. Overpayments, duplicate payments, lost discounts, and erroneous payments are identified by the auditors and the related documentation is accumulated as proof of the payment error.

The contract review part of the recovery audit is more labor intensive than the automated duplicate payment review or statement letter process because the auditors must become highly knowledgeable about the contracts in order to effectively audit the payments made under those contracts.

## **Current Status**

PRG-Schultz began their contract review with the Virginia Department of Transportation (VDOT), primarily due to the large amount of funds disbursed by VDOT under contractual agreements. VDOT currently employs an extensive audit process over the disbursement of funds pertaining to contracts once the construction or maintenance contract is completed but prior to the contract being closed. This review could occur up to three years after construction completion. Only closed contracts were subject to review by cost recovery auditors. Although the auditors identified several potential claims, all but one were subsequently invalidated. To-date \$1,765 has been collected.

PRG-Schultz also reviewed contracts at Virginia State Police and the Department of Alcoholic Beverage Control but yielded no collections. The auditors began review of contracts at the Department of Corrections in November 2006 and this audit is currently active.

## **Planned Activities for Calendar Year 2007**

Efforts to validate and collect outstanding claims from fiscal years 2002, 2003, and 2004 are ongoing. Additionally, PRG-Schultz is performing the extensive preliminary work for the audit of fiscal years 2005 and 2006 vendor payments. DOA has provided the auditors with 2005 and 2006 vendor payment files to assist with the data analysis. The auditors have requested similar files from the higher education institutions who are decentralized for payment processing. The terms of the original contract with PRG-Schultz provided for audit services from July 2, 2005 through December 31, 2006. The contract was extended to provide for audit services until December 31, 2007, with one year renewal options for an additional two years. PRG-Schultz's familiarity with the Commonwealth's data will enable them to perform the audit process with even greater efficiency during this review. The audit process will continue to focus on the three primary areas of duplicate payments, statement letters, and contract review.

DOA is currently in the process of confirming the appropriate funding source of the funds collected to-date to ensure their accurate final disposition. Once this analysis is complete all nongeneral funds (net of fees) will be returned to the originating agency. General fund collections will remain in the general fund of the Commonwealth (net of fees) and will not be available to the originating agency for disbursement. Collections originally disbursed from federal funds will be returned to the originating agency (net of fees) for appropriate disposition between that state agency and the applicable federal agency. The Federal Office of Management and Budget Memorandum M-03-12 allows payment of such contingency fees from recovered federal funds. Execution of these accounting entries should be complete in early 2007.

## **Appendix A – Code of Virginia § 2.2-1822.1**

### § 2.2-1822.1. Recovery audits of state contracts.

The Department of Accounts shall procure the services of one or more private contractors, in accordance with the Virginia Public Procurement Act (§ [2.2-4300](#) et seq.), to conduct systematic recovery audits of agency contracts. Such recovery audit contracts shall be performance-based and shall contain a provision that authorizes the contractor to be paid a percentage of any payment error that is recovered by such contractor. Individual recovery audits shall consist of the review of contracts to identify payment errors made by agencies to vendors and other entities resulting from (1) duplicate payments, (2) invoice errors, (3) failure to apply applicable discounts, rebates, or other allowances, or (4) any other errors resulting in inaccurate payments. The Department of Accounts shall report on the status and effectiveness of recovery audits, including any savings realized, to the Chairs of the House Committee on Appropriations and the Senate Committee on Finance by January 1 of each year.

(2004, c. 644; 2005, c. 109.)