



COMMONWEALTH of VIRGINIA

DAVID A. VON MOLL, CPA
COMPTROLLER

Office of the Comptroller

P. O. BOX 1971
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December 30, 2005

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.

The contract was awarded to PRG-Schultz USA, Inc. which is one of the most established and experienced companies that provide cost recovery audit services. They began the audit process in early July 2005 and are now in the process of conducting field work at several state agencies and institutions. The attached report provides more detailed information on the progress of this program.

If I can provide any additional information, please contact me at 804.225.2109 or david.vonmoll@doa.virginia.gov.

Sincerely,

A handwritten signature in cursive script that reads 'D. Von Moll'.

David A. Von Moll

Copy: The Honorable John M. Bennett
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 30, 2005

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Background

Statutory Requirement

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, 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

The current revised statute reflects an amendment that eliminated a problematic constraint. The original statute included a 10 percent cap on the contingency fee payment payable to an audit firm. Code § 2.2-1822.1 (Appendix A) also stated that recovery audit contracts be performance-based. DOA research confirmed that it is standard industry practice for recovery audits to be performed on a contingency fee basis, but a 10 per cent cap on such a fee would have been too low to attract the interest of qualified and capable recovery audit firms. The statute was amended in the 2005 General Assembly session to

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remove the 10 percent cap on contingent fees and became effective in its current form on July 1, 2005.

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, 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. None of the responding bidders offered their services for a 10% contingency fee.

Audit Scope

Cost recovery auditors primarily examine payments to vendors, excluding other major expenditure categories such as personnel, employee health benefits, and employee retirement contributions. In accordance with the DOA RFP provisions, PRG-Schultz is currently examining these payments for Fiscal Years 2002 through 2004 for the Commonwealth's agencies and institutions. The Department of Accounts performed an analysis of state expenditures for these fiscal years in order to provide a dollar estimate of transactions that represent vendor payments. The analysis calculated estimated average annual expenditures for the purchase of goods and services by agencies to be approximately \$5.9 billion.

Too many variables exist to predict recovery amounts or percentages in the Commonwealth or any other audit environment. Some of the variables include the extent of payment automation, the design and utilization of information systems, the integration of purchasing and accounts payable systems, and the existence and effective utilization of internal controls. Cost recovery audit firms find engagements worthwhile for them and their clients even when a very small fraction of a percent is recovered from the total dollars spent.

MEDICAID PAYMENTS

The estimated \$5.9 billion of annual state expenditures currently exclude 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, and the experiences of other states 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 that initial recovery audit efforts was carefully

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considered. The DMAS Medicaid Program presents a unique control and funding environment as described below:

- **Expanded edits in the new Medicaid Management Information System (MMIS).** This system was installed in 2003 and uses over 1,000 automated edits to prevent fraudulent or erroneous payments (the prior system had 500 edits), including edits that prevent duplicate payments.
- **Federal certification of MMIS by the Centers for Medicare and Medicaid Services (CMS).** To qualify DMAS for federal funding, CMS reviewed the new MMIS and awarded its unqualified certification, signifying federal endorsement for the sufficiency of MMIS payment controls.
- **ClaimCheck Auditing Software.** This software performs an automated analysis of payments after those payments pass MMIS edits, providing another layer of control incorporating rules unique to Virginia’s Medicaid program.
- **DMAS Program Integrity Division.** This division conducts continuous monitoring to identify inappropriate or abusive billing practices by providers in multiple programs, and reports suspected frauds to the Medicaid Fraud Control Unit of the Office of Attorney General for investigation.
- **Federal Payment Accuracy Measurement Project.** DMAS received a CMS grant to participate in this project, the purpose of which is to develop payment accuracy measurement methodologies that can be used on both state-specific and potentially nationwide bases. DMAS participation will enable DMAS to collaborate with CMS and other states to identify and implement best practices that prevent erroneous payments.
- **Oversight by DMAS Internal Auditor.** DMAS has an extensive testing program conducted by its internal auditor, which includes testing for opportunities in which overpayments could occur.
- **Funding Problem Raised by the 60-Day Rule.** The so-called “60-Day Rule” appears in Section 1903(d)(2) of the Social Security Act, as amended. Medicaid overpayments must be reported to CMS within 60 days of discovery, whether or not DMAS has collected the overpaid amount. This causes an immediate reduction in federal Medicaid funding, even if DMAS never collects the overpaid amount.

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Collectively these controls and funding factors presented a reasonable case for deferring and possibly omitting Medicaid from the recovery audit process. DOA wanted to focus efforts on vendor payments and gain experience administering the recovery audit program before dealing with the issues unique to Medicaid. DOA plans to reexamine the merits of Medicaid cost recovery auditing in the coming year.

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 some degree of audit by VDOT staff throughout the course of the construction. Final reviews are often performed to ultimately ensure accuracy of the billings and payments and the products and services delivered throughout the contract term. Because of the nature of construction contracts VDOT has a large number of road building and maintenance projects that have been completed during 2002-2004 and also a large number of projects for which progress payments were made during this period but which are still in progress. Accordingly, the mix of open contracts and closed contracts reflects the nature of their business.

DOA decided to defer audit of open contracts in order to allow VDOT staff to complete the internal contractual review process prior to opening the contracts up for review by PRG-Schultz. PRG-Schultz will audit all of the closed contracts for the audit period. For any contracts closed during the audit period (Fiscal Years 2002 through 2004), any identified erroneous payments will be recovered even if the contract originated before Fiscal Year 2002 and the erroneous payments were made prior to Fiscal Year 2002.

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. Once current open contract reviews are completed, the results should provide an indication of the effectiveness of VDOT's contract review methodology and whether any benefit may be realized by auditing open contracts under the recovery audit program.

The Audit Process

The PRG-Schultz audit process involves significant preparatory effort and several phases.

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. To initiate this analytical review, the Department of Accounts provided CARS (Commonwealth Accounting and Reporting System) and charge card electronic vendor payment and history files for Fiscal Years 2002, 2003, and 2004. DOA also provided record layout documents to enable PRG-Schultz data acquisition specialists to properly interpret the CARS files.

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 must interpret these reports and eliminate certain payments that, upon individual review, are determined to not be duplicates. This visual 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 obtains original payment vouchers from the disbursing agency for further scrutiny. The list of potential duplicate payments is further refined by examining the payment vouchers. The final list represents payments that have been substantially proven to be duplicate or erroneous, which will be presented to each vendor with a request for a refund check payable to the Commonwealth.

State universities that have met DOA management standards for decentralization of accounts payable are operating their own general ledger systems and make some payments directly to vendors outside of the centralized payment process. While summary postings of these university-paid transactions are recorded in CARS (the official state general ledger), the payment transaction detail resides with each decentralized university. As a condition of their decentralization agreements, these universities must make their detailed transaction records and supporting paper documentation available to the recovery auditor.

CURRENT STATUS

The automated analysis process has been completed for those agencies in which CARS serves as the primary accounting system and for those decentralized universities from

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which data files have been requested. DOA and auditor personnel will meet with the remaining decentralized universities in early 2006 to obtain their data files and begin this analysis. Auditors are presently conducting field work with agency personal to confirm that payments identified by the automated process are in fact duplicate payments. When this confirmation process concludes, DOA will provide final review and approval, after which the auditor will mail payment requests to vendors. Payment requests have not yet been issued from this process.

Statement Letters and Contract Review

STATEMENT LETTERS

The second audit phase requires a mass mailing of statement letters by PRG-Schultz to vendors that have provided significant volumes of goods and services to agencies and institutions. PRG-Schultz generates the vendor mailing list from DOA vendor files. The “statement letter” (Appendix B) process can occur concurrently with the duplicate payment review.

The statement letter asks the vendor to 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 (Appendix B), since vendors may not always 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 appropriate agency and send a payment request to the vendor. The payment request instructs the vendor to mail a refund check to the Commonwealth.

CURRENT STATUS

PRG-Schultz issued statement letters in late October 2005 and now is starting to receive vendor responses. PRG-Schultz has found through experience that the statement letter process yields worthwhile results. PRG-Schultz bears the entire costs of postage and administrative handling. As the auditors receive vendor responses to the statement letters each response will be analyzed, agency personnel and DOA will confirm the available credit, and the auditor will mail payment requests to the vendors. Payment requests have not yet been issued from this process.

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. However, PRG-Schultz has found that historically this process produces approximately 80% of the recovered payments.

CURRENT STATUS

Contract review is currently underway. Payment requests have not yet been issued as a result of the contract review process.

Agencies and Institutions Currently Engaged In Field Work

In addition to the automated analysis conducted in PRG-Schultz's offices, the auditors are currently engaged in field work for the duplicate payment, statement letter, and contract analysis processes to confirm potential overpayments at the following agencies and institutions:

- Department of Alcoholic Beverage Control
- Department of Corrections – Central Office
- Department of Corrections – Deerfield Correctional Center
- Department of Corrections – Southampton
- Department of Corrections – St. Brides
- Department of Corrections – Sussex I
- Department of Corrections – Sussex II
- Department of General Services
- Department of Motor Vehicles

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- Department of Social Services
- University of Virginia – Academic Campus (decentralized for accounts payable)
- University of Virginia Medical Center (decentralized for accounts payable)
- Virginia Commonwealth University (decentralized for accounts payable)
- Virginia Correctional Enterprises
- Virginia Department of Health
- Virginia Department of Transportation
- Virginia Polytechnic Institute and State University (decentralized for accounts payable)

Overview of Audit Progress

As previously stated, recovery audits require significant preparatory effort and several phases before any payments are recovered. Since PRG-Schultz operates on a contingency fee basis, it must pay startup costs (information systems, data analysis, administrative overhead, travel, lodging, salaries, fringe benefits, and other items) for months before the Commonwealth can collect any recoveries and pay contingency fees. Much of the preparatory work is now complete and extensive field audit work is underway.

In order to generate a revenue stream that will cover their costs already incurred, PRG-Schultz initially focuses on agencies that, based on their experience, are most likely to generate substantial recoveries. For that reason, the auditors have focused their initial review on the Virginia Department of Transportation, Department of Corrections Central Office, Virginia Correctional Enterprises, and the Department of Alcoholic Beverage Control.

To date, PRG-Schultz has identified over \$280,000 in potential payment errors, consisting almost entirely of duplicate payment errors, with a small amount resulting from contract payment errors. This amount has not been confirmed and finalized and does not reflect the deduction of the contingency fee that would be owed to the auditor should the amount identified ultimately be collected.

After agencies and DOA confirm potential payment errors, the auditor will then issue payment requests to the vendors, asking the vendor to mail a refund check to the Commonwealth (DOA).

Planned Activities for Calendar Year 2006

The pace of audit activity, particularly field work, is expected to increase significantly in January 2006 and to conclude by July 2006. At this time, much of the preliminary audit work (such as automated analysis of payment files) has been performed and related analytical reports have been generated for each agency. These reports are essential audit tools that help the auditor identify suspected erroneous or duplicate payments. Therefore, the auditors have the essential information needed for their field work of analyzing original payment documents to confirm the status of suspected erroneous payments. This confirmation process will reach full speed in early 2006.

For those decentralized universities that have not yet provided payment files, DOA and auditor personnel will meet with those universities' representatives in early 2006 to obtain their data files and begin the automated duplicate payment analysis process.

Concurrent to the field work to validate erroneous payments, the auditors also will examine agency payments made under contractual agreements. The contract review process will increase in momentum in 2006.

Whenever the auditors identify an overpayment, several months may pass before the erroneous payment is verified and DOA actually receives a refund check. The auditors maintain a database of each suspected overpayment and the status of each overpayment for oversight and control purposes. Reconciliations will be performed to ensure that the actual amounts recovered from vendors agree with the auditors' records.

DOA will initially record each collection in a special fund (number 0205), with a unique revenue source (number 09012), and with a tracking number linked to the original disbursing agency and fund. Any collection originally disbursed from the general fund will be deposited back into the general fund and revert at the end of the fiscal year, net of the auditor's contingency fee. Collections originally disbursed from federal funds will be recorded to the original disbursing agency (net of contingency fees), for disposition to be negotiated by that agency with federal authorities. The Federal Office of Management and Budget Memorandum M-03-12 allows payment of such contingency fees.

When the audit concludes, PRG-Schultz will provide management reports to DOA that describe process and system improvements that can reduce or prevent future erroneous payments.

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.)

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Appendix B – Sample “Statement Letter”

Dear Accounts Receivable Supervisor:

The Commonwealth of Virginia has engaged PRG-Schultz USA, Inc. to perform a statewide recovery audit for agencies and institutions in accordance with § 2.2-1822.1 of the Code of Virginia. A list of agencies and institutions is provided on the back of this letter. In connection with this examination, PRG-Schultz is requesting your most recent **statement or aging for accounts with any and all of these agencies and institutions**. Your statement or aging should identify the following types of transactions:

- Open invoices and credit memos
- Deductions or payments on account
- Unapplied cash, cash on account, or deposits
- Other items in suspense and other deferred items

Delivery options for your statement or aging are:

U. S. Mail: Accounts Payable Special Projects
 Attention: Philip Keeneth, Audit Manager
 P. O. Box 725229
 Atlanta, GA 31139-9998

Fax: 866-714-7702 Phone: 866-273-3196
E-Mail: philip.keeneth@prgx.com

Please return this letter, including your name, telephone number, and any other information you would like to convey, as soon as possible. **If you have a zero balance**, please check the box below. **Please do not send copies of invoices.**

Thank you for your assistance.

Sincerely,

David A. Von Moll

Check here if all balances are zero (no credits)

Your name and title

Your company's name

Your telephone number

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(Statement Letter, Page 2)

Accounts, Department of
Aging, Department for the
Agriculture & Consumer Services, Department of
Alcoholic Beverage Control, Department of
Augusta Correctional Center
Aviation, Department of
Bland Correctional Center
Blue Ridge Community College
Brunswick Correctional Center
Buckingham Correctional Center
Business Assistance, Department of
Catawba Hospital
Central State Hospital
Central Virginia Community College
Charitable Gaming, Department of
Christopher Newport University
Coffeewood Correctional Center
College of William & Mary in Virginia, The
Commonwealth Preparedness, Office of
Conservation and Recreation, Department of
Correctional Center for Women, Virginia
Correctional Education, Department of
Corrections - Central Administration, Department
Criminal Justice Services, Department of
Dabney S. Lancaster Community College
Danville Community College
Deaf and Hard-of-Hearing, Department for the
Deep Meadow Correctional Center
Deerfield Correctional Center
Dillwyn Correctional Center
Eastern Shore Community College
Eastern State Hospital
Eastern Virginia Medical School
Education, Direct Aid to Public Education, Department of
Emergency Management, Department of
Employment Dispute Resolution, Department of
Environmental Quality, Department of
Fire Programs, Department of
Fluvanna Women's Correctional Center
Forestry, Department of
Game and Inland Fisheries, Department of
General Services, Department of
George Mason University
Germanna Community College
Greensville Correctional Center
Haynesville Correctional Center
Health, Department of
Health Professions, Department of
Historic Resources, Department of
Housing and Community Development
Human Resource Management, Department of
Indian Creek Correctional Center
J. Sargeant Reynolds Community College
James Madison University
James River Correctional Center
John Tyler Community College
Juvenile Justice, Department of
Keen Mountain Correctional Center
Labor & Industry, Department of
Longwood University
Lord Fairfax Community College
Lunenburg Correctional Center
Marion Correctional Treatment Center
Mary Washington College
Mecklenburg Correctional Center
Medical Assistance Services, Department of
Mental Health, Mental Retardation & Substance Abuse
Services, Department of
Military Affairs, Department of
Mines, Minerals and Energy, Department of
Minority Business Enterprise, Department of
Motor Vehicles, Department of
Mountain Empire Community College
New River Community College
Norfolk State University
Northern Virginia Community College
Northern Virginia Mental Health Institute
Nottoway Correctional Center
Old Dominion University
Patrick Henry Community College
Paul D. Camp Community College
Piedmont Geriatric Hospital
Piedmont Virginia Community College
Planning and Budget, Department of
Port Authority, Virginia
Powhatan Correctional Center
Radford University
Rail and Public Transportation, Department
Rappahannock Community College
Rehabilitative Services, Department of
Red Onion State Prison
Richard Bland College
St. Brides Correctional Center
Social Services, Department of
Southampton Correctional Center
Southern Virginia Mental Health Institute
Southside Virginia Community College
Southwest Virginia Community College
Southwestern Virginia Mental Health Institute
State Lottery Department
State Police, Department of
Staunton Correctional Center
Sussex I State Prison
Sussex II State Prison
Taxation, Department of
Thomas Nelson Community College
Tidewater Community College
Transportation, Department of
Treasury, Department of the
University of Virginia - Academic Division
University of Virginia Medical Center
University of Virginia's College at Wise
Veterans Services, Department of
Virginia Commonwealth University - Academic Division
Virginia Highlands Community College
Virginia Military Institute
Va. Polytechnic Institute & State University
Virginia State University
Virginia Western Community College
Wallens Ridge State Prison
Western State Hospital
Wytheville Community College