



COMMONWEALTH of VIRGINIA

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December 28, 2007

The Honorable John H. Chichester, Chair
Senate Finance Committee
General Assembly Building, 10th Floor
Capitol Square
Richmond, Virginia 23219

The Honorable Vincent F. Callahan, Jr. Chair
House Appropriations Committee
General Assembly Building, 9th Floor
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.

Sincerely,

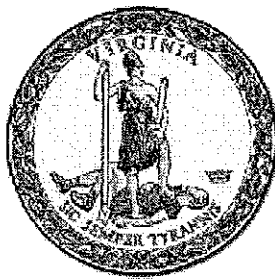
A handwritten signature in dark ink, appearing to read "D. A. Von Moll".

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 28, 2007

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Recovery Audit of State Agencies and Institutions
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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. (auditors) in early 2005 for recovery audit services. The audit process involves a review of state agency expenditures to vendors for payment for goods and services to identify duplicate and erroneous payments, unclaimed credits and contract terms compliance. Reports regarding the status of these services have been submitted to the respective Chairs of the Senate Finance and House Appropriation Committees for the previous two calendar years.

Review of Fiscal Years 2002, 2003, and 2004 Expenditures

The cost recovery audit for this period is complete and \$502,517 was recovered from vendors. Most of the recovered funds stemmed from duplicate payments. In January, 2007, approximately \$114,500 was returned to the general fund, with the balance of recovered funds transferred back to the state agencies that originated the erroneous expenditures, net of the auditor's 20% fee.

An additional \$60,587 in overpayments is subject to subsequent collection through the Commonwealth's set-off debt collection process. This represents the remaining verified claims for which vendors have failed to respond to repeated administrative collection efforts.

Review of Fiscal Years 2005 and 2006 Expenditures

The PRG-Schultz auditors are currently engaged in the collection of overpayments made to vendors by state agencies for fiscal years 2005 and 2006. The auditors have completed their review and analysis of vendor payments and are focusing on the collection of overpayments (claims).

To-date, \$244,719 in overpayments has been collected from vendors. Additionally, the auditors have identified an additional \$200,428 in potential claims. PRG-Schultz is currently working with vendors to determine the validity of these potential claims. The auditors plan to complete the audit for this period in the next several months.

Review of Fiscal Year 2007 Expenditures

Expenditure data for fiscal 2007 was recently provided to the auditors. The auditors will spend the next several months analyzing this data before beginning field work to identify and confirm potential overpayments.

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 employed 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.

Since this initial award the contract has been extended twice. The first extension provided for continuation of audit services through December 31, 2007 and the second extension through December 31, 2008. The existing contractual agreement allows for one more extension through 2009.

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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. Cost recovery auditors primarily examine payments to vendors, excluding other major categories such as personnel, employee health benefits, and employee retirement contributions. Also excluded from review were payments made under the Medicaid Program administered by Virginia's Department of Medical Assistance Services due to its extensive existing control structure and unique funding environment.

Results of Fiscal Years 2002, 2003, and 2004 Review

To-date, this program has generated collections of \$502,517 from reviewing total expenditures of \$22.3 billion. The majority, or about \$401,000, of these recoveries represents duplicate payments made by State agencies. About \$100,000 was collected through the statement letter process where vendors are asked to report State agency account balances and remit information on any credit balances. The remaining collections were the result of contract reviews.

The majority of the collections were returned to State agencies and institutions in January 2007. Approximately \$276,800 was returned to agencies and \$114,500 to the general fund after deducting the auditor's fees. Since the auditors were required to identify the original funding source for the erroneous payment, DOA was able to provide the original funding source to the agencies in order to apply the recoveries to the appropriate fund.

The final error rate for these three years was .002% of the \$22.3 billion in total expenditures. In comparison to other Federal and State recovery reviews PRG-Schultz stated in their final report on this audit that *"the Commonwealth of Virginia is to be complimented for several procedures which support the minimal overpayment of disbursements."*

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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. No unusual year-to-year or repeat vendor performance trends were noted for any specific agencies or secretarial areas.

Results of Fiscal Years 2005 and 2006 Review

To-date, \$14.4 billion in expenditures were reviewed with \$244,719 in overpayments collected. Again, the majority, about \$227,000 of these recoveries represent duplicate payments made by State agencies to vendors. About \$17,000 was collected through the statement letter process. Statement letter recoveries are not expected to be as large as the first audit since many old outstanding credit balances were cleared in the first audit cycle.

Currently the auditors are focusing on collecting identified and confirmed claims. Just over \$200,000 in claims is in the process of being validated by the auditors.

Fiscal Year 2007 Audit

Review of fiscal 2007 expenditures is in the very early stages of the cost recovery audit process. The field work phase of examining expenditures and validating overpayments will begin in early 2008. Expenditure files were made available to the auditors in late November.

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 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.

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.

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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 for the 2005 – 2006 audit was sent to vendors in April 2007 and a second mailing was issued in June 2007. In total, statement letter requests were sent to about 3,500 vendors. The response rate to this request for account information was approximately 53%, and follow-up on selected non-responsive vendors continues.

PRG-Schultz has found through experience that the statement letter process often yields successful 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 overpayment and the auditor mailed payment notices to the vendors. The vendors are specifically instructed to issue a refund to the Commonwealth and not issue a credit memo.

An additional benefit of the process was that it identified errors by both the agencies and the vendors that they were able to reconcile and correct.

The statement letter process conducted during the review of fiscal years 2002, 2003, and 2004 expenditures cleared many of the older credits on account reported by vendors. Therefore, the auditors do not expect a significant amount of recoveries for the current audit.

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.

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The auditors learned in the first audit that much of the contract based payments were related to the Virginia Department of Transportation (VDOT). They also learned that VDOT employs an extensive audit process over the disbursement of funds pertaining to contracts. Additionally, this review could occur up to three years after the construction or maintenance is completed. Only closed contracts were subject to review by cost recovery auditors. PRG-Schultz also reviewed contracts at Virginia State Police, Department of Corrections, and the Department of Alcoholic Beverage Control but yielded no collections.

While the contract review did not generate claims for the audit period, recommendations were sent to various agencies on items identified during the review that could result in cost savings for the future. They included prompt payment or cash discounts offered by vendors, rebates offered by vendors for orders placed on their websites, combining orders, and review of minimum order requirements to avoid additional fees.

Planned Activities for Calendar Year 2008

PRG-Schultz auditors have fully completed audit activity for the fiscal years 2002, 2003, and 2004 audit period. DOA has assumed responsibility for collecting the remaining claims, amounting to \$60,587, and has submitted them to the set-off debt collection process. Any State payment to the vendors on debt set-off will be intercepted and the vendor will be notified of this action. The claims collected through this process will be exempt from payment of the auditor's 20% fee. Any non-general fund collections will ultimately be returned to the agency that made the erroneous payment in its entirety. General fund collections will be returned to the general fund.

The cost recovery auditors will focus their efforts on collecting the claims already identified for the fiscal 2005 – 2006 audit period. Once all reasonable efforts have been made to collect overpayments from vendors, the auditors will issue one last letter to the vendor advising that if a response is still not forthcoming then the claim will be turned over the debt set-off process.

Expenditure data for fiscal year 2007 has been provided to PRG-Schultz. The contractual agreement with PRG-Schultz for providing audit services was recently extended until December 31, 2008 to provide them with sufficient time to complete their audit of fiscal 2007 expenditures.

PRG-Schultz's familiarity with the Commonwealth's data should 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.

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.)