



COMMONWEALTH of VIRGINIA

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December 23, 2008

The Honorable Charles J. Colgan, Chair
Senate Finance Committee
General Assembly Building, 10th Floor
Capitol Square
Richmond, Virginia 23219

The Honorable Lacey E. Putney, 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,

David A. Von Moll

Copy: The Honorable Richard D. Brown
Robert Vaughn, Staff Director, House Appropriations
Betsey 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 Charles J. Colgan, Chair
Senate Finance Committee
and
The Honorable Lacey E. Putney, Chair
House Appropriation Committee

Presented by
David A. Von Moll, State Comptroller
December 23, 2008

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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 review of state agency expenditures made to vendors for payment for goods and services. 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 three calendar years.

The Contract with PRG-Schultz will expire on December 31, 2008. As a result, this will be the final report to the money committees on the results of the cost recovery audit services. Beginning in fiscal year 2011 the Department of Accounts will give careful consideration to implementing a new cost recovery audit initiative.

Review of Fiscal Years 2002, 2003, and 2004 Expenditures

The cost recovery audit for this period is complete and \$502,517 in erroneous expenditures has been recaptured from vendors. Most of the collected refunds were transferred back to the state agency for which the claim was written in January 2006, net of the auditor's 20% fee. General Fund collections were retained in the General Fund.

DOA submitted \$60,587 in claims that the auditors could not collect to the state Debt-Setoff program for collection. As of this report date nearly \$30,000 of these claims have been collected. Expectations for further collections from these claims are low.

Review of Fiscal Years 2005 and 2006 Expenditures

The cost recovery audit for this period is also complete and \$304,750 in erroneous expenditures was recovered from vendors. These collections, net of the auditor's 20% fee were returned to the agency that originally made the erroneous payment. General Fund collections are not returned to the agencies but are returned to the General Fund after deducting auditor fees.

Any claims the auditors were not able to collect after extensive efforts are submitted to the Debt-Setoff program for collection. These claims total approximately \$44,000 and a portion of these claims will be collected through this process. However, some will ultimately be proven invalid once the vendor finally responds to DOA by providing documentation that proves the claim was invalid. The auditors are not paid any fees for collections made through the state Debt-Setoff process.

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Review of Fiscal Year 2007 Expenditures

The auditors are currently in the final stages of auditing the fiscal 2007 expenditures for erroneous payments. They are concentrating their efforts on collecting as many outstanding written claims as possible before the contract expires at the end of December.

As of mid-November the audit has generated \$173,300 in payments from vendors who were overpaid erroneously by state agencies and institutions. The auditors are in the final stages of attempting to collect the remaining \$59,000 in written claims. While some of these claims will be collected, many will not. The auditors will be paid their fee for any collections received from vendors by the end of December.

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.

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 (DMAS).]

Results of Fiscal Years 2002, 2003, and 2004 Review

To date, this program has generated collections of \$502,517 from review of 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. About \$276,800 was returned to agencies after deducting the auditor's fees and about \$114,500 was returned to the general fund. 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.

The 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."* 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

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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.

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.

Results of Fiscal Years 2005 and 2006 Review

\$14.4 billion in expenditures were reviewed and \$304,750 in overpayments was collected. Again, the majority, about \$279,000 of these recoveries represent duplicate payments made by State agencies to vendors. About \$25,000 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.

This audit is closed and the only potential for further collections would be from the Debt-Setoff process.

Fiscal Year 2007 Audit

The review of fiscal 2007 expenditures is complete and the collection of \$173,300 represents duplicate payments exclusively. Statement letters were not issued to vendors since it had been only several months since they were last issued for the fiscal 2005 and 2006 audit. Many agency accounts with vendors were cleaned up in prior statement letter mailings.

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 continued.

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 fiscal years 2002, 2003, and 2004 expenditures cleared many of the older credits on account reported by vendors.

About \$25,000 has been collected by the Commonwealth from this statement review process for fiscal years 2005 and 2006.

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.

Planned Activities for Calendar Year 2009

PRG-Schultz auditors will conclude their audit of state expenditures at the end of calendar year 2008. At that point DOA will be concluding the remaining tasks associated with the cost recovery audits. It is likely that some claims will continue to be paid by vendors after the end of the year.

DOA will account for collections in the reporting system designed to track the cost recovery audit after the auditors are gone. After appropriate analysis, certain outstanding claims will be considered uncollectible and will be submitted to the Debt-Setoff program for potential collection. When a state payment to a vendor is intercepted by this program the vendor generally will contact DOA and we will have the opportunity to determine whether the claim is valid or should be rescinded. DOA resources will be required for some time to bring all claims to a final status.

Money collected from vendors for erroneous state payments will be returned to the state agency that made the erroneous payment. Collections from the Debt-Setoff program will not have the auditor fee deducted. Erroneous payments that were originally made from the general fund will not be returned to agencies and will be retained in the general fund.

This will conclude the Commonwealth's efforts under this cost recovery audit initiative. While the audit costs to the Commonwealth under this program are contingency based, Commonwealth staffing costs (both within DOA as well as the various agency fiscal staffs) are incurred in researching and resolving potentially recoverable vendor payments. While these costs have not been quantified, they are substantial relative to actual recoveries and are pertinent when weighing the overall merits of the cost recovery program. Beginning in fiscal year 2011, DOA will evaluate the appropriateness of renewing this initiative.

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.)