

State of Colorado



John W. Hickenlooper
Governor

Kathy Nesbitt
Executive Director

Jennifer Okes
Deputy Executive Director

David J. McDermott
State Controller

DPA

Department of Personnel
& Administration

Office of the State Controller
633 17th Street, Suite 1500
Denver, Colorado 80202
(303) 866-6200
Fax (303) 866-4233
www.colorado.gov/dpa

June 28, 2012

John Hickenlooper, Governor
136 State Capitol
Denver, Colorado 80203

Dear Governor Hickenlooper:

Pursuant to Section 24-30-203.5(6), C.R.S., I am issuing this report to the General Assembly that summarizes the reports received from the recovery audit contractor, Balance Risk LLC. To date, the contractor has issued three reports dated December 5, 2011, March 20, 2012, and June 25, 2012. All three reports, as well as this summary, are posted on the Office of the State Controller's website at <http://www.colorado.gov/dpa/dfp/sco/Audit.htm>. In addition, the June 25, 2012 report is attached.

This report includes a background on the recovery audit contract, recovery audit status, and items noted in the contractor's reports.

Background

Section 24-30-203.5, C.R.S., requires the Office of the State Controller to contract for recovery audits to recoup improper payments by state agencies. The Office of the State Controller entered into a contract with the Colorado firm, Balance Risk LLC, on August 22, 2011, following Legislative Audit Committee approval of audit exemptions on July 11, 2011.

Improper payments are payments that a state agency made to a vendor or other entity in error or in excess of the amount the recipient is entitled. Improper payments include duplicate payments; payments resulting from an invoice or pricing error, or failure to apply applicable discounts or rebates; and payments to a recipient who does not meet the eligibility requirements for receiving payment.

June 28, 2012

The contract requires that the contractor review several areas to identify improper payments including conducting a comprehensive review of the state's payment data, soliciting vendor accounts receivable statements for open credits, reviewing vendor compliance with State price agreements and performance requirements, and reviewing telecom charges for missing refunds and discounts. The scope of the contractor's review is for Fiscal Years 2008 through 2010 and includes all state agencies except institutions of higher education and a portion of the Department of Health Care Policy and Financing that is already subject to a separate recovery audit.

The contractor is paid on a contingency fee basis (i.e., the contractor receives a fee only on amounts recovered). At the completion of the audit cycle, all state moneys recovered, less the contingency fee and actual administrative costs related to the recovery audit, are to be transferred to the general fund except moneys that are constitutionally specified, or originally received by the State as a fiduciary, or as gifts, grants, donations, or custodial funds. In these cases, funds must be returned to fund from which the improper payment was made. Additionally, all federal moneys recovered must be reimbursed to the federal government in accordance with federal regulations.

Recovery Audit Status

- **Payment analysis:** The contractor reviewed detailed transaction data from Fiscal Years 2008 through 2010 which included about 5.1 million transaction lines totaling \$25 billion. The contractor identified potential duplicate payments and will review the documentation with agency controllers to determine legitimacy prior to submitting claims to vendors.
- **Unclaimed property review:** The contractor reviewed expired warrant data from the State Treasurer's Unclaimed Property Office to determine whether the State issued payment to a vendor but also sent an expired warrant to Unclaimed Property related to the same payment (i.e., a duplicate payment). The contractor is still in the process of identifying potential duplicates.
- **Statement review:** The contractor issued about 2,200 statement letters to vendors to identify credits that were owed but had not been paid to the State. The contractor has identified five vendors who in total owe a minimal amount to the State.
- **Contract review:** The contractor reviewed a sample of about 90 contracts totaling \$487 million. A majority of the contracts reviewed were from the Departments of Corrections and Transportation and were primarily for construction projects. The purpose of the review was to ensure compliance with contract price agreements and performance. Based on the contractor's review, no areas for potential recovery were identified.
- **Telecommunication audit:** The contractor continues in the process of reviewing telecommunication services to identify opportunities for vendor refunds and ongoing cost savings.

June 28, 2012

Items Noted in Contractor's Reports

The contractor also addressed some of the challenges related to the recovery audit including:

- **Data:** The contractor's report discusses data issues in three areas. First, payments do not consistently include invoice numbers and dates. The lack of an invoice number and date limits the contractor's use of data analytics to identify duplicate payments. Of the 5.1 million transaction lines that the contractor reviewed, 1.2 million (24%) did not have an invoice number which represents about \$16 million or 64% of the total payments reviewed. A majority of these relate to the Department of Education for payments to school districts that do not generally invoice the Department, but instead receive formula-based payments. Second, about 8% of the transaction lines were missing the warrant header data (i.e., header data from the actual warrant that was issued to a vendor) that is needed to analyze the payments. Therefore, the contractor excluded the 8% from its review. Third, payment data provided to the contractor contains incomplete vendor numbers. COFRS contains unique numbers for each vendor, however some are SSNs; therefore to protect confidentiality, the State only provided the contractor a portion of the vendor number which impacted the contractor's ability to conduct its duplicate analysis.
- **Federal recoveries:** The State is required to return any federal-fund related recoveries that the contractor identifies to the federal government unless the federal funding agency allows the State to keep a portion to pay for costs associated to recoveries. As a result, it is difficult for the contractor to know in advance, whether it will be compensated for its efforts. In response, the Office of the State Controller has requested that state agencies specifically contact their federal agencies and request approval to pay recovery related costs for claims issued to vendors.
- **Documentation:** The State's record retention guidelines require that agencies retain financial records for the current and three prior fiscal years. The recovery audit period includes Fiscal Year 2008 which is outside of the retention period and therefore may be unavailable. In these cases, the contractor will request documentation from the vendor.

To date we have found the Balance Risk team to be professional, competent, and genuinely interested in providing value to the State. The Balance Risk team anticipates completing the audit fieldwork by mid-August 2012. Please contact my office if you have questions regarding progress of the audit or Balance Risk's reports.

Sincerely yours,



David J. McDermott, CPA
Colorado State Controller

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June 28, 2012

Dianne E. Ray, State Auditor,
Representative Cindy Acree, Chair Legislative Audit Committee, and
Representative Cheri Gerou, Chair Joint Budget Committee
200 East 14th Avenue
Denver, Colorado 80203

Dear Auditor Ray, Representative Acree, and Representative Gerou:

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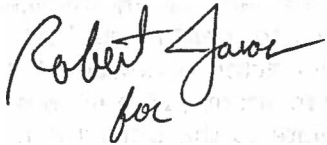
Dianne E. Ray,
Representative Cindy Acree, and
Representative Cheri Gerou

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June 28, 2012

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Sincerely yours,

A handwritten signature in black ink that reads "Robert J. McDermott" with "for" written below it.

David J. McDermott, CPA
Colorado State Controller

Cc:

Legislative Audit Committee Members

Representative Cindy Acree, Chair
Representative Angela Williams, Vice-Chair
Senator Lucia Guzman
Representative James Kerr
Senator Steve King
Senator Scott Renfroe
Representative Su Ryden
Senator Lois Tochtrop

Joint Budget Committee Members

Representative Cheri Gerou, Chair
Senator Mary Hodge, Vice-Chair
Representative Jon Becker
Senator Kent Lambert
Representative Claire Levy
Senator Pat Steadman



June 25, 2012

Jennifer Henry, Manager Statewide Internal Audit
Acting Recovery Audit Administrator, Office of the State Controller
State of Colorado
633 17th Street, Suite 1500
Denver, CO 80202

State of Colorado Recovery and Contract Audit – Contract 12AAA 34968, Report #3

Dear Jennifer,

Here is the latest status for the recovery and contract compliance audit for the State of Colorado.

Since our last report issued on March 20, 2012 Balance Risk has:

- Completed data acquisition for COFRS
- Identified potential inappropriate payments for all agencies in scope excluding HCPF
- Begun pulling documents to validate potential improper payment issues
- Started packaging the documentation into claims for review by the applicable agency controller

These activities will continue for the duration of our fieldwork, which is expected to be completed by mid-August 2012. Balance Risk will begin contacting vendors to review claim issues following agency review and approval.

Balance Risk reviewed contract terms and spend for suppliers listed on the CLIN (legacy) and CMS (current) contract tracking systems. Following review of approximately 90 contracts with material spend across several agencies, Balance Risk has determined that there are no suitable opportunities for contingent recovery auditing during this engagement primarily due to:

- The structure of the contract language (primarily lump sum and unit cost agreements)
- Many high dollar agreements already receive extensive internal agency review
- State employees were unable to identify contracts with potential recovery opportunities. Suggestions we received included agreements with inadequate levels of spend, contracts that had already been audited or contracts where settlements had already been negotiated with the State.
- Questions regarding the ability to be compensated for recovery of federally funded claim issues.

Balance Risk noted during our preliminary review two control issues that had potential fraud opportunities. We discussed our concerns with the State Controller, David McDermott. Mr. McDermott utilized established internal processes to communicate areas for potential investigation to appropriate State personnel.

Audit Progress

Balance Risk has completed the preliminary phase of work for the recovery audit.

Data

The table below summarizes the volume of transaction data (invoice lines input for payment) that we received, processed and analyzed as part of this recovery audit. Some of the data was not complete due to one of the following issues:

- Payment voucher information (labeled “Warrant Header” data) was purged on a recurring basis and could not be retrieved.
- If one or more transactions within a payment voucher were missing causing the payment voucher detail to be out of balance with the payment value, we excluded that information from the audit dataset.

State of Colorado Recovery Audit Scope

	With Warrant Header – In Audit		No Warrant Header or Incomplete– Out of Audit		Total Universe of Data Received	
	Count (000)	Amount (\$M)	Count (000)	Amount (\$M)	Count (000)	Amount (\$M)
Transaction count and amount	5,113	\$ 25,290	422	\$ 1,922	5,535	\$ 27,212
Percent of Total (%)	92	93	8	7	100	100

Significant audit issues exist due to COFRS system configuration and agency accounts payable processing procedures. Recovery auditing is based on analysis of several key data elements:

- Invoice number
- Invoice date
- Invoice amount
- Payment information (warrant)

Specifically for COFRS, invoice number and invoice date are not required to be input for a payment to be processed. The impact on the audit execution is significant. It is important to understand that even

with our best efforts, there will be many instances where we will not be able to affectively identify for review an improper payment. The table below represents the total number of transactions that were input for payment where the invoice field is populated or blank. Certain agencies have a significantly higher percentage of blank invoice transactions due to the nature of payments made relative to their work. Individual agency reports will include this aspect of the review.

No Invoice Number (Blank Invoice Field) input for payment

	Invoice Field Populated		No Invoice Number Input – “Blank”		Total Audit Transactions	
	Count (000)	Amount (\$M)	Count (000)	Amount (\$M)	Count (000)	Amount (\$M)
Transaction count and amount	3,937	\$ 9,289	1,176	\$ 16,001	5,113	\$ 25,290
Percent of Total (%)	77	37	23	63	100	100

We have discussed the “no invoice number/no invoice date issue” extensively with both the Controller and Deputy Controller. COFRS is a very old system and the inherent risk within this area is significant. The inability to run credible data analytics and generate basic payment processing metrics places much more reliance on manual controls and vendor integrity to return improper payments. We will be elaborating on this topic and providing specific examples for illustration purposes in our management report. Poor data quality for review directly impacts the ability to identify potential improper payments.

Audit Fieldwork

Documentation – The State’s record retention policy for invoices is current fiscal year plus three additional years. Balance Risk’s preliminary review of document filing for the following agencies- DPA, DOT and DOC indicates that some agencies retain records longer due to federal agency requirements. It is likely that documents required for fiscal year 2008 across many agencies may not be available as they were destroyed prior to our request to review the materials. The Office of the Controller’s Audit Coordinator is currently assessing document availability for agencies in scope at this time.

In the event that records required for our review have been destroyed or cannot be located, after reporting to the agency controller, Balance Risk will work with the vendor and request that they review the issue and provide support for the payment items in question. This is a standard practice within recovery auditing and occurs more frequently when the client does not have a document imaging system in place.

Balance Risk will include a recommendation for the State to consider implementation of an invoice documentation imaging system as part of our final management report relative to this review.

Statement Solicitation – Balance Risk has initiated two separate phases of statements solicitation to vendors during the audit. During the first phase 1,265 letters were sent to COFRS vendors in December 2011 and January 2012. In the second phase, 953 letters were sent to DOT vendors. Responses received from vendors yielded a significantly lower incident of potential claim issues and open invoices than traditionally occurs with private sector clients. We suspended mailing additional letters and are currently following up on a selected basis by direct contact with vendors that have not submitted a response to our initial requests.

Improper Payment Review – Balance Risk is completing the data analysis on base improper payment reports. As noted in our proposal, following completion of the base analytic review, Balance Risk then develops custom potential overpayment reports. Beginning in June 2012, Balance Risk will present a list of required documents for review to the agency controller and schedule a date to visit and inspect the invoices and supporting information. We anticipate that most of the visits can be scheduled and completed by the end of July 2012.

It is important to note that not all potential improper payment issues will result in a recovery claim. Review of documentation does prove some items are not valid. Also, some valid items have already been addressed and resolved by a combination of efforts by the vendor and the state agency.

Contract Compliance Audit – Balance Risk has reviewed both spend data and selected contract terms for the scope period of this audit. Balance Risk has determined due to the structure of material dollar contracts let by the State (lump sum and unit cost versus cost plus), extensive internal review performed by agencies such as DOT and some instances where we felt there was not full support to execute contract audit work - there are no suitable opportunities for contingent recovery auditing at this time.

Some agencies are taking proactive steps internally to monitor contracts and attempt to identify and realize cost savings. These efforts demonstrate a positive culture. However, we also encountered a few specific instances where it was apparent that state employees were reluctant to highlight contract audit opportunities, especially when it could reflect negatively on their own work or organization. In these instances we noted a display of cooperation that would satisfy the legislative requirement. Balance Risk will provide additional observations and comments in the management report relative to contract compliance auditing.

Telecommunications – The Abilita audit team (Balance Risk partner brought in to execute this specialty area of the audit) has focused their efforts specifically on DOT telecom spend to develop a standard approach for telecom issues and cost savings. Results will indicate whether it is beneficial to expand the review to other agencies.

Recoveries related to Federal funds or Federal match agreements –During our preliminary review Balance Risk learned that if improper payment monies are identified and recovered that relate to open federally funded programs or are part of a federal fund matching agreement Balance Risk potentially would not receive fee for those recoveries. The current audit requirement is that potential issues will be identified and claims initiated. At that point if the improper payment is deemed to be funded with federal funds, the agency controller will contact the federal agency and request review of the issue and whether recovery fee can be paid to Balance Risk.

The Office of the Controller has attempted to get resolution with the Office of Management and Budget (OMB) – and the efforts have been ongoing. One test case claim for approximately \$170.00 with Colorado Department of Natural Resources written and recovered in January 2012 is still pending a federal agency decision on whether we can be paid fee from the recovery amount. Colorado Department of Natural Resources receives federal matching funds. Balance Risk’s concern is that recoveries related to federal funding questions will remain in limbo waiting for federal agency approval for contingent fee payment. This uncertainty will impact audit review of several state agencies.

To date the only Federal Agency Balance Risk is aware of that has formally acknowledged fees can be paid related to recoveries is the Department of Transportation.

Balance Risk appreciates the support and cooperation received from the Office of the State Controller and all of the agencies within the scope of this recovery audit.

Respectfully,

A handwritten signature in cursive script, appearing to read "R. Serocki".

Robert J. Serocki
President, Balance Risk, LLC