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
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December 28, 2012

John Hickenlooper, Governor
136 State Capitol
Denver, Colorado 80203

Dear Governor Hickenlooper:

I am issuing this letter to summarize the recovery audit that was conducted by Balance Risk LLC (Recovery Auditor). I previously sent the Recovery Auditor's final report to you on October 5, 2012. This letter includes highlights of the recovery audit and summarizes the statute, audit scope, findings, challenges of recovery audits, and the Recovery Auditor's recommendations. Attachments include detail of the distribution of the recovered amount (Attachment A), further detail on the unique challenges associated with recovery audits in Colorado (Attachment B), the State Controller's responses to the Recovery Auditor's recommendations (Attachment C), and the Department of Revenue's responses to the Recovery Auditor's Report (Attachment D).

Highlights of the Recovery Audit

The recovery audit conducted by the Recovery Auditor was designed to identify improper payments. Highlights of the recovery audit include:

- Payment Analysis Scope:
    - Approximately 5.1 million transactions for payments totaling $25.3 billion.
    - Fiscal Years 2008 through 2010.
    - 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.

- Other Areas of Audit:
    - Statement Review – Recovery Auditor sent about 2,200 statement letters to vendors to identify credits that were owed but had not been paid to the State.
    - Contract Review – Recovery Auditor reviewed a sample of about 90 contracts totaling about $488 million.
    - Unclaimed Property Review – Recovery Auditor reviewed expired warrant data from the State Treasurer's Unclaimed Property Office to determine whether the

State issued payment to a vendor or other entity and also sent monies supporting an expired warrant to Unclaimed Property related to the same payment (a duplicate payment).
- o Telecommunication Audit – Abilita, a subcontractor of the Recovery Auditor reviewed one year of invoices for telecommunication services ordered by the Colorado Department of Transportation, Regions 1 and 6.

- Timing
  - o Recovery Auditor signed a contract with the State acting by and through the Department of Personnel & Administration Office of the State Controller on August 22, 2011 and submitted its final invoice on November 26, 2012.
  - o For the 15-month period, most of this time was spent on data preparation, with the remaining time spent on identifying improper payments and collecting the improper payments from the vendors.

- Resources Devoted to the Recovery Audit and Related Program Implementation
  - o Recovery Auditor devoted 15 months of the principal's time, and several months of at least five other individuals on the team.
  - o Office of the State Controller devoted several months time of the Statewide Internal Audit Manager, the Recovery Audit Specialist, Deputy State Controller, and the State Controller.
  - o Controllers at every state department devoted at least several days and many department staff members devoted several weeks of their time to the audit.
  - o The Recovery Auditor identified improper payments at five agencies, but only three agencies submitted claims for reimbursement of administrative costs. Under the statute, only departments that had recoveries could submit claims for administrative costs. Only two departments received a reimbursement for administrative costs because improper payments at one department were funded by federal agencies that required the entire amount to be returned to the granting federal agencies.

- Results
  - o The Recovery Auditor initially identified 51 potential improper payments for a total of $214,635. This amount is included in the Recovery Auditor's Report.
  - o Of the claims, 78% were not improper payments because the State departments applied the overpayments to the vendor's next invoice or the vendor had already repaid the State.
  - o After investigation by the Recovery Auditor, with the assistance of the department controllers, there were 10 improper payments recovered for a total of $13,023.65. There is one pending collection for $750.00. The recovered total represents a very small portion of the $25.3 billion total transactions subject to the recovery audit.
  - o In accordance with CRS §24-30-203.5(5) and (7), the disposition of the total amount recovered of $13,023.65 is as follows:
    - ▪ $7,198.08 returned to Federal agencies
    - ▪ $961.22 contingency fee paid to the Recovery Auditor, equal to the contingency fee of 16.5% in the contract multiplied by $5,825.57, the net amount of $13,023.65 recovered less $7,198.08 returned to Federal agencies that do not allow a recovery audit fee to be deducted from improper payments,
    - ▪ $780.47 administrative costs submitted by the Department of Public Health and Environment ($620.00) and the Department of Agriculture ($160.47).
    - ▪ $1,255.21 returned to the Highway Users Trust Fund (HUTF). Under statute, recoveries related to a constitutionally created fund are required to be

returned to that fund, in this case, the HUTF fund at the Department of Public Safety.

  - $727.90 gifts, grants, and donations that are restricted and are required to be returned to the source that generated the recovery, in this case, to restricted awards held by the Department of Public Health and Environment.
  - $2,100.77 remaining will be returned to the General Fund.
  - No portion of the recovered amounts was retained by the Office of the State Controller.
  - A summary of the distribution is included in Attachment A.

- Lessons Learned
  - In monetary terms, the costs of this recovery audit far exceeded the amounts recovered.
  - Based on the time devoted to the recovery audit since the passage of the statute, the Office of the State Controller alone had costs of about $130,000 to manage the recovery audit that well exceeded the amount recovered of $13,023.65. Departments also incurred costs to review potential claims that were well in excess of the amount recovered.
  - In programmatic terms and within the limitations of the current financial system, the recovery audit demonstrated that the State's internal controls are very effective in correcting duplicate payments.
  - Recovery Audits are not designed to be and cannot function as eligibility audits for State programs or benefits. That process requires a much higher level of resources and more focused approach to auditing.
  - Most of the 10 improper payments were the result of departments paying the same invoice twice because the invoice number was entered incorrectly or not entered at all. To the extent possible, this weakness will be addressed in COFRS Modernization.
  - Recovery Auditor was required to analyze all data, even though payments that were federally funded generally did not allow the Recovery Auditor to collect its fee.
  - Recovery Auditor was compensated solely from the contingency fee and so was motivated to focus on areas with the greatest potential for improper payments. This did not always align with the Office of the State Controller's objective to also identify weaknesses in internal control.
  - Recovery audit activities are built on the premise that expenditures are tied to invoices (a traditional accounts payable concept). However, only about a third of the State's payments reviewed (in dollars) fall into this category; the remainder are non-exchange formula-based transactions such as grant distributions.

Recovery Audit Statute

CRS §24-30-203.5 requires the Office of the State Controller to manage recovery audits and contract for recovery audits every three years, beginning July 1, 2011, to recoup improper payments, such as duplicate payments by state agencies. The Office of the State Controller entered into a contract with the Colorado firm, Balance Risk LLC, to conduct the audit on August 22, 2011 following JBC approved adjustments to Fiscal Year 2012 appropriations for $1.6 million on June 20, 2011 and LAC approval of audit exemptions on July 11, 2011.
According to statute, the contractor is paid on a contingency fee basis (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 the 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.

Improper payments include duplicate payments, payments resulting from an invoice or pricing error, failure to apply applicable discounts or rebates, and payments to a recipient who does not meet the eligibility requirements for receiving payment.

Contract between the State of Colorado and the Recovery Auditor

The contract provided for a 16.5% contingency fee. The Recovery Auditor was required to 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, reviewing contracts, and reviewing telecom charges for missing refunds and discounts. The scope of the contractor's review was for Fiscal Years 2008 through 2010 and included all state agencies except institutions of higher education and a portion of the Department of Health Care Policy and Financing that was already subject to a separate recovery audit. The contractor subcontracted for a review of telecom charges and the subcontractor completed reviews at Regions 1 and 6 at the Colorado Department of Transportation (CDOT). The subcontractor identified $3,802 of savings and submitted an invoice for $1,331 (35% telecom fee). CDOT is in the process of verifying the savings reported.

Audit Findings

Of the $25.3 billion transactions subject to review, the Recovery Auditor identified 51 potential duplicate payments totaling $214,635. After investigation by the Recovery Auditor, with the assistance of State department controllers, there were 10 confirmed improper payments for a total of $13,023.65. This represents a small portion of the amount of the total transactions audited of $25.3 billion. The majority of the potential improper payments had already been applied to the vendor's next invoice or the vendor had already repaid the State

Most of the 10 instances of improper payments were due to departments paying the same invoice twice. COFRS contains an edit to prevent payment to the same vendor for the same invoice number. The edit is intended to help prevent duplicate payments; however COFRS will only flag the duplicate if the invoice number is an exact match. For most of these improper payments, either the invoice number was entered incorrectly or not entered at all. To address this situation, the State Controller will require departments to enter invoice numbers where provided by vendors as part of the COFRS Modernization.

Challenges with Recovery Audits in Colorado

As noted in the Recovery Auditor's report, there were significant challenges to this recovery audit. These limitations concerned data issues primarily arising from the State's 20-year old financial system (COFRS), government transactions which are mostly non-exchange transactions and do not involve an invoice, and federal laws which generally prohibit payment of a recovery audit fee. These are further explained in Attachment B.

Recommendations

The Recovery Auditor included the following recommendations:

- Address accounts payable system inadequacies and process issues.

- Improve access to accounts payable data.
- Improve productivity of the accounts payable process.
- Establish standards for communication and accountability for material aged open items.
- Increase visibility and frequency of the recovery audit process.
- Change management and control.

Please see the Recovery Auditor's Report for further detail on these recommendations. The State Controller's Responses to the Recovery Audit recommendations are included in Attachment C.

Overall Assessment

Overall, the costs of this recovery audit far exceeded the benefits. For several reasons, we believe future the recovery audits required by statute will yield similar results. The State of Colorado had a low level of improper payments due to 1) financial controls instituted by the State departments that help ensure improper payments are minimized, particularly for typical and routine accounts payable-type activities, 2) budgetary controls implemented by State departments to avoid improper payments in an environment of scarce funds, and 3) annual financial audits including a review of internal controls and performance audits conducted by the State Auditor. Moreover, it is inefficient and cumbersome to extract data from the State's existing COFRS financial system, adding a unique complexity to the process of performing recovery audits in Colorado. Even with the implementation of a new accounting system, however, we believe future recovery audits are unlikely to find significant amounts of improper payments.

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David J McDermott

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December 28, 2012

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

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Recommendations

The Recovery Auditor included the following recommendations:

- Address accounts payable system inadequacies and process issues.
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- Establish standards for communication and accountability for material aged open items.
- Increase visibility and frequency of the recovery audit process.
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Overall Assessment

Overall, the costs of this recovery audit far exceeded the benefits. For several reasons, we believe future the recovery audits required by statute will yield similar results. The State of Colorado had a low level of improper payments due to 1) financial controls instituted by the State departments that help ensure improper payments are minimized, particularly for typical and routine accounts payable-type activities, 2) budgetary controls implemented by State departments to avoid improper payments in an environment of scarce funds, and 3) annual financial audits including a review of internal controls and performance audits conducted by the State Auditor. Moreover, it is inefficient and cumbersome to extract data from the State's existing COFRS financial system, adding a unique complexity to the process of performing recovery audits in Colorado. Even with the implementation of a new accounting system, however, we believe future recovery audits are unlikely to find significant amounts of improper payments.

Sincerely yours,

David J. McDermott

David J. McDermott, CPA
Colorado State Controller

Cc:
Joint Budget Committee Members
Senator Pat Steadman, Chair
Representative Claire Levy, Vice-Chair
Senator Mary Hodge
Senator Kent Lambert
Representative Crisanta Duran
Representative Cheri Gerou

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

Attachment A

Distribution of Recoveries (according to Section 24-30-203.5(5) and (7), C.R.S.

			Distribution								
Department	**Number of Claims**	**Amount Recovered**	**Federal**	**Recovery Auditor's Contingency Fee (16.5%)**	**Departments' Actual Admin. Costs**	**Constitutional**	**Fiduciary**	**Gifts, Grant, Donations**	**Custodial**	**General Fund**
Agriculture	1	$ 848.12	$ -	$ 139.94	$ 160.47	$ -	$ -	$ -	$ -	$ 547.71
Corrections	2	$ 1,859.95	$ -	$ 306.89	$ -	$ -	$ -	$ -	$ -	$ 1,553.06
Public Health and Environment*	2	$ 2,260.00	$ 645.75	$ 266.35	$ 620.00	$ -	$ -	$ 727.90	$ -	$ -
Natural Resources	4	$ 6,552.33	$ 6,552.33	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Public Safety	1	$ 1,503.25	$ -	$ 248.04	$ -	$ 1,255.21	$ -	$ -	$ -	$ -
Total	**10**	**$ 13,023.65**	**$ 7,198.08**	**$ 961.22**	**$ 780.47**	**$ 1,255.21**	**$ -**	**$ 727.90**	**$ -**	**$ 2,100.77**

Note: An additional $3,802 was identified in telecom savings at the Colorado Department of Transportation (CDOT). CDOT is in the process of verifying the savings reported. The Recovery Auditor's contingency fee for telecom savings is 35% or $1,331.

*Data provided by the Department of Public Health and Environment as of December 2012.

Attachment B

Challenges with Recovery Audits in Colorado

As noted in the Recovery Auditor's report, there were significant challenges with this recovery audit. These challenges concerned data issues, government transactions, and federal laws, and are further explained below.

Data Issues

- **20-year Old Financial System.** COFRS contains a complex payment structure designed on decades-old technology. For example, for every payment processed there are 3 separate transactions with a minimum of two lines per transaction with each line containing up to 95 separate data fields. For this recovery audit, the Office of the State Controller pulled more than 47 million transaction lines including 5.1 million lines related to disbursements, and provided this data to the Recovery Auditor. An extraction and transmission of COFRS data of this volume had never before been attempted, and limitations of available database tools required developing new techniques to parse the requests into manageable portions. Further, the data was filtered to mask data protected under the Colorado Open Records Act and HIPAA. Additionally, a separate data extraction was conducted to compile data related to the Department of Health Care Policy and Financing to exclude transactions that were already subject to a separate recovery audit. The entire extraction process required extensive programming including about 162 manual and automated steps to produce nearly 600 individual output files which took about 300 hours of staff time (about two months) to complete. The extraction process occurred and was performed by staff at the Office of the State Controller in the middle of the State's statutorily mandated financial statement preparation.

- **Invoice Numbers.** Traditional recovery audit data analytics rely on invoice number and date as two critical fields to perform duplicate payment analysis. However, as we will discuss in more detail below under Government Transactions, not all transactions had an invoice number. Additionally, the invoice field is an optional field in COFRS. Therefore, the Recovery Auditor excluded transactions without an invoice number from its analysis.

- **Vendor Numbers.** Unique vendor numbers are also needed to conduct recovery audit-related analytics. Each vendor in COFRS has a unique identification number, however in some cases these vendor numbers are SSNs and EINs which are needed to meet IRS 1099 reporting requirements where a summary of payments issued by the State is mailed to each vendor annually. This information is not released to any person or entity outside State employment, and it is limited to the greatest extent possible within State employment. In order to secure this protected information, the State Controller provided only a portion of the vendor number, as is commonly done with bank account numbers. The decision to limit the vendor number information was based on an assessment of both the risk of disclosure and the magnitude of the consequences resulting from a potential breach of protected information. Because of the volume of the data, the Recovery Auditor uses a system that requires transmission of the data over the public internet. While the data was encrypted in transmission, the Recovery Auditor did not provide an audit report of its system controls to secure protected data once the data was received. According to the Recovery Auditor, additional work was required to create a usable vendor file to conduct its analysis because of the partially masked vendor numbers. However, at the time the State Controller made the decision to mask a portion of the SSNs and EINs, the Recovery Auditor agreed that a portion of the vendor number would adequately meet the recovery audit needs.

- **Vendor Adjustments.** In general, when a vendor receives a check from the State, the funds are immediately deposited into the vendor's bank account. If at a later date the vendor or the State determines that the payment amount was incorrect (the State accidentally paid more than the amount due) the vendor typically adjusts their next invoice to the State by any over-or-under payments. For efficiency purposes, the State often records the net amount of the invoice, rather than recording a separate entry for the adjustment. However, for recovery audit purposes, the full transaction trail is needed, particularly when using data analytics. Without the full trail, more false-positives were identified that required the Recovery Auditor to conduct additional analysis to determine whether the vendor actually owed the State money. While a complete trail is helpful for recovery audits, it is often not cost-effective for the agencies to record the adjustment, particularly in cases where the expense was allocated to various programs, appropriations, and funds.

- **Warrant Header Data.** Header data from the actual warrant that is issued to a vendor is not critical information for financial operations and therefore is not retained directly in COFRS. Instead, the information is saved into files and archived by the Governor's Office of Information Technology (OIT), but generally not used or accessed. However, for recovery audit purposes the header data contains detail needed to conduct the analysis. OIT was able to locate and provide a majority (92%) of the data. The Recovery Auditor excluded the remaining 8% from its review.

- **Telecom.** The recovery audit also included a review of telecommunication services, such as determining if the State was receiving applicable discounts or paying for unnecessary or unused services. In order to conduct a meaningful review, the Recovery Auditor needs to review recent telecom contracts and services. However, the statutory scope of the audit was for Fiscal Years 2008 through 2010, which in some cases involves reviewing data that is more than three years old. This may be reasonable for typical accounts payable-type activities but not for telecom services. Therefore, the Recovery Auditor reviewed only current telecom activity.

Attachment B

Government Transactions

A majority of the State's disbursements are non-exchange transactions in which payments are made without receipt of a benefit, such as a good or service. For example, non-exchange expenditures are generally either formula-based payments (funds are allocated based on statute or other governing guidance, such as allocations to school districts) or grant payments (funds are provided to an outside entity to accomplish a defined goal for the benefit of the recipient). In these cases, the State does not receive an invoice.

Traditional recovery audit activities are built on the premise that expenditures are tied to invoices (a traditional accounts payable concept). However, only about a third of the State's payment activities fall into this category; the remainder are non-exchange transactions. Specifically, of the 5.1 million transaction lines subject to review totaling $25.3 billion, about 1.2 million transaction lines (24%) did not have an invoice number which represents about $16 billion or 64% of the total payments subject to review. A majority of these related to the Colorado Department of Education for payments to school districts that receive formula-based payments, and therefore, it is expected that no invoice numbers would be available. To prevent duplicate payments when invoice numbers are not available, the Department of Education has implemented alternative controls including reconciliation processes and extensive audit procedures.

Federal Law

Federal law requires that all federal dollars recovered by states, must be returned to the federal government unless the State receives approval to retain the funds. In accordance with statute, the State's Recovery Auditor is paid on a contingency fee basis (i.e., the fee is based on a percentage of the duplicate payments that the Recovery Auditor identifies and recovers). However, if the Recovery Auditor identifies a duplicate payment involving federal funds and the State does not receive approval from the federal agency to retain all or a portion of the funds, the Recovery Auditor does not receive a fee. In fact, five of the ten duplicate payments that the Recovery Auditor identified involved federal funds that the State was not authorized to retain, and therefore, the Recovery Auditor did not receive a fee for the work.

Colorado statute requires the Recovery Auditor to review all funds. However, this requirement combined with federal law creates a significant gap in equity in which the Recovery Auditor bears the entire cost of identifying duplicate payments involving federal funds and yet does not receive compensation unless the federal government agency grants approval.

Attachment C

Recovery Auditor's (RA) Recommendations and Responses by the Office of the State Controller (OSC)

1.0 RA's Recommendation: Address accounts payable system inadequacies and process issues. (Page 3 of RA's Report)

1.1 RA's Recommendation: Capture essential data elements in the accounts payable process including invoice date and invoice number. (Page 4)

OSC's Response: Partially Agree. COFRS contains about 95 separate fields to capture payment data including invoice number and payment description where agencies can elect to enter the invoice date. Since not all transactions have an invoice number, these fields are optional. Where the vendor provides an invoice number, the OSC agrees that the departments should input the invoice number into COFRS.

Where the vendor does not provide an invoice number, the OSC does not see any value in the State generating a substitute invoice number. For example, the recovery auditor found that 24% of the transactions, representing 64% of the dollars reviewed, did not have an invoice number. A majority of these transactions relate to formula-based payments to school districts, which are calculated by the State and therefore the State does not receive an invoice. For formula-based payments, the State determines the allocation of funds each school receives, not the school. The allocation is based on a per-pupil count which is audited by the department every six months. In the OSC's judgment, an audit by the department, rather than an invoice number, is a more effective and efficient control to help ensure schools are not over-or-under paid.

The OSC believes that generating a substitute invoice number will not prevent duplicate payments. The purpose and value of an invoice is that it is generated by an independent source, i.e., the vendor, and contains not only an invoice number, but information regarding the purchase that the State uses to verify goods or services were provided and to approve payment. If the State generates a substitute invoice number, it would do so at each payment even if the payment were a duplicate; the generated number would be different, but it would be for the same payment purpose.

Additionally, most business accounting software by default uses sequential numbering for invoices, which helps prevent the vendor from double billing its customers. Further, COFRS has a feature that rejects invoices from a particular vendor if that invoice number has already been paid. As noted, if the State were to simply generate its own invoice number, this edit feature becomes ineffective.

1.2 **RA's Recommendation:** Establish unique vendor numbers that are not the tax identification number. (Page 4)

OSC's response: Agree. Each vendor in COFRS has a unique identification number; however in some cases these vendor numbers are Taxpayer Identification Numbers (TINs), i.e., SSNs and EINs which are needed to meet IRS 1099 reporting requirements where a summary of payments issued by the State is mailed to each vendor annually. The State is in the process of implementing the new accounting system, COFRS Modernization. The OSC will work with the COFRS Modernization vendor to establish unique vendor numbers that are not the TIN.

1.3 **RA's Recommendation:** Input transactions at the invoice level versus payment voucher level. (Page 4)

OSC's Response: Disagree. COFRS uses the payment voucher to link the invoice with the warrant. This provides flexibility to pay multiple invoices for the same vendor in a single payment. As a result, agencies are not required to issue a separate warrant for each invoice, which helps reduce costs and increase productivity. For recovery audit purposes, the OSC understands the benefit of a one-to-one relationship between invoice and payment; however, the OSC believes the cost of that control exceeds the benefit it would provide. COFRS Modernization may have additional functionality that will better link the invoice and the warrant that will reduce the time required to conduct a recovery audit.

1.4 **RA's Recommendation:** Retain payment header information and ensure payment status reflects actual activity – we found this information in many cases was not archived. (Page 4)

OSC's Response: Partially Agree. The Governor's Office of Information Technology (OIT) retains and archives the header data which shows the status (e.g., cleared or voided) of the warrant at the time the data is archived. OIT was able to locate and provide a majority (92%) of the header data for the audit, so that these data were generally available. Additionally, warrant status is not updated since it is not critical or relevant to the State's financial operations. The OSC has requested that OIT retain payment header information for the next recovery audit cycle (FY 2010, 2011, and 2012). However, some of that data may have already been purged at the time the recovery audit need was identified.

1.5 **RA's Recommendation:** Implement a statewide invoice input convention (smart invoice numbering methodologies for unique payment types). (Page 4)

OSC's Response: Disagree. In general, the OSC found that most of the departments have adopted invoice input conventions which are tailored to each department's unique operations. The types of payments vary widely among state departments such as formula-based payments, grant payments, payments to the same vendor but under different grants and programs within the same department, commodity-based inventory payments for food and care of offenders, and payments that are determined based on information that is fed to COFRS from numerous outside systems. A convention that works well for one agency may hinder another agency. For example, the OSC could issue a policy that the department should enter the invoice month and year in the invoice field for situations where there is no invoice number. This invoice input convention would not work for an agency that receives multiple invoices from the same vendor, in the same month, but for different programs. Departments need the flexibility to establish an invoice input convention that supports their operations; therefore the OSC believes a statewide convention is unworkable. Instead, the OSC will encourage all departments to establish an invoice input convention, particularly in cases where an invoice number is not provided. As previously noted, generation of a unique number by the State rather than the payee does not guarantee duplicate payments will be avoided.

1.6 **RA's Recommendation:** Utilize migration to the new accounts payable system to upgrade standards for vendor master file definition and file maintenance. (Page 4)

OSC's Response: Agree. COFRS presently includes limited remittance information. As a result, vendors request that the departments set up separate bill-to addresses so that the vendors can more readily recognize how to apply the payments received from the State. With COFRS Modernization, there will be additional functionality so that remittance information should no longer be a constraint. The OSC will review the functionality of COFRS Modernization and adopt best practices for vendor file maintenance. Ideally, the vendor file would be set up with one master record and one remittance address. Any changes to the present approach of vendors having multiple remittance addresses will be communicated to the State's vendors and assessed for cost versus benefit.

1.7 **RA's Recommendation:** Eliminate application of vendor credits against open invoices. (Page 4)

OSC's Response: Partially Agree. For efficiency purposes, departments often record the net amount owed to a vendor, rather than recording a separate entry for any adjustments. For instance, if a department issues an improper payment to a vendor, the department will reduce the next payment to that vendor by the amount of the improper payment. To implement the RA's recommendation, the department will need to request that the vendor send back the erroneous warrant, and if the vendor has already cashed the warrant, to request that the vendor send a check to the State. This would be time-consuming for both the department and the vendor. The OSC will evaluate how COFRS Modernization addresses improper payments and will implement the best practices for improper payments which could result in a change to the existing practice.

1.8 **RA's Recommendation:** Input gross invoice payment amount, including vendor invoice credits. (Page 4)

OSC's Response: See answer to 1.7.

1.9 **RA's Recommendation:** Recognize vendor refunds in accounts payable transaction detail. (Page 4)

OSC's Response: See answer to 1.7.

2.0 **RA's Recommendation: Improve access to accounts payable data. (Page 4)**

2.1 **RA's Recommendation:** Implement statewide accounts payable and contract document imaging. (Page 4)

OSC's Response: Agree within budget constraints. Currently, payment documentation (e.g., a copy of the invoice and payment document from COFRS) is maintained in hardcopy by each department. Although the Recovery Auditor did not have significant issues locating documents, an imaging system could provide efficiencies in document retention and access. An imaging system was considered in COFRS Modernization; however, due to limited funds, it was determined that this feature would not be included. In meetings with the departments to better understand the functionality of COFRS Modernization, departments expressed an interest in attaching documents. These attached documents may result in slowing down the performance of COFRS Modernization, which could prompt the need for additional storage and a re-evaluation of purchasing the vendor's document management module.

2.2 **RA's Recommendation:** Develop data analytics to improve identification and remediation of payment errors prior to warrant issue. (Page 4)

OSC's Response: Agree. OSC will review the data analytics available in COFRS Modernization to help identify and reduce payment errors prior to issuing payment.

2.3 RA's Recommendation: Set statewide standards for data capture and metrics for all payment activity across all agencies (accounts payable, purchase and travel cards, automated payment processing). (Page 4)

OSC's Response: Agree. One important goal of COFRS Modernization is to establish data input standards that would apply to all agencies with edits to maintain data integrity.

3.0 RA's Recommendation: Improve productivity of the accounts payable process. (Page 5)

3.1 RA's Recommendation: Centralize the accounts payable function, specifically, transaction input and payment of invoices. (Page 5)

OSC's Response: Partially Agree. In the near term, the COFRS Modernization will change the way departments process financial transactions, and the OSC does not plan to change any organization responsibilities. Longer-term, once input standards have been established as discussed in recommendation 2.3 and COFRS Modernization has been fully implemented, the OSC will review opportunities for shared services, such as payment processing.

3.2 RA's Recommendation: Utilize new system functionality including batch upload and recurring payments to increase the volume of automated processing. (Page 5)

OSC's Response: Agree. The current COFRS system has the ability to batch upload and process recurring payments and COFRS Modernization has the same functionality.

3.3 RA's Recommendation: Monitor days to pay and other standard metrics to dramatically improve productivity, reduce cost and highlight potential process issues across all agencies. (Page 5)

OSC's Response: Agree with COFRS Modernization. The current COFRS system does not contain data fields to capture the number of days from the invoice date to the paid date. Despite this inability to manage payments, the recovery auditor did not identify problems with late payments. The OSC plans to implement tracking of days-to-pay with COFRS Modernization to ensure payments are timely and applicable early payment discounts are taken.

4.0 RA's Recommendation: Establish standards for communication and accountability for material aged open items. Since COFRS does not capture invoice date, there is currently no system capability to measure and report days to pay or late payment of invoices. Establishing statewide processes from current agency best practices for reporting and escalation of issues will provide efficiencies and improve vendor relations. (Page 5)

OSC's Response: See answer to 3.3.

5.0 RA's Recommendation: Increase visibility and frequency of the recovery audit process. While the audit from a financial perspective can be categorized as unproductive, this engagement revealed some significant control concerns and process issues that need to be addressed as a high priority in the conversion to the new accounting system. Balance Risk recommends the State consider ongoing recovery/process audits as part of their regular control practice. Considering the challenges, barriers and lessons learned, there should be an examination of the fee basis for work and the scope period reviewed should be aligned more closely to actual current activity which would allow a more accurate assessment of existing controls and procedures. (Page 6)

OSC's Response: Disagree; General Assembly action required. The OSC is required to comply with CRS 24-30-203.5, the recovery audit statute that requires the State Controller to contract with an experienced consultant to conduct a recovery audit every three years. The scope of the review includes the last three fiscal years of payment activity. Additionally, the consultant is paid on a contingency fee basis (i.e., the contractor receives a fee only on amounts recovered) which aligns with industry practice and meets the declaration of Legislative intent that recovery audits occur at no cost to the State. Because Colorado's recovery audit statute aligns with recovery audit practices of other states, the OSC does not support the recovery auditor's recommendation. Given the low dollar amount recovered, the OSC has concerns about whether any other recovery auditor will bid on the next contract. The State Auditor has audit responsibility for the departments, and in the State Controller's judgment, the recovery auditor should not duplicate that process, but rather should rely on data analytics traditionally associated with recovery audits. Until the full implementation of COFRS Modernization is complete, that approach will continue to require substantial resources and yield little benefit.

6.0 RA's Recommendation: Change management and control. With current reliance on manual controls and reconciliation processes due to system limitations, the State will need to move up a steep learning curve to get both State finance and operations personnel up to speed on new accounting system functionality. Some of this will require a leap of faith to leave reliable slow manual processes and convert to unknown but dramatically more efficient means to get things done. Effective change management control will be essential to ensure new procedures are incorporated in a productive and thoughtful manner. (Page 6)

OSC's Response: Agree. With the modernization of COFRS, there are many opportunities for improved functionality of the financial system that will drive changes to work duties and workflow – all of which will have a significant impact on staff. The implementation team has identified several elements critical to the success of the COFRS Modernization including obtaining participation from all departments in each phase of the project, discussing department-specific issues and exceptions and configuring the system to meet those needs, and providing training and detailed functionality demonstrations to ensure no gaps are left unaddressed. The State is ensuring that best practices are implemented in the modernization by requiring the vendor to work with the State agencies collectively rather than individually. This group interaction approach is already increasing standardization as the agencies work together to pair the new system's best-practice-based functionality with the best of existing State practices. Another critical element of the project will be addressing change management by working with staff to learn an entirely different system and addressing the new system's impact on work duties. For example, a process that took several days or weeks to perform under the old system may be done automatically under the new system, which will result in a shift in responsibilities. The Governor's Office of Information Technology plans to hire a change manager and communications specialist as part of the COFRS Modernization project team. Acceptance of the new system will depend on our ability to provide employees a clear map of how they get from what they do today to more efficient transaction processing and analysis under the new system's tools.

Attachment D

STATE OF COLORADO

DEPARTMENT OF REVENUE
State Capital Annex

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John W. Hickenlooper
Governor

Barbara J. Brohl
Executive Director

October 30, 2012

David McDermott, State Controller
Office of the State Controller
633 17th Street, Suite 1500
Denver, CO 80202

Dear Mr. McDermott:

The Department of Revenue appreciates the opportunity to provide comments and clarity with regard to tax administration in the context of this recovery audit. The department welcomed a review of its vendor payments. It is our position that the recovery audit was intended to focus on vendor payments and not on income tax refunds. The report of the contractor does not provide a complete picture regarding unclaimed property and income tax processes; therefore, the DOR offers the following comments in regard to the section on unclaimed property beginning on page 29. The Department of Revenue has been granted specific statutory authority for the administration of taxes. The statutes governing the administration of taxes recognize that it is a dynamic environment in which taxpayers perform self reporting against which the department performs post filing reviews and audits of the information contained on returns and available in written books and records.

It should be noted that taxpayers can amend their returns up to four years after they were originally filed. Amended returns can have the affect of adjusting refund amounts both upward and downward. Secondly, the department has statutory authority to audit any tax period which is open under the statute of limitations. Generally, the statute of limitations is also four years in duration; however, this period can be extended with the written agreement of the taxpayer or it can remain open if the taxpayer has open periods under Federal Internal Revenue Service statutes. Income tax refunds are not payments but rather a return to the taxpayer of monies the state has held in deposit for the tax liability which is self-reported by the taxpayer in April of the following year.

The account referenced in this report was in fact a large corporate taxpayer who is on a routine audit schedule and would have been audited in the normal course of business. It is the assertion of the Department of Revenue that the carry forward amount in question would have been identified and corrected upon audit. Furthermore, because of the dynamic nature of tax filing and administration, the legislature has given the Department of Revenue specific statutory authority to retrieve amounts in the unclaimed property fund if they were issued in error. This specific statute gives the department guidance in regard to how to treat these transactions.

Lastly, the Department of Revenue recently completed the implementation of an integrated tax system. The implementation of this tax system introduced internal controls that would make it impossible for a similar situation to occur now. In our legacy environment the refund generation system was separate from the accounting system. The incident in question occurred because a scheduled refund job terminated unexpectedly and was restarted. However, the accounting system was not properly updated with the coding necessary to prevent the allowance of a carry forward. This issue cannot present itself in our new computer environment because the refund system and the accounting system are integrated and the credits and debits must match accordingly.

During the course of the audit, it became clear to the Department of Revenue that there was some confusion regarding the distinction between a vendor payment and an income tax refund. It is the Department of Revenue's position that income tax refunds are not part of the Recovery Audit. An income tax refund is not a payment, but is instead the return of excess credits to the taxpayer. The money does not belong to the state and should not be treated in the same fashion as a payment to the taxpayer. As a result, the department requested a legal clarification from the Attorney General's Office as to whether an income tax refund is indeed a vendor payment and therefore subject to Recovery Audit or not. It is the department's understanding that there was no specific timeframe in which the Attorney General's opinion would be issued.

Lastly, the Department of Revenue agrees with the agency specific comment on page 73 of the report that with the COFRS Modernization a "smart" invoice numbering sequence should be developed and implemented. The Department of Revenue's Accounting and Financial Services section will review existing processes and implement new procedures to record invoice numbers if applicable.

Sincerely,

John Vecchiarelli
Senior Director Taxation