

EXECUTIVE SUMMARY

Revenue Recovery Auditing Implementation and RFP Considerations

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: June 3, 2011

IBA Report Number: 11-32

Audit Committee Docket Date: June 6, 2011

Item Number: 3

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On May, 2, 2011, the Audit Committee recommended: 1) City Council effect the creation of a robust revenue recovery audit program in the City and include a recovery audit provision in the FY 2012 Budget; 2) the IBA prepare a report on revenue recovery auditing services for the Audit Committee; and 3) the City Council consider directing the IBA to issue an RFP for revenue recovery audit services.

Based on feedback received from City Council Budget Priority Memoranda, the IBA has recommended consideration be given to budgeting \$500,000 in revenue for FY 2012 tied to the implementation of revenue recovery auditing. We made this recommendation acknowledging it is difficult to predict in advance the amount of revenue that might result from these audits. If the Council elects to budget this revenue in FY 2012, it will be important that the identified recovery auditing processes begin as soon as possible.

In her April 29th memorandum to the Audit Committee, the CFO indicated her staff would conduct an audit of the County's court fee revenues in FY 2012. She further indicated that her staff was planning to undertake a combined accounts payable and reverse sales tax audit in June 2012. Given the planned timeframe for these audits, it is unlikely \$500,000 of budgeted recovery auditing revenue can be realized in FY 2012 unless the audit of court fees were to begin early in the fiscal year and identify significant errors in favor of the City.

The IBA has identified and made contact with several outside audit firms providing revenue recovery audit services. Most of these firms specialize in revenue recovery auditing with a focus on accounts payable audits. Based on our conversations with these audit firms, we believe several are qualified to perform revenue recovery auditing for the City and would be interested in responding to an RFP. If directed to prepare an RFP, the IBA will work with City staff to expeditiously select an outside auditor to perform an accounts payable audit; however, it will be imperative that our Office have support from key City staff if the resulting audit is to be successful.

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OVERVIEW

On May 2, 2011, the Audit Committee received a report from the Office of the City Attorney regarding actions the City Council could take to ensure revenue recovery auditing was included in the FY 2012 Budget. In response to the report, the Audit Committee recommended: 1) City Council effect the creation of a robust revenue recovery audit program in the City and include a recovery audit provision in the FY 2012 Budget; 2) the IBA prepare a report on revenue recovery auditing services for the Audit Committee; and 3) the City Council consider directing the IBA to issue an RFP for revenue recovery audit services.

In addition to the above referenced report from the Office of the City Attorney, the Audit Committee has received two reports in 2011 from the Office of the City Auditor suggesting significant revenue recovery auditing opportunities may exist in the areas of accounts payable, reverse sales tax and municipal court revenues. On April 29, 2011, the CFO provided the Audit Committee with a memorandum acknowledging revenue recovery audits have merit and stating that her staff would be evaluating and pursuing or performing revenue recovery audits in FY 2012 in the areas identified by the City Auditor. The CFO indicated that she did not plan to begin a combined accounts payable and reverse sales tax audit until June of 2012.

This report responds to the Audit Committee's request that the IBA prepare a report to assist them in further considering possible implementation of revenue recovery auditing services in FY 2012. In particular, the report provides feedback from private sector providers of accounts payable revenue recovery audits regarding how service is provided, compensation arrangements and what to expect. Additionally, we discuss the timeframe required for a RFP and raise other considerations related to revenue recovery audits.

FISCAL/POLICY DISCUSSION

In response to the Audit Committee's direction, the IBA has identified and made contact with several outside audit firms providing revenue recovery audit services. Most of these firms specialize in revenue recovery auditing with a focus on accounts payable audits. Based on conversations with these audit firms, we believe several are qualified to perform revenue recovery auditing for the City and would be interested in responding to a City RFP.

Why Engage an Outside Firm to Audit Accounts Payable?

There are two primary reasons to pursue recovery revenue auditing:

1. To discover and recover overpayments from duplicative payments, wrong vendor payments, payments for services not rendered, and to identify unutilized cash discounts and/or payment credits from vendors; and
2. To utilize information and feedback received from the outside auditor to improve internal controls and other practices related to City payment processes. These improvements result in a reduction in payment errors and increased revenue going forward.

Revenue recovery audit firms indicate that accounts payable audits yield recoveries equal to approximately 1/10th of 1% of an organization's expenditures. For example, if the City had \$500 million of non-payroll expenditures in a fiscal year, it would be reasonable to estimate recoveries of approximately \$500,000 attributable to an accounts payable audit for that year.

Accounts payable audits are recommended, and typically result in larger recoveries, when an organization has recently undergone a change in their financial payment systems. The City falls into this category having recently migrated from the old legacy financial system to the new SAP Finance and Logistics Module. The new Financial and Logistics Module of SAP which handles the accounts payable function went live in July 2009.

How Accounts Payable Audits Performed by Outside Auditors Typically Work

Once an outside audit firm has been selected, it is typical to have a pre-audit planning meeting involving the key participants who will perform and support the audit process. The City would probably be asked to identify and assign representatives from the Information Technology, Comptroller and Purchasing & Contracting departments. If the audit process is to be successful, it is imperative that there be a coordinated and collaborative partnership between the outside auditors and key City staff. The IBA was informed that accounts payable audit processes should not require an inordinate amount of City staff time.

Once the scope and nature of the audit has been clearly defined, the City would transmit vendor data to the outside auditor. This data would typically include the vendor master file, payments file and invoice file. Steps are taken to ensure secure transmission of data. The contract with the auditor requires that vendor data be handled confidentially. Revenue recovery audit firms typically have specialized SAP compatible software to facilitate the transmission of data. The auditor then uses analytical software to evaluate vendor and payment data for overpayments and missed credits.

Once City vendor and payment data has been evaluated, the outside auditor may request additional information from the City (contract provisions, payment circumstances, etc.) before courteously communicating directly with the vendor on the City's behalf. Data that flags for further evaluation may either be cleared following communication with the City/vendor or result in a recovery. If the scope of work is properly defined, the outside auditor only reports overpayments when there is a very high degree of certainty. If the auditor relationship is structured this way, the City does not bear the burden of further researching payment issues with the vendor once notification of recovery is received from the auditor.

Some audit firms will help their clients develop "self-audit" capabilities by evaluating payment data and providing the client with exception reporting. This allows the client to validate possible errors and directly investigate and/or recover overpayments from vendors.

Outside Auditor Compensation

Compensation for revenue recovery audit services is most often structured to be a percentage of the resulting revenue recoveries. Depending on the term and structure of the audit engagement, the outside auditor typically receives between 20% and 30% of each recovery depending on the cumulative recovery for the client.

The compensation arrangement can be tiered so that City share percentages increase once certain recovery thresholds are reached. Single line item recovery percentage caps for the auditor can also be negotiated for unexpectedly large recoveries attributable to a single error. When compensation is contingent upon actual recoveries, the revenue recovery auditor has incentive and the City incurs no expense for accounts payable audit services beyond the staff time required to support the audit.

Alternatively, compensation can be structured on an hourly or fixed price basis with certain outside auditors if requested by the City. One audit firm provides data evaluation services for a fixed monthly or quarterly subscription rate. This firm has offered to provide a "proof of concept" trial run at no charge; however, the scope of work for the trial run is limited. A similar trial run performed for the city of Phoenix did not identify any significant overpayments.

RFP Development and Associated Time Requirements

In discussing what outside auditors like to see in a RFP for accounts payable auditing services, the following items were mentioned:

- Description of the anticipated scope of work including the number of years to be reviewed/audited and when the last accounts payable audit was performed.
- Will all vendor/payment data be available to audit or will there be exclusions.
- What type of financial information system the City uses;
- Approximate number and dollar amount of annual City payments.
- If the City can provide electronic access to supporting documents (i.e., contracts).

The Purchasing & Contracting department recommends approximately four to six months be allotted to complete a RFP process. This allows for RFP development, proposal solicitation, proposal evaluation and contract approval. If the City Council were to direct the IBA to

develop a RFP for revenue recovery audit services, the Purchasing & Contracting Director has suggested it may be possible to shorten the timeframe to approximately three months.

Other Considerations

- It is recommended that accounts payable audits not go back more than three years as the likelihood of recoveries and associated cost/benefit declines significantly.
- In addition to increased revenue and improved internal controls, accounts payable audits can also result in enhanced data reporting capabilities, improved contract structuring and identification of fraudulent activity.
- In selecting an outside auditor and structuring the scope of work, it is important to discuss how the City would like to handle vendor interactions, to specify what constitutes a recovery, and to identify key City staff for the auditor to contact in the course of performing the audit.
- There are other forms of revenue recovery audits the City may wish consider going forward. For example, *contract compliance audits* ensure the City is taking advantage of all contract provisions - these audits tend to be more complex and require more time; however, the returns are typically higher than accounts payable audits. A *utility bill audit* is another example. These and other recovery audits could be performed internally by staff or by utilizing outside auditors with specialized expertise.

CONCLUSION

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[SIGNED]

Jeff Kawar
Fiscal & Policy Analyst

[SIGNED]

APPROVED: Andrea Tevlin
Independent Budget Analyst