

# CHAPTER 1

## Benefits of Recovery Services

### U.S. General Accounting Office Report<sup>1</sup> “Recommends” Recovery Auditing

Like many private sector business leaders, circumstances in 1996 dictated that the Secretary of Defense evaluate the possibility of using a recovery audit firm to uncover overpayments made by the Department of Defense (DOD) to their vendors. When the final results were in, the United States General Accounting Office (GAO) issued its assessment of the completed process. The results were instructive. (For the full report from the GAO, please visit <http://gao.gov/archive/1999/ns99012.pdf>.)

The effort began in September 1996, and the recovery audit covered purchases made during fiscal years 1993 to 1995. In late 1997, Congress authorized expansion of the program, and in an August 1998 memorandum, the DOD Comptroller encouraged DOD agencies “to use recovery auditing as a way to identify and correct payment problems.”

The methods used resulted in the detection of \$19.1 million in overpayments—about the cost of four new M1-A2 Abrams Main Battle Tanks at the time.<sup>2</sup> Efforts to identify additional amounts continue. Of the \$19.1 million in overpayments, \$12.4 million was due to cash discounts not taken or deducted at the wrong rate, \$2.2 million was related to most favored customer terms not received, \$1.3 million was due to duplicate payments, and \$1.2 million related to credits not taken.

The fact that the overpayments were made four to six years before the audit recovery began made overpayment identification or recovery challenging. This was yet another example of “get it early or it’s gone,” which is word to the wise for anyone looking to recover lost profits. Another hurdle encountered by the recovery firm was when it realized that the DOD payment system did not retain all of the information needed for analysis. In some instances, the firm found that it had to manually sort through records.

So another lesson for the private sector is to make sure your computer system stores all necessary and critical information.

In addition to identifying overpayments, the recovery firm also recommended methods outside the scope of its contract to reduce future overpayments. This is not unusual and another reason why recovery audits pay off. The DOD concurred with the recommendations made by the recovery firm and then worked to implement them to reduce and eliminate future overpayments.

While the GAO report did not suggest any definitions, what follows are two key concepts that will be defined here for future reference in this publication:

- *Cost recovery.* Cost savings that are either retrospective or prospective in nature and result from the detection of internal or external errors and fraud; industry benchmarking; previously unknown tax advantages; contractual analysis; and contractual or price sheet compliance.
- *Recovery audit.* The methodical process of reviewing disbursement transactions and related supporting data to identify various opportunities for cost recovery and that often suggest new process improvements and technology to ensure such cost recoveries are minimized or eliminated in the future.

## Top Benefits of Cost Recovery

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The aforementioned GAO report was an extensive analysis of a cost recovery engagement and from it some simple truths can be inferred. In its essence, the service found cash that the DOD never knew it was missing and it obtained process improvements to ensure that such cash is never overpaid again.

These two simple truths are explored further here:

- *Every process flow has a margin of error.* In a process flow of \$100 million, a 0.1 percent margin of error (that is, 0.001) translates into \$100,000 in recoveries. This statistic is used frequently for accounts payable audits, and while never fully validated, it is a reasonable starting point. Essentially, the process flow in this example is 99.9 percent accurate. Other recovery services find much more in percentage form but may look at a smaller area of spend, such as the advertising expense of a company.
- *Incur costs only after getting paid.* Companies generally will only pay a recovery firm if the company deposits cash into their bank account as a recovery. The practice is so productive, and the effect on the bottom line so substantial, that many corporations hire more than one recovery

auditing firm to analyze the same data. That is in addition to companies' own auditors, who usually find the most obvious errors. Recovered overpayments are *found money* and add directly to a company's bottom line, except for the percentage paid to the recovery auditor.

- *Measure the need for improvements.* Rather than identifying vague concerns within a business process, a recovery audit finds quantified cash leakages within the process. These are deposited at the company's bank. Then, depending on their materiality, allow the company's management to assess whether it will work to improve its operations. Some companies never improve their operations and view recovery audits as a safety net that will collect the error rate in the process. This approach is more detective in nature but is a valid approach, especially if the error rate at the company is found to be relatively low.
- *Provide the company an opportunity to learn from outsiders as to industry best practices.* Such best practices come in the areas of process, technology, and people skills based on the auditors' experience in various other similar companies. Systems (and the demands made on them) are growing as payment departments are shrinking. Companies merge, change systems, outsource, and have employee turnover. All of these scenarios contribute to potential lost profits and, therefore, best practices are needed just to keep pace with the rate of change. When best practices are applied to processes, any benefits received can be for current procured activity but can also apply to future activity and, hence, future savings.
- *Improve Sarbanes-Oxley compliance.* As discussed in more depth later in this chapter, another more recent motivation for conducting a recovery audit is to help comply with Sarbanes-Oxley. A recovery audit covers much of the same ground a CFO must cover to ensure the integrity of a business, from process controls to contract compliance to payment checks and balances. An asset recovery audit firm will normally provide detailed reports on the financial health and well-being of your payments process and contract compliance. You may think of a recovery audit as an extension of your existing audit strategy. In all likelihood, however, the return on your recovery audit investment will exceed that of other similar pursuits.
- *Add free resources to the audit team.* Audit teams can be supplemented by additional staff of recovery auditors who are paid only if they add to the company's bottom line. It is almost a best-case scenario for hiring employees, and recovery firms are more than willing to oblige.
- *Add profits by not increasing sales.* Most companies work under the model that if they can just increase sales, their net profits will increase. As an alternative to increasing sales, however, recovery audits have distinct benefits, since recovering \$1 million to the pretax bottom line can equate

to \$10 million in sales at a company. Nonsales departments are engaged and increases in fixed overhead and working capital required for more sales are avoided. Lastly, it is not uncommon in some businesses that the more they increase sales, the more they lose money. While it sounds impossible, some companies will sign up for sales price arrangements whereby every additional unit costs them more than they can sell it for and, hence, they lose more for every unit. Recovering costs will never have this effect.

- *Create an air of transparency between your company and your vendors.* The recovery auditor may find nothing. But even then, the company still knows more definitively that there are not any cash leakages being held by vendors.
- *Get it before it disappears.* As profit recoveries are time sensitive, the longer an organization waits, the more difficult it is to identify, validate, and retrieve them. A no-risk contingency-based audit is the most cost- and time-effective way to recoup your lost dollars. Lastly, there is no downside with contingency engagements as, say, \$0.70 after recovery fees for every \$1 recovered a company never knew it had is better than nothing.

Recovery to most companies is a no-brainer decision. While all audit areas may not be material enough to make a review fruitful, even the smallest of spend could benefit from applied recovery audit techniques.

### Top Reasons for Recovery

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At this time, it may be useful to see how such recoveries are found so that the potential can be visualized. There are five broad activities that can be considered under the heading of recovery auditing.

- *Internal error and fraud.* These are recoveries that are due to an internal mistake in processing a payment or an employee who has a conflict of interest with a vendor.
- *External error and fraud.* Such recoveries are due to vendor mistakes or an attempt to defraud an organization, which may take the form of purposefully sent duplicate invoices.
- *Industry benchmarking and tax advantages.* Experts who understand the marketplace or the tax code can apply this knowledge to organizations that were previously ignorant of such information. With this new information, they can make better business decisions, which can lead to previous and future savings.

- *Contractual analysis.* Similar to industry benchmarking, contracts can be reviewed by experts to assess any unfair provisions that, when modified, lead to a more profitable agreement with the vendor.
- *Contractual and price sheet compliance.* Writing the best contract in the world does no one any good unless it is followed and vendors are held to key provisions. By reviewing these contracts and making sure vendors are living by them, companies can recover lost funds. The company can also do a self-audit of its organization by making sure it is using preferred pricing when available. For example, many companies will sign group purchasing contracts with office supply vendors and then never buy under those contracts because it is easier to simply walk down to the local supply store. This internal compliance can also be monitored by recovery firms to everyone's benefit.

### Recovery Estimates—Embrace the Uncertainty

For a number of reasons, some laudable and some not, modern corporations seek to eliminate uncertainty before making even the smallest commitment. For this reason, nearly every recovery audit being considered faces questions about its likely outcome. Unfortunately, many promising audits are never pursued because it is too difficult to estimate recovery levels for most specific recovery areas. This is due to the following reasons, although this list is not extensive nor is it in any particular order:

- Willingness of the company to support the recovery firm
- Company's changes in technology
- Company's staff experience and knowledge
- Extensiveness of the audit
- Volume of transactions
- Value of transactions
- Vendor(s) selected for the area of spend under review

Many accounts payable audit firms have quoted a 0.1 percent recovery rate. While this sounds reasonable, there is generally no basis for the number, and the types of recoveries found can vary widely between companies. Some accounts payable audits may find duplicate payments while others detect pricing discrepancies, so it is difficult to assess the level of potential recovery. Some audits can have recovery rates that exceed 40 percent of the client spend, although this is in an extreme case.

Given the difficulty in estimating recovery, some firms will analyze the client situation to assess potential which may be by:

- Reviewing building leases
- Running duplicate payment reports to see how many exist in the client files
- Reviewing advertising agency contracts
- Running health care medical claim payment data to understand the nature, types of procedures, and providers with high spend

Suffice to say, some standards have developed over time, yet it is too difficult to predict the expected savings at a company. This should never be a concern as *any* recoveries found, regardless of the size, puts companies in a better position than before starting the audit.

### When Recovery Becomes Fraud<sup>3</sup>

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Recovery audits routinely uncover instances of accidental double billings, overpayments, and missed discounts. But at what point does a simple mistake become a crime? Here, we'll examine several examples, taken from recovery audits, which at first glance weren't blatant but were actual fraud. These are fictional accounts, but the frauds are all too real, as are the losses suffered by the victims of these "victimless" crimes.

#### Kickback Fraud

This crime, one of the most prevalent forms of fraud, can be one of the most difficult to detect without a recovery audit—and an observant auditor—because there's no audit trail *within the company* that highlights the fraud (or so the fraudster thinks).

For instance, while doing a procurement analysis, an observant recovery auditor noticed that the unit price of toner cartridges was 25 percent higher than it should have been. How did he discover the fraud? He first ran a data analysis report using the purchase order data tables and looked across all purchases to identify unusual increasing trends. He calculated the first increasing trend, based on unit price, using a Pivot Table in Microsoft Excel. (He could also have done it in Microsoft Access as a crosstab query.) The rows in the Pivot Table represented the products, the columns represented the purchase date from each individual purchase order, and the data section was simply a Sum of the unit price field. Because there was only one purchase on each date, this led to only one unit price being listed for each product number and date in the Pivot Table.

The auditor looked across the report and easily saw a marked price increase in toner cartridges over a three-month period even without a graph. (The graph is available by selecting the Pivot Chart button from the Pivot

Table toolbar in Excel once a Pivot Table is created.) The auditor then took a different perspective and changed the Pivot Table to Sum—the Quantity Purchased instead of the Unit Price, which also showed increasing purchases of the toner cartridges during the same three-month period.

Armed with this information, the auditor requested that the toner be re-bid with the vendor in question and two others, which ultimately identified a marked difference in pricing. A 25 percent variance in price doesn't necessarily indicate fraud. But coupled with the new, much lower bid price and the volume of cartridges being purchased, the recovery auditor became convinced there was something amiss. Now acting as a fraud examiner, he confronted the purchasing manager who admitted to receiving a large part of the purchase price back from the vendor as a kickback.

### **“Oops, I Did It Again” Fraud**

Sometimes this fraud starts out as a crime of opportunity. Here's a good example: A vendor delivers 500 cases of meat to a grocery warehouse but neglects to bill for it. The grocery warehouse, which didn't report the error to the shipper, didn't intend to commit a crime, but it broke the law regardless. Here's another variation: A grocery warehouse mistakenly pays a vendor twice for the same invoice and the vendor doesn't say anything.

A suspicious fraud examiner can find this fraud by:

- Extracting all invoice receipts that don't have corresponding accounts payable invoices for such product receipts
- Summarizing invoice receipts and accounts payable invoices by vendor to identify any under- or overpayment trends
- Identifying duplicate accounts payable invoices based on vendor number, invoice number, or amount
- Extracting all open (no payment date) negative values within the accounts payable system

### **“Show Me the Money” Fraud**

Company A repeatedly calls Company B to complain that it hasn't been paid for an invoice. But Company A knows it's been paid and is trying to force a duplicate payment through Company B's accounting system. Company A even adds a “-1” to the original invoice number in an effort to have a similar invoice number but yet still be different.

This can be a relatively easy fraud to perpetrate, especially at a large company with multiple locations and accounting systems that don't talk to one another. If the caller is particularly irate, Company B will often pay the second fraudulent invoice just to get rid of them.

A recovery auditor, looking for duplicate payments, would've seen that Company B had been making a large number of payments to Company A. A simple report testing for duplicates on vendor number, invoice number, and amount wouldn't work because the "-1" added to the invoice isn't an exact match on invoice number. However, the auditor could detect the questionable activities by running a test that recognizes the first three digits of the invoice number field as a duplicate match field and another that shows duplicate vendors and amounts.

### **"Use It or Lose It" Fraud**

Companies frequently prepay advertising agencies for projects from planned budgets. As the project progresses, the agency should produce receipts that itemize the use of the budgeted funds. When the agency completes the project, the agency should return unused funds to the client company but it sometimes doesn't. After six months or so—enough time for the client to possibly forget about the money—the agency converts the cash into income and the cycle is complete. If the client subsequently asks about the money, the agency denies the existence of a credit balance.

A recovery auditor would need to understand the client's accounting system well enough to obtain the data files to match actual vendor payments and payroll charges made by the agency for the project against the original prepayments made by the company. Any differences would be the missing credits; the recovery auditor would simply ask for payment support, which the agency wouldn't be able to produce.

### **Health Care Eligibility Fraud**

Frequently, an employee doesn't tell the employer that her dependent has exceeded the maximum age for health care coverage, or the employee doesn't report that the dependent has married and so the coverage remains the same (when the dependent should be removed from the plan). Even more devious employees add ineligible dependents to their coverage.

The recovery auditor can detect this fraud by:

- Matching the roster of employees against a list of employees receiving health benefits
- Extracting dependents with birth dates that exceed plan guidelines for normal coverage
- Summarizing by employee the number of dependents to assess if the number exceeds the average number of dependents for the entire health plan

Also, based on these reports, the auditor can extract a sample of employees to request dependent documentation for review against the plan.

These frauds and case studies illustrate how susceptible companies can be to a variety of frauds and scams. Some are crimes of opportunity and others are more organized and systematic in nature. A thorough recovery audit can not only discover these frauds but also return the cash to the proper owner or, at least, stop the bleeding.

## **Sarbanes-Oxley Implications<sup>4</sup>**

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### **Introduction**

A host of financial disasters, most notably the Enron debacle, led to an uproar in the capital marketplace, as well as affecting the thousands of people working for the affected organizations. The investing public responded with one of the most volatile stock markets in history. A few corporations had tested the level of grayness in their application of generally accepted accounting principles to a point many would say was a downright cooking of the books.

The world's capital markets depend on trust between:

- Shareholders or financial institutions and corporations' financial reporting
- Managers
- Corporate reporting

This trust leads to efficiency and, thus, reduced costs to all parties. For example, improved trust between financial institutions and corporations leads to improved debt ratings and, thus, lower interest rates on debt. Improved trust in business process controls leads to improved trust between an auditor and a corporation relating to their control consciousness and thus will lead to a less costly Sarbanes-Oxley attestation.

### **Transparent Reporting<sup>5</sup>**

The first step in rebuilding trust is to enhance transparent reporting. This can be readily seen as companies provide segment information, sustainability reporting, and improved notes to make financial statements easier to understand. Some companies are going beyond regulatory requirements to provide the investor an improved picture, such as through detailing forward-looking information. The desire to hold this transparency has many motives.

- *Market expectations.* Companies in danger of not meeting analyst expectations.
- *Increase shareholder value.* Companies that display a move toward transparency have been known to attract increased marketplace value.
- *Contractual.* To comply with outside contractual requirements, such as a debt covenant on a loan.
- *Regulatory.* Companies needing to give an appearance to regulators so as to influence their actions such as lowering earnings to feign an antitrust lawsuit.
- *Clean house.* When there is a new incoming management team, there is a tendency to write off questionable balances and blame the previous regime. Not only does it allow for improved reporting in future periods, no blame is placed on the management at hand.
- *Doing the right thing.* Aside from these business-focused motives, some companies just want to make sure they are doing all they can to present an honest and open picture of their current status.

### Sarbanes-Oxley Act<sup>6</sup>

On July 30, 2002, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002 (Accounting Industry Reform Act). The law of sweeping changes creates an oversight board to monitor the accounting industry, toughens penalties against executives who commit corporate fraud, and increases the Securities and Exchange Commission (SEC) budget for auditors and investigators. The law is also intended to restore investor confidence in U.S. markets. This was a landmark event, representing the most dramatic changes in federal securities laws since the 1930s.

Sections one and two of the Act (see [soxlaw.com](http://www.pcaob.com) for a full list of sections) made dramatic changes to the accounting industry and created the Public Company Accounting Oversight Board (PCAOB) to provide industry oversight. According to its Web site, "The PCAOB is a private-sector non-profit corporation whose job is to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports." It has the authority to set and enforce auditing, attestation, quality control, and ethics standards (including independence) for auditors of public companies. It also is empowered to inspect the auditing operations of public accounting firms that audit public companies as well as impose disciplinary and remedial sanctions for violations of the board's rules, securities laws, and professional auditing and accounting standards. The board held its first public meeting in January 2003. Its staff was filled to its full capacity, and the board had a \$104 million annual budget as of fiscal year 2004.

Sections three and four of the Act focused mainly on company management, their responsibilities relative to financial statements, and prohibited activities in relation to the company. Two of the most profound sections of the Act are 302 and 404, which are further discussed in the below section. Another key section included section nine, which focused on increased penalties for white-collar crimes. In particular was section 906, which states that the CFO and CEO can be fined up to \$5,000,000 and imprisoned for up to 20 years for willfully certifying false financial conditions and results of operations.

### Sections 302 and 404<sup>7</sup>

Financial statement certification requirements have been the focal point of the Sarbanes-Oxley Act, which relate primarily to representations regarding the fair presentation of financial statements and the effectiveness of disclosure controls and procedures. Sections 302 (focused on the certification) and 906 (focused on the penalties) lay a foundation for restoring investor confidence. Section 404 builds on that foundation by requiring management to file an internal control report with its annual report (SEC filing 10-K) articulating management's responsibilities to establish and maintain adequate internal controls over financial reporting and management's conclusions on the effectiveness of these internal controls at year-end. The report must also be attested to by the company's external auditor through a written report.

### Focus on Internal Controls

As a reaction to the disasters, the definition of internal control resulted in great fanfare as the companies benchmarked themselves against the Committee of Sponsoring Organizations' (COSO) definition of internal control more stringently than ever before. With this noted, *internal control* is broadly defined by COSO as<sup>8</sup>

*a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:*

- *Effectiveness and efficiency of operations*
- *Reliability of financial reporting*
- *Compliance with applicable laws and regulations*

Internal controls in the payments cycle can be seen as a collection of prevention and detection controls that are either key or act in a compensating fashion to mitigate risks. In Exhibit 1.1, sample controls can be seen along the life cycle of a supplier payment whereby all prevention

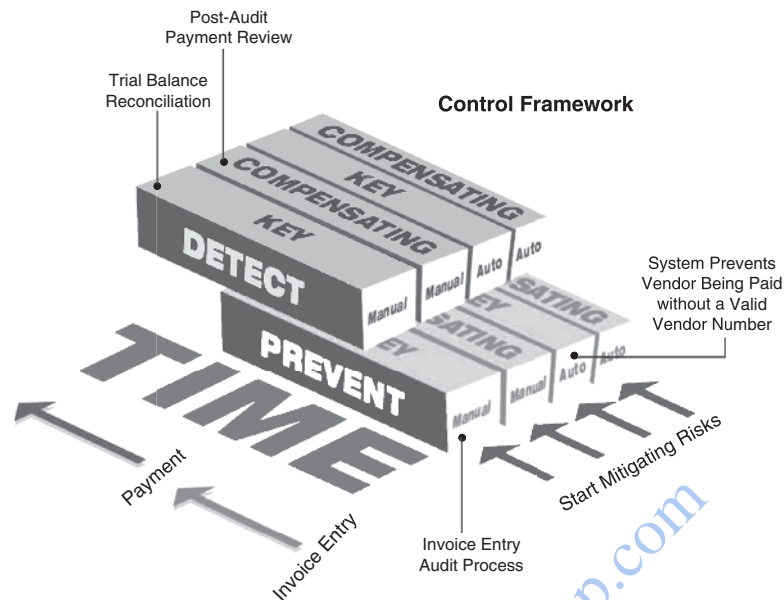


EXHIBIT 1.1 Overview of Controls

controls occur as the invoice is entered into the system but not paid and then all detection controls occur after payment is made to the supplier. The post-audit payment review in this graphic is a compensating control after payment is made to a supplier and also a key part of internal controls. It works to meet all of the category objectives listed in the definition and is a free way (assuming the work is done on a contingency fee basis) to control supplier payment activity.

### How Do Recovery Audits Align to Sarbanes-Oxley?

In simple terms, Sarbanes-Oxley is aimed at ensuring accurate financial reporting. Recovery auditing also works toward that end, although this reality may not be readily apparent. Aside from the cash savings that a recovery audit produces (which may be the only factor on company managements' minds), recovery audits also detect hidden assets that are sitting on the books of vendors, which usually leads to overstated expenses on the company's books. As noted in the previous section of this chapter, recovery audits also inadvertently detect fraud.

One may ask why recovery audits can detect inaccurate financial reporting and fraud. The key reason is that the recovery auditor is incentivized

to go deeper into the companies' books to identify savings. External audit firms that bill by the hour simply can't get down to the same levels of detail as a cost recovery firm and keep their audits cost beneficial. Hence, in an accounts payable process flow, the firm may look at a sample of 30 items for internal control weaknesses. In turn, the recovery auditor would probably look at more than 3,000 sample items in a typical audit. The recovery auditor will also use data analysis technology (discussed later in this book) that can essentially audit 100 percent of the population.

External audit firms frequently assert that the findings from a recovery audit are too small to be material to a financial investor making a decision about the organization. Granted, recovery efforts should only be applied to material dollar spend at the company for it to have more Sarbanes-Oxley relevance. Yet at almost every company, the total accounts payable spend, advertising spend, and health care expenses are material financial events. By way of an example, small recoveries can add up to a material issue. In one accounts payable processing flow, a recovery audit detected collusion between the controller and CFO. The two were making payments to a bogus entity they created and then splitting the profits for all payments. Rather than writing million-dollar payments to the entity, they stayed within their approval limits (\$3,500 and \$5,000). They were also very astute financial accountants who knew not to make the amounts round dollars, had varied invoice numbers, and had very professional-looking invoices. They were able to process over 800 of these checks to amount to almost \$3 million. In addition to this now being a material fraud, this would generally not be detected unless a recovery auditor was getting down to this level of immaterial transactions in the organization. Furthermore, even if one of these transactions occurred, fraud being committed by such high-level personnel in the company is material in itself, as who knows what else they are up to if they are paying themselves through phony vendors.

In summary, recovery audits provide a means for a company to go deeper into financial transactions that would otherwise be considered immaterial so that they can find cash savings and financial misstatements or fraud. Also, recovery auditors are very experienced in the areas they review and can provide the organization with insights into best practices not previously considered that strengthen the internal business processes.

## Notes

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1. General Accounting Office, Contract Management: Recovery Auditing Offers Potential to Identify Overpayments—Document GAO/NSIAD-99-12 (Washington, D.C.: GAO, 1998).
2. GlobalSecurity.org, "Lima Army Tank Plant (LATP)," available at [globalsecurity.org/military/facility/lima.htm](http://globalsecurity.org/military/facility/lima.htm).

3. Richard B. Lanza, "When Recovery Reveals Fraud," *Fraud Magazine*, Association of Certified Fraud Examiners, Austin, Tex., January/February 2008.
4. Steven C. Rollins and Richard B. Lanza, *Essential Project Investment Governance and Reporting: Preventing Project Fraud and Ensuring Sarbanes-Oxley Compliance* (Fort Lauderdale, Fla.: J. Ross Publishing, 2005).
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6. Ibid.
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8. American Institute of Certified Public Accountants, *Internal Control—Integrated Framework*, (Jersey City, N.J.: Committee of Sponsoring Organizations of the Treadway Commission, 1992)6.

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