

AGENCIES OF THE SECRETARY OF FINANCE

**REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2012**

APA

**Auditor of
Public Accounts**

COMMONWEALTH OF VIRGINIA

Audit Summary

This report summarizes our fiscal year 2012 audit results for the five agencies under the Secretary of Finance and arises from our work on the Comprehensive Annual Financial Report.

Audit Results

Overall our audit for the year ended June 30, 2012, found the following:

- Proper recording and reporting of transactions, in all material respects, in the Commonwealth Accounting and Reporting System and in the agencies' accounting systems.
- Matters requiring management's attention that are included in the section entitled "Comments to Management."
- Adequate corrective action with respect to audit findings reported in the prior year that are not repeated in this report.

System Modernization Projects

This report includes a status of the Commonwealth's efforts to modernize its accounting and budgeting systems in the section entitled "Comments to Management."

- The Commonwealth implemented Phase 1 of the Cardinal System project in December 2011 with the implementation of the Department of Transportation's financial system. Phase two of the implementation occurred in October of 2012 with the Department of Accounts implementing the base modules of Cardinal. Phase three, which involves an incremental rollout to all state agencies, will occur over the next two years with Cardinal becoming the official system of record beginning in fiscal year 2016.
- The Commonwealth has implemented the Performance Budgeting System and while the system is still undergoing some minor enhancements, the system entered the project close out phase in September 2012.
- The Commonwealth has developed a funding methodology to support system maintenance and operation costs for both systems, and in October 2012, the Joint Legislative Audit and Review Commission approved the rates.

Upcoming Pension Accounting Changes

This report includes a summary of the impact of new pension accounting and reporting standards on the Commonwealth in the section entitled "Comments to Management." These new standards will increase the amount of pension liability and expenses the Commonwealth and its localities report in their financial statements.

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Comments to Management

Status of System Development Projects and Other Modernization Efforts

Status of System Development Projects

Applicable to: Secretary of Finance, Secretary of Transportation, Department of Accounts, Department of Planning and Budget, Virginia Information Technologies Agency, and Virginia Department of Transportation

Cardinal System

The Commonwealth has continued to make progress on its Cardinal system, which will replace the Commonwealth's financial system (CARS) with a modern, enterprise-wide financial system (base financial system). Due to their age and lack of integration, the Commonwealth's current systems either do not contain the information, or cannot easily exchange information, to support current state and federal initiatives related to government transparency and timelier financial reporting.

This is a key project for the Commonwealth since the current accounting systems are outdated both in terms of the technology and available functionality.

Cardinal's first implementation phase occurred in December 2011 with the implementation of Transportation's financial system. Phase two of the implementation occurred in October of 2012 with the Department of Accounts (Accounts) implementing the base modules of Cardinal. The base modules consist of general ledger, accounts payable, and a portion of the accounts receivable module. Phase three, which involves an incremental roll out of the base modules to all state agencies, will occur over the next two years with Cardinal becoming the official system of record for the Commonwealth beginning in fiscal year 2016. The base modules will provide the foundation for a modern financial system for the Commonwealth with the ability to add other modules and expand functionality in future phases. The project team is already preparing for these future phases, and the Commonwealth is currently in the process of procuring a vendor to perform a study to determine whether to purchase a separate procurement system or integrate its existing system with Cardinal.

The project development and implementation budget is \$58 million for phases one and two and is funded by Transportation and a working capital advance of approximately \$7.3 million. As of November 2012, project expenses totaled approximately \$54 million. The project development and implementation budget is \$57 million for phase three and will be funded by a working capital advance. Transportation is funding all operating costs through fiscal year 2013. Charges to agencies in the form of an internal service fund rate will fund operating costs and repayment of the working capital advance starting in fiscal year 2014. A detailed description of the internal service fund rate is described later in the section titled, "*Enterprise Applications Internal Service Fund.*"

In September 2012, the State Comptroller certified to the Auditor of Public Accounts his compliance with Item 260B.2. of Chapter 3, 2012 Special Session I Acts of Assembly, which

required that prior to accessing the working capital advance to fund the statewide roll-out of Cardinal, the State Comptroller should certify that standards for vendor accounting information have been developed, incorporated into the design of Cardinal, and Cardinal and other agency and institutions' financial systems have internal controls procedures incorporating industry best practices for a standard vendor database to minimize improper payments to vendors.

As part of Cardinal's development and implementation process, the Departments of Accounts, Transportation, and General Services and the Virginia Information Technologies Agency (VITA) worked together to develop and incorporate vendor data standards. In January 2013, the Cardinal project team adopted chart of account data standards, which incorporate the existing CARS chart of accounts. The team will review and modify the chart of accounts data standards once phase three is implemented and all state agencies are using Cardinal.

Performance Budgeting System

Planning and Budget and the Enterprise Applications Division at VITA have implemented the Performance Budgeting System. This system addresses several functional areas including budget development (operating and capital), six-year financial planning, budget execution, and strategic planning. While the system is still undergoing some minor enhancements, the system entered the project close out phase in September 2012.

Funding for this \$14.2 million project comes from a working capital advance administered by VITA. The Appropriation Act directs the repayments of the advance from enhanced collections, cost recoveries, inter-agency collaborative projects, and other initiatives. No repayment from these sources has occurred to date.

Enterprise Applications Internal Service Fund

Item 260 of Chapter 3, 2012 Special Session I Acts of Assembly, provides the authority for a new internal service fund that Accounts will manage and authorizes the Secretary of Finance to establish a fee charged to agencies to support enterprise system administration.

The rate for the Cardinal system will be \$1.05 per transaction for agencies. Transportation is using additional modules not being used by any other agency and therefore will be charged a separate additional rate of 36.2% of budgeted annual operating costs of the system. The rate will be collected through quarterly payments beginning in fiscal year 2014. Fiscal year 2015 and subsequent years' rates will be adjusted based on profit/loss in the fund. Rates will increase in fiscal year 2016 to account for the repayment of the working capital advance.

Accounts developed a funding methodology to support system maintenance and operation costs for both systems, and in October 2012 the Joint Legislative Audit and Review Commission approved the rates.

Rates for the Performance Budgeting system will be based on an agency's appropriations and collected through quarterly payments. The rate will be \$99.24 per one million dollars in

appropriations retroactively effective for fiscal year 2013 and will decrease to \$95.98 per one million dollars in appropriations for fiscal year 2014. The decrease is due to an increase in statewide appropriations. The rate includes the repayment of the working capital advance over a ten year period.

Modernization of Financial Reporting Processes

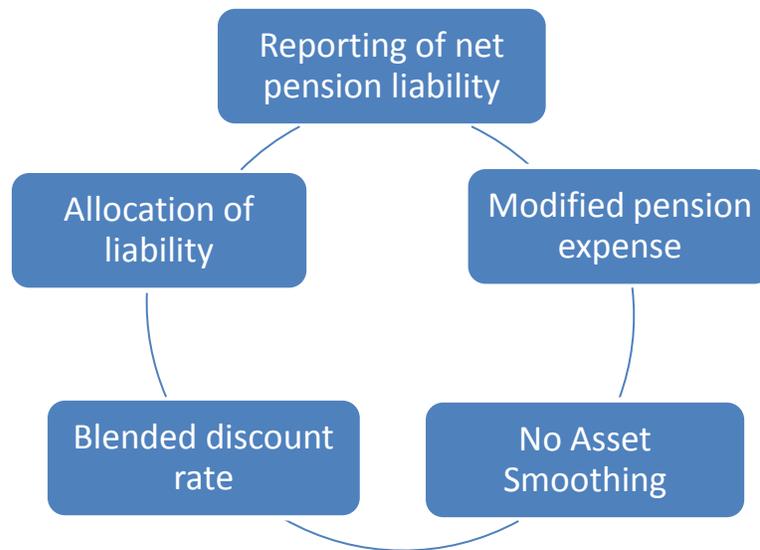
Applicable to: Department of Accounts

As we have previously recommended, while a modern financial system will provide some of the flexibility and technology needed, without changing its current financial reporting processes, due to the changing accounting and regulatory environment and reduced administrative personnel at the agency level, there is the risk of the Commonwealth issuing inaccurate financial reports or not being able to comply with state or federal mandates for more comprehensive and timely reporting. We recognize that it takes time to implement these changes and that Accounts has focused their efforts primarily on the development and implementation of the Cardinal System. However, as the Commonwealth moves closer towards implementing the Cardinal System at the statewide level, we continue to stress the importance of Accounts reexamining the Commonwealth's financial reporting process to identify opportunities for improving their use of technology, communication with agencies, and analysis of financial activity.

Upcoming Pension Accounting Changes

In June 2012, the Governmental Accounting Standards Board (GASB) issued two new standards for accounting and reporting pension activity for state and local governments. GASB Statement No. 67 covers accounting and reporting by pension plans, and GASB Statement No. 68 covers accounting and reporting of pension activity by employers. The Virginia Retirement System must implement Statement No. 67 in fiscal year 2014, while the Commonwealth and its various localities must implement Statement No. 68 in fiscal year 2015.

GASB issued these standards to increase transparency, consistency, and comparability of pension information across state and local governments and to improve the usefulness of the reported pension information for decision making. These standards do not address how governments approach pension funding. Some key changes in the new standards include the following:



The new standards have a conceptual shift in the reporting of liabilities and expenses from a funding approach to an earnings approach. Currently, the Commonwealth only reports a liability to the extent it did not fully fund the annually required contribution as determined by its actuary. Under the new standards, the Commonwealth will report a pension liability as employees earn their benefits by providing services. The Commonwealth is allowed to offset the pension liability by the assets it has accumulated to fund the benefits to arrive at the net pension liability in its financial statements.

The Commonwealth's pension expense under Statement No. 68 will be based on the change in total pension liability from year to year. The Commonwealth will recognize some of the expense immediately and defer part of the expense to later years. Currently, the GASB expense, which is based on the annual required contribution, was also the standard for responsible funding. A new funding model is being developed by various professional associations.

The new standard will result in a large increase in the Commonwealth's net pension liability and expense in its financial statements.

Another new provision of the standard is that governments must report the change in market value of their pension investments immediately. This will increase the volatility of the accounting expense since investment earnings are a factor governments must use in determining the annual pension expense. Under the existing standards, the Virginia Retirement System was allowed to smooth fluctuations in the market value of its investments over a five year period.

If the government has adopted a funding strategy to fully fund the net pension liability, they are allowed to continue to use the long-term expected rate of return during the period that assets are accumulated to reach the fully funded status.

Current standards require a discount rate equal to the long-term expected rate of return on the pension plan's investments. Under the new standards, if the pension plan's investments are not sufficient to cover all of the projected benefit payments, for the portion not covered the Virginia Retirement System will be required to use a blended rate consisting of the long-term expected rate of return and the municipal borrowing rate.

Finally, government employers participating in cost-sharing multiple-employer plans must recognize their proportionate share of the collective amounts for the plan as a whole. Currently, the main impact of this change will be an increase in the net pension liability the Commonwealth's localities report in their financial statements. The Virginia Retirement System has provided information to the localities estimating the extent of this increase.

As a result of this change, the Commonwealth's localities will now be required to report a large net pension liability in their individually published financial statements for teachers covered under the cost-sharing multiple-employer plan administered by the Virginia Retirement System.

Accounts and the Virginia Retirement System will work together to coordinate the Commonwealth's implementation of these new standards.

Efficiency Finding and Recommendation

Re-examine Financial Recordkeeping and Reporting Process for Authorities and LGIP

Applicable to: Department of Accounts and Department of the Treasury

The Department of the Treasury (Treasury) uses trustee statements, the Commonwealth Accounting and Reporting System (CARS), and other source records to record and track the financial activity and prepare financial reports for the Authorities and LGIP. Staff transfer this information to Excel spreadsheets to review financial transactions and prepare monthly and annual financial reports.

The level and volume of financial activity of the Authorities and LGIP has grown over the years, and this use of Excel spreadsheets to track and record critical information is inefficient, requires excess effort, and is prone to errors due to the complexity of the data and reporting requirements. Further, this method also may lead to difficulties as reporting requirements change and accounting standards require additional data or new reporting formats.

We believe that Treasury should evaluate the need for a comprehensive accounting system for recording and reporting the activity of the Authorities and the LGIP. Treasury should first work with the State Comptroller to include all the activity in the new statewide accounting system Cardinal. If the State Comptroller cannot accommodate the needs of Treasury, the State Comptroller should work with Treasury to select a system that improves the controls and efficiency of Treasury staff and minimizes the interface required for the preparation of information for the Comprehensive Financial Annual Report.

Internal Control and Compliance Findings and Recommendations

Improve Communication Surrounding Financial Reporting Process

Applicable to: Department of Accounts and Department of Taxation

The Departments of Accounts and Taxation need to have a more collaborative process to ensure activity related to Taxation is properly reported in the Commonwealth's financial statements. Over the last several years, we have noted instances where it does not appear that Accounts and Taxation are collaborating to the extent necessary to ensure they fully understand the others' financial reporting processes. This increases the risk that the Commonwealth's financial statements could have material errors.

Taxation and Accounts do communicate with each other as part of the financial reporting process, and we acknowledge the communication that occurred to resolve issues related to the fiscal year 2012 financial statements. Our recommendations are intended to improve the level and nature of communication between the two agencies to create a more proactive and collaborative financial reporting process for activity that is significant to the CAFR.

Both Accounts and Taxation play vital roles in the process used to prepare the Commonwealth's Comprehensive Annual Financial Report (CAFR). Accounts is responsible for accumulating and analyzing financial information from the Commonwealth's agencies and institutions. Taxation provides information to Accounts on material financial activity reported in the CAFR. While each agency has staff that are very knowledgeable about their internal processes and activity, it is important that they are also continuously sharing information to ensure the financial reporting process accurately presents the Commonwealth's financial activity. Over the last few years, we have either proposed adjustments or posed questions concerning financial information that either Taxation provided to Accounts or Accounts reported based on activity in CARS, which resulted in material changes to the CAFR. We believe that strengthening the communication process between Taxation and Accounts could minimize the risk of future misstatements.

As part of strengthening this process, Taxation needs to improve their financial reporting procedures. Taxation's accounts receivable reporting procedures adequately document the mechanics of the process but do not adequately address the underlying concepts and methodologies that are critical to understanding their reporting processes. There are also a number of specific assumptions that Accounts and Taxation have agreed to over the years that are not documented in Taxation's procedures. Taxation needs to expand their procedures to address and document some of these underlying methodologies and concepts. In addition, methodology changes and the justification, similar to the ones this year, need to be documented so information is available on decisions and methodology changes, should questions arise in future years.

Accounts also has a responsibility for understanding the methodologies and assumptions for activity that is material to the CAFR. Accounts should review Taxation's procedures to ensure the methodology is sound and it correctly includes assumptions that they have mutually agreed to in the past. Both Taxation and Accounts need to periodically reevaluate these assumptions to ensure they are still valid and relevant.

To minimize the risk of future errors related to Taxation's financial activity, Accounts and Taxation need to work more closely together and have a more collaborative process. We recommend that Taxation and Accounts ensure that they have sufficient documentation surrounding the financial reporting process and have discussed their internal processes with each other. In addition, we recommend they have periodic communications surrounding Taxation's financial activity to discuss the need for modifications to the procedures and/or the manner in which the activity is reported in CARS and in the CAFR. We also recommend that Accounts evaluate whether there are other agencies with material activity and higher risk financial reporting processes for which this type of periodic communication is necessary.

Enhance Controls Over System Access for Critical Systems

Applicable to: Department of Accounts

Accounts should enhance controls over system access to critical systems for Accounts' employees. During our review of access management, we noted areas in need of improvement for the Commonwealth's Payroll system (CIPPS) and the Commonwealth's Accounting System (CARS) including the documentation of policies and procedures surrounding granting access, such as what

type of access is necessary for specific job functions of Accounts' employees and periodic review of employees' access.

Accounts is responsible for granting access to CARS and CIPPS for all of the Commonwealth's agencies. While there are controls in place for granting access to individuals at the various agencies, the controls do not always apply for Accounts' employees who often have much more system access capabilities than the individuals at the various agencies.

Access is granted on an ad-hoc basis depending on what job functions Accounts assigns the employee. There are no documented policies and procedures specific to granting access for Accounts' employees, including what type of access is necessary for specific job functions. This not only makes it more difficult to periodically review access, but also increases the risk of inappropriate access. In addition, CIPPS is an old and complex mainframe system and there is no formal training for those granting access. There is also no clear documentation on what users can do with their access, making it difficult to grant the appropriate access or determine if ongoing access is reasonable.

We noted Accounts' users having access that extends beyond their normal job duties. This was noted for critical functions within the system such as granting security; therefore, these users can modify their own security or add or modify any other user's security. We also noted instances of individuals keeping their access after changing positions, which management indicated was for backup purposes; however, this creates numerous levels of backups. Further, there is no periodic review of Accounts employees' access to CIPPS, and management's internal control testing (ARMICS) does not cover CIPPS security.

Management should develop policies and procedures for granting access for Accounts' employees including a description of the type of access necessary to perform specific job functions. The policies and procedures should be based on the principle of least privilege and address the level of backup needed for critical functions. In addition, management should ensure that individuals granting access have a thorough understanding of what each role allows the user to do within the system. Management should also implement periodic reviews of employees' access to ensure it is appropriate based on the individual's current job duties and in compliance with its policies and procedures. Further, management should incorporate CIPPS security within its ARMICS reviews.

Accounts is currently in the process of implementing a new enterprise system to replace CARS. Modern systems offer more comprehensive access options, which will make it even more important to have comprehensive policies and procedures surrounding granting of access. Therefore, management should also consider these issues when designing and implementing access policies and procedures for the new system.

Create Information Security Review Plan

Applicable to: Department of the Treasury

Treasury does not have a three-year plan that coordinates reviews of information systems containing sensitive information. The Commonwealth's IT Security Audit Standard, SEC502-02.1,

requires agencies to create a plan that considers independent review coverage of all systems containing sensitive data over a three year period.

We recommend that Treasury create a plan per the requirements outlined in the Commonwealth's standard. Treasury should coordinate these review activities across independent parties who are not associated with the process or procedures of particular systems, such as Treasury's Information Security Officer or other qualified party.

Introduction

The Departments of Accounts, Planning and Budget, Taxation, and the Treasury and the Treasury Board report to the Secretary of Finance. The individual audits of these agencies primarily support the audit of the Commonwealth's CAFR for the fiscal year ended June 30, 2012 and this report is intended to report on the results of this work.

Our office also issues several other reports related to activities or agencies under the Secretary of Finance, these include:

- The "Governor's Cabinet Secretaries" report, which was issued in November 2012. This report summarizes activities of the cabinet secretaries, including the Secretary of Finance.
- The "Statewide Analysis of Operating Appropriation Adjustments" Report, which will analyze administrative adjustments processed by Planning and Budget during fiscal year 2012. We expect to issue this report in February 2013.
- The "Statewide Performance Measures" report, which summarizes work on performance measures reported on Virginia Performs website, which Planning and Budget maintains. We expect to issue this report in April 2013.

The following section provides a brief overview of the Secretariat and financial information related to the agencies in this area.

Finance Secretariat Overview

The Secretary of Finance (Secretary) assists the Governor in the management and direction of the finance agencies and performs program coordination, policy planning, and budget formulation activities. To accomplish this, the Secretary oversees the following agencies, which perform critical functions in the Commonwealth's statewide financial management system.



These four agencies work closely together in the budgeting, management, and reporting of the Commonwealth's financial resources. They handle all the financial transactions of the Commonwealth from collecting taxes to paying bills to distributing aid to localities. Their primary responsibilities include:

- forecasting and collecting revenues
- preparing and executing the Commonwealth's budget
- managing the Commonwealth's cash and investments
- selling bonds
- administering the Commonwealth statewide accounting and payroll systems
- overseeing the Commonwealth's financial reporting processes
- making strategic financial plans

These agencies primarily serve other agencies within the Commonwealth in a central support capacity. A more detailed discussion of these activities is included in Appendix A along with the interaction of the agencies within the Finance Secretariat while performing these activities.

The operations of these four agencies are primarily funded with general funds. The following table summarizes the original and final operating budgets, as well as expenses for all finance agencies except the Treasury Board. The Treasury Board's financial activity is not included since its activities consist primarily of the payment of debt service on general obligation debt rather than administrative expenses. In addition, Taxation's financial activity does not include the telecommunication sales tax or the motor fuels tax distributions since these are not administrative expenses.

Summary of Budget and Expenses for Fiscal Year 2012

	Original Budget	Final Budget	Expenses
Secretary of Finance	\$ 420,423	\$ 13,060,578	\$ 13,058,687
Department of Accounts	11,851,424	14,252,529	13,663,787
Department of Planning and Budget	6,869,909	7,772,460	6,543,538
Department of Taxation	97,000,522	102,178,734	93,596,129
Department of the Treasury	18,549,030	18,804,262	17,427,154
Total – Finance Agencies	\$ 134,691,308	\$ 156,068,563	\$ 144,289,295

The budget for the Secretary's office increased due to payments related to the Base Realignment and Closure Commission. The majority of expenses in the Finance Secretariat are for personal services (approximately 57 percent) and contractual services (approximately 26 percent). The following table summarizes the type of expenses each of the Finance Secretariat agencies incurred during fiscal year 2012.

Summary of Expenses by Type for Fiscal Year 2012

	Secretary of Finance	Accounts	Planning and Budget	Taxation	Treasury
Personal services	\$ 479,990	\$ 9,529,431	\$ 4,567,709	\$60,057,987	\$ 8,308,096
Contractual services	7,603	2,159,831	1,651,022	25,430,848	8,023,709
Supplies and materials	830	72,203	8,487	293,194	207,356
Transfer payments	12,564,069	1,026,260	191	149,157	100,404
Continuous charges	6,195	559,181	308,524	5,049,808	735,688
Equipment	0	316,881	7,605	2,615,135	51,901
Total expenses	\$ 13,058,687	\$ 13,663,787	\$ 6,543,538	\$93,596,129	\$17,427,154



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January 31, 2013

The Honorable Robert F. McDonnell
Governor of Virginia

The Honorable John M. O'Bannon, III
Chairman, Joint Legislative Audit
and Review Commission

We have audited the financial records and operations of the agencies under the **Secretary of Finance** for the year ended June 30, 2012. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Audit Objectives

Our primary audit objectives for the audit of the Departments of Accounts, Planning and Budget, Taxation, and the Treasury for the fiscal year ended June 30, 2012, include the following:

- to determine whether management has established and maintained internal controls over the Commonwealth's financial reporting and other central processes and the centralized services provided to agencies and institutions in support of the preparation of the financial statements as indicated in the scope section of this report;
- to determine whether management has established and maintained adequate operating and application system controls over CARS, CIPPS, FAACS, LAS, the Integrated Revenue Management System, the Performance Budgeting System, and other central systems;
- to evaluate the accuracy of financial transactions related to the processing of payroll and leave activity by Accounts' Payroll Service Bureau;
- to evaluate the accuracy of financial transactions related to tax collections including accounts receivable, deferred revenues and taxes, accounts payable and other liabilities, and tax and interest revenue as reported in CARS and the

Integrated Revenue Management System and in supplemental information prepared by Taxation;

- to evaluate the accuracy of financial transactions related to cash and cash equivalents, investments, debt, risk management, and unclaimed property activity which is controlled by Treasury as reported in CARS and Treasury's accounting records, and in supplemental information prepared by Treasury (including the activity of the Treasury Board, the Local Government Investment Pool, the Virginia College Building Authority, the Virginia Public School Authority, and the Virginia Public Building Authority);
- to evaluate whether the budget approved by the General Assembly is appropriately recorded in CARS and appropriation controls in CARS are adequate to ensure program expenses do not exceed appropriations;
- to evaluate the proper approval and documentation of administrative budget adjustments;
- to determine whether the agencies have complied with applicable laws, regulations, contracts and grant agreements; and
- to review corrective actions related to audit findings from the prior year report.

Audit Scope and Methodology

Management has responsibility for establishing and maintaining internal control and complying with applicable laws and regulations. Internal control is a process designed to provide reasonable, but not absolute, assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

We reviewed and gained an understanding of the overall internal controls, both automated and manual, sufficient to plan the audit. We considered materiality and risk in determining the nature and extent of our audit procedures. Our review encompassed controls over the following processes and systems.

Department of Accounts

Financial Reporting*

Commonwealth Accounting and Reporting System (CARS)
Commonwealth Integrated Payroll/Personnel System (CIPPS)
Fixed Asset Accounting and Control System (FAACS)
Lease Accounting System (LAS)

Department of Planning and Budget

Performance Budgeting System
Budget Execution

Department of Taxation

Financial Reporting
Tax Return Processing
Tax Revenue Collections
Integrated Revenue Management System

Department of the Treasury (including Treasury Board operations)

Financial Reporting*	Bank Reconciliation System
Bond Issuance	Trust Accounting
Debt Service Expenses	Check Processing System
Investment Trading	Risk Management Claim System
Investment Accounting	Unclaimed Property Management System
Investment Accounting System	

*including preparation of the Comprehensive Annual Financial Report and Schedule of Expenditures of Federal Awards by Accounts and the preparation of financial statements of the Local Government Investment Pool, the Virginia College Building Authority, the Virginia Public Building Authority, and the Virginia Public School Authority by Treasury.

We performed audit tests to determine whether controls were adequate, had been placed in operation, and were being followed. Our audit also included tests of compliance with provisions of applicable laws and regulations. Our audit procedures included inquiries of appropriate personnel, inspection of documents, records, and contracts, and observation of the agencies' operations. We tested transactions and performed analytical procedures, including budgetary and trend analysis.

Audit Conclusions

We noted a matter at Accounts and Taxation involving internal control related to the Commonwealth's financial reporting process that we consider necessary to be reported to management, which is described in the finding entitled "Improve Communication Surrounding Financial Reporting Process" in the section entitled "Internal Control and Compliance Findings and Recommendations."

We noted a matter at Accounts involving application system controls over CARS and CIPPS that we consider necessary to be reported to management, which is described in the finding entitled "Enhance Controls Over System Access for Critical Systems" in the section entitled "Internal Control and Compliance Findings and Recommendations."

We found that Accounts' Payroll Service Bureau properly stated, in all material respects, the financial records reviewed in support of payroll and leave activity.

We found that Taxation properly stated, in all material respects, the financial records reviewed in support of the tax collections activity detailed in the audit objectives as reported in CARS, the Integrated Revenue Management System, and supplemental information.

We found that Treasury properly stated, in all material respects, the financial records reviewed in support of the cash and investments, debt, risk management and unclaimed property activity reported in CARS, Treasury's accounting records, and supplemental information.

We found that the budget approved by the General Assembly is appropriately recorded in CARS, and appropriation controls in CARS were adequate to ensure program expenses do not exceed appropriations.

We found that budget adjustments were properly approved and documented.

We noted a matter at Treasury involving internal control and compliance with applicable laws and regulations that is required to be reported under Government Auditing Standards, which is described in the finding entitled "Create Information Security Review Plan" in the section entitled "Internal Control and Compliance Findings and Recommendations."

The agencies of the Secretary of Finance have taken adequate corrective action with respect to audit findings reported in the prior year that are not repeated in this report.

Exit Conference and Report Distribution

We discussed this letter with management of the respective agencies of the Secretary of Finance and have included their response at the end of this report. We did not audit management's response and, accordingly, we express no opinion on it.

This report is for the information and use of the Governor and General Assembly, management, and citizens of the Commonwealth of Virginia and is a public record.

AUDITOR OF PUBLIC ACCOUNTS

SAH/alh

Appendix A

This Appendix includes more detailed information on the various services, programs, and activities managed by the agencies in the Finance Secretariat.

Planning, Budgeting, and Evaluation Services

Planning and Budget aids in the development and administration of the state budget, ensuring that agencies conduct their activities within fund limitations provided in the Appropriation Act and in accordance with gubernatorial and legislative intent. Planning and Budget relies on information from all agencies and universities in developing revenue estimates and expense budgets. Accounts provides Planning and Budget with information regarding unspent balances and carry forward amounts. Taxation develops the General Fund revenue forecast due to the fact that the largest source of revenue for the Commonwealth is individual and fiduciary income taxes and state sales and use taxes. Taxation also develops the revenue forecasts for certain non-general fund revenues, which are primarily transportation-related.

Once the General Assembly and the Governor have approved the budget, Planning and Budget provides an electronic copy to Accounts to upload into the Commonwealth Accounting and Reporting System (CARS). CARS contains automated edit controls to ensure agencies do not exceed the spending authority established in the budget.

Throughout the year, along with the Governor, Planning and Budget has certain statutory authority to increase, decrease, or transfer funds and personnel positions within constraints set forth in the Act. Jointly, Planning and Budget and Accounts ensure that CARS properly reflects these adjustments. During fiscal year 2012, the administrative adjustments processed by Planning and Budget resulted in a \$5.8 billion increase to the Commonwealth's operating budget.

Revenue Administration Services

Taxation administers and enforces the tax laws of the Commonwealth. Due to its tax return processing duties, Taxation is the single largest collector of Commonwealth revenue, which it primarily deposits to the General Fund. During fiscal year 2012, Taxation collected \$15 billion in net revenue, depositing \$14.5 billion into the General Fund. In addition, both Taxation and Accounts collect money owed to the Commonwealth through a debt set-off program that they jointly administer in accordance with the Code of Virginia's Debt Collection Act.

Taxation collects and distributes Communication Sales and Use Tax and Motor Vehicle Fuel Sales Tax to localities and members of the transportation districts as required by the Code of Virginia. The Appropriation Act budgets these payments as part of Taxation's budget. During fiscal year 2012, Tax distributed \$420.5 million of Communication Sales and Use Tax revenues and \$80.6 million of Motor Vehicle Fuel Sales revenues.

Check Processing and Bank Reconciliation

Treasury processes agency disbursements from revenue the Commonwealth collects. Treasury is responsible for the printing and distribution process of all checks and distributes

electronic payments for individual agencies. Monthly, the Commonwealth's two disbursement banks are responsible for full reconciliation of check disbursement activity. Treasury's fully automated system, "Recon Plus," interfaces with other bank systems and allows Treasury to reconcile accounts within 45 days of month end.

Unclaimed Property Administration

Additionally, under the Unclaimed Property Act, Treasury serves as custodian of certain personal properties (intangible and tangible personal property and real property) until the Commonwealth can locate the owner. Treasury identifies abandoned personal property through annual reporting requirements and the performance of audits and compliance reviews, administers the fund under the Commonwealth's control, and uses its best efforts to return the property to its owner.

Investment, Trust, and Insurance Services

Treasury, under the direction of the State Treasurer, invests the Commonwealth's funds and provides trust and insurance services. Treasury manages and invests the Commonwealth's funds throughout the year striving to achieve the highest level of return based on the operational needs of the Commonwealth. The largest portfolio Treasury manages is the General Account of the Commonwealth, a pool of investments representing assets of the Commonwealth's General Fund, highway maintenance, and transportation trust funds. The General Account has two portfolios: the primary liquidity portfolio and the extended duration and credit portfolio. Treasury internally manages the primary liquidity portfolio, which provides the major source of liquidity for the disbursement requirements and operational needs of the Commonwealth. The externally managed "Extended Duration and Credit Portfolio" seeks to generate higher total returns over time. Treasury's target allocation for the overall general account asset mix is 75 percent for the primary liquidity pool and 25 percent for the total return pool.

Treasury also manages the Local Government Investment Pool (LGIP), a short-term investment pool offered to counties, towns, cities, state agencies, departments, and authorities of the Commonwealth of Virginia. It is an open-ended money market type fund that offers public funds investors daily liquidity, diversification, and professional management. Further, Treasury manages the Commonwealth's statewide banking network and monitors its own and other agencies' specialized banking services.

Through providing staff services to the Treasury Board, Treasury is also responsible for the issuance and management of debt of the Commonwealth and several of its boards and authorities. Treasury monitors outstanding Commonwealth debt issued by certain boards and authorities for financial reporting and analysis purposes and provides staff support to the Virginia Public School Authority, the Virginia College Building Authority, the Virginia Public Building Authority, the Debt Capacity Advisory Committee, and the Treasury Board.

Finally, Treasury administers insurance programs on behalf of the Commonwealth that cover state government, other public entities, and certain individuals serving in the public interest. Administered insurance programs are either self-insured or commercially insured. Treasury bills state

agencies, the Compensation Board, and local governments for insurance premiums to cover current and future costs. Types of insurance include liability and property insurance and fidelity bonds.

We performed an audit of the financial activity of the Local Government Investment Pool, the Virginia College Building Authority, the Virginia Public School Authority, and the Virginia Public Building Authority for the year ended June 30, 2012, and reported our audit results in a separate audit report issued in December 2012.

Bond and Loan Retirement and Redemption

The Code of Virginia sets forth the appointments to the Treasury Board, which includes the State Treasurer, the State Comptroller, the State Tax Commissioner, and four members appointed by the Governor. Treasury provides support services to the Treasury Board in fulfilling its responsibilities, which include the following.

- Exercise general supervision over the investment of state funds
- Administer the Virginia Security for Public Deposits Act
- Control and manage sinking and other funds that the Commonwealth holds as fiduciary
- Contract with an outside manager for the administration of the State Non-Arbitrage Program
- Provide advice and supervision in the financing of state buildings
- Approve the terms and structure of proposed state educational institution bond issues and other financing arrangements
- Approve the terms and structure of proposed bond issues secured by state appropriations
- Administer the regional jail financing reimbursement program
- Issue all general obligation debt of the Commonwealth
- Manage its bond issues in compliance with federal taxation and arbitrage laws

In addition, the Treasury Board makes payments to the Virginia College Building Authority and the Virginia Public Building Authority for lease payments and/or bond principal and interest on the Authorities' appropriation-supported debt. The Board also pays debt service on Article X, Section 9(b) general obligation bonds and processes debt service payments to trustees and/or paying agents on behalf of the Commonwealth Transportation Board.

Financial Systems Development and Management

Accounts operates and maintains the Commonwealth's centralized automated accounting, payroll, and fixed asset systems. CARS is a cash-basis accounting system that records all of the Commonwealth's cash receipts and disbursement transactions and provides a means to enforce state

appropriation law for all state agencies through automatic edits and manual reviews. The Commonwealth Integrated Payroll/Personnel System (CIPPS) is the Commonwealth's central payroll and leave system. Agencies and institutions use CIPPS to process employee salaries and wages, tax computations, payroll deductions, and leave transactions. The Fixed Asset Accounting and Control System (FAACS) and Lease Accounting System (LAS) record the Commonwealth's capital and controllable assets and equipment leases.

Accounting Services

To facilitate the operation of CARS, CIPPS, FAACS, and LAS, Accounts has developed policies and procedures for entering transactions in the systems and offers periodic training courses to other agencies. In addition, Accounts grants access to the systems, monitors activity in the systems, provides assistance to agencies on financial reporting issues, performs reconciliations, and resolves errors as necessary.

Accounts processes certain transactions in CARS including reoccurring or correcting journal entries, transfers as required by the Appropriation Act, and the quarterly calculation and allocation among the various funds of interest earned by Treasury on the Commonwealth's cash and investments. Accounts is responsible for all aspects of the payroll process including payroll production, payroll and benefits accounting, and compliance with state and federal tax regulations.

Accounts calculates and distributes certain revenues collected by Taxation to local governments as required by the Code of Virginia. The Appropriation Act budgets and Accounts records these transfer payments under separate agency numbers. Accounts distributed the following amount of revenue during fiscal year 2012.

Sales and use tax for education	\$1,163,468,848
Personal Property Tax Relief Act	950,000,000
Recordation taxes	16,502,595
Other	<u>7,678,890</u>
Total	<u>\$2,137,650,333</u>

Source: Commonwealth Accounting and Reporting System

Accounts also made recordation tax transfers to the Department of Transportation for the Northern Virginia Transportation District Fund and the Transportation Improvement Set-Aside Fund in the amounts of \$32,710,608 and \$996,270, respectively.

Another accounting services item Accounts completes is the preparation of several key reports used to monitor the Commonwealth's activity throughout the year and report year-end results. The other agencies within the Finance Secretariat contribute to this process due to the significance of their roles in the budgeting and financial management activities of the Commonwealth.

During the year, the Commonwealth monitors its General Fund revenue collections using the Monthly Revenue Report, which the Secretary of Finance issues. Accounts accumulates the financial information for this report from CARS and various agencies. Taxation provides Accounts with the General Fund revenue forecast for the report and provides detailed information on certain actual revenue collections. Treasury provides Accounts with information on the Commonwealth's investing activity.

At year-end, Accounts prepares two reports: The General Fund Preliminary Report and the Comprehensive Annual Financial Report (CAFR). Accounts prepares the General Fund Preliminary Report using CARS financial activity and information provided by Planning and Budget for the classification of remaining General Fund balances. Accounts prepares the CAFR using financial activity recorded in CARS as well as information submitted by agencies. Due to the significance of the activity controlled by Taxation and Treasury, these agencies must work closely with Accounts in providing the information necessary to prepare the CAFR. To ensure accuracy of the data in the General Fund Preliminary Report and CAFR, the Financial Reporting division of Accounts performs periodic quality assurance reviews of agency submitted information.

Other reports prepared throughout the year include the Popular Annual Financial Report, the federal and full-costing Statewide Indirect Cost Allocation Plan, and the Statewide Schedule of Expenditures of Federal Awards.

Service Center Administration

The Payroll Service Bureau division of Accounts processes payroll, leave accounting, and certain benefits data entry functions for selected agencies.



COMMONWEALTH of VIRGINIA

DAVID A. VON MOLL, CPA
COMPTROLLER

Office of the Comptroller

P. O. BOX 1971
RICHMOND, VIRGINIA 23218-1971

February 12, 2013

Ms. Martha S. Mavredes
Auditor of Public Accounts
James Monroe Building
101 N. 14th Street
Richmond, Virginia 23219

Dear Ms. Mavredes:

The Department of Accounts (Accounts) appreciates the opportunity to respond to the *Comments to Management* contained in your 2012 Secretary of Finance Audit Report. We give your comments the highest level of importance and consideration as we continue to review and improve our current practices. Accounts appreciates your acknowledgement of the progress made and the recognition that some issues take significant time and resources to resolve.

Comments to Management

Status of System Development Projects and Other Modernization Efforts

Status of Systems Development Projects

Accounts understands the risks associated with older computer systems and ramifications of potential system failures and appreciates your role in helping to ensure the Commonwealth is appropriately addressing these risks. As noted in previous years, Accounts has been directly involved in the Cardinal project for several years. With the successful completion of the first two implementation phases, the State Comptroller is now the primary project sponsor and Chairman of the Enterprise Applications Steering Committee, and the Assistant State Comptroller of Accounting and Reporting is also a voting member. To date, Accounts has assigned seven permanent project members to the Cardinal project team and is currently in the process of adding the necessary resources to address the vendor standardization initiative along with strengthening agency oversight. As noted, Accounts has established the Enterprise Applications Internal Service Fund and applicable rates, which have been approved by JLARC, and will fully fund the Cardinal and Performance Budgeting systems.

Modernization of Financial Reporting Processes

Accounts appreciates the recognition that the financial reporting landscape is changing and that additional process changes are required to successfully navigate additional reporting complexities arising from new accounting standards, laws and regulations while facing decreasing numbers of financial reporting staff in the Commonwealth. Accounts' General Accounting and Financial Reporting Divisions are striving to identify new systems applications or changes to existing applications in order to evaluate the appropriate accounting and reporting treatment. Additionally, the Financial Reporting Division has incorporated, and continues to explore the expanded use of, databases into the reporting process. Accounts will continue using a risk-based approach when evaluating agency financial information. The

Financial Reporting Division will continue to evaluate both efficiency and effectiveness of agency processes when performing agency quality assurance reviews. Accounts will strive to continue partnership arrangements with line agencies to facilitate the agencies' understanding and process improvements. Accounts will continue to evaluate the best means of communicating with agencies and will strive to provide policies and procedures governing the Cardinal project prior to implementation.

Upcoming Pension Accounting Changes

As noted, the newly issued Governmental Accounting Standards Board standards for accounting and reporting pension activity for state and local governments will change the way the Commonwealth and localities compute and report pension obligations. Accounts will work with the Virginia Retirement System (System) to implement to necessary changes to the System's financial statements in fiscal year 2014 and the Commonwealth's financial statements in fiscal year 2015.

Re-examine Financial Recordkeeping and Reporting Process for Authorities and LGIP

Accounts will consult with Treasury regarding any CARS or Cardinal system or process changes that could potentially facilitate Treasury's reporting responsibilities and the compilation of data for the Comprehensive Annual Financial Report.

Improve Communication Surrounding Financial Reporting Process

Accounts and Taxation have met to discuss the accounting and reporting processes in previous years. These collaborative meetings have both improved and strengthened the information-gathering process and data reported in the Comprehensive Annual Financial Report. Since these previous collaborative efforts have added significant value to the financial reporting process, Accounts agrees that these collaborative efforts should be expanded and enhanced. Accounts will assume responsibility for convening regular meetings going forward.

Enhance Controls Over System Access for Critical Systems

Accounts understands the risks associated with granting Accounts' employees system access to CIPPS and CARS. Accounts plans to document the policies and procedures for granting access to both CIPPS and CARS, addressing the type of access necessary to accomplish specific job functions that are unique to Accounts. Accounts currently has in place a semi-annual review of CARS Security for staff and plans to extend this process to CIPPS Security. Accounts will also include CIPPS Security in our internal control testing pursuant to ARMICS. As noted in our discussions, Accounts is responsible for unique and significant mission critical functions that comport directly to the Commonwealth's overall financial management goals and objectives. This critical responsibility necessitates certain key and experienced staff members maintain specific security capabilities that may appear to be outside of their normal duties to ensure these functions are executed in a timely and accurate manner. Accounts' management will continue to monitor these circumstances and use prudent judgment to ensure security capabilities granted are appropriate and necessary. Accounts recognizes the importance of training staff responsible for granting CIPPS system access and will ensure adequate training is provided.

Sincerely,



David A. Von Moll

Copy: The Honorable Richard D. Brown, Secretary of Finance
Lewis R. McCabe, Jr., Assistant State Comptroller – Accounting & Reporting



COMMONWEALTH of VIRGINIA

Department of Taxation

February 8, 2013

Ms. Martha S. Mavredes
Auditor of Public Accounts
James Monroe Building
101 N. 14th Street
Richmond, Virginia 23219

Dear Ms. Mavredes:

Thank you for the opportunity to provide the Department of Taxation's response to the finding identified as part of your audit of Taxation's financial records and operations for the year ended June 30, 2012. A short summary of Taxation's plan to address the report finding follows:

Improve Communication Surrounding Financial Reporting Process

We agree that Taxation should continue to work with the Department of Accounts (DOA) to improve the communication between the two agencies regarding the Commonwealth's financial statements. Over the next few months, we will work with DOA to develop a process to accomplish this goal. The development plan for this finding will have a completion date of September 30, 2013.

The Department of Taxation strives to maintain strong internal controls and business processes that ensure high standards of integrity, efficiency, and control. Completely addressing your finding will ensure we meet these expectations.

Again, thank you for the opportunity to respond to your report.

Sincerely,

A handwritten signature in black ink, appearing to read "Craig M. Burns".

Craig M. Burns
Tax Commissioner

c: The Honorable Richard D. Brown



COMMONWEALTH of VIRGINIA

Department of the Treasury

MANJU S. GANERIWALA
TREASURER OF VIRGINIA

P. O. BOX 1879
RICHMOND, VIRGINIA 23218-1879
(804) 225-2142
Fax (804) 225-3187

February 12, 2013

Martha S. Mavredes
Auditor of Public Accounts
James Monroe Building
101 N. 14th Street
Richmond, Virginia 23219

Dear Ms. Mavredes

The Department of the Treasury (Treasury) appreciates the opportunity to respond to both the *Efficiency Finding and Recommendation and the Internal Control and Compliance Finding and Recommendation* in your Report on Audit of the Agencies of the Secretary of Finance for the year ended June 30, 2012. Your comments and recommendations are appreciated and given the highest level of consideration by Treasury as we continually strive to improve our processes.

Comments to Management

Re-examine Financial Recordkeeping and Reporting Process for Authorities and LGIP

Treasury places significant emphasis on the integrity of its financial recordkeeping and reporting processes for the Authorities and LGIP. As noted in your comment, our current process for the recording and reporting of this data involves the use of Excel spreadsheets. We believe the procedures and controls Treasury currently has in place adequately mitigate the risk of reporting errors. Given the growth in the level and volume of financial activity of the Authorities and the LGIP, however, the use of Excel spreadsheets for this function may not be the most efficient means of recording this data.

Treasury will continue to re-examine our recording and reporting process and in doing so, will work with the State Comptroller to consider the feasibility of using the new statewide accounting system, Cardinal, once available to Treasury. If this system cannot accommodate the needs of Treasury, we will work with the State Comptroller to examine the feasibility of selecting a comprehensive accounting system that improves the controls and efficiency of Treasury staff and minimizes the interface required for the preparation of information for the Comprehensive Financial Annual Report.

Martha S. Mavredes
February 12, 2013
Page 2

Create Information Security Review Plan

Treasury concurs with this finding. Although Treasury has developed strong internal controls in an effort to safeguard sensitive data and places significant emphasis on adherence to these controls for both our operational staff and our system development staff, we recognize the importance of developing a three-year audit plan and timeline that structures the performance of an independent review of these controls in compliance with the Commonwealth's IT Security Audit Standard.

Treasury will develop a three-year plan that coordinates reviews of information systems containing sensitive information in compliance with the Commonwealth's IT Security Audit Standard, SEC502-02.1. We will coordinate these review activities across independent parties who are not associated with the process or procedures of particular systems, such as Treasury's Information Security Officer or other qualified party and submit to VITA as required.

Sincerely,



Manju S. Ganeriwala

Copy: The Honorable Richard D. Brown, Secretary of Finance
Robert S. Young, Deputy State Treasurer

SECRETARY OF FINANCE AGENCY OFFICIALS

As of June 30, 2012

Richard D. Brown
Secretary of Finance

David A. Von Moll
Comptroller

Daniel S. Timberlake
Director of the Department of Planning and Budget

Craig M. Burns
Tax Commissioner

Manju S. Ganeriwala
Treasurer