DEPARTMENT OF TAXATION

REPORT ON AUDIT

FOR THE YEAR ENDED

JUNE 30, 2024

Auditor of Public Accounts
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AUDIT SUMMARY

Our audit of the Department of Taxation (Taxation) for the fiscal year ended June 30, 2024, found:

- proper recording and reporting of all transactions, in all material respects, in the Commonwealth's accounting and reporting system, Taxation's financial system, and supplemental information and attachments submitted to the Department of Accounts;

- two matters involving internal control and its operation necessary to bring to management's attention that also represent instances of noncompliance with applicable laws and regulations or other matters that are required to be reported; and

- corrective action on prior audit findings remains ongoing as indicated in the Findings Summary included in the Appendix.

In the section titled "Internal Control and Compliance Findings and Recommendations," we have included our assessment of the conditions and causes resulting in the internal control and compliance findings identified through our audits as well as recommendations for addressing those findings. Our assessment does not remove management's responsibility to perform a thorough assessment of the conditions and causes of the findings and develop and appropriately implement adequate corrective actions to resolve the findings as required by the Department of Accounts in Topic 10205 – Agency Response to APA Audit of the Commonwealth Accounting Policies and Procedures Manual. Those corrective actions may include additional items beyond our recommendation.

Our report includes a risk alert that requires the action and cooperation of Taxation's management and the Virginia Information Technologies Agency (VITA) regarding risks related to unpatched software.

In fiscal year 2023, we included the results of our audit over Taxation in the report titled "Agencies of the Secretary of Finance for the year ended June 30, 2023."

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INTERNAL CONTROL AND COMPLIANCE FINDINGS AND RECOMMENDATIONS

Develop and Implement a Third-Party Service Provider Oversight Process
Type: Internal Control and Compliance
Severity: Significant Deficiency
First Reported: Fiscal Year 2023

Taxation is making progress to develop and implement a documented process to identify, procure, maintain, and monitor external service providers (providers) that store, transfer, and process Taxation's mission-critical and confidential data. Since the prior audit, Taxation drafted a supply chain management policy and procedure that requires Taxation to evaluate the providers' information security controls prior to commencing contract negotiations and conduct annual oversight thereafter. However, as of the end of fiscal year 2024, Taxation did not approve and implement the policy and process. Additionally, while Taxation has a list of providers, it has not yet developed written procedures for maintaining the list to ensure it is accurate and complete on an ongoing basis. While Taxation's Internal Audit department reviews assurance reports from some providers every three years, Taxation's lack of process to maintain a complete and accurate agency-wide list of providers resulted in Internal Audit not reviewing some providers. Additionally, reviewing the assurance reports every three years does not meet the Security Standard requirement of performing annual reviews.

The Commonwealth's Information Security Standard, SEC530 (Security Standard), which supersedes the Commonwealth's Hosted Environment Information Security Standard, SEC525, requires that agency management hold providers accountable for compliance with the Commonwealth's security standards through documented agreements and oversight activities. Specifically, the Security Standard requires Taxation to "… develop, document, and disseminate an organization-level system and services acquisition policy that addresses purpose, scope, roles, responsibilities, management commitment, coordination among organizational entities, and compliance." The Security Standard also requires Taxation to have documented procedures and processes that facilitate the implementation of policies and associated controls. Lastly, the Security Standard requires annual monitoring of the providers' controls to ensure continued compliance with the Security Standard and agency expectations.

The lack of a written policy and procedure that specifically addresses the contractual requirements that Taxation should consider before procuring providers' services may prevent Taxation from holding providers accountable to the Security Standard. Additionally, providers' internal control deficiencies may go undetected for up to three years due to Taxation's lack of an implemented process to annually monitor providers' controls. Taxation was unable to finalize, approve, implement, and train staff on the policy and procedure before fiscal year-end due to higher priorities. Additionally, resource constraints precluded Taxation from completing its draft of policies and procedures for maintaining a complete and accurate list of providers.

Taxation should continue its efforts to finalize a written policy and procedure that aligns with the requirements in the Security Standard for procuring and monitoring providers. Taxation should then

implement a formal process to consistently validate the effectiveness of providers' security controls on an annual basis. Taxation should develop and implement a process to maintain a complete and accurate list of providers to ensure the agency maintains effective oversight for all its providers, which will help maintain the confidentiality, integrity, and availability of sensitive and mission critical data.

Revoke Systems Access for Separated Employees in a Timely Manner
Type: Internal Control and Compliance
Severity: Significant Deficiency
First Reported: Fiscal Year 2023

Taxation did not timely revoke systems access for separated employees. Of the 118 terminated employees tested, Taxation did not timely remove access for 18 separated employees (15%) due to delayed separation requests. Taxation implemented corrective action in April 2024; however, one of the 18 untimely separations occurred after Taxation implemented corrective action. Managers submitted separation requests between one and 49 days late. The delays in submission were due to the managers being unaware of their responsibilities and, in some instances, overlooking the need to submit a separation request. The Security Standard requires agencies to disable information systems access within 24 hours of termination.

Untimely removal of user access can compromise the integrity of Taxation's internal systems and increase the risk of unauthorized transactions. Taxation should timely revoke systems access for separated employees and should ensure that managers understand their responsibility for submitting separation requests timely.

RISK ALERT

During our audit, we encountered an issue that is beyond the corrective action of Taxation's management alone and requires the action and cooperation of management and VITA. The following issue represents such a risk to Taxation and the Commonwealth.

Unpatched Software

First Reported: Fiscal Year 2015

VITA contracts with various providers to create the Commonwealth's Information Technology Infrastructure Services Program (ITISP) to provide agencies with installation, maintenance, operation, and support of IT infrastructure components, such as servers, routers, firewalls, and virtual private networks. Taxation continues to rely on contractors procured by VITA for the installation of security patches in systems that support Taxation's operations. Additionally, Taxation relies on VITA as the contract administrator to maintain oversight and enforce the contract agreements with the ITISP contractors. As of July 2024, the ITISP contactors had not applied a significant number of security patches that are critical and highly important to Taxation's IT infrastructure components, all of which are past the 30-day update window allowed by the Security Standard.

The Security Standard requires the installation of security-relevant software and firmware updates within 30 days of release or within a timeframe approved by VITA's Commonwealth Security and Risk Management division. The Security Standard does allow for varying time periods depending on factors such as the criticality of the update, but generally the ITISP uses a 30-day window from the date of release as its standard for determining timely implementation of security patches. Missing system security updates increases the risk of successful cyberattack, exploit, and data breach by malicious parties.

While VITA is responsible for enforcing the service level agreement, it has not been able to compel the current ITISP contractors to install certain security patches to Taxation's IT infrastructure to remediate vulnerabilities in a timely manner or take actions to obtain these required services from another source. Taxation is working with VITA and the ITISP contractors to ensure that the ITISP contractors install all critical and highly important security patches on all servers. Our separate audit of VITA's contract management will also continue to report on this issue.

RETAIL SALES AND USE TAX COLLECTION AND DISTRIBUTION

In accordance with § 30-133.2 of the Code of Virginia, we perform work related to retail sales and use tax distributions as part of our annual audit of Taxation. As a part of our initial review, we established a one percent benchmark that Taxation should use to measure the effectiveness of the local sales and use tax distribution process. If the error rates exceed one percent, Taxation should perform additional analysis to determine the causes of the errors and whether further actions are required. Our audit included inquiries about the distribution and error processes and reviewed the error rate to ensure Taxation distributed the local sales and use taxes within the established benchmark.

In fiscal year 2024, Taxation collected approximately $9.3 billion in retail sales and use taxes, with $1.8 billion of these revenues being distributed to localities as a one percent local option tax. Taxation collects the tax and determines the local portion, which is distributed to the locality where the sale or activity occurred.

The sales and use tax distribution process requires a joint effort between Taxation, localities, and businesses. There are controls and processes in place to help ensure that locality distributions are accurate and made to the correct locality. When Taxation or localities detect a distribution error, they work together to research the error and, if necessary, Taxation processes an adjustment to correct the error and transfer the funds to the correct locality. Table 1 shows the local distribution amount for retail sales and use tax, as well as the amount and rate of distribution errors identified and corrected by Taxation in each of the last three fiscal years.

Error Rate for Local Sales Tax Distributions

Table 1

	2022	2023	2024
Local distribution amount	$1,662,896,995	$1,770,841,651	$1,808,582,889
Errors identified and corrected	6,873,994	2,646,637	1,801,527
Error rate	0.41%	0.15%	0.10%

Source: Taxation's financial accounting and reporting system

As shown above, the error rate for fiscal year 2024 was 0.10 percent. This is within the one percent benchmark established, which indicates Taxation is properly distributing the local portion of the retail sales and use tax. We do not recommend any changes in the established benchmark or to Taxation's procedures for ensuring localities receive the correct distribution based on locality sales.

Commonwealth of Virginia

Auditor of Public Accounts

Staci A. Henshaw, CPA
Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218

December 13, 2024

The Honorable Glenn Youngkin
Governor of Virginia

Joint Legislative Audit
and Review Commission

Stephen E. Cummings
Secretary of Finance

James J. Alex
Tax Commissioner, Department of Taxation

We have audited the financial records and operations of the **Department of Taxation** (Taxation) for the year ended June 30, 2024. We conducted this audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States, in support of the Commonwealth's Annual Comprehensive Financial Report audit. 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 audit's primary objective was to evaluate the accuracy of Taxation's financial transactions as reported in the Annual Comprehensive Financial Report for the Commonwealth of Virginia for the year ended June 30, 2024. In support of this objective, we evaluated the accuracy of recorded financial transactions related to tax collections, including accounts receivable, unearned revenues and taxes, accounts payable and other liabilities, tax abatements, and tax and interest revenue as reported in the Commonwealth's accounting and financial reporting system, Taxation's financial system, and supplemental information and attachments submitted to the Department of Accounts. In addition, we reviewed the adequacy of Taxation's internal control; tested for compliance with applicable laws, regulations, contracts, and grant agreements; and reviewed corrective actions with respect to audit findings from prior year reports.

Audit Scope and Methodology

Taxation's management has responsibility for establishing and maintaining internal control and complying with applicable laws, regulations, contracts, and grant agreements. 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, regulations, contracts, and grant agreements.

We 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 significant cycles, classes of transactions, and account balances.

Financial reporting
Tax return processing
Tax revenue collections
Taxation's accounting and financial reporting system
Information security and general system controls (including access controls)

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

A nonstatistical sampling approach was used. Our samples were designed to support conclusions about our audit objectives. An appropriate sampling methodology was used to ensure the samples selected were representative of the population and provided sufficient, appropriate evidence. We identified specific attributes for testing each of the samples and, when appropriate, we projected our results to the population.

Our consideration of internal control over financial reporting (internal control) was for the limited purpose described in the section "Audit Objectives" and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies, and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control titled "Develop and Implement a Third-Party Service Provider Oversight Process" and "Revoke Systems Access for Separated Employees in a Timely Manner," which are described in the section titled "Internal Control and Compliance Findings and Recommendations," that we consider to be significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Conclusions

We found that Taxation properly stated, in all material respects, the amounts recorded and reported in the Commonwealth's accounting and financial reporting system, Taxation's financial system, and supplemental information and attachments submitted to the Department of Accounts. The financial information presented in this report came directly from Taxation's financial system.

We noted certain matters involving internal control and its operation and compliance with applicable laws, regulations, contracts, and grant agreements that require management's attention and corrective action. These matters are described in the section titled "Internal Control and Compliance Findings and Recommendations."

Since the findings noted above include those that have been identified as significant deficiencies, they will be reported as such in the "Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of the Financial Statements Performed in Accordance with Government Auditing Standards," which is included in the Commonwealth of Virginia's Single Audit Report for the year ended June 30, 2024. The Single Audit Report will be available at www.apa.virginia.gov in February 2025.

Exit Conference and Report Distribution

We provided Taxation management with a draft of this report on January 27, 2025. Government Auditing Standards require the auditor to perform limited procedures on Taxation's response to the findings identified in our audit, which is included in the accompanying section titled "Agency Response." Taxation's response was not subjected to the other auditing procedures applied in the audit and, accordingly, we express no opinion on the response.

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

Staci A. Henshaw
AUDITOR OF PUBLIC ACCOUNTS

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FINDINGS SUMMARY

Finding Title	Status of Corrective Action*	First Reported for Fiscal Year
Develop and Implement a Third-Party Service Provider Oversight Process	Ongoing	2023
Revoke Systems Access for Separated Employees in a Timely Manner	Ongoing	2023

* A status of **Ongoing** indicates new and/or existing findings that require management's corrective action as of fiscal year end.

COMMONWEALTH of VIRGINIA

Department of Taxation

February 5, 2025

Ms. Staci A. Henshaw
Auditor of Public Accounts
James Monroe Building
101 N. 14th Street
Richmond, VA 23219

Dear Ms. Henshaw:

The Department of Taxation ("Virginia Tax") has reviewed the findings and recommendations provided by the Auditor of Public Accounts from your audit of the agency's financial records and operations for the year ended June 30, 2024. I appreciate the professionalism of your staff in the performance of the audit and the opportunity to provide the following response.

Develop and Implement a Third-Party Service Provider Oversight Process

Virginia Tax has made progress in developing a supply chain risk management policy, standards, and related procedures to address the oversight of third-party service providers. Virginia Tax will continue its efforts to implement and train staff on the new policy and procedures. In addition, Virginia Tax will implement written procedures for maintaining its list of third-party service providers to ensure it is accurate and complete. We anticipate these tasks will be completed by July 1, 2025.

Revoke Systems Access for Separated Employees in a Timely Manner

The Human Resources Director has reminded supervisors of the importance of the timely revocation of systems access for separated employees. Additionally, the *Employee Separation Checklist* was revised so that responsible supervisors are instructed to enter the revocation of systems access upon the notice of separation rather than the actual separation date. Procedures for the delegation of separation actions during periods of leave were distributed to supervisors and above on January 31, 2025.

Risk Alert-Unpatched Software

As your report documents, Virginia Information Technologies Agency (VITA) is responsible for ensuring this Risk Alert is corrected. Virginia Tax will continue to assist VITA where possible regarding this issue.

If you or your staff have any questions, please contact me at 804-786-3332.

Sincerely,

James J. Alex
Tax Commissioner
Commonwealth of Virginia

C: The Honorable Stephen E. Cummings, Secretary of Finance