AGENCIES OF THE SECRETARY OF FINANCE

RICHMOND, VIRGINIA

REPORT ON AUDIT

FOR THE YEAR ENDED

JUNE 30, 2002

APA
Auditor of
Public Accounts
COMMONWEALTH OF VIRGINIA

AUDIT SUMMARY

This report includes all agencies reporting to the Secretary of Finance, as well as the Secretary's office. The agencies are the Departments of Accounts, Planning and Budget, State Internal Auditor, Taxation, and the Treasury and the Treasury Board. The finance agencies handle the financial transactions of the Commonwealth including collecting taxes, paying bills, and distributing aid to localities. Responsibilities include forecasting and collecting revenues; managing the Commonwealth's cash, investments, and debt; and preparing and executing the Commonwealth's budget.

Our audits of these agencies for the year ended June 30, 2002, found:

- internal control matters that we consider reportable conditions;

- no instances of noncompliance with laws and regulations tested that are required to be reported under Government Auditing Standards;

- proper recording of transactions, in all material respects, in the Commonwealth Accounting and Reporting Systems; and

- adequate implementation of corrective action on prior audit findings, except as noted in this report.

Each audit finding is explained in detail throughout the report.

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FINANCE SECRETARIAL AREA

OVERVIEW

The Departments of Accounts, Planning and Budget, State Internal Auditor, Taxation, and Treasury and the Treasury Board report to the Secretary of Finance. These agencies handle the financial transactions of the Commonwealth, from collecting taxes to paying bills and distributing aid to localities. Responsibilities include: forecasting and collecting revenues; managing the Commonwealth's cash, investments, and debt; selling bonds; and preparing and executing the Commonwealth's budget. The "Summary Financial Information" section contains a secretarial-wide summary of operating resources and uses and changes in operating appropriations. In addition to operating activity, the Department of Accounts distributes certain state revenues to localities. Selected financial data for each agency is on the schedule on pages 18 and 19.

STATEWIDE SYSTEMS

The Department of Accounts (Accounts) operates several systems. The Commonwealth Accounting and Reporting System (CARS) records the state's financial transactions and is the official accounting record of the Commonwealth. Any agency-based accounting system must interface electronically or through magnetic media with CARS. The Commonwealth Integrated Personnel Payroll System (CIPPS) processes payrolls for classified and hourly employees. The Fixed Asset Accounting and Control System (FAACS) tracks fixed assets owned or controlled by the Commonwealth. Agencies record detailed or summary fixed asset accounting information in this system. The Electronic Data Interchange (EDI) electronically transmits payments to localities, non-state agencies, vendors, and state employees. EDI, payroll direct deposit, and the Small Purchase Charge Card are payment options offered by Accounts as part of its electronic commerce initiative to reduce the number of state-issued checks. These options are more reliable, cost effective, and secure than traditional paper checks. During the first quarter of fiscal year 2003, Accounts processed 81.3 percent of the dollars and 54.4 percent of the disbursement transactions using electronic commerce payment options.

The Department of Planning and Budget maintains several statewide systems used for budget development and budget execution. Agencies use an internet-based Budget Entry and Report System (Web Bears) to develop and submit their budget requests to Planning and Budget. Planning and Budget uses the Program Budget System (PROBUD) to accumulate agency budget requests for use in preparation of the Governor's budget. Planning and Budget also maintains the FATS system, the Form 27 Automated Transaction System. This system allows Planning and Budget to review and approve agency budget adjustments. FATS also interfaces with and updates budget information in the Commonwealth's centralized accounting system.

REVENUE STABILIZATION FUND

The Revenue Stabilization Fund (Rainy Day Fund) seeks to offset anticipated revenue shortfalls. The constitutionally-mandatory deposit calculation uses the certified tax revenues as compared to the anticipated revenues in the most recent tax year. The following shows the required deposits, withdrawals, and maximum fund allowed.

Fiscal Year for Deposit Calculation	Mandatory Deposit Requirement
1993	$ 79,896,927
1995	66,624,672
1996	58,314,172
1997	123,833,649
1998	194,135,805
1999	103,345,741
2000	187,091,474
Total deposits	813,242,440
Interest earnings through June 30, 2002	126,864,183
Total withdrawals to date	(467,730,875)
Total on deposit at June 30, 2002	$472,375,748
Maximum Fund Allowed (MFA)	$963,035,507
Actual as percentage of MFA	49%
Total available for withdrawal in fiscal year 2003	$236,187,874

In April, in accordance with Item 270(B) of the Appropriation Act, Chapter 814 of the Virginia Acts of Assembly, $467,730,875 was withdrawn from the Revenue Stabilization Fund. Section 2.2-1830 of the Code of Virginia allows for a further withdrawal from the Revenue Stabilization Fund if the revised official General Fund revenues appropriated for fiscal year 2003 reflect a decline when compared to General Fund revenues appropriated for fiscal year 2003 and the decrease is more than two percent of certified tax revenue collected in fiscal year 2002. As of June 30, 2002, the fund balance was 49 percent of the maximum size allowed.

DEPARTMENT OF ACCOUNTS

Systems

The Department of Accounts (Accounts), under the direction of the State Comptroller, maintains the Commonwealth's centralized automated accounting, payroll, and fixed asset systems. To maintain appropriation controls and provide statutory budget reports, the State Comptroller requires the reporting of all revenue and expense transactions involving state funds in the accounting system. Accounts is responsible for ensuring that controls over the centralized systems are adequate.

Reporting

Accounts coordinates the Commonwealth's statewide reporting efforts and prepares the Commonwealth's Comprehensive Annual Financial Report (CAFR) and the Popular Report to inform the general public, Governor, and other state officials of the state's financial condition. Accounts also issues policies and procedures to provide agencies with guidance for maintaining internal controls over state funds.

The State Comptroller produces a quarterly Report on Statewide Financial Management and Compliance that reports the degree of agency compliance with Commonwealth accounting and financial management policies, procedures, regulations, and practices.

The Commonwealth follows the Governmental Accounting Standards Board (GASB) statements when preparing financial reports. GASB required the implementation of GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments* for the fiscal year ending June 30, 2002. The new standard established new financial reporting requirements for state and local governments throughout the United States. In addition, GASB Statement No. 35, *Basic Financial Statements – and Management's Discussion and Analysis – for Public Colleges and Universities*, extends the requirements of GASB Statement No. 34 to include institutions of higher education. Implementation of these statements required new information and restructured much of the financial information governments had previously presented. For fiscal year 2002, the Commonwealth implemented GASB Statements No. 34 and No. 35 as required by GASB. Major changes to the CAFR include the addition of Management's Discussion and Analysis and full accrual government-wide statements, which includes infrastructure as capital assets.

Revenue Distribution

Another responsibility of Accounts is to make distributions to the Commonwealth's counties, cities, and towns. For fiscal year 2002, the following revenues were distributed:

Sales and use tax for education	$769,384,884
Recordation taxes	19,605,650
ABC profits	19,241,671
Wine taxes	9,977,501
Rolling stock taxes	5,623,928
Public facilities rebate tax	512,740
Other	81,992
Total	$824,428,366

Accounts also made recordation tax transfers to the Department of Transportation for the Northern Virginia Transportation District Fund and the Transportation and Improvement Set-Aside Fund in the amounts of $19,491,598 and $902,750, respectively.

DEPARTMENT OF PLANNING AND BUDGET

The Department of Planning and Budget is the central budgeting agency for the state government and is responsible for developing and administering the state budget, which allocates money for state agencies and institutions. Planning and Budget conducts policy analyses and evaluations of state programs and services and coordinates statewide strategic planning and performance measurement efforts. In addition, Planning and Budget ensures that agencies conduct their activities within the fund limitations provided in the Appropriations Act and in accordance with gubernatorial and legislative intent. Their mission includes advising the Governor in the prudent allocation of public resources and promoting the development and implementation of fiscal, programmatic, and regulatory policies that benefit Virginians.

DEPARTMENT OF THE STATE INTERNAL AUDITOR

The Department of the State Internal Auditor primarily coordinates with agency and institution internal auditors for the investigation of anonymous complaints of fraud, waste, and abuse reported through the State Employee Hotline. In addition, the Department sponsors and coordinates training courses for internal auditors and completes special projects and reviews requested by cabinet secretaries or agency heads. The Department's responsibilities also include assisting state agencies and institutions in developing and maintaining internal audit programs. As of July 1, 2002, the State Internal Auditor became a division of the Department of Accounts.

DEPARTMENT OF TAXATION

Revenue Collections

The Department of Taxation is the largest collector of Commonwealth revenue and during fiscal year 2002, Taxation collected $12.0 billion in revenue, depositing $10.7 billion (89 percent) into the Commonwealth's General Fund. Taxation distributed the remaining revenues as refunds to taxpayers or as transfers to other state agencies and localities for taxes collected on their behalf by Taxation. The largest sources of General Fund revenues are individual and fiduciary income taxes and state sales and use taxes. Individual and fiduciary income taxes include taxes collected from employer withholdings, estimated taxes paid, and individual income tax returns.

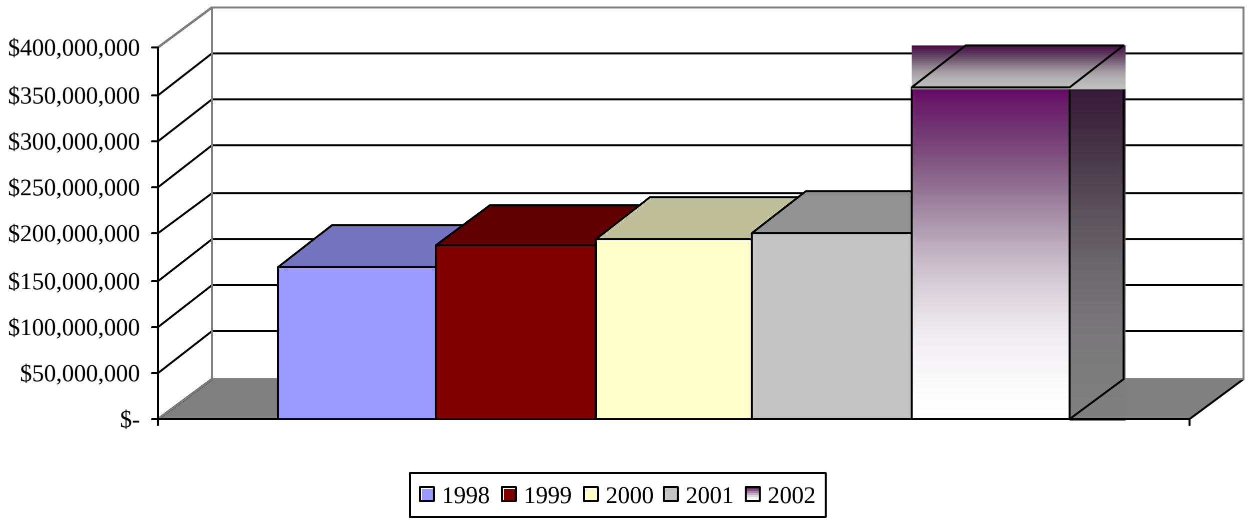
Accelerated Sales and Use Tax

Fiscal year 2002 sales and use tax collections were boosted $192 million by the implementation of accelerated sales and use tax in June 2002. These provisions demanded payment equal to 90 percent of the dealer's June 2001 liability by June 25, 2002, if paying by check, or June 30, 2002, if paying by electronic means. Approximately 6,500 dealers who had taxable sales and purchases totaling at least $1.3 million in fiscal year 2001 had to comply with accelerated sales and use tax provisions.

All payments received by June 30, 2002, went into the state's General Fund with the localities' portion ($42,678,324) going to Agency Fund 0710 for distribution in fiscal 2003. Normally, a portion of the sales and use collections goes to the state's Transportation Trust Fund (TTF). However, in accordance with legislation, the Transportation Trust Fund did not receive a portion of the state's accelerated sales and use tax revenue in fiscal 2002. It was not until August 2002 that a cash transfer of the TTF's portion ($21,339,162) occurred, upon the Governor's announcement that sufficient cash was available.

The accelerated sales and use tax is expected to continue each fiscal year through fiscal 2005. The current law has a phase-out to span fiscal years 2006 through 2012. As illustrated in the following graph, the effects of accelerated sales tax implementation in fiscal 2002 were significant when comparing the June sales and use tax revenue recorded in the state's General Fund over the last five fiscal years.

June Sales and Use Tax Revenue*

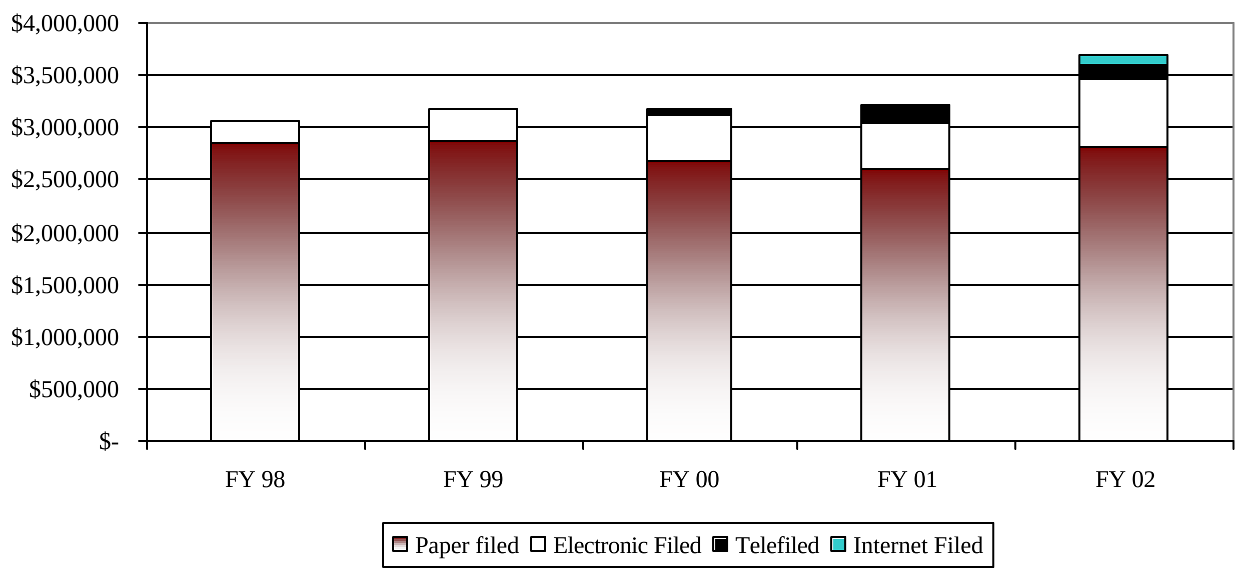


*Includes all General Fund sales and use tax revenues as recorded on the CARS 1671 reports for the respective fiscal years

Tax Return Process

Taxation introduced several changes in the processing of individual tax returns beginning in 2000 to improve efficiency and expedite processing. These changes included a redesigned tax form and several new ways for taxpayers to file their returns. The use of the alternative filing methods has continued to grow since their inception, as have the total number of returns processed by Taxation. The following graph reflects this growth, most notably in electronically-filed returns.

Summary of Returns by Filing Option



Source: Individual Income Tax Return Processing Statistics

Over the same period, the number and value of refunds issued have also increased. These changes are primarily attributable to the economic conditions present over the past five years. The following schedule reflects the shifts in refunds processed by Taxation during this period.

Fiscal Year	Total Refunds	Total Count	Average Refund
1998	$ 631,450,547	2,072,517	$305
1999	701,844,821	2,043,111	344
2000	696,050,864	2,311,602	301
2001	822,855,940	2,412,098	341
2002	1,150,984,066	2,836,890	406

Source: CARS ACTR 1671 Report at June 30 for the respective years, Individual Income Tax Return Processing Statistics

Impact of Budget Reductions

As with all state agencies, Taxation has undergone recent budget reductions. The most notable changes include the elimination of most toll-free telephone services, closing of six district offices, reduction of tax forms distributed to public libraries, and elimination of extended hours for customer service during the month of April. Taxation is relying on alternative avenues for communication implemented as a result of the Partnership Project (discussed below), including electronic and telephonic means, to mitigate the impact of these changes on taxpayers.

The largest impact on Taxation employees involves the closing of six district offices by July 1, 2003, which will result in the elimination of customer service staff and support positions. Remaining compliance employees who perform audit and collection functions will transition to home-based operations. Taxation successfully completed pilot programs for home-based work in fiscal year 2001, laying the foundation for this transition. The Norfolk district office will remain open, as it serves as the backup site for Taxation's call center in Richmond.

The changes in toll-free services, distribution of tax forms, and customer service hours will most directly impact taxpayers. Effective December 1, 2002, Taxation eliminated all existing toll-free service, except for Telefile. Further, Taxation reduced its bulk distribution of paper tax forms to public libraries. Instead, each library branch will receive about 40 percent of the quantity of Form 760, Form 760-ADJ, and Form 760 Instructions received in previous years and will also receive Package X in hard copy and compact disk that can be used for duplicating and printing forms. Taxpayers will continue to be able to obtain tax forms from Commissioners of the Revenue and Taxation's website or by calling Taxation directly. Finally, hours for telephone and walk-in assistance during the tax-filing season will be limited to 8:30 a.m. to 4:30 p.m.

Since Taxation has not yet fully implemented the budget reduction changes, we cannot determine their impact on Taxation's operations. However, it is reasonable to expect that they will place an increased strain on the remaining resources and make the timely completion of the remaining Partnership Project initiatives more imperative.

Public-Private Partnership Project

In 1998, Taxation contracted with American Management Systems (AMS) to develop and implement an Integrated Revenue Management System. Taxation also contracted with TRW Systems & Information Technology Group (TRW) to conduct periodic project performance monitoring and evaluation services. The project had an original completion date of 2003; however, through a change order executed November 2001, the completion date is now June 30, 2004.

The primary justification for the Partnership Project was the replacement of Taxation's legacy revenue accounting system, STARS (State Tax Accounting and Reporting System), which is approaching 20 years of operation. The Partnership Project expects to implement the STARS replacement, Advantage Revenue, in October 2003. Its implementation represents the largest milestone defined in the contract with AMS. Due to the nature of business operations within Taxation, any significant slippage in the current project plan for Advantage Revenue would delay its implementation until July 2004.

Partnership Project Funding

Partnership Project funding comes from increased tax revenues generated as a result of technological solutions and improved business processes the Partnership Project developed and implemented. The additional revenues go into the 90 percent fund and the 10 percent fund. The 90 percent fund pays AMS its contractual obligations, while the 10 percent fund pays all other expenses attributable to the project. These collections increased approximately $7 million over the prior year, and as of June 30, 2002, cumulative Partnership Project revenues totaled almost $99 million.

Partnership Project Revenues

Fiscal Year	90 Percent Fund	10 Percent Fund	Total
1999	$ 5,695,458	$ 632,799	$ 6,328,257
2000	10,487,760	1,165,337	11,653,097
2001	33,140,337	3,682,260	36,822,597
2002	39,522,127	4,391,347	43,913,474
Total	$88,845,682	$9,871,743	$98,717,425

Partnership Project Cost

Original contract costs with AMS totaled $123 million. In addition, Taxation agreed to pay AMS interest on any interim billing if the 90 percent fund did not have the resources to pay. Taxation initially estimated that interest payments would total $17 million over the life of the contract.

Due to various change orders, the contract price has increased to $153 million, but as of June 30, 2002, Taxation projected interest costs of $3 million rather than the original $17 million. This interest projection decreased $6 million from November 2001 and resulted from the project initiatives generating revenues in a shorter-than-expected period.

Taxation is incurring other project costs in addition to the AMS payments discussed above. These additional costs include overhead and miscellaneous expenses such as TRW payments supported by the 10 percent fund, as well as Taxation staff time spent directly on the projects, primarily supported by Taxation's operating general fund budget.

The following chart highlights that total anticipated project costs exceed $200 million, including interest payments and Taxation payroll projections. The chart also summarizes the corresponding actual costs incurred during fiscal 2002 and for the project to date through June 30, 2002.

	Anticipated Costs *	Fiscal Year 2002 Activity	Activity to Date *
Partnership Project contract cost (90 percent fund)	$153,000,000	$31,895,861	$ 75,832,298
Partnership Project interest payments (90 percent fund)	3,000,000	243	1,075,586
TRW (10 percent fund)	5,000,000	983,786	2,625,804
Overhead/miscellaneous (10 percent fund)	13,000,000	3,876,081	5,566,419
Taxation payroll (Taxation general fund) **	33,000,000	7,761,065	19,606,190
Total projected project costs	$207,000,000	$44,517,036	$104,706,297

* as of June 30, 2002
** Anticipated amount includes actual balance at June 2002 ($20 million) and projected costs of $13 million through June 2004

After completion of the project, Taxation will have a need for ongoing funding to support the operating costs of the new system. On November 20, 2001, Taxation and AMS made several contractual changes. One of these changes adjusted the fund retention figures from 90/10 to 70/30, beginning July 1, 2003. This change will allow Taxation to accumulate $7.4 million more in their administrative account to pay future operating cost increases, rather than receive increased General Fund appropriations. This change allows Taxation to have up to $11 million available for use in funding various parts of the project, including lease payments and hardware and software maintenance costs.

Once Taxation accumulates these monies, the fund split will revert back to 90/10. This essentially takes away funding that would otherwise have been used to pay AMS progress billings and places Taxation at risk of paying more interest payments to AMS. On the other hand, this funding arrangement relieves the General Assembly from the burden of appropriating General Funds to support these operating cost increases in fiscal year 2004. For allowing this change, Taxation agreed to lengthen the payback period from 10 years to 11 years.

Court Debt Collections Office

Through the Department of Taxation's Partnership Project, the Court Debt Collections Office (CDCO) implemented a new collections system called "Computer Assisted Collections System" in May 2002. Under contract with AMS, the implementation costs totaled $3.7 million. As of June 30, 2002, $1.3 million of these costs remain outstanding.

During the fiscal year, CDCO transferred $185,720 to support the implementation of the accelerated sales tax (previously discussed), transferred $774,000 to the state's General Fund, and expects to transfer an additional $2 million in fiscal 2003. Accordingly, CDCO's fee charged to courts for debt collection services will increase from 14 percent to 17 percent in fiscal 2003.

AUDIT FINDINGS

Strengthen Controls Over Program Change Procedures

Taxation uses three applications and one form to manage the program change control process; however, there is insufficient information to compare information between the applications and forms to adequately document the change request's progression through the workflow. By not capturing this data, Taxation does not have the assurance a program change has gone through all the processes to completion.

Further, for some applications, Taxation has not provided proper segregation of duties between staff modifying program code and moving program changes into production. This practice increases Taxation's risk of fraud by allowing the same individual to write and load potentially harmful production code.

Implementing new technologies has strained Taxation's staff resources as they attempt to maintain their legacy systems and this partially contributes to the issues noted above. However, Taxation is developing enhancements to the program change applications that will allow them to better capture and communicate program change activity. Taxation expects to implement these changes by March 2003.

Taxation should continue their enhancement of the program change applications to include the necessary information to track change requests as they move through the established program change workflow and ensure that they capture the approval of each phase. In addition, Taxation should expedite efforts to separate responsibilities for developing code and placing it into production to ensure proper segregation of duties throughout the program change process.

Approve and Implement Formalized Information Security Policy

Taxation developed their Information Security Policy in Fall 2000, which specifies how to establish and monitor logical and physical security. Although the Information Security Policy meets the COV ITRM Standard SEC 2001-01.1 and reflects many of the practices in place within the organization today, Taxation has not formally accepted, approved, or implemented the proposed policy.

Within the last several years, Taxation has implemented several critical and non-critical applications and plans to implement additional critical applications within the next year. By not formally adopting and implementing their Information Security Policy, there is no standard for securing their operating environment either physically or logically. Thus as turnover occurs, staffing resources decrease, and new systems are implemented, the risk of unauthorized access to and misuse of sensitive data and applications increases.

Taxation should formally approve and implement their Information Security Policy. Once implemented, Taxation should review all existing systems to ensure they are in compliance with the policy. Taxation should also specifically identify the department(s) responsible for enforcing the Information Security Policy, addressing both logical and physical access.

Strengthen Operating System Security Policies and Procedures

Taxation's Internet Filing Application servers reside at the Department of Technology's (DIT) data center to take advantage of centralized physical and environmental controls. Taxation also relies on DIT to maintain the operating system on these servers. Taxation has an Internet Filing Security Policy and Strategy, as well as a written agreement with DIT, defining DIT's responsibilities for these servers.

We found the written agreement does not reflect changes in the level of services provided by DIT to Taxation that have occurred over time. In addition, we found there were system users without passwords, unnecessary network services enabled, and inappropriate file and directory permissions. Finally, we found a lack of a standard configuration among the various servers.

We recommend management update its agreement to reflect the level of service Taxation expects to receive and its policies and procedures to include Taxation's expectations for the security of the Internet Filing Application servers. Taxation should develop, implement, and monitor a standard secure operating system configuration for these servers to ensure the security over and integrity of the information maintained on these servers.

Update and Improve Revenue Accounting Procedures

Taxation has implemented a number of new applications, processes, and procedures that have changed how Taxation does business and handles transactions. While this change process has improved overall operations, revenue accounting has not updated many of the tools and procedures in their area. By not effectively integrating these changing processes into their work and better using the technology available, this section encounters inefficiencies in tracking and resolving reconciling items.

Management has indicated that resolution of most of these issues will occur through the Partnership Project. We encourage management to utilize the advanced technology available through the Partnership Project to improve revenue accounting operations and controls. Management should review all existing procedures and reports used to complete revenue accounting activities and determine their applicability and usefulness given the functionality offered through the new revenue accounting system. Management should ensure the elimination of all duplicative processes. In addition, management should ensure staff obtain sufficient training to perform their daily tasks with proficiency and efficiency.

Improve the Data Capture Process for Refund Performance Measurement

Taxation does not accurately capture accelerated refund return information it uses to generate its refund performance measurement, which identifies the percentage of direct-filed, current-year individual income tax refunds processed within 12 days of receipt. Taxation's system begins tracking accelerated tax return refunds the day someone enters them into the system rather than the day Taxation receives the tax return, making tracking of this measure unreliable.

Taxation plans to change this performance measure in fiscal year 2003 to include all refund returns, not just the direct-filed returns. Taxation does not plan to use the separate accelerated refund process beginning in 2003 because of technological advancements in its systems; instead Taxation will process accelerated refund returns in the same processing stream as other returns directly filed at Taxation. However, the localities will continue to use the accelerated refund process in fiscal year 2003, so the new performance measure will still be affected by the manner in which the accelerated refund return information is gathered.

Taxation should change its process for accelerated refunds to capture the data needed to properly measure refund performance. These modifications should give consideration to data captured by localities. This will ensure that performance measures used by the General Assembly and others are accurate.

Ensure Timely Suspension of ACF2 Accounts

As noted in prior years, Taxation does not suspend access of terminated employees in a timely manner. Our review of ACF2 access found a delay in the suspension of three terminated employees' access from three days up to four months. Untimely suspension and deletion of access could result in unauthorized or abusive use of system privileges. Depending on the type of access, someone could use this access to alter or delete financial records.

Management should improve procedures and controls over the deletion of access to ensure the integrity of accounting transactions. These procedures and controls should ensure suspension of access to agency systems occurs on an employee's last day of employment.

DEPARTMENT OF THE TREASURY

Overview

The Department of the Treasury (Treasury), under the direction of the State Treasurer, serves as the custodian of state funds. Treasury has the following divisions, which provide services to the Commonwealth:

- Cash Management and Investments Division
- Debt Management Division
- Division of Risk Management
- Unclaimed Property Division
- Operations Division
  - Check Processing
  - Trust Accounting
  - Bank Reconciliation

In addition, Treasury staff also provide administrative support for the following entities:

- Virginia Public School Authority
- Virginia College Building Authority
- Virginia Public Building Authority
- Debt Capacity Advisory Committee
- Treasury Board

Cash Management and Investments Division

The General Account of the Commonwealth, a pool of investments representing assets of various funds including the General Fund of the Commonwealth and higher education (operating), highway maintenance, and transportation trust funds, is the largest portfolio managed by the Cash Management and Investments Division. The General Account portfolio has two pools: the primary liquidity pool and the total return pool. The Cash Management and Investments Division manages the primary liquidity pool, which provides the major source of liquidity for the disbursement requirements and operational needs of the Commonwealth. The externally-managed total return pool seeks to generate higher total returns over time as compared to the liquidity pool. 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's monthly average invested balance for fiscal year 2002 was $3.16 billion. The yield for fiscal year 2002 was 5.66 percent.

The Cash Management and Investments Division also manages the Local Government Investment Pool (LGIP). LGIP is an investment program 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, professional management, and compliance with Virginia's Investment of Public Funds statutes and Governmental Accounting Standards Board requirements. Further, Treasury manages the Commonwealth's statewide banking network and monitors its own and other agencies' specialized banking services.

Debt Management Division

Virginia is one of only eight states with a "AAA" bond rating for general obligation debt from three rating services: Moody's Investors Service, Standard & Poors Corporation, and Fitch Ratings, Inc. The Debt Management Division is responsible for the issuance and management of debt for the Commonwealth and several of its boards and authorities. Debt Management also monitors outstanding Commonwealth debt issued by certain boards and authorities for reporting purposes, advises on the financing of state capital projects, 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. Through providing staff services to the Treasury Board, Debt Management participated in approving the terms and structure of all issues of Commonwealth appropriation-supported debt. In fiscal 2002, Debt Management executed 38 equipment leases totaling $33,001,605 under the Master Equipment Leasing Program.

Division of Risk Management

The Division of Risk Management is responsible for administering insurance programs on behalf of the Commonwealth. Insurance programs are either self-insured or commercially-insured.

Risk Management administers the following programs under Treasury:

- State Agency Programs
  - Liability Insurance
  - Property Insurance
  - Fidelity Bonds
- Constitutional Officer Programs
  - Liability Insurance
  - Fidelity Bonds
- Local Government Programs
  - Liability Insurance
  - Property Insurance

Risk Management bills state agencies, the Compensation Board, and local governments for insurance premiums to cover current and future claims. The Commonwealth assumes all risk for the self-insured program and if this fund were to have a deficit, the Commonwealth would have to pay the outstanding claims. The Commonwealth should ensure that this fund has sufficient cash balances and reserves to cover claims payable.

Adding to the risk of becoming under-funded, the General Assembly has required several transfers to the General Fund from the Insurance Trust Funds. The 2002 - 2004 proposed budget bill, if passed, will direct Risk Management to transfer an additional $5 million from the General Liability Insurance Reserves to the General Fund. Following are tables that show the estimated change in fund balances from June 30, 2002 to June 30, 2003, for state programs only and reflect what Risk Management projects the balances to be as of June 30, 2004.

	General Liability	Medical Malpractice	Automobile	Property
Fund balance, June 30, 2002	$ 6,246,659	$ 3,472,488	$ 3,124,766	$ 6,585,222
Premiums collected from agencies	5,463,847	4,114,260	2,961,896	4,193,342
Loss payments *	(6,303,064)	(4,865,644)	(3,267,429)	(13,318,927)
Administrative and program expenses	(282,709)	(202,431)	(184,237)	(5,665,306)
Investment income	336,277	292,536	237,618	429,950
Transfer to General Fund **	(5,000,000)	-	-	-
Fund balance, June 30, 2003	461,010	2,811,209	2,872,614	(7,775,719)

Premiums collected from agencies ***	5,463,847	4,114,260	2,961,896	5,462,832
Loss payments *	(4,074,000)	(2,720,000)	(2,726,000)	(3,139,000)
Administrative and program expenses	(285,537)	(204,455)	(186,080)	(5,721,959)
Investment income	339,640	295,461	239,994	434,249
Fund balance, June 30, 2004	$ 1,904,960	$ 4,296,475	$ 3,162,424	$(10,739,597)

	Indemnity Bond	Watercraft	Aviation	Constitutional Officers
Fund balance, June 30, 2002	$ 535,344	$ 347,695	$ 382,948	$ 5,728,873
Premiums collected from agencies	180,043	142,258	954,613	2,833,999
Loss payments *	(802,500)	-	-	(6,519,004)
Administrative and program expenses	(187,444)	(125,509)	(1,447,848)	(457,117)
Investment income	22,229	19,008	40,392	332,308
Transfer to General Fund **	-	-	-	-
Fund balance, June 30, 2003	(252,328)	383,452	(69,895)	1,919,059
Premiums collected from agencies ***	180,043	142,258	954,613	2,833,999
Loss payments *	(416,000)	-	-	(3,265,000)
Administrative and program expenses	(189,318)	(126,764)	(1,462,327)	(461,688)
Investment income	22,451	19,198	40,796	335,631
Fund balance, June 30, 2004	$ (655,152)	$ 418,144	$ (536,813)	$ 1,362,001

* The loss payments in FY 2003 include reserves for claims in process.
** Transfer in the Governor's introduced budget bill (Section 3-1.01 BBB)
*** The premiums collected for the property insurance program for FY 2004 include an increase of $1.27 million as provided for in the Governor's introduced budget bill (General Fund portion provided in Item 512 M).

Unclaimed Property Division

The Unclaimed Property Division is responsible for the administration of two major types of abandoned property programs:

- Personal property
- Real property

The Unclaimed Property Act establishes the Commonwealth as custodian of certain personal properties (both intangible and tangible) until the Commonwealth can locate the owners. The Unclaimed Property Division holds funds it receives under the Unclaimed Property Act in perpetuity until the Division identifies the owner.

The Escheats Statute generally benefits localities through the sale of abandoned real estate by placing the property back on the tax rolls and paying delinquent taxes from the sales proceeds. Owners may claim the excess proceeds of a sale for up to five years after the date of the sale. After five years, the Division deposits these excess funds in the Literary Fund.

The Division identifies abandoned personal property through annual reporting requirements and the performance of audits and compliance reviews, administers the funds under the Commonwealth's control, and uses its best efforts to return the property to its owner. These efforts include a property search mechanism located on Treasury's website.

The primary non-general fund source of Treasury's budget for the Unclaimed Property Division comes from the receipt of unclaimed property. In 2002, Treasury collected over $54 million in unclaimed property. Treasury had the following activity in the Unclaimed Property Fund for fiscal 2002:

Collections	$ 54,380,560
Property returned to owners	(14,079,478)
Transfers to the Literary Fund	(35,000,000)
Operating expenses	(3,152,779)
Net change	2,148,303
Balance at July 1, 2001	10,346,900
Balance at July 1, 2002	$ 12,495,203

Operations Division

Check Processing

Treasury is responsible for the printing and distribution process of all checks. The check writing function is one continuous operation from file transmission, to printer, to the output of the check document. Last year, Treasury fully-implemented a new system, which has made the check printing function quicker and more efficient.

Trust Accounting

Trust Accounting performs a variety of functions for Treasury, which include the following:

- Acting as trustee for college bond issues
- Ensuring all debt service payments are made timely
- Preparing financial statements for the Virginia Public School Authority, Virginia College Building Authority, and Virginia Public Building Authority
- Servicing Literary Fund loans for the Virginia Public School Authority
- Monitoring public depositories under the Security for Public Deposits Act
- Monitoring the administration of the State Non-Arbitrage Program
- Accounting and monitoring securities lending transactions
- General accounting and financial reporting

Bank Reconciliation

Treasury reconciles all state deposits between the State Comptroller's ledger and the bank for the following accounts:

- Concentration Bank Accounts
- Regional Bank Accounts
- Special and Trust Bank Accounts

The Commonwealth's two disbursement banks are responsible for full reconciliation of check disbursement activity. Treasury employs a completely automated system to reconcile bank accounts. The Recon Plus system interfaces with other bank systems, allowing Treasury to reconcile accounts within 45 days of month end.

AUDIT FINDING

Evaluate Remote Access of the Check Writing System

Treasury should reevaluate the vendor's need to perform remote support of the check writing system. The check writing system is a fully-implemented system and should not require remote administration for maintenance and other activities. Allowing remote access of the system reduces internal controls and increases the risk of unauthorized access.

If Treasury determines that remote access is necessary, they should immediately address the security and controls over this access, which should include restrictions placed on its use by the vendor, as well as establishing a password key on the modem used for dial-up connectivity.

TREASURY BOARD

The Code of Virginia sets forth the appointments to the Treasury Board, which include the State Treasurer, the State Comptroller, the State Tax Commissioner, and four members appointed by the Governor. The Treasury Board has the responsibility to:

- Exercise general supervision over the investment of state funds
- Administer the Virginia Security for the 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 (SNAP)
- Provide advice and supervision in the financing of state buildings
- Approve the terms and structure of proposed state educational institution bond issues
- 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

The Treasury Board also 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 bonds to trustees and agents for the bondholders.

Bond and loan payments made by the Treasury Board in the fiscal year ended June 30, 2002, are as follows:

General Fund	$255,205,963
Special Revenue Fund	4,254,836
Higher Education Fund	2,422,604
Total	$261,883,403

The Treasury Board operates a tax-exempt commercial paper program to provide start-up funding for several of the Commonwealth's capital borrowing programs. As of June 30, 2002, there was no tax-exempt commercial paper for general obligation bond projects outstanding.

AGENCIES OF THE SECRETARY OF FINANCE
SELECTED SUMMARY FINANCIAL INFORMATION
FOR THE YEAR ENDED JUNE 30, 2002

	Office of the Secretary	Accounts		Planning and Budget	State Internal Auditor
	General Fund	General Fund	Nongeneral Funds	General Fund	General Fund
Original operating appropriations	$ 501,719	$ 9,462,951	$ 2,210,218	$ 5,672,698	$ 760,155
Adjustments:					
Reappropriations	35,683	-	-	140,000	-
Additional revenue	-	-	-	-	-
Transfer between years	-	-	-	-	-
Federal cash management interest	-	-	-	-	-
Other	(5,102)	(517,369)	-	(145,181)	16,917
Adjusted operating appropriations	$ 532,300	$ 8,945,582	$ 2,210,218	$ 5,667,517	$ 777,072
Resources:					
General Fund appropriations	$ 532,300	$ 8,945,582	$ -	$ 5,667,517	$ 777,072
Unclaimed property collections	-	-	-	-	-
Public service company taxes	-	-	-	-	-
Treasury loan activity*	-	-	(1,520,000)	-	-
Transfer in	-	-	1,520,000	-	71,203
Risk Management charged for services	-	-	-	-	-
Delinquent tax collection fees	-	-	-	-	-
Court debt collection fees	-	-	-	-	-
Technology fund (90 percent)	-	-	-	-	-
Technology fund (10 percent)	-	-	-	-	-
Other	-	-	138,469	-	-
Total resources	532,300	8,945,582	138,469	5,667,517	848,275
Uses:					
Salaries and benefits	423,905	7,191,699	42,000	4,668,631	510,349
EDP operations, supplies, and equipment	2,543	725,586	-	184,826	4,099
Postage and printing	799	64,277	-	8,178	757
Investment management services	-	-	-	-	-
Draw down loan interest	-	-	-	-	-
Building rentals	14,476	444,663	-	-	28,318
Payments to unclaimed property claimants	-	-	-	-	-
Technology funds	-	-	-	-	-
Risk Management expenditures	-	-	-	-	-
Bonds and loan payments	-	-	-	-	-
Other	17,626	519,348	75,218	751,546	66,229
Transfer to the Literary Fund	-	-	-	-	-
Transfer out	-	-	-	-	56,821
Total uses	459,349	8,945,573	117,218	5,613,181	666,573
Net activity in fiscal year 2002	$ 72,951	$ 9	21,251	$ 54,336	$ 181,702
Nongeneral cash available at beginning of year			2,083,333		
Nongeneral cash available at end of year			$ 2,104,584		

The financial information presented above came directly from the Commonwealth Accounting and Reporting System which is recorded on a cash basis of accounting.

*This amount represents a Treasury loan for the Program Budgeting (PROBUD) computer system.

Taxation		Treasury		Treasury Board		Secretarial Totals	
General Fund	Nongeneral Funds	General Fund	Nongeneral Funds	General Fund	Nongeneral Funds	General Fund	Nongeneral Funds
$ 58,374,320	$ 39,433,216	$ 7,889,181	$ 7,508,129	$ 259,903,421	$ 6,677,440	$ 342,564,445	$ 55,829,003
-	4,138,550	-	443,000	-	-	175,683	4,581,550
-	-	-	156,171	-	-	-	156,171
-	1,717,983	-	-	-	-	-	1,717,983
-	-	738,627	-	-	-	738,627	-
(268,847)	774,000	(393,784)	697,954	1,214,737	-	(98,629)	1,471,954
$ 58,105,473	$ 46,063,749	$ 8,234,024	$ 8,805,254	$ 261,118,158	$ 6,677,440	$ 343,380,126	$ 63,756,661
$ 58,105,473	$ -	$ 8,234,024	$ -	$ 261,118,158	$ -	$ 343,380,126	$ -
-	-	-	54,380,560	-	-	-	54,380,560
-	227,113	-	-	-	-	-	227,113
-	-	-	-	-	-	-	(1,520,000)
-	-	-	23,012,544	111,521	8,195,005	182,724	32,727,549
-	-	-	20,089,598	-	-	-	20,089,598
-	4,539,983	-	-	-	-	-	4,539,983
-	3,159,447	-	-	-	-	-	3,159,447
-	39,522,127	-	-	-	-	-	39,522,127
-	4,391,347	-	-	-	-	-	4,391,347
-	55,121	-	1,233,229	-	905,039	-	2,331,858
58,105,473	51,895,138	8,234,024	98,715,931	261,229,679	9,100,044	343,562,850	159,849,582
43,101,622	1,191,481	2,604,551	3,654,885	1,161	-	58,501,918	4,888,366
2,293,737	477,581	221,752	351,591	3,763	-	3,436,306	829,172
3,663,566	235,182	1,132,424	114,864	6,304	-	4,876,305	350,046
-	-	2,142,163	-	-	-	2,142,163	-
-	-	738,627	-	-	-	738,627	-
3,059,604	52,065	179,907	212,347	-	-	3,726,968	264,412
-	-	-	13,846,192	-	-	-	13,846,192
-	36,755,972	-	-	-	-	-	36,755,972
-	-	-	21,750,128	-	-	-	21,750,128
-	-	-	-	255,205,963	6,677,440	255,205,963	6,677,440
5,559,906	6,581,035	1,211,371	1,550,292	3,953,068	-	12,079,094	8,206,545
-	-	-	35,000,000	-	-	-	35,000,000
-	801,605	-	22,321,666	-	2,422,604	56,821	25,545,875
57,678,435	46,094,921	8,230,795	98,801,965	259,170,259	9,100,044	340,764,165	154,114,148
$ 427,038	5,800,217	$ 3,229	(86,034)	$ 2,059,420	$ -	$ 2,798,685	5,735,434
	11,588,685		67,893,034				81,565,052
	$ 17,388,902		$ 67,807,000				$ 87,300,486

DEPARTMENT OF TREASURY- RISK MANAGEMENT FUNDS
SELECTED FINANCIAL INFORMATION
FOR THE PERIOD ENDING JUNE 30, 2002

	Governmental Activities Internal Service Funds			
	Property	Water Craft and Aviation	Indemnity Bond	General Liability*
Operating revenue:				
Charges for services	$ 4,146,275	$ 810,665	$ -	$ 9,887,465
Restitution revenue	-	-	-	-
Total operating revenues	4,146,275	810,665	-	9,887,465
Operating expenses:				
Claim payments	1,797,110	-	118,035	2,537,722
Program expenses	1,921,633	920,022	62,960	482,308
Administrative expenses	247,843	7,148	14,828	575,527
Total operating expenses	3,966,586	927,170	195,823	3,595,557
Operating income (loss)	179,689	(116,505)	(195,823)	6,291,908
Nonoperating revenues (expenses):				
Interest, dividends, and rent	403,274	32,376	31,646	636,088
Increase in the fair market value of investments	-	-	-	-
Income from securities lending	27,114	2,285	2,124	43,584
Expenses from securities lending	(27,114)	(2,285)	(2,124)	(43,584)
Transfer to the General Fund	-	-	-	(78)
Total nonoperating revenues (expenses)	403,274	32,376	31,646	636,010
Change in net assets	582,963	(84,129)	(164,177)	6,927,918
Total net assets - July 1, 2001 (as restated)	2,097,842	812,217	259,348	(11,954,371)
Total net assets - June 30, 2002	$ 2,680,805	$ 728,088	$ 95,171	$ (5,026,453)

The financial information presented above came from the Commonwealth Accounting and Reporting System and was adjusted for revenues earned but not received and expenses incurred but not paid.

Complete financial information for all risk management funds presented using accounting principles generally accepted in the United States is available in the Commonwealth's Comprehensive Annual Financial Report.

* General Liability includes Medical Malpractice and Automobile insurance funds.

Business-type Activities Enterprise Funds			
Local Entities Bond Insurance	Constitutional Officers Insurance	Local Government Plan Insurance	Commuter Rail Insurance
$ 60,902	$ 3,654,000	$ 1,530,291	$ -
-	-	-	8,500
60,902	3,654,000	1,530,291	8,500
733,960	2,000,766	1,474,262	-
115,524	87,555	159,146	2,176,076
2,413	312,028	225,319	20,901
851,897	2,400,349	1,858,727	2,196,977
(790,995)	1,253,651	(328,436)	(2,188,477)
34,346	296,493	407,696	1,202,193
-	-	-	245,074
-	-	-	-
(2,150)	(19,139)	(25,940)	(21,518)
-	-	-	-
32,196	277,354	381,756	1,425,749
(758,799)	1,531,005	53,320	(762,728)
776,722	(1,131,312)	3,885,962	20,251,825
$ 17,923	$ 399,693	$ 3,939,282	$ 19,489,097

Commonwealth of Virginia

Walter J. Kucharski, Auditor

Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218

February 21, 2003

The Honorable Mark R. Warner
Governor of Virginia
State Capitol
Richmond, Virginia

The Honorable Kevin G. Miller
Chairman, Joint Legislative Audit
and Review Commission
General Assembly Building
Richmond, Virginia

INDEPENDENT AUDITOR'S REPORT

We have audited the financial records and operations of the **Office of the Secretary of Finance, the Departments of Accounts, Planning and Budget, State Internal Auditor, Taxation, and the Treasury, and the Treasury Board** for the year ended June 30, 2002. We conducted our audit in accordance with Government Auditing Standards, issued by the Comptroller General of the United States.

Audit Objectives, Scope, and Methodology

Our audits' primary objectives were to review the internal control over the Commonwealth's financial reporting process, central accounting and reporting systems, centralized services provided to agencies and institutions, and processing of tax returns; review the agencies' internal control over payroll and other expenses; test their compliance with applicable laws and regulations; and evaluate the accuracy of financial transactions recorded on the Commonwealth Accounting and Reporting System. We also determined the status of audit findings from prior year reports.

Our audit procedures included inquiries of appropriate personnel, inspection of documents and records, and observation of the following operations:

- Financial Reporting
- Commonwealth Accounting and Reporting System
- Commonwealth Integrated Payroll and Personnel System
- Fixed Asset Accounting and Control System
- Cash Management and Investment
- Debt Financing
- General Fund Appropriation Transaction Processing
- Tax Revenue Collection
- Unclaimed Property
- State Indirect Cost Allocation Plan

We also tested transactions and performed such other auditing procedures, as we considered necessary to achieve our objectives. We reviewed the overall internal accounting controls, including controls for administering compliance with applicable laws and regulations, over the significant cycles, classes of transactions, and account balances.

We obtained an understanding of the relevant internal control components sufficient to plan the audit. We considered materiality and control risk in determining the nature and extent of our audit procedures. We performed audit tests to determine whether the agencies' policies and procedures were adequate, had been placed in operation, and were being followed. Our audits also included tests of compliance with provisions of applicable laws and regulations.

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.

Our audits were more limited than would be necessary to provide assurance on internal control or to provide an opinion on overall compliance with laws and regulations. Because of inherent limitations in internal control, errors, irregularities, or noncompliance may nevertheless occur and not be detected. Also, projecting the evaluation of internal control to future periods is subject to the risk that the controls may become inadequate because of changes in conditions or that the effectiveness of the design and operation of controls may deteriorate.

Audit Conclusions

We noted certain matters involving internal control and its operation that we considered to be reportable conditions for the Departments of Taxation and the Treasury. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the agencies' ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial records. These reportable conditions are discussed in the Departments of Taxation and the Treasury sections of the report. We believe none of the reportable conditions are material weaknesses. Further, the results of our tests of compliance disclosed no instances of noncompliance that are required to be reported herein under Government Auditing Standards.

We found that the agencies properly stated, in all material respects, the amounts recorded and reported in the Commonwealth Accounting and Reporting System. The agencies record their financial transactions on the cash basis of accounting, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America. The financial information presented in the accompanying schedules came directly from the Commonwealth Accounting and Reporting System.

Except for Taxation, the agencies have taken adequate corrective action with respect to audit findings reported in the prior year. Taxation has not taken adequate corrective action with respect to the previously reported finding "Strengthen Controls Over Access Security." Accordingly, we included the finding "Ensure Timely Suspension of ACF2 Accounts" in this report in Taxation's section entitled "Audit Findings."

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

EXIT CONFERENCES

We discussed this report with management at each agency.

AUDITOR OF PUBLIC ACCOUNTS

SAH:kva
kva:

AGENCIES OF THE SECRETARY OF FINANCE
Richmond, Virginia

as of June 30, 2002

John M. Bennett
Secretary of Finance

David A. Von Moll
Comptroller

Richard D. Brown
Director of the Department of Planning and Budget

Merritt L. Cogswell
State Internal Auditor

Kenneth W. Thorson
Tax Commissioner

Jody M. Wagner
Treasurer