

**DEPARTMENT OF TRANSPORTATION
RICHMOND, VIRGINIA**

**REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2002**



AUDIT SUMMARY

Our audit of the Department of Transportation for the year ended June 30, 2002, found:

- internal control matters that we consider to be reportable conditions, one of which we consider to be a material weakness;
- proper recording and reporting of transactions, in all material respects, in the Commonwealth Accounting and Reporting System and Transportation's accounting records, except as explained in the finding "Implement Review Procedures and Post CARS and FMSII Adjustments Timely" in the section entitled "Findings and Recommendations;"
- issues of noncompliance with applicable laws and regulations tested; and
- inadequate corrective action on prior year audit findings.

We found that Transportation does not have adequate internal controls surrounding the recording and reporting of capital assets. Transportation has not assigned central responsibility for recording and reporting capital assets. Because of the lack of central controls, Transportation did not capture all capital assets, recorded some capital assets twice, and did not properly report and record depreciation expense. We believe the controls surrounding capital assets are inadequate and that these issues are so pervasive that they represent a material weakness in Transportation's internal controls.

Transportation did not properly disclose their future lease payments or contractual commitments. We reported previously that Transportation did not properly track and record operating leases. While they have taken corrective action on last year's findings, we found additional issues during fiscal year 2002. Transportation also does not have adequate procedures to properly track and disclose its contractual commitments balance.

Transportation has not adequately documented its Financial Management System (FMSII) database, and does not have a long-range plan to address version upgrades to FMSII. Transportation extensively customized FMSII, but has not adequately documented these customizations. Additionally, Transportation has lost vendor support for the PeopleSoft and Oracle versions on which FMSII runs.

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January 15, 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 **Virginia Department of Transportation** 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 Objective, Scope, and Methodology

Our audit's primary objectives were to evaluate the accuracy of recording financial transactions on the Commonwealth Accounting and Reporting System and in Transportation's accounting records, review the adequacy of Transportation's internal control, and test compliance with applicable laws and regulations. We also reviewed Transportation's corrective actions of audit findings from prior year reports.

Our audit procedures included inquiries of appropriate personnel, inspection of documents and records, and observation of Transportation's operations. 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. Our review encompassed controls over the following significant cycles, classes of transactions, and account balances:

- Cash and Investments
- Capital Assets and Infrastructure
- Long Term Debt
- Revenues and Receivables
- Federal Grants and Contracts
- Expenses and Payables, including Payroll

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 Transportation'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 and regulations.

Transportation's 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 audit was 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 found that, except as stated in the following paragraph, Transportation properly stated, in all material respects, the amounts recorded and reported in the Commonwealth Accounting and Reporting System (CARS) and in Transportation's accounting records. Transportation records its 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 this report came directly from Transportation's accounting records.

During fiscal year 2002, Transportation paid for Northern Virginia Transportation District highway construction expenses out of its Highway Construction Fund. Transportation funds these expenses with bond proceeds and tracks them in a separate fund. After year-end, Transportation posted an adjustment to its accounting records to move the expenses and related cash spent to the Northern Virginia Transportation District fund but did not post the corresponding adjustment to the Highway Construction Fund. Furthermore, Transportation did not adjust fiscal year 2002 balances in CARS. As a result, Transportation understated expenses and overstated cash in the Northern Virginia Transportation District Fund in CARS and overstated expenses and understated cash in the Highway Construction Fund in CARS and its accounting records by \$11.9 million. Additional information is included in the finding entitled "Implement Review Procedures and Record CARS and FMSII Adjustments Timely" in the section entitled "Findings and Recommendations."

We noted certain matters involving internal control and its operation that we consider to be reportable conditions. 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 Transportation's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial records. Reportable conditions are included in the section entitled "Findings and Recommendations."

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider "Improve Internal Controls over Assets to Prevent Capital Asset Misstatements" to be a material weakness.

The results of our tests of compliance with applicable laws and regulations disclosed instances of noncompliance that are required to be reported under Government Auditing Standards. The instances of noncompliance are described in the section entitled “Findings and Recommendations.”

Transportation has not taken adequate corrective action with respect to the previously reported findings “Properly Track and Record Operating Leases” and “Develop a Long-Term Plan to Address Version Upgrades for FMSII.” Accordingly, we included these findings, respectively, in the findings entitled “Properly Track and Record Leases and Lease Payments” and “Develop Adequate Documentation of and a Long- Range Plan for FMSII” in the section entitled “Findings and Recommendations.” Transportation has taken adequate corrective action with respect to audit findings reported in the prior year that are not repeated in this report.

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.

EXIT CONFERENCE

We discussed this report with management at an exit conference held on January 29, 2003.

AUDITOR OF PUBLIC ACCOUNTS

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NEW REPORTING REQUIREMENTS

The Commonwealth implemented Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments* (GASB Statement No. 34) for fiscal year 2002. GASB Statement No. 34 is a new reporting model intended for use by governments to make annual reports more comprehensive and easier to understand. GASB did not develop the model for use by individual governmental departments and agencies. There are some inherent problems in applying the model to individual governmental departments and agencies, notably the requirements for "Government-Wide" statements and Management's Discussion and Analysis.

Traditionally Transportation has produced financial statements, and we have audited those statements, primarily for use by Transportation's bond rating agencies. Due to our concerns about a governmental department's ability to comply with the new model's reporting requirements, Transportation sought an opinion from their bond counsel and bond rating agencies concerning the requirement for separately audited Transportation statements. Both bond counsel and the rating agencies agreed that they did not need separately audited financial statements for Transportation. Transportation will continue to provide financial disclosures to the rating agencies, and we will continue to provide an audited Commonwealth Comprehensive Annual Financial Report, which includes Transportation, for rating purposes.

For fiscal year 2002, we audited Transportation's financial account balances that were material to the Commonwealth and reviewed Transportation's internal controls and compliance with laws and regulations. Our report provides a description of our findings and a summary of Transportation's financial data. We will continue to audit Transportation and issue reports on our findings.

FINDINGS AND RECOMMENDATIONS

The Virginia Department of Transportation is one of the three largest agencies in the Commonwealth with over 10,200 employees and a fiscal year 2002 budget of over \$3.2 billion. Transportation is a highly decentralized agency comprised of nine districts and a central office. The districts contain 42 residencies, and each county contains at least one area maintenance headquarters. The central office is headquarters for approximately 30 operational and administrative units. Transportation's decentralized organization has created a compartmentalized and hierarchical environment that does not promote communication and has led to several findings discussed in this report. Transportation's new Commissioner is dedicated to changing the current culture of Transportation to promote communication between and within Transportation's divisions and districts.

During our audit, we found reportable internal control weaknesses and instances of noncompliance in the following broad areas:

- Financial Disclosures
- Accounting and Information Systems
- Federal Subrecipient Monitoring

FINANCIAL DISCLOSURES

Capital Assets

Transportation maintains and reports the majority of the Commonwealth's infrastructure, which consists of highways, bridges, tunnels, and right-of-way land, as well as a material amount of the

Commonwealth's capital asset balances other than infrastructure. For fiscal year 2002, Transportation's infrastructure and other capital assets totaled \$10.7 billion, net of accumulated depreciation, with \$306.3 million in related depreciation expense.

During fiscal year 2002, Transportation and the Commonwealth implemented the new governmental reporting model, GASB Statement No. 34 *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments* (GASB Statement No. 34). GASB Statement No. 34 requires that capital assets, which include land, buildings, improvements, vehicles, machinery, equipment, and infrastructure, be reported net of accumulated depreciation and that depreciation expense be recognized in the financial statements. GASB Statement No. 34 also requires that Transportation depreciate capital assets (except inexhaustible assets such as land) over their estimated useful lives. Transportation reports most depreciation as a direct expense of the highway construction and maintenance programs.

Finding: *Improve Internal Controls over Assets to Prevent Capital Asset Misstatements*

Transportation did not fully prepare for the recording and reporting of capital assets under the new governmental reporting model, GASB Statement No. 34. Transportation did not properly identify and address all issues surrounding the new reporting requirements for capital assets, did not provide guidance to all personnel responsible for maintaining capital assets, and did not properly report capital assets.

We first reported our concern about Transportation's ability to properly prepare for the implementation of GASB Statement No. 34 in our 1999 audit report in a finding entitled "Monitor and Comply with Accounting and Reporting Standards and Properly Prepare Financial Statements." We specifically identified GASB Statement No. 34 implementation and reported that the changes would be so substantial that the financial staff would need to restructure how they performed most of their work. In 1999, we recommended that management work with the financial staff to develop a working plan to address the implementation issues surrounding the changes in financial reporting. In our 2001 audit report, we again expressed our concerns over financial reporting procedures and recommended that Transportation use the GASB Statement No. 34 implementation process to establish written policies and procedures for financial statement preparation. Transportation did perform substantial work addressing the implementation of infrastructure asset capitalization, including participation with GASB and other groups on implementation issues, setting up a GASB 34 website, and providing guidance to localities. We recognize Transportation for the lead role they took regarding infrastructure implementation issues. Transportation did not, however, fully address the capitalization and depreciation of assets other than infrastructure.

We found several recording and reporting errors during our audit of Transportation's capital asset balances including a net \$34 million dollar overstatement of Transportation's reported capital asset balances and a net \$3.5 million understatement of reported depreciation expense. In fiscal year 2001, Transportation's capital asset balances comprised a significant portion of the Commonwealth's capital asset balances as reported in the Commonwealth's Comprehensive Annual Report (CAFR). Because Transportation's capital assets are a significant portion of the Commonwealth's reported capital asset balances, it is important that Transportation accurately report these balances. We believe the controls surrounding capital assets are inadequate and that these issues are so pervasive that they represent a material weakness in Transportation's internal controls.

Briefly, we found:

- Transportation has not capitalized all building construction as construction in progress as it occurs nor is Transportation able to identify all building construction currently in progress.

- Transportation has not capitalized all costs associated with capital assets and has not recorded any improvements to land and buildings. For example, Transportation has not capitalized the costs of parking lots, fences, or sewer systems.
- Transportation capitalized a Welcome Center financed through its Six Year (Highway Construction) Program twice as both highway system infrastructure and as a building. The amount capitalized as a building represented only half of the project's \$8.3 million cost.
- Transportation incorrectly recorded and reported over \$4 million in accumulated depreciation on controlled (not capitalized) assets, thereby understating assets.
- Transportation did not record or report accumulated depreciation or depreciation expense for one category of capitalized equipment, which overstated assets \$22.3 million and understated expenses by \$3.9 million.
- Transportation's Administrative Services division required all districts and divisions to complete an annual inventory of major equipment during fiscal year 2002. Four divisions and one district did not complete the inventory: Fiscal, Construction, Data Management, and Community and Public Relations divisions and the Northern Virginia District. These divisions and district account for approximately 10 percent of the asset inventory, which Transportation valued at \$19.5 million for fiscal year 2002.

We found that Transportation is only tracking and capitalizing construction in progress on assets constructed as part of the Commonwealth's capital outlay program and approved in the Appropriations Act. The Fiscal Division was unaware that divisions outside of the Capital Outlay division construct and acquire buildings and other improvements using funding from the Six Year Program for highways. As a result, Transportation is not tracking and recording construction in progress on these projects during construction and cannot determine what projects are currently in progress. The Fiscal Division could not identify project construction related expenses in the financial reporting system (FMSII) other than capital outlay expenses because the highway construction program includes these expenses. Transportation does not have a uniform policy for constructing and recording buildings and other improvements outside of the capital outlay process. Transportation relies on the responsible division, district, residency, or area headquarters to inform the Capital Outlay section that they have acquired an asset.

Commonwealth accounting and reporting procedures establish four categories of capitalizable fixed assets, specifically land, buildings, improvements other than buildings (now infrastructure), and equipment. Several years ago Transportation requested and received an exemption from the Department of Accounts allowing them not to capitalize any assets as improvements other than buildings, which now includes infrastructure. With the implementation of GASB Statement No. 34, this exemption is no longer valid since GASB Statement No. 34 requires the capitalization of all infrastructure. Because Transportation did not adequately prepare for GASB Statement No. 34 and research all relevant issues, Transportation's Fiscal Division did not identify that Transportation was not capitalizing improvements other than buildings. Similarly, Fiscal was also unaware that they had recorded depreciation on controlled assets and had not recorded depreciation on material amounts of capitalized assets, as noted above.

Additionally, because Transportation had an exemption from recording improvements other than buildings before implementation of GASB Statement No. 34, Transportation is not capitalizing the entire cost of a project. Transportation only capitalizes the portion of the project expenses they believe to be the land and building costs. We also found that Transportation was not using a rational or uniform method to determine the amount to capitalize. In one instance, we identified \$8.3 million in project expenses for a Welcome Center completed and capitalized during fiscal year 2002 for which Transportation capitalized only \$4.1 million as a building. Because the Fiscal Division was not aware of these types of projects and the fact that the funding flows through the Six Year Program, the Fiscal Division also capitalized the entire cost (\$8.3 million) of the Welcome Center as Road System Infrastructure.

Transportation has the responsibility for capitalizing all weigh station land and buildings and all welcome centers and rest stops as well as Transportation's own capital assets. The omission of improvements other than buildings considerably understates the value of Transportation's capital asset balances. GASB Statement No. 34 allows governmental entities to report infrastructure prospectively for the fiscal years 2002 through 2005. By 2006, governments must report infrastructure retroactively back to 1980. As GASB provides the phase-in period for the capitalization of infrastructure, we allowed Transportation to estimate improvements other than buildings additions only for fiscal year 2002. Transportation must develop a method to capture and capitalize the costs of improvements other than buildings for existing assets and for future projects so that they can capitalize this information by 2006. Transportation must also determine and record accumulated depreciation on those assets based on year of acquisition and useful life.

Transportation does not have uniform agency-wide policies and procedures for recording and reporting capital assets and has not designated a responsible individual or division to ensure proper recording of all categories of capital assets. Transportation groups its fixed assets into many smaller categories. Multiple individuals, divisions, and districts have responsibility for recording, managing, inventorying, and reporting these assets. There is no communication between these individuals, divisions, and districts or with the Fiscal division. Transportation records and tracks the different categories of capital assets using several different systems and an access database. Transportation's use of multiple systems and schedules makes tracking capital assets extremely difficult. In addition, Transportation does not code all capital asset additions and the related expenses associated with the capital asset acquisition uniformly in its financial reporting system, FMSII. As a result, Transportation is not able to readily identify and properly categorize all capital asset additions. These internal control weaknesses resulted in both material omissions and the double counting of assets.

Transportation should place overall responsibility for capital assets with one individual, group, or division. The responsible area should prepare written agency-wide policies and procedures for recording and reporting capital assets and ensure compliance with the policies. The policies should include uniform financial recording procedures so that Transportation can readily identify all asset acquisition expenses, capture all asset additions and disposals, and depreciate all capitalized assets in accordance with state accounting policies. Transportation should develop controls and oversight for all construction projects, not just those in capital outlay, and should ensure proper capitalization of all project related expenses. Transportation must determine the value of all improvements other than buildings and capitalize those amounts, and the related depreciation by 2006 and must determine a method to ensure that new improvement projects are captured and capitalized as they occur. Transportation should take immediate action to address and resolve these issues.

Leases

We found similar issues regarding Transportation's tracking, recording, and reporting of lease payments. Transportation has not properly recorded or reported leases because of the decentralized responsibility for leases. Transportation has numerous leases for items such as copiers that it records both in

its Financial Management System (FMSII) and the Commonwealth's Lease Accounting System (LAS). In addition to these operating leases, Transportation was the pilot agency for a program referred to as "Seat Management," which provides computer hardware and software through a contract from a single source. Seat Management services include hardware, software, support, and disposal. Transportation cannot enter the lease into LAS because Seat Management lease payments are not fixed but vary according to the amount of hardware and services provided and LAS cannot handle a lease with those terms and conditions. Transportation determines these annual lease expenses using FMSII.

Finding: Properly Track and Record Leases and Lease Payments

As reported in the previous audit, Transportation does not properly track and record leases and lease payments. Transportation did address our concerns; however, there are additional matters that Transportation must address. Transportation must record all leases, with the exception of its Seat Management Lease, on LAS. Transportation must compile and record all lease information for lease disclosure purposes. We found several internal control weaknesses that resulted in a \$21 million overstatement of Transportation's lease commitment disclosure and the improper recording of leases on LAS. In addition, Transportation is not recording lease payments in accordance with Commonwealth accounting policies. Transportation lacks communication between responsible areas and lacks specific, readily identifiable procedures for lease transactions.

We found:

- Transportation does not have adequate procedures to track all of its leases. Transportation does not record the Seat Management Lease on LAS because lease payments fluctuate based on the total equipment rented, not a stated monthly total. Transportation and the Department of Accounts (DOA) have agreed not to include this lease in LAS, provided that Transportation had adequate controls to properly account for the lease. Transportation has not developed procedures to properly track the terms and conditions of the lease, and therefore overestimated the total future value of the lease payments by more than \$21 million.
- Transportation does not have procedures to ensure that personnel properly forward lease documentation to the Department of Accounts (DOA) for recording in LAS. Based on the lease terms reported by Transportation personnel, the Administrative Services Division prepares lease documentation for submission to DOA. Because agency personnel incorrectly reported lease terms to Administrative Services, Transportation improperly recorded in LAS four of the eight (50 percent) leases tested.
- Agency employees are not properly recording lease expenses in Transportation's accounting system. In eight of twelve (67 percent) vouchers tested, Transportation either improperly recorded non-lease expenses as lease payments or improperly recorded lease payments as a non-lease expense. As a result, lease payments in Transportation's Financial Management System II (FMSII) and the Commonwealth Accounting and Reporting System (CARS) are not properly stated.

Transportation should implement procedures to ensure proper tracking and recording of leases in LAS, FMSII, and CARS. In addition, management should develop procedures to properly track the Seat Management Leases for proper lease commitment disclosure.

Contractual Commitments

Transportation did not properly disclose its contractual commitment obligations for fiscal year 2002. Contractual commitments represent Transportation's remaining monetary obligations under all current contracts. A contractual commitment is the difference between the original value of a contract and all payments made through year-end on a contract. Because of Transportation's substantial number of contracts, the commitment balance is included in the Commonwealth's CAFR disclosures.

Finding: *Develop Procedures to Properly Track Contractual Commitments*

Transportation does not have procedures to properly track its contractual commitments. When Transportation enters into a contract, personnel record the total value of the contract in FMSII. As Transportation makes payments and processes change orders against the contract, the remaining commitment of the contract changes. At fiscal year end, Transportation performs a manual reconciliation of the contractual commitment liabilities to develop the contractual commitment balance for inclusion in the Commonwealth's CAFR.

Transportation's fiscal year 2002 contractual commitments totaled approximately \$2 billion. We found internal control weaknesses in the recording of contract payments and the preparation of the contractual commitment disclosure that caused a \$255 million adjustment to Transportation's fiscal year end contractual commitment disclosure.

Specifically,

- Transportation personnel do not always charge contract expenses to the proper contract. Transportation did not properly record all vendor payments to the correct vendor's contract in twenty-seven percent of the contracts tested, resulting in a \$29 million dollar decrease in the contractual commitment liability as originally reported.
- Transportation personnel are not properly recording the terms of contracts in FMS II. We found three contracts where personnel did not properly record the total contract value in FMSII, resulting in a \$284 million increase in the contractual commitment to reflect the actual value of the contracts. In addition, we found several other contracts, listed in FMSII, with a negative contractual commitment balance. Negative contractual commitments result from personnel not properly updating the terms of the contract or not charging expenses to the correct contract. Transportation must manually adjust the commitment liability to eliminate the negative balances.
- Agency personnel do not always process a final voucher in FMSII to close out the contract in the system. Transportation must manually research the contracts to determine status.
- Transportation does not have proper procedures for tracking outstanding contractual commitments. FMSII cannot generate an accurate contractual commitment figure and central office personnel must perform a labor intensive and

largely ineffective manual reconciliation of the contractual commitment liabilities. Transportation amended the contractual commitments as reported in FMSII by over \$89 million dollars. We also found additional adjustments that Transportation personnel missed during the reconciliation.

Transportation should implement procedures to ensure that personnel properly record contracts, contract modifications, and contract expenses, including requiring a contract number before processing expense payments in FMSII. Transportation should develop procedures for ensuring that minor price changes that do not require contract modifications do not affect the remaining contractual commitment for the contract. Transportation should also develop a process to ensure that agency personnel are processing the final voucher in FMSII upon completion of the contract. Implementing these recommendations should improve the reconciliation process at fiscal year end and decrease the adjustments necessary to obtain an accurate contractual commitment balance.

Financial Statement Procedures

Finding: Implement Review Procedures and Record CARS and FMSII Adjustments Timely

Transportation did not properly record a fiscal year 2002 financial statement adjustment totaling \$11.9 million, thereby overstating expenses and understating cash. During fiscal year 2002, Transportation paid for Northern Virginia Transportation District highway construction expenses out of its Highway Construction Fund. Because Transportation funds Northern Virginia Transportation District expenses with bond proceeds, Transportation tracks these expenses in a separate fund. After year-end, Transportation posted a financial statement adjustment to move the expenses and related cash spent to the Northern Virginia Transportation District Fund, thereby increasing expenses and decreasing cash in the fund. They did not, however, post the corresponding adjustment to reduce expenses and increase cash in the Highway Construction Fund. Transportation did not adjust FMSII or CARS for fiscal year 2002 for the movement of the cash and expenses between funds.

Transportation subsequently posted these adjustments to both FMS II and CARS as fiscal year 2003 adjustments, even though the amounts related to fiscal year 2002 expenses. Although this will not have an effect on total transportation expenses and cash because the amounts are moving between transportation funds, the balances in the individual funds in CARS and FMSII are incorrect for both fiscal years.

Transportation should reverse the fiscal year 2003 entries in both FMSII and CARS and work with the Department of Accounts to properly post a prior period adjustment to CARS. Transportation should post necessary adjustments timely to avoid this situation in the future and should implement procedures, including thoroughly reviewing all adjustments, to accurately and timely report financial balances.

ACCOUNTING AND INFORMATION SYSTEMS

Transportation relies heavily on the data generated by its information systems. To audit Transportation's financial account balances, we also rely heavily on our ability to test and validate the data contained in those systems. Our ability to audit through a system is integral to our ability to provide assurance that controls are functioning and financial information is reasonably accurate. Because of the level of customization of Transportation's main accounting information system, FMSII, coupled with a lack of adequate system documentation, we were not able to gain independent access to the financial data.

Transportation implemented its primary financial management system, FMS II, during fiscal year 1999. This financial system is a client/server-based system that consists of a PeopleSoft Financial and Human Resources application, an Oracle Database, and a Windows NT FMS Panel Server all running on a Unix Operating System. Transportation networks the system over the Commonwealth Telecommunications Network and various local frame relay networks to all Transportation districts, area headquarters, and residencies. There are over 5,000 users of FMS II throughout the Commonwealth.

Finding: *Develop Adequate Documentation of and a Long-Range Plan for FMSII*

Transportation does not have adequate documentation of its FMSII database and still does not have a long-range plan to address version upgrades to FMSII. Without complete and accurate documentation of the tables' links and relationships, the auditors could not obtain a complete download of fiscal data for offline query and analysis; the vulnerability of Transportation to loss of key personnel is increased; and Transportation's ability to perform desired future upgrades to the system is threatened. Transportation has customized the PeopleSoft applications to include a Project Accounting module and a Time Entry module for employee timesheets. Neither the developer nor Transportation adequately documented these customizations. In addition, Transportation has lost vendor support for the PeopleSoft and Oracle versions on which FMSII runs.

Documentation of a database is fundamental to making databases useful. COV ITRM Guideline 91-5, Model Standard for Maintenance and Enhancement Projects, states that systems change documentation "should be equivalent to or better than existing documentation in content, format, style and completeness." This standard, when observed, promotes systems auditability and can help provide reasonable protection against computer systems fraud and error which could endanger the flow of information and resources through FMSII. When agencies do not observe this standard, as is the present case with FMSII, the resultant casual change control environment poses an unacceptable and unnecessary risk to systems integrity. Furthermore, incomplete documentation leads to fewer staff that fully understand the system. This poses the unnecessary risk that one key person will leave the organization, leaving the remaining users unable to perform the work or understand the system. Because of this missing documentation, the auditors were unable to accomplish retrieval and analysis of FMSII data and had to rely on Transportation staff to provide data as needed.

Transportation should work towards documenting the FMSII system and take action to ensure that it documents all future customizations and upgrades to all systems timely and accurately. To that end, management should not accept delivery of any pending or future software or hardware customizations or upgrades without ensuring the developer has also provided complete, sufficiently detailed documentation. If management lacks the time or expertise to ensure this contract deliverable, it should contract with a separate independent validation and verification provider to supervise the developer's progress.

In its attempts to upgrade Oracle, Transportation has encountered several obstacles that necessitated upgrading FMSII components other than PeopleSoft. As a result, Transportation has altered its Oracle upgrade plan to include the entire FMSII environment. Transportation has inventoried the current components of FMSII and determined which versions are no longer supported by the vendors and which ones are approaching that status. Transportation has also begun to document potential issues that could result due to the use of these components. Throughout this ongoing process, Transportation is considering the cost-benefit of performing and not performing the various upgrades. Transportation should continue its analysis and use it to develop a long-range plan for its financial system.

FEDERAL GRANTS MONITORING

Transportation receives certain grant funds from the federal government that it "passes through" to localities. As the "pass-through" entity, Transportation cannot spend the funds, but has the responsibility of reimbursing the locality, known as the subrecipient, once they have met the terms of the federal grant. When the federal government provides the federal funding to one entity to pass through to another, the pass-through entity assumes certain responsibilities for monitoring the subrecipient.

Finding: *Perform Subrecipient Monitoring of Localities*

Transportation does not properly monitor Federal funds passed through to localities as required by OMB Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations," Section .400(d), which states that a pass-through entity shall perform the following for Federal awards it makes:

- Ensure that subrecipients expending over \$300,000 or more in Federal awards during the subrecipient's fiscal year have met the audit requirements of this part for that fiscal year.
- Issue a management decision on audit findings within six months after receipt of the subrecipient's audit report and ensure that the subrecipient takes appropriate and timely corrective action.
- Consider whether subrecipient audits necessitate adjustment of the pass-through entity's own records.

Transportation has not designated an employee or division as responsible for ensuring Transportation is in compliance with OMB Circular A-133 provisions for subrecipient monitoring of localities. In addition, Transportation has not established procedures to determine which subrecipients must receive an audit, whether these applicable subrecipients have been audited, or what findings in their audit reports require follow up or adjustment to Transportation's records.

As a pass-through entity, Transportation must be familiar with OMB Circular A-133. Transportation must understand the roles and responsibilities of a pass-through entity as well as those of a subrecipient. They must know how to structure award agreements in accordance with OMB Circular A-133. They must also know the most effective methods for monitoring subrecipients. The Transportation and Mobility Planning Division ensures that Transportation is in compliance with OMB Circular A-133 with regards to subrecipient monitoring of Metropolitan Planning Organizations and Planning District Commissions; however, Transportation has not developed similar procedures for the localities receiving pass-through funds. Transportation should develop appropriate procedures and designate an employee or division responsible for ensuring that Transportation is in compliance with OMB Circular A-133 with regards to subrecipient monitoring of localities. Without assigned responsibilities and proper procedures, federal funds passed-through to subrecipients are susceptible to abuse.

AGENCY HIGHLIGHTS

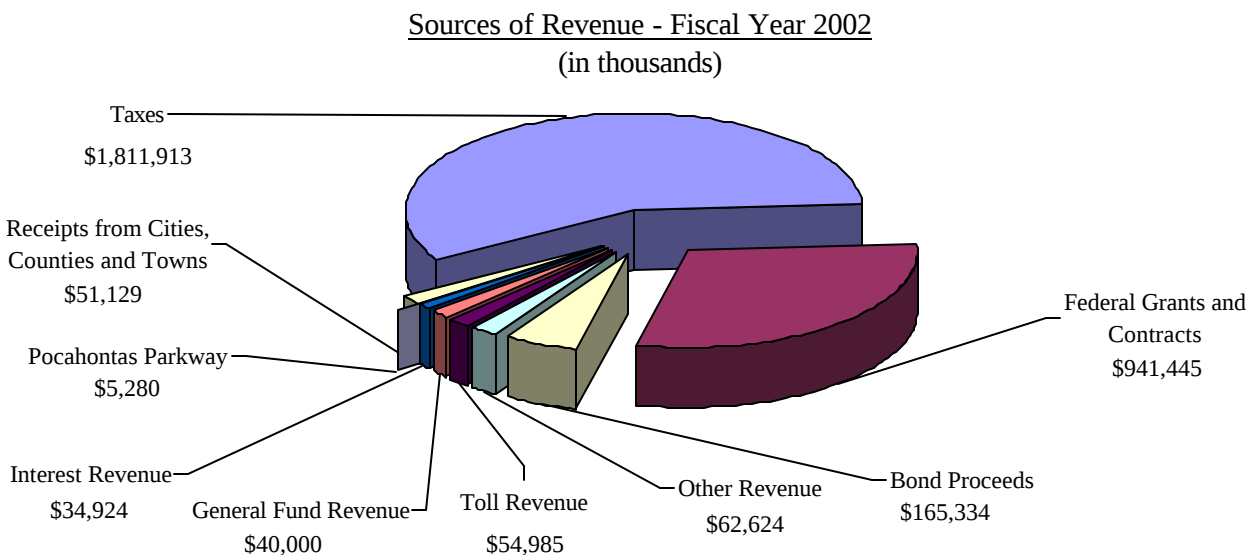
The Virginia Department of Transportation is responsible for building, maintaining, and operating the Commonwealth's roads, bridges, and tunnels. Virginia maintains the third largest state maintained highway system in the country, just behind Texas and North Carolina. Transportation's primary mission of building and maintaining roads requires extensive use of contractors, consultants, federal funds, and debt.

Transportation faced several challenges and obstacles during fiscal year 2002. Transportation experienced significant cash flow problems resulting in highway construction stoppages, contract delays, and contract cancellations. Transportation's under-funded highway construction program coupled with additional statewide revenue shortfalls forced Transportation to revise its budget and its Six Year [Highway Construction] Program to help alleviate the shortfalls. Due to the Commonwealth's revised revenue estimates and subsequent budgetary shortfalls, Transportation lost General Fund revenue previously allocated to them under the Virginia Transportation Act of 2000 (VTA). The General Assembly also diverted a portion of Transportation's dedicated sales tax revenue to the General Fund for fiscal year 2003, replacing the revenue with the authorization for additional debt. The Governor appointed a new Commissioner who is extensively re-organizing Transportation.

FINANCIAL INFORMATION

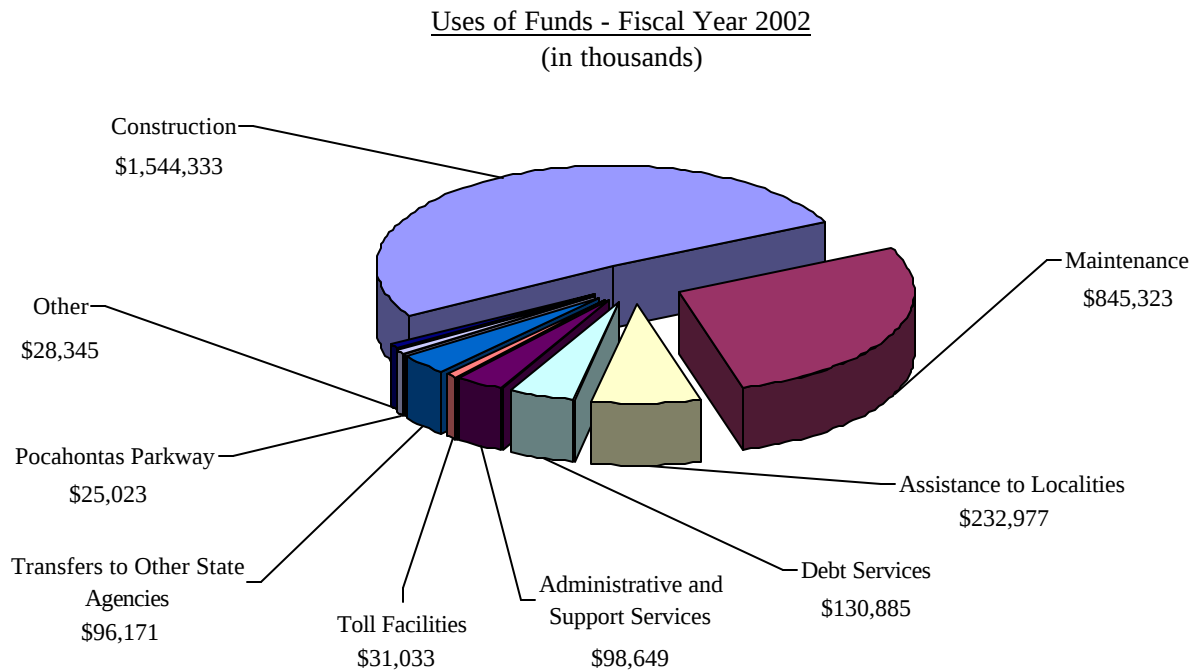
Transportation's main sources of revenue are the Highway Maintenance and Operating Fund and the Transportation Trust Fund. Revenues collected by the Departments of Motor Vehicles and Taxation from taxes, licenses, and vehicle registrations support both these Transportation Funds. Highway Maintenance and Operating Fund revenues provide road maintenance funding, while Transportation Trust Fund revenues primarily support road construction. Transportation receives an allocation of 78.7 percent of the Transportation Trust Fund revenues collected. The remaining 21.3 percent of Transportation Trust Fund revenue provides funding for the Mass Transit, Port, and Airport Funds. Transportation also receives a substantial portion of its highway construction funding from the Federal Highway Administration (FHWA) in the form of federal grants.

Transportation's funding sources, including its Transportation Trust Fund allocation, totaled \$3.1 billion and are illustrated below:



(Source: Cash basis statement of revenues and expenditures for Special Revenue and Debt Service. Pocahontas Parkway revenues were obtained from the component unit's financial statements, which an independent CPA firm audited.)

Transportation expended over \$2.9 billion in fiscal year 2002 and transferred out an additional \$96 million. Of the total expended and transferred out, 87 percent went towards construction, maintenance, and assistance to localities, three percent was transferred out, the remaining ten percent was expended for administration, toll facilities, debt service, and other expenses as illustrated in the following chart:



(Source: Cash basis statement of revenues and expenditures for Special Revenue and Debt Service. Pocahontas Parkway expenses were obtained from the component unit's financial statement, which an independent CPA firm audited.)

Revenues and Funding for Highway Projects

During fiscal year 2002, Transportation lost \$70 million in anticipated General Fund revenues that the Virginia Transportation Act of 2000 (VTA) allocated to highway construction. Also beginning July 1, 2002 (fiscal year 2003), the General Assembly has diverted Transportation's portion of the State Sales and Use Tax (1/2¢), up to \$317 million, to the General Fund to help alleviate budgetary shortfalls in the Commonwealth. Transportation received \$8.8 million in June sales and use tax revenue collected in July, August, and September and transferred the revenue to the General Fund as part of the \$317 million diverted for fiscal 2003. The General Assembly provided Transportation with increased capacity for debt issuance to replace the lost revenues by increasing the limit on Federal Highway Revenue Anticipation Notes (FRANs) outstanding at any one time from \$800 million to \$1.2 billion. The General Assembly also provided Transportation with greater flexibility over the \$317 million in FRANs issued to replace diverted sales tax revenue. Transportation may now use them on any approved project in the Six Year Program.

Increased Federal Revenues

Transportation experienced a significant increase in federal revenues during fiscal year 2002, which amounted to \$941.4 million, a \$402.5 million increase or 75 percent over the \$538.9 million received in fiscal year 2001. This increase represents \$264 million in one-time catch-ups in "unbilled" federal reimbursements and new funding for several large construction projects, including the Woodrow Wilson Bridge.

Transportation receives federal funds for approved road construction projects from the Federal Highway Administration (FHWA). All grants are on a reimbursement basis, which means that Transportation must spend its own funds and then apply for reimbursement of the costs to the federal government. In addition, most federal funds provided for road construction require a state to "match" a portion of the project's cost from other funding sources. The state match for most projects is typically 20 percent of the project's cost.

FHWA provides Transportation with a federal project agreement at the beginning of a road construction project. The federal project agreement states the federal reimbursement share of the project, the total amount reimbursable, and the federal project identification number for billing FHWA. Transportation tracks its federal expenses through FMSII, which automatically requests reimbursement from FHWA. Reimbursement requests may not exceed the total federal share stated on the project agreement. For many reasons, projects incur additional expenses, and Transportation must request approval from FHWA for additional reimbursement. If approved, Transportation receives a modified agreement from FHWA, which allows for additional billing. If Transportation does not process project modification agreements timely, they do not receive reimbursement timely for the state funds spent. Transportation has not processed modification agreements efficiently in the past, resulting in unnecessary "unbilled" federal reimbursements for eligible projects.

Towards the end of fiscal year 2002, Transportation management improved its procedures for submitting outstanding project modifications and submitted its outstanding project modification requests to FHWA for approval. Transportation had either received or had submitted reimbursement requests for previously unbilled federal expenses totaling \$264 million (revenue and receivables) by the end of the fiscal year.

The remaining increase in federal revenue is attributable to the following large construction projects:

- Woodrow Wilson Bridge Replacement
- Hampton Roads I-64
- Atlee Elmont Project on Interstate 95
- I-64 project in Goochland County
- Springfield Interchange (Mixing Bowl)

Although Transportation increased its federal revenues in fiscal year 2002, they did not take advantage of all available federal revenues. Annually, the federal government allocates to each state a share of federal highway dollars, termed its apportionment. The federal government also limits the amount of the apportionment a state can obligate in the year through obligation authority. Toward the end of the federal fiscal year, September 30, the Federal Highway Administration determines which states have not used all their obligation authority and allows eligible states to request additional obligation authority. Then, FHWA divides the unused obligation authority among the states. Because Transportation did not have available matching funds (typically 20 percent) due to its current cash flow situation, Virginia was the only state that did not request additional obligation authority, which averaged \$9.7 million per state.

HIGHWAY CONSTRUCTION

There are three major phases in the life cycle of a construction project: Preliminary Engineering (design phase), Right of Way (acquiring/relocating property and utilities), and Construction (building). During fiscal year 2002, Transportation spent over \$1.5 billion on highway construction projects, including \$941 million in federal expenses.

Transportation has several major ongoing construction projects, including the Springfield Interchange, the Coalfields Expressway, and the Woodrow Wilson Bridge. Transportation is currently soliciting proposals to begin the Interstate 81 project. Transportation also recently completed the four-year Pocahontas Parkway construction project.

Springfield Interchange

The Springfield Interchange project is one of the largest construction projects in the nation and is the highest dollar, non-bridge or tunnel project Transportation has ever undertaken. Transportation anticipates that the project will last up to eight years, affecting thousands of commuters. Transportation identified the Springfield Interchange as one of the busiest interchanges in the country and the most dangerous spot on the Capital Beltway. Because of this, Transportation embarked on a massive construction project to make the interchange safer, less congested, and more manageable. The new interchange will separate local traffic, making it easier for commuters to get to work and for travelers to pass through the area.

During calendar year 2002, Transportation revised the project's estimated costs, and as of July 29, 2002, the estimated cost is \$676.3 million. This is an \$86.7 million increase over the estimated cost reported in November 2001. Total estimated cost is comprised of the following:

<u>Project Phase</u>	<u>Estimated Cost</u>
Preliminary Engineering	\$ 44,992,000
Real Estate (Right of Way)	71,106,000
Spring Mall Drive Ramps	2,040,000
Beltway Ramps (future project)	891,000
Phase 1	2,778,000
Phases 2 and 3	133,000,000
Phase 4	178,500,000
Phase 5	95,500,000
Phases 6 and 7	113,000,000
Congestion Management Programs	28,000,000
Springfield Interchange Information Center	6,000,000
Stream Mitigation	<u>450,000</u>
Total:	<u>\$ 676,257,000</u>

(Source: Springfield Interchange Fact Sheet obtained from www.springfieldinterchange.com)

Coalfields Expressway

In November 1995, Congress enacted the National Highway System Designation Act of 1995, which extended the Coalfields Expressway from the West Virginia state line into Virginia. The proposed roadway is defined in the legislation as going to Pound, Virginia, and generally following State Route 83 through Buchanan, Dickenson, and Wise counties. The new legislation identified the Coalfields Expressway as a “Congressional High Priority Corridor” and included it as a part of the National Highway System (NHS).

Virginia’s Commonwealth Transportation Board approved the location for the Coalfields Expressway in August 2000. The Federal Highway Administration (FHWA) approved the route in November 2001. In January 2002, Transportation signed a Public Private Transportation Act (PPTA) agreement with Kellogg Brown & Root (KBR), and in September 2002, Transportation entered into a \$30.6 million contract for all preliminary engineering activities for the first segment of the Coalfields Expressway. Transportation’s preliminary estimated total cost for the roadway is \$1.6 billion.

Woodrow Wilson Bridge

Transportation has identified the Woodrow Wilson Bridge as one of the worst bottlenecks in the country. The project will build two new six-lane bridges to replace the existing six-lane bridge and will take an estimated ten years to complete. As of August 2001, the entire project had an estimated cost of \$2.44 billion as shown below. Virginia and Maryland will each provide state and federal funding, and the federal government will provide a total \$1.6 billion in federal highway funds. The District of Columbia will also fund a small portion of the project.

Federal and state appropriations will entirely finance the Woodrow Wilson Bridge Project. The federal government has made available special federal funding for the project from the federal Highway Trust Fund (\$900 million) and the General Fund of the Treasury (\$600 million). Maryland’s contribution will originate from a combination of general funds in the state Consolidated Transportation Program, regular federal-aid apportionments, and other state or federal revenue sources. Virginia funding will come from a combination of the Transportation Trust Fund, regular federal-aid apportionments, and other state or federal revenue sources. Funding for the District of Columbia’s contribution will originate from federal Interstate maintenance funds with a District provided match.

Currently the project has committed funding sources equaling \$2,058 million and anticipated funding equaling \$385 million for a total of \$2,443 million, broken down as follows:

FUNDING SOURCE	Committed	Anticipated	Total
Federal Government	\$ 1,585,147,857	\$ 45,532,143	\$ 1,630,680,000
Virginia	258,000,000	247,310,000	505,310,000
Maryland	200,000,000	91,810,000	291,810,000
District of Columbia (Interstate Maintenance)	15,100,000		15,100,000
TOTAL	\$ 2,058,247,857	\$ 384,652,143	\$ 2,442,900,000

(Source: 2001 Financial Plan obtained from www.wilsonbridge.com)

Interstate 81

In Virginia, Interstate 81 is 325 miles long, the longest interstate in Virginia, and is more than 30 years old. The daily traffic volume more than doubled in some areas from 25,000 vehicles in 1980 to more than 50,000 vehicles in 2000. Though mostly a rural corridor, I-81 is one of the top eight truck routes in the country. Transportation designed I-81 for 15 percent truck traffic, but trucks now account for 20 percent to 40 percent of the traffic.

Transportation is soliciting proposals under the Public Private Transportation Act (PPTA) for major improvements to the interstate. The I-81 project consists of numerous smaller projects that Transportation is completing to improve the interstate and prepare for future widening of I-81.

Pocahontas Parkway (Route 895)

The Route 895 Connector is a nine-mile, four-lane limited access toll road extending from the current eastern terminus of Chippenham Parkway at Interstate 95 to a connection with Interstate 295, southeast of Richmond International Airport. Construction began in late fall 1998 and was completed in September 2002. The Parkway opened for two-way traffic in September 2002.

The Route 895 Connector is the first project completed under the PPTA, which allows private companies to build public facilities using alternate funding sources. Of the \$314 million total cost of the project, public money funded \$27 million and the sale of bonds funded the remainder. Pocahontas Parkway plans to recoup bondholders' investments with the \$1.50 toll. As of June 30, 2002, the parkway was operating at a deficit of \$48,014,204 due to lower than anticipated usage.

UPDATE: PROGRESS ON IMPLEMENTATION OF THE RECOMMENDATIONS CONTAINED IN THE "SPECIAL REVIEW OF TRANSPORTATION'S CASH MANAGEMENT AND CAPITAL BUDGETING PRACTICES"

The Auditor of Public Accounts published a review of Transportation's cash management and capital budgeting practices in July 2002. The review contained recommendations for Transportation, the Commonwealth Transportation Board, the Governor, and the General Assembly. The Secretary of Transportation has designated a Commonwealth Transportation Board (CTB) ad hoc committee to address the 12 recommendations addressed to the Governor, the General Assembly, and the CTB. As of January 2003, of the 50 recommendations specifically within Transportation's control, Transportation has implemented eight, is actively working on implementing 36, and has not started implementing the remaining six. Transportation has developed a work plan containing "deliverables" needed to fully implement the recommendations. Of the 36 recommendations in progress, Transportation has completed 18 percent of the work plan deliverables according to its records.

Many of the Transportation recommendations specifically related to Transportation's cost estimation for road construction projects. Transportation studied cost estimation and developed a new cost estimation system for use on construction projects. The cost estimation system provides estimates at five different stages of a project, accounts for regional differences, and uses an inflation factor to estimate cost at projected advertisement date as listed in the Six Year Program. Transportation will use the new cost estimation system to develop its next Six Year Program, and any construction projects scheduled for advertisement after July 1, 2003 must use the new system. Transportation has combined this system with other databases into a web-based Integrated Six Year Programming System. This new database pulls data from Transportation's legacy systems and will allow for development of the Six Year Program using an integrated database perspective.

DEPARTMENT OF TRANSPORTATION

Richmond, Virginia

As of June 30, 2002

Whittington W. Clement, Secretary of Transportation

Philip A. Shucet, Commissioner

Stacy D. McCracken, Controller

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