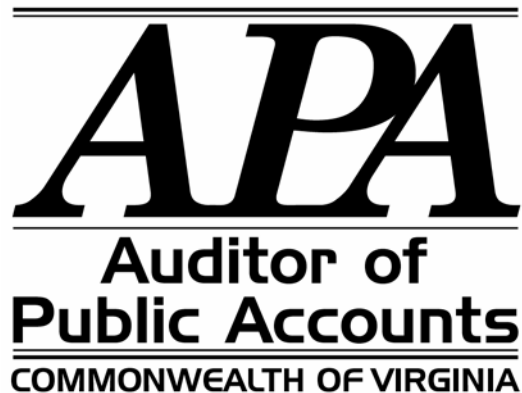


VIRGINIA EMPLOYMENT COMMISSION

RICHMOND, VIRGINIA

**REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2003**



AUDIT SUMMARY

Our audit of the Virginia Employment Commission for the year ended June 30, 2003, in support of the Comprehensive Annual Financial and Statewide Single Auditor Reports for the Commonwealth of Virginia, found:

- for the sixth consecutive year, Unemployment Trust Fund benefits payouts have exceeded collections. The fund balance, which totaled over \$1 billion in 2000, may go as low as \$65 million during the spring of 2004 as projected by the Employment Commission;
- proper recording and reporting of transactions, in all material respects, in the Commonwealth Accounting and Reporting System and in the Employment Commission's Tax and Benefits Systems;
- no internal control matters that we consider to be material weaknesses; however, we noted other matters involving internal control that we have reported to management. The section titled "Internal Control Findings and Recommendations" discusses these matters;
- no instances of noncompliance that required reporting under Government Auditing Standards; and
- adequate corrective action of prior year audit findings.

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SELECTED AGENCY INFORMATION

The Virginia Employment Commission's mission statement reads: "We provide workforce services that promote maximum employment to enhance the economic stability of Virginia." The Employment Commission accomplishes this goal through the Unemployment Insurance, Job Service, and Workforce Investment Act programs. The Employment Commission also compiles and provides labor market and economic information through the Economic Information Services Division.

The Unemployment Insurance program makes benefit payments to laid-off workers, ensuring they have minimal income during the course of a job search. The Employment Commission collects unemployment taxes from employers and uses these taxes to pay benefit claims. The tax collections go into the Unemployment Trust Fund, for which the Employment Commission is the trustee. The Employment Commission pays all unemployment benefit payments from the Trust Fund.

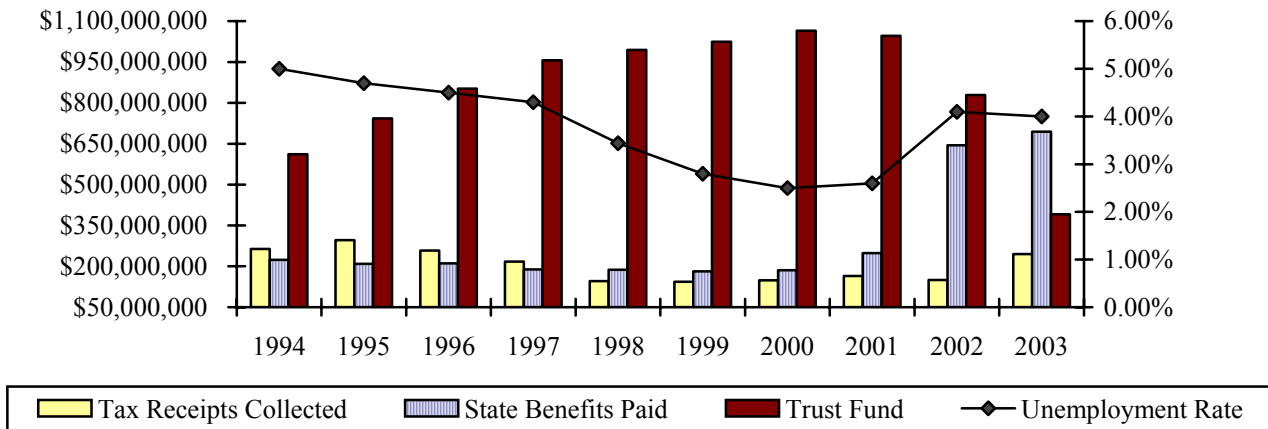
UNEMPLOYMENT TRUST FUND

The Unemployment Trust Fund's solvency factor, applicable to calendar year 2004, has dropped below 50 percent for the first time since 1984. For the sixth consecutive year, benefits paid out have exceeded collections and the Trust Fund balance has dropped below \$400 million at fiscal year end 2003. The difference between payments and collections resulted in a net loss of nearly \$84 million in calendar year 2001; however, the most significant net losses have occurred in both 2002 and 2003 with a total net loss for the two years approaching \$950 million. This net loss comes out of a starting fund balance of slightly over \$1 billion in 2000. The Employment Commission projects that the fund may go as low as \$65 million during the spring of 2004.

As a result of the economic downturn in 2001, the former Governor issued an Executive Order increasing all unemployment benefits by 37.3 percent. This increased the minimum weekly benefit from \$50 to \$69 and the maximum weekly benefit from \$268 to \$368. These higher benefit amounts remained in effect through January 4, 2003. As the economy works towards recovery, the General Assembly continues to reduce these increased benefit levels. Legislation reduced minimum and maximum weekly benefits to \$59 and \$318, respectively, for the period January 5, 2003 to July 5, 2003. Additional legislation reduced the minimum and maximum weekly benefits to \$50 and \$316, respectively, beginning July 6, 2003 through July 3, 2004.

The illustration below presents historical trends, which show the changes in tax collections, benefit payments, the Trust Fund balance, and the unemployment rate over the past several years.

Trends in the Unemployment Trust Fund



Notes: The Trust Fund balance also includes interest credited to the account. The unemployment rate represents the average rate for the entire fiscal year.

The Trust Fund's solvency and the employer tax rates are inversely related. As the Fund's solvency decreases, the tax rates increase. The Employment Commission levies taxes on employers' wages according to rates set by the General Assembly. Under current law, employers only pay taxes on the first \$8,000 of each employee's wages. The tax rates imposed on employers consider the Trust Fund's solvency and the employment histories of individual businesses, referred to as the experience rating. This rating requires employers with a history of higher unemployment claims to pay a greater rate and allows those with fewer claims to pay less or nothing at all.

The Unemployment Compensation Act sets the lowest tax rate at zero as long as the Trust Fund solvency remains at or above 100 percent. Since the Trust Fund solvency dropped below 100 percent at fiscal year ending 2002, the zero minimum rate was not applicable for calendar year 2003, therefore, requiring all employers to pay unemployment taxes. For calendar year 2003, the minimum rate that an employer could be required to pay on taxable wages was 0.13 percent, while the maximum rate was 6.23 percent.

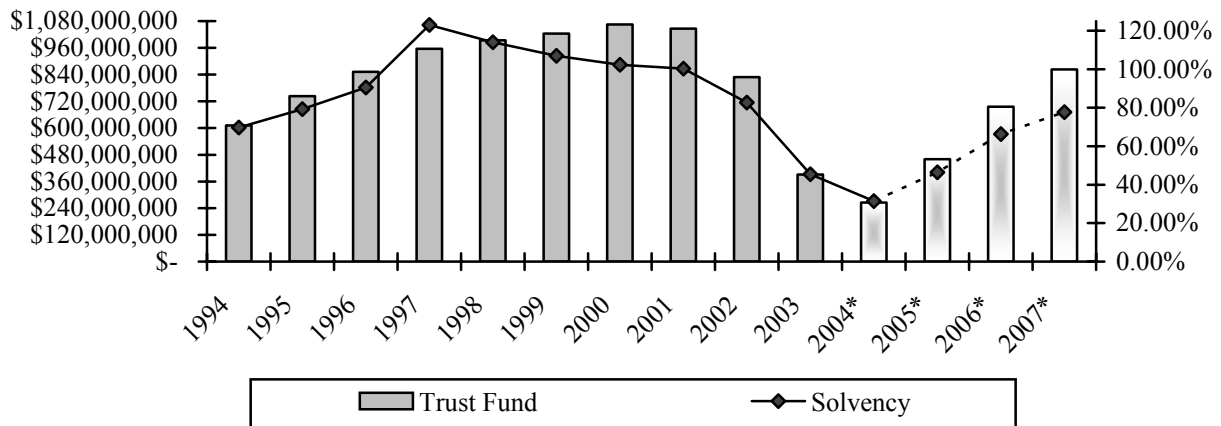
An additional adjustment to the tax rates for calendar year 2003 was the inclusion of the pool tax. The pool tax represents a levy to recover benefits not chargeable to a specific employer and is referred to as pool costs. Interest income from the Trust Fund offsets the total pool costs. Due to prior year interest income not exceeding pool costs, the Employment Commission added a pool tax rate of 0.03 percent to the employer tax rates for calendar year 2003 (included in the minimum and maximum rates above). The Employment Commission cannot use interest income to offset the total pool costs when the Trust Fund solvency is below 50 percent. Because the solvency has fallen below 50 percent, the pool tax for calendar year 2004 will increase to 0.14 percent. 1996 was the last calendar year in which the Employment Commission levied a pool tax.

As mentioned above, the Trust Fund solvency is currently below 50 percent and should continue to decrease in the coming year. State law requires a fund-building tax rate of 0.2 percent to the employer tax rates if the fund balance drops below 50 percent, which helps the Trust Fund remain solvent. The minimum and maximum rates for calendar year 2004 are 0.44 percent and 6.54 percent, respectively. These rates include both the pool tax for calendar year 2004 and the fund-building tax. The following table breaks down the various taxes for calendar years 2003 and 2004.

	Calendar Year 2003 Tax Rates		Calendar Year 2004 Tax Rates	
	Minimum	Maximum	Minimum	Maximum
Tax rate	0.10%	6.20%	0.10%	6.20%
Pool tax	0.03%	0.03%	0.14%	0.14%
Fund-building tax	0.00%	0.00%	0.20%	0.20%
Total	0.13%	6.23%	0.44%	6.54%

The Trust Fund has a projected balance of approximately \$294 million by the end of fiscal year 2004 and the solvency rate at 33 percent. Due to the increasing pool tax and the fund-building rate addition, the Trust Fund balance should begin increasing. The following illustration presents the projections for the Trust Fund balance and solvency as projected by the Employment Commission.

Unemployment Trust Fund Balance and Solvency



* Projected figures

Note: Trust Fund solvency is an indicator of the Fund's ability to pay benefits during periods of high unemployment. The solvency indicator compares the Fund's actual balance to the calculated balance needed to pay these benefits for 16.5 months. The formula used to calculate the balance uses historical benefit and wages data. Trust Fund solvency does not directly relate to current year tax collections or benefits paid. Since June 1996, the computation of solvency uses a modified accrual basis as stipulated in §60.2-533 of the Code of Virginia. Both the Trust Fund balance and solvency rate are calculated for the state fiscal year.

Current Employment Commission calculations estimate the Trust Fund balance to drop as low as \$65 million by April of 2004, which is the period before the Trust Fund receives quarterly taxes from employers. These calculations do not forecast that the Trust Fund will run out of money, although additional changes in the economy, unemployment levels, and severe weather will continue to change these projections. If the Trust Fund does run out of money, short-term, no-interest loans are available from the United States Department of Labor. The last federal loan Virginia received was for \$45.6 million in 1983, which the Commonwealth repaid during the same year. The Employment Commission has never received money from the General Fund to pay regular unemployment benefits.

INTERNAL CONTROL FINDINGS AND RECOMMENDATIONS

Improve Document Retention

The Employment Commission is not sufficiently maintaining the report detailing the daily changes made to the wage file. This report is needed to confirm that the appropriate changes have been made to the wage file daily. Changes are being made directly to the master wage file and there is no control log created for audit purposes. The auditor was unable to obtain half of these requested reports for the fiscal year 2003 period.

Sufficient document retention is required for adequate control and support of changes made to the wage file. The Employment Commission should maintain these reports for at least one fiscal year or until audited by the Auditor of Public Accounts.

Implement Adequate Environmental Controls in Central Office Computer Rooms

The Employment Commission does not have adequate environmental controls in their computer rooms. The main computer room and the network wiring center do not have an automated fire suppression system, such as a sprinkler or chemical system.

Adequate environmental controls ensure the safeguard of critical system components and without these controls, the Employment Commission has a greater risk of critical losses. The main computer room and the network wiring center house critical system and network components, such as their routers and firewalls. The Employment Commission should install reasonable fire suppression controls in the central office computer room to protect life and property.

Enable Firewall Security Logging

The Employment Commission has not enabled the firewall security logging software feature required by the Information Technology Resource Management Security Standard, issued by the Virginia Information Technology Agency (VITA). Without having the firewall security logging software feature operating, the Employment Commission cannot properly assess threats to their network since proper threat detection safeguarding activities are not occurring to help eliminate an attack on a system or network.

The Employment Commission should enable firewall security logging as required by the VITA Security Standard.

Improve Timeliness of Benefits Reports Reviews

Internal Audit has the responsibility to review specific benefits reports that show suspicious activity, often indicative of fraudulent activity. The Employment Commission's Internal Security Program Procedure Manual requires a review of these reports. We found the following:

- Internal Audit did not review three of the four test cases showing multiple checks to the same address for four months. These weekly reports list multiple checks sent to one address.
- Internal Audit has not reviewed any cases of recipients receiving checks with excessive amounts for calendar year 2003 from the weekly report.

The Internal Security Program Procedure Manual requires the Office of Internal Audit to review these reports to identify incorrect payments or fraudulent activities. Without prompt review and follow up, the Employment Commission incurs the risk of not discovering inaccurate benefit payments or fraudulent activities in a timely manner. The Employment Commission should allocate sufficient resources to ensure that Internal Audit has the resources to conduct these reviews in a timely manner.



Commonwealth of Virginia

Walter J. Kucharski, Auditor

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

January 20, 2004

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

The Honorable Lacey E. Putney
Vice Chairman, Joint Legislative Audit
and Review Commission
General Assembly Building
Richmond, Virginia

INDEPENDENT AUDITOR'S REPORT

We have audited selected financial records and operations of the **Virginia Employment Commission** for the year ended June 30, 2003, in support of the Comprehensive Annual Financial and Statewide Single Audit Reports for the Commonwealth of Virginia.

Audit Objective, Scope, and Methodology

Our audit's primary objective was to evaluate the accuracy of the Employment Commission's financial transactions as reported in the Comprehensive Annual Financial and Statewide Single Audit Reports for the Commonwealth of Virginia for the year ended June 30, 2003. In support of this objective, we evaluated the accuracy of recording financial transactions on the Commonwealth Accounting and Reporting System and in the Employment Commission's Tax and Benefits Systems, reviewed the adequacy of the Employment Commission's internal control, tested for compliance with applicable laws and regulations, and reviewed corrective actions of audit findings from prior year reports. Our review encompassed controls over the following significant cycles, classes of transactions, and account balances:

Unemployment Benefit Payments	Accounts Receivable
Taxes and Cash Receipts	Accounts Payable
Federal Grants Management	Expenditures

We reviewed and gained an understanding of the overall internal controls, both automated and manual, including controls for administering compliance with applicable laws and regulations, sufficient to plan the audit. We considered materiality and control risk in determining the nature and extent of our audit procedures. Our audit procedures included inquiries of appropriate personnel, inspection of documents and records, and observation of the following operations:

Unemployment Benefit Processing	Expenditures
Employment Tax Collections	Financial Reporting

Management has responsibility for establishing and maintaining internal control and complying with applicable laws and regulations. Internal control is a process designed to provide reasonable, but not absolute, assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. We tested transactions and controls and performed other audit tests we deemed necessary to determine whether the Employment Commission's controls were adequate, had been placed in operation, and were being followed.

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 Results

We found that the Employment Commission properly stated, in all material respects, the amounts recorded and reported in the Commonwealth Accounting and Reporting System and in the Employment Commission's Tax and Benefit Systems.

We noted no matters involving internal control and its operation that we consider to be material weaknesses relative to the Comprehensive Annual Financial and Statewide Single Audit Reports for the Commonwealth. Our consideration of internal control would not necessarily disclose all matters in internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of the specific internal control components does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material to financial operations may occur and not be detected promptly by employees in the normal course of performing their duties.

We did note other matters involving internal control that we have reported to Management. The additional matters are described in the section titled "Internal Control Findings and Recommendations." In addition, vulnerability and penetration testing was performed on the Commission's network and the results will appear in a future report.

The results of our tests of compliance with applicable laws and regulations disclosed no instances of noncompliance that are required to be reported.

The Employment Commission has taken adequate corrective action with respect audit findings reported in the prior year.

We discussed this letter with management on March 11, 2004.

AUDITOR OF PUBLIC ACCOUNTS

KJS/kva
kva:



COMMONWEALTH of VIRGINIA

Virginia Employment Commission

*Dolores A. Esser
Commissioner*

703 East Main Street

March 8, 2004

*Post Office Box 1358
Richmond, Virginia 23218-1358*

Mr. Walter J. Kucharski
Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218

Dear Mr. Kucharski:

Thank you for the opportunity to respond to the following internal control findings and recommendations identified during your office's audit of VEC's financial records and operations for the year ended June 30, 2003.

Management's Response To Findings of the Auditor:

1. Improve Document Retention

The audit states, "The Employment Commission is not sufficiently maintaining the report detailing the daily changes made to the wage file. This report is needed to confirm that the appropriate changes have been made to the wage file daily. Changes are being made directly to the master wage file and there is no control log created for audit purposes. The auditor was unable to obtain half of these requested reports for the Fiscal Year 2003 period.

Sufficient document retention is required for adequate control and support of changes made to the wage file. The Employment Commission should maintain these reports for at least one fiscal year or until audited by the Auditor of Public Accounts."

VEC Response:

The VEC recognizes a deficiency exists and proposes the following remedy: Wage inquiry screen DW-41 currently shows all wage changes made to a Social Security Number (SSN) with the exception of combined wage transfers. The inquiry will now be enhanced to include transfers. This will give VEC staff the capability of viewing on-line all wage activity by SSN or requesting a report of all wage activity for a specific date. The VEC believes this action will satisfy the point raised by the Auditor of Public Accounts.

2. Implement Adequate Environmental Controls in the Central Office Computer Rooms

The audit states, "The Employment Commission does not have adequate environmental controls in their computer room. The main computer room and the network wiring center do not have an automated fire suppression systems, such as a sprinkler or chemical system.

Adequate environmental controls ensure the safeguard of critical system components and without these controls the Employment Commission has a greater risk of critical losses. The main computer room and the network wiring center house critical system and network components, such as their routers and firewalls. The Employment Commission should install reasonable fire suppression controls in the central office computer room to protect life and property."

VEC Response:

VEC agrees that limiting the risk from fire to computer room staff and resources should be considered and has been. We previously estimated the cost at approximately \$180K - \$200K. While funds were not available, it was ultimately determined the actual impact of the cost to our service delivery operations would present a higher degree of risk to our clients than the "potential risk" of a computer room fire to staff and equipment.

We are currently gathering the current cost of known products and exploring new product opportunities. When our inquiries are complete, all potential courses of action and the cost of each will be considered.

3. Enable Firewall Security Logging

The audit states, "The Employment Commission has not enabled the firewall security logging software feature required by the Information Technology Resource Management Security Standard, issued by the Virginia Information Technology Agency (VITA). Without having the firewall security logging software feature operating, the Employment Commission cannot properly assess threats to their network since proper threat detection safeguarding activities are not occurring to help eliminate an attack on a system or network.

The Employment Commission should enable firewall security logging as required by the VITA Security Standard."

VEC Response:

We agree. Firewall security logging has already been implemented.

4. Improve Timeliness of Benefits Reports Reviews

The audit states, "Internal Audit has the responsibility to review specific benefits reports that show suspicious activity often indicative of fraudulent activity. The

Employment Commission's Internal Security Program Procedure Manual requires a review of these reports, and we found the following:

- Internal Audit did not review three of the four test cases showing multiple checks to the same address for 4 months.
- Internal Audit has not reviewed any cases of recipients receiving checks in excess of a specified dollar amount for the calendar year 2003.

The Internal Security Program Procedure Manual requires the Office of Internal Audit to review these reports to identify incorrect payments or fraudulent activities. Without prompt review and follow up, the Employment Commission incurs the risk of not discovering inaccurate benefit payments or fraudulent activities in a timely manner. The Employment Commission should allocate sufficient resources to ensure that Internal Audit has the resources to conduct these reviews in a timely manner."

VEC Response:

For the past several years we have recognized that the Internal Security (IS) procedures outlined in the Internal Security Manual are less than efficient and effective in preventing and detecting fraudulent transactions. These procedures were developed many years ago and have not kept pace with technological and programmatic changes.

In the current year management allocated additional resources for internal security enhancements. We have begun the process of redesigning our Internal Security program with emphasis on automation and data analysis to highlight high-risk transactions for further review. To date we have developed several reports based on the objectives of the IS program and have plans to address additional areas in the coming months. The reports identified by the APA in this recommendation are among those being replaced by more effective procedures.

Again, I appreciate the opportunity to provide the Virginia Employment Commission's comments as part of your office's report of VEC's financial records and operations for the year ended June 30, 2003.

Sincerely,

A handwritten signature in black ink, appearing to read "Dolores A. Esser". The signature is fluid and cursive, with the first name "Dolores" being more prominent and the last name "Esser" following in a similar style.

Dolores A. Esser