

**REVIEW OF THE
BUDGET AND APPROPRIATION
PROCESSING CONTROL SYSTEM**

**REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2007**



AUDIT SUMMARY

Neither a lay person nor the sophisticated user can easily relate the budget to the actions of the Commonwealth. This report as well as our previous report discusses various budget transparency issues that make understanding the budget process difficult. Current accounting, budgeting, and procedural processes obscure the easy comparison of budgeted to actual activity. As the legislature and administration continue to explore making information on government activities more accessible to the public, these issues need to be addressed.

The Department of Planning and Budget (Planning and Budget) and the Governor have recognized the complexity of the process and are issuing a request for proposal for a new performance budgeting system. However, this system will take several years to secure and implement and only provide half of the information necessary to perform a comparison of budgeted or planned activity to actual.

While we concur with the need to secure a new budget development system, there are several procedural changes Planning and Budget and the Department of Accounts (Accounts) could implement on an interim basis to make the reporting and comparison of budget and actual activity more transparent. This report recommends several procedural changes to improve reporting budgetary data and actual information which the Commonwealth could implement quickly and with minimal cost.

The most significant budget transparency issue is the transfer of General Funds to various non-general funds that occurs after the budget's approval. These transfers affect programs such as Personal Property Tax Relief and higher education operations, and result in a loss of transparency of close to \$3 billion in general funds. These transfers occur to comply with various requirements in the Appropriation Act which are intended to allow for separate monitoring and tracking of these funds; however, the current practice adopted by Planning and Budget and Accounts creates a disconnect between the budgeting and accounting for these programs.

Another budget transparency issue is the lack of a reporting process for administrative changes made to the budget after the General Assembly's approval. There is no process in place to inform the General Assembly and the public of changes made to the budget during any fiscal year. Administrative adjustments can significantly alter the approved budget, and regular reporting of these changes to the General Assembly and public should exist to improve the transparency of the budgeting process.

We offer the following recommendations for consideration to address some of the budget transparency issues caused by current practices.

- Accounts should consider adding a sub fund of the General Fund in the Commonwealth Accounting and Reporting System to account for the Personal Property Tax Relief Program. The creation of a sub-fund for this program would improve the budget transparency of close to \$1 billion in General Funds. Another alternative would be making the payments from the General Fund.
- The Commonwealth should re-examine the practice of transferring General Funds budgeted for colleges and universities to higher education funds and similar transactions to other funds. This practice originated twenty years ago to accommodate certain accounting system technology; however, this practice may no longer be necessary given the capabilities of modern financial systems at the higher education institutions and other funds. The elimination of this practice would improve the budget transparency of \$1.5 billion in General Funds.
- As part of the new performance budget system, Planning and Budget should consider an improved reporting mechanism for administrative adjustments processed during a year.

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FINDINGS AND RECOMMENDATIONS

Address Budget Transparency Issues

In our previous report, we reported significant budget transparency issues that affect the ability of citizens to understand the Commonwealth's budget and how resources are used. Given the emphasis, both in Virginia and nationwide, on greater accountability and transparency in government, we think these issues should be a priority. We originally recommended these issues be addressed as part of the enterprise application project; however, the status of this system development effort is uncertain. The Governor and Planning and Budget are in the process of developing a request for proposal for a new performance budgeting system for budget development activities. These issues should be considered as they move forward with this initiative.

In the interim period, we recommend that the Governor and Planning and Budget develop alternative solutions to address these issues. A transparent budget process allows any informed citizen sufficient ease in understanding and following the budget process without having any special training. This term describes a budget process which is clear, visible, and understandable to a citizen with an interest in the information. We discuss below two practices which affect the transparency of the Commonwealth's budget as well as recommendations for consideration.

Significant transfers of General Funds to Other Funds

Significant transfers of General Funds to various non-general funds occur after the budget's approval for certain programs making it difficult to identify the source of funds for these programs in the accounting records. The two largest transfers are for the Personal Property Tax Relief Program and higher education operating funds. Together, these two programs result in almost \$3 billion in general funds being transferred to non-general funds after the budget is approved.

In the case of the Personal Property Tax Relief program, these transfers occur to comply with various requirements in the Appropriation Act, which require setting aside and spending these funds from a separate fund. In an effort to satisfy the legislative requirements, the current practice is to move these General Fund amounts to non-general fund accounts, in order to separate the funds to monitor and control the spending of the appropriation. The creation of these funds changes the nature of how both the accounting and budget systems show these funds.

While the current statewide accounting system, the Commonwealth Accounting and Reporting System (CARS), could accommodate creating separate sub-funds within the General Fund, the Department of Accounts (Accounts) has not attempted to do this. We recommend Accounts and Planning and Budget determine whether a separate sub-fund of the General Fund could be established to account for the Personal Property Tax Relief program. The creation of a sub-fund would improve the budget transparency of close to \$1 billion in General Funds.

In the case of the transfer of general funds to higher education operating funds, this practice originated over twenty years ago to simplify accounting for these funds at each university. Given that technology has advanced since then, we recommend that the Commonwealth re-examine this practice and determine whether or not this transfer is still necessary given the capabilities of current financial systems. Most of the Commonwealth's colleges and

universities have financial management systems that can process transactions with multiple funding sources, making the current practice of transferring general funds outdated. The elimination of this practice would improve the budget transparency of \$1.5 billion in General Funds.

Aside from the two programs discussed above, the practice also affects several other programs including water quality improvement, some transportation programs, and the Governor's Opportunity Fund. These programs should also be considered when examining the current practice.

Lack of a Reporting Mechanism for Budget Adjustments

The current reporting mechanisms for administrative adjustments processed during the year need to be improved. While the Comptroller's year-end preliminary financial report does show some original and final budget information, it focuses primarily on the General Fund. Other than the Comptroller's report, our Data Point website, and FATS reports sent to Senate Finance and House Appropriations monthly, there is no comprehensive statewide budget information reported that includes the administrative budget adjustments. Without a formal reporting mechanism in place, legislators and the average citizen have no means to understand changes to the budget after its approval.

Update the FATS Manual

Planning and Budget needs to review and update the Form 27 Automated Transaction (FATS) Manual (Manual) to reflect current practices and changes in authority. The last comprehensive revision to the Manual was in 1998. Numerous changes have occurred since, including substantial changes in the authority delegated to Planning and Budget as provided in the Act. As a result, the Manual is out of date, incomplete, or irrelevant in the current environment.

The Manual is the primary resource for policies, operational procedures, and analytical criteria for budget analysts to follow when processing administrative budget adjustments. Planning and Budget also uses the Manual as a training and reference resource for both Planning and Budget and other agency budget staff.

We reviewed a sample of 50 operating budget adjustments from fiscal year 2007, and identified five (10 percent) transactions where the transaction brief did not meet the criteria in the Manual. We identified the following specific shortcomings in the Manual and have included the reference to the specific adjustment type.

- The Manual does not require analysts to include a reference to the authorizing legislation in the transaction brief. (Special legislative adjustment, type C)
- The Manual does not document operating policies or procedures for adjustments initiated by Planning and Budget ProBud Services staff. Examples would be increases from Central Appropriations for salary and fringe benefit increases.
- Planning and Budget analysts frequently gather additional data that support certain adjustments; however, analysts do not summarize or reference this information in the FATS transaction brief. Further, the Manual does not provide complete instructions for gathering, evaluating, and documenting the supporting data.

- The Manual does not provide instructions for sum sufficient transactions related to internal service funds.
- The criteria specified in the Manual is no longer relevant for transfers that are executed pursuant to language in the Act or for technical reasons specified in Part 4 of the Act.

We recommend Planning and Budget allocate resources to update the current Manual or implement an alternative solution for providing policies and procedures to Planning and Budget staff. Reliance by analysts on the existing Manual could cause errors in transaction processing due to outdated requirements.

Status of Prior Year Finding and Recommendation on Information Security

Last year, we reported that Planning and Budget did not have a complete or current information security program; and thus, did not meet Virginia's information technology security standard, ITRM Standard SEC 2001-01.1. Although Planning and Budget did have informal security procedures, the security plan was undocumented. Planning and Budget should allocate the time and resources necessary to complete a comprehensive information security program that will meet industry best practices. Due to the timing of this year's audit, the auditor was not able to secure the Planning and Budget staff resources necessary to follow up on this recommendation. The auditor plans to follow up on this finding in 2008.

REVIEW OF THE BUDGET AND APPROPRIATION
PROCESSING CONTROL SYSTEM

Operating Budget Adjustments

The Governor and Planning and Budget have the authority to make changes to the budget after its approval. Planning and Budget refers to these budget changes as “administrative adjustments”, which resulted in a \$2.6 billion (7 percent) increase to the fiscal year 2007 budget. These adjustments are within the authority granted to Planning and Budget and the Governor by the General Assembly through the Appropriation Act.

There are a variety of reasons for administrative adjustments and the following table shows the amount of each type of adjustment and the effect on the General Fund and Non-General Fund operating budgets. For purposes of this analysis, we have divided the administrative adjustments into two categories in the table below: transfers, and adjustments and reappropriations. Transfers generally move appropriations between agencies and/or funds, while adjustments and reappropriations generally represent increases in appropriations. We provide more detail in the sections that follow the table on the most significant administrative adjustments processed in 2007.

Detailed Schedule of Fiscal Year 2007 Operating Budget Adjustments

	<u>General Fund</u>	<u>Non-General Fund</u>	<u>Total</u>
Original budget, Chapter 3	\$16,779,048,401	\$18,125,220,885	\$34,904,269,286
Subsequent legislative amendments	254,702,914	(62,541,713)	192,161,201
Administrative adjustments:			
Transfers:			
General fund to non-general fund	(3,041,981,382)	3,040,065,904	(1,915,478)
Other transfers	6,865,907	-	6,865,907
Adjustments and reappropriations:			
Sum sufficient appropriations	6,404,168	1,432,320,021	1,438,724,189
Additional revenues	358,728	365,500,848	365,859,576
Carry forward prior year cash balances	-	310,905,440	310,905,440
Other non-general fund appropriations	-	199,012,564	199,012,564
Mandatory reappropriations	84,792,098	-	84,792,098
Discretionary reappropriations	22,422,471	-	22,422,471
Deficit appropriations	<u>9,634,014</u>	<u>-</u>	<u>9,634,014</u>
Adjusted budget as of June 30, 2007	<u>\$14,122,247,319</u>	<u>\$23,410,483,949</u>	<u>\$37,532,731,268</u>

Transfers

There are several types of transfer adjustments - transfers within general funds, transfers within non-general funds, and transfers between general funds and non-general funds. The first two types transfer appropriations within fund types and have no net effect on the overall budget. However, the third type of transfer between general and non-general funds has a significant effect on the budget by creating significant budget transparency issues that we discussed in the section entitled “Findings and Recommendations.”

These transfers usually occur so that Accounts can account for certain types of General Funds activities separately. Historically, both Accounts and Planning and Budget have agreed to move these General Fund amounts to non-general fund accounts, in order to separate the funds to monitor and control the spending of the appropriation. The creation of these funds changes the nature of how both the accounting and budget systems show these funds. While CARS could accommodate creating separate sub-funds within the General Fund, Accounts has not attempted to do this.

As the prior table shows, appropriation transfers from the General Fund to the Non-General Fund totaled \$3 billion in 2007. The following table lists the major types of General to Non-General fund transfers. The two largest items, higher education operating funds and the Personal Property Tax Relief program, account for the majority of this type of transfer.

Transfers from General Fund to Non-General Funds for Fiscal Year 2007

<u>Description of Transfer</u>	<u>Amount</u>
To Higher Education Operating Funds (Chapter 847, 4-1.03)	\$ 1,548,445,414
To Personal Property Tax Relief (Chapter 847, Item 459)	950,000,000
To Virginia Water Quality Improvement Fund (Chapter 847, Item 364)	214,328,155
To Priority Transportation Fund (Chapter 847, Item 447.F.3.)	102,700,000
To Revenue Stabilization Fund (Chapter 847, Item 260.10.A.2.)	126,802,594
To Other Non-General funds	<u>99,705,219</u>
Total Transfers from General Fund to Non-General Funds	<u>\$ 3,041,981,382</u>

Sum Sufficient Appropriations

A sum sufficient appropriation is a mechanism within the Act to allow the Governor and agencies to deal with unique programs. The Act uses this type of appropriation primarily in two situations. The first situation is a program where the amount of the program revenue or expenses requires some flexibility. An example is disaster related funding that is difficult to estimate from year to year.

The second situation where the Commonwealth uses a sum sufficient appropriation is in an internal service program to not double count expenses in the budget. Sum sufficient appropriations may have limits set by a “not to exceed” amount within the language of the Act, or it provides no specific dollar spending limit but instead sets a limit of actual amounts collected. Planning and Budget has the authority to process adjustments to increase the budget to cover sum sufficient appropriations.

The Administration of Health Insurance, which is the Commonwealth's self insured health benefit program for employees, accounts for most of the sum sufficient appropriation. The Department of Human Resource Management manages the Administration of Health Insurance program by collecting premiums from state agencies for employees to cover state employee health claims. The current budget process includes the cost of employee health insurance in the agency's budget.

Therefore, the Commonwealth budgets the Administration of Health Insurance costs as a sum sufficient so as not to double count these amounts in the Budget Bill and the Appropriation Act. The adjustment is an increase in the state's budget because there is an offset by the corresponding increase in revenues that the Department of Human Resources collects from agencies.

The following table shows the largest sum sufficient adjustments by agency and program processed by Planning and Budget in 2007. The table lists the item number in the Act that provides the authority for each sum sufficient amount shown.

Sum Sufficient Budget Adjustments for Fiscal Year 2007

<u>Act Item No.</u>	<u>Agency Name</u>	<u>Program</u>	<u>Total</u>
78	Administration of Health Insurance	Health Benefits Services	\$ 860,250,000
423 -426	Virginia Information Technologies Agency	Computer, Telecommunications and Other Services	273,904,274
469	State Lottery Department	Lottery Prize Payments	175,000,000
70-75	Department of General Services	Procurement, Plant Management and Other Services	88,780,477
470	Virginia College Savings Plan	Tuition Trust and Other Services	20,000,000
223	Virginia Tech	Auxiliary Enterprises	11,315,923
46	Office of the Governor	Disaster Operations and Assistance	5,527,879
	Other Agencies	Various	<u>3,945,636</u>
		Total	<u>\$1,438,724,189</u>

Additional Revenue Appropriations

These types of adjustments occur when resources exceed the amount initially budgeted and appropriated. Agencies request these increases so they can spend the additional funds. For example, additional funds may become available under a federal grant that an agency did not anticipate during budget development. In this case, an agency would need to request an additional appropriation to spend these funds. In some cases, the additional resource may not represent solely revenue collections, but may also include bond proceeds or other sources of receipts not originally anticipated.

The following agencies made up the majority of these adjustments in fiscal year 2007. It should be noted that the amount of these adjustment has significantly decreased over the last several years as Planning and Budget has emphasized the need for better revenue estimation when developing the budget.

Additional Revenue Adjustments for Fiscal Year 2007

<u>Fund Source</u>	<u>Agency Name</u>	<u>General Explanation for Adjustment</u>	<u>Amount</u>
Federal	Direct Aid to Public Education	Additional special education grant funds for unanticipated expenses	\$100,000,000
Federal, Special Revenue	Department of Medical Assistance Services	Funding for Federal funds transferred from DMHRSAS, Medicaid settlement, and increases in operating expenses	34,235,015
Higher Ed	Virginia Community College System	Funding for increase in financial aid and operating expenses due to higher enrollment	22,770,763
Federal	Department of Emergency Services	Funding of disaster related expenses	22,336,057
Federal	Department of Social Services	Funding increase for Energy Assistance Program and increases in operating expenses and local aid	20,295,733
Internal	Department of General Services	Payments to eVA related to revised procurement contract	17,069,839
Internal - premiums paid by agencies	Health Insurance Administration	Funding of increases claims expenses related to increased enrollment and health care costs	15,320,000
Special funds	Mental Health Treatment Centers	Funding to replace general funds transferred to DMAS for Medicaid match	12,045,905
Higher Ed	Virginia Commonwealth University - Academic Division	Funding for increased expenses related to Qatar campus and other entrepreneurial activities	11,000,000
Federal and Special	Department of Conservation and Recreation	Funding of Civil War Preservation Trust	10,971,532
	Other Agencies		<u>99,814,732</u>
	Total		<u>\$365,859,576</u>

Carry Forward of Prior Year Cash Balances

These administrative adjustments represent unspent cash in non-general funds at the end of a fiscal year, which agencies request to use in the next fiscal year. These adjustments are necessary when agencies wish to use the unspent balance that was not included as a funding source when the agencies developed their budget. A significant number of these adjustments are for Transportation agencies rolling forward unspent cash for long term projects.

Carry-forward of Prior Year Non-General Fund Cash Balances for Fiscal Year 2007

Transportation Agencies	\$ 124,935,979
Tobacco Indemnification and Revitalization Commission	42,000,000
Department of Conservation and Recreation	33,701,650
Personal Property Tax Relief Act	26,678,077
State Board of Elections	22,000,000
Virginia Information Technologies Agency	13,629,580
Other Agencies	<u>47,960,154</u>
Total	<u>\$ 310,905,440</u>

Other Non-General Fund Adjustments

This adjustment type represents an increase in appropriations for additional non-general fund resources not considered revenues such as bond proceeds. In fiscal year 2007, other non-general fund adjustments totaled \$199 million of which the Department of Transportation accounted for \$197 million. This represented the remaining cash balance in FRANS (federal anticipation notes) as of June 30, 2006.

Mandatory and Discretionary Reappropriations

Reappropriations represent adjustments for unspent cash balances as of June 30, 2006, that an agency could carry forward into the next fiscal year. As a general rule, unspent general fund balances as of the end of a fiscal year revert to the Commonwealth's General Fund. The Appropriation Act does include some exceptions to this policy, which include legislative, judicial, and independent agencies that automatically carry forward unspent general funds. The Commonwealth shows these adjustments as mandatory reappropriations and totaled \$85 million in fiscal year 2007.

The Governor also has the authority to approve reappropriation of unspent general fund cash balances at the end of a year, and the Commonwealth refers to these items as discretionary reappropriations. These general fund reappropriations totaled \$22 million in fiscal year 2007. Some of the more significant items were \$4 million for Department of Social Services for a one-time supplement for child care funds passed through to localities, and \$1.5 million for the Department of Health to complete purchases of antiviral medications by the end of calendar year 2006.

Deficit Appropriations

This adjustment type represents additional General Fund appropriations as authorized in the Act or by the Governor. Planning and Budget processed only one deficit appropriation in 2007 for the Department of Health totaling \$9.6 million. The Governor authorized this appropriation for the purchase of Virginia's full allotment of antiviral medications through the federal government.

Central Appropriations

Planning and Budget also has responsibility for executing items within the Central Appropriations section of the Act. The Act uses a section known as Central Appropriations to implement budget actions, which will affect multiple agencies and funds. Central Appropriations also serve to deal with budgetary decisions, which do not require the action of an individual agency, but may require multiple agencies to execute the action. Central Appropriations includes the funding for the Personal Property Tax Relief Act, which require the segregation of the funding and the joint cooperation of the Departments of Motor Vehicles and Accounts.

Planning and Budget and Accounts establish an agency on their systems to control the budgetary transactions arising from the Central Appropriation actions in the Act. Planning and Budget relies on information from other agencies to determine the amount and allocation of the Central Appropriations to individual agencies. For example, Planning and Budget uses payroll information from Accounts and agencies to distribute increases in salary and fringe benefit amounts. In fiscal year 2007, Planning and Budget processed more than \$1.1 billion in Central Appropriations administrative budget adjustments, some of which we have already discussed in this report.

The following sections below discuss the largest appropriations for fiscal year 2007 from Central Appropriations by purpose, program description, and item number in Chapter 3. The tables show the amount appropriated for each program, any adjustments, the amount transferred out, and any remaining balance at fiscal year-end 2007. For comparison, the 2008 budget approved by the 2007 General Assembly in Acts of the Assembly, Chapter 847 is included in each table.

Tobacco Settlement Funds (Program 745, Item 502)

This item provides spending authority for the Tobacco Indemnification and Community Revitalization Fund and the Virginia Tobacco Settlement Fund from amounts awarded to the Commonwealth under the Master Settlement Agreement with tobacco manufacturers.

Appropriation per Chapter 3	\$ 46,971,974
Amended Legislative Appropriation	(7,212,512)
Transfer NGF appropriation from central accounts to Tobacco Indemnification and Community Revitalization Fund and VA Tobacco Settlement Fund	<u>(39,759,462)</u>
Unexpended balance	\$ <u>-</u>
Proposed appropriation for 2008	\$ 46,313,093

Personal Property Tax Relief (Program 746, Item 503)

This item includes the Commonwealth's portion of the Personal Property Tax Relief amounts paid to localities for registered vehicles assessed at \$20,000 or less and limited to personal use. The General Assembly capped the total amount for the tax year 2006 at \$950 million. In fiscal year 2007, Planning and Budget made quarterly transfers from this account to Agency 850-Personal Property Tax Relief (PPTR) so that Accounts could distribute the amount to localities.

Appropriation per Chapter 3	\$ 950,000,000
Transfers to Agency 850 Personal Property Relief Act	<u>(950,000,000)</u>
Unexpended balance	<u>\$ -</u>
Proposed appropriation for 2008	\$ 950,000,000

Compensation Supplements (Program 757, Item 505)

This item provides a mechanism for funding for increases in state employee salaries and benefits.

Appropriation per Chapter 3	\$ 137,085,279
Transfer of mileage reimbursement funding between programs (Payments for Special and Unanticipated Expenditures to Compensation and Benefits Supplements)	1,600,000
Transfer to agencies for salary benefits and mileage reimbursement	<u>(138,675,695)</u>
Unexpended balance	<u>\$ 9,584</u>
Proposed appropriation for 2008	\$ 290,167,430

Economic Contingency (Program 758, Item 506)

This item provides funding to address emergency or other unbudgeted costs to state agencies for essential commodities and services, which agencies cannot absorb in their existing appropriations.

Appropriation per Chapter 3	\$ 53,057,985
Amended Appropriations	2,800,000
Mandatory Reappropriation	15,457,483
Transfer from other agencies for amount of VITA services	3,470,088
Transfer to the Governor's Opportunity Fund	(15,100,000)
Transfer to the Secretary of Commerce for the Semiconductor Memory Logic Water Manufacture Performance Grant Fund	(14,220,000)
Transfer to VITA for information technology services	(8,909,140)
Transfer to support Infineon Technologies major expansion	(3,000,000)
Transfer of funds to VITA for a statewide imagery base and updating high resolution images	(3,662,985)
Transfer of mileage reimbursement funding to program 757 (Compensation and Benefits Supplements)	(1,600,000)
Transfer to the Governor's Motion Picture Fund	(250,000)

Transfer to State Police	(1,241,717)
Transfer to the Jamestown 2007 celebration and Queen's visit	(2,102,110)
Transfers to Russell County Industrial Development	(1,000,000)
Transfers related to NAS Oceana base	(471,164)
Transfer to VITA for information technology services	(748,219)
Other miscellaneous transfers	<u>(1,320,600)</u>
Unexpended Balance	<u>\$ 20,159,621</u>
Proposed appropriation for 2008	\$ 41,515,000

Capital Budget Adjustments

In fiscal year 2007, administrative adjustments to the capital budget resulted in a net increase of approximately \$4.2 billion. Most of the adjustments represent unspent appropriations at the end of a fiscal year that automatically carry forward into the next fiscal year. Unexpended appropriations from completed or closed capital projects revert to their funding source and are the reversions in the table below.

Detailed Schedule of Fiscal Year 2007 Capital Budget Adjustments

	<u>General Fund</u>	<u>Non General Fund</u>	<u>Total</u>
Original budget, Chapter 3	\$ 791,181,398	\$ 1,311,537,000	\$ 2,102,718,398
Subsequent legislative amendments	111,789,499	365,648,000	477,437,499
Administrative Adjustments			
Carry forward of prior year balances	125,309,881	3,650,818,917	3,776,128,798
Reversions	(244,578)	(125,343,917)	(125,588,495)
Other non-general fund appropriations and additional revenues	-	108,993,879	108,993,879
Transfers	<u>1,826,559</u>	<u>1,915,478</u>	<u>3,742,037</u>
Adjusted budget as of June 30, 2007	<u>\$1,029,862,759</u>	<u>\$ 5,313,569,357</u>	<u>\$ 6,343,432,116</u>

Background Information on the Commonwealth's Budget Process

Virginia has a biennial budget system, which means it adopts a two-year budget. The budget development process involves many participants and spans several months. The Act is a special piece of legislation to authorize the spending of the projected revenues approved by the General Assembly and the Governor. The Virginia Constitution limits appropriation acts to a life of two years and six months, unless shortened by the Act and requires balancing the total biennial budget.

The following chart shows the projected revenue and appropriation for fiscal year 2007 during the 2006-2008 biennium as shown in the original and then amended in subsequent Acts. Chapter 3 represents the original budget for the first year of the biennium. Chapter 847 amended the budget at the end of the first fiscal year of the biennium.

2007 Projected Revenues and Appropriations Approved by the General Assembly

<u>General Assembly Session</u>	<u>Appropriation Act Chapter</u>	<u>Projected Revenues</u>	<u>Appropriation</u>
2006	Chapter 3	\$39,293,108,834	\$ 37,006,987,684
2007	Chapter 847	\$42,172,764,363	\$ 37,470,395,340

The Commonwealth budgets expenses based on projected state revenues. State statutes differentiate revenues into two broad categories: general and non-general funds. Non-general funds are revenues that, by law or external authorities, support specific programs, activities, or purposes.

General funds consist primarily of taxes paid by Virginia citizens and businesses, including fees and other revenues that support basic governmental programs. The Governor and General Assembly have more discretion in allocating general funds to programs than non-general funds. The Commonwealth budgets separately for operating expenses and capital projects due to the long-term and non-recurring nature of capital expenses.

The Governor and Planning and Budget have certain statutory authority to increase, decrease, or transfer funds and positions during the implementation of the budget. This authority is primarily set forth in Section 4-1.00 of the Act, but there are also other requirements throughout the Act.

Section 4-1.00 establishes the overall criteria by which an agency can request appropriation adjustments. The Director of Planning and Budget has further delegated his authority over certain types of adjustments to Planning and Budget staff, and documented this delegation of authority in a memorandum, effective October 18, 2006. Under this delegation, for example, Planning and Budget analysts have the authority to transfer appropriations between programs within an agency; however, appropriations transfers between agencies require authorization by a Planning and Budget Associate Director or the Director.

Upon approval of the Act, the Division of Legislative Services sends an electronic file with the appropriation data to Planning and Budget. Planning and Budget performs various control procedures to ensure the file's completeness and accuracy and then creates a budget development master (BDM) file on the mainframe. Planning and Budget then creates an execution master (EXM) file from the BDM file along with a copy for Accounts. Planning and Budget procedures vary depending on whether the file contains a new biennial budget or amendments to an existing budget. Accounts accesses its appropriation file copy and uploads the data to CARS.

The appropriations set forth in the Act set annual legal spending limits by secretarial area, agency, program, and project. Automated edit controls within CARS ensure agencies do not exceed their spending authority at each of these levels. CARS edit controls analyze expenses to determine if appropriations and allotments are sufficient before paying an expense transaction. However, there are instances where Accounts can override transactions that do not meet appropriation edit controls. Although Accounts may override the controls, Accounts implements additional manual control procedures to ensure that agencies do not exceed their authorized appropriation levels.

Planning and Budget operates several information systems that support the budget process. FATS processes most administrative changes to the budget. Planning and Budget maintains FATS and controls the granting and deleting of access for individual users. Agency personnel initiate most budget adjustments and staff of Planning and Budget approve and process these adjustments through FATS. During fiscal year 2007, Planning and Budget processed about 3,300 budget adjustments through FATS.

The level of supervisory review within Planning and Budget depends on the type of transaction. FATS transactions are subject to a series of edits that verify the accuracy of the information. These edit controls include verifying funding availability, validity of program codes, agency codes, project codes, fund detail, and the completion of transaction briefs. Planning and Budget staff complete transaction briefs in FATS and maintain additional documents that explain details of certain FATS transactions.

After Planning and Budget approval, staff uploads FATS transactions into an EXM file on the mainframe, which updates CARS on a nightly basis. Planning and Budget and Accounts staff review a daily listing to verify the proper processing of FATS transactions in CARS. Amendments to the Act approved by the General Assembly do not go through FATS, but go directly to Accounts for loading to CARS. Within FATS, Planning and Budget uses alpha codes to differentiate types of budget adjustments. The FATS adjustment type code initiates the proper program budgeting adjustment and when uploaded to CARS identifies the correct transaction codes for recording in CARS.

There are a few types of routine appropriation adjustments that do not flow through FATS that Accounts records directly in CARS. An example is the transfer of the initial higher education general funds appropriations to non-general funds and the transfer of transportation general funds to non-general funds.



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January 26, 2008

The Honorable Timothy M. Kaine
Governor of Virginia
State Capital
Richmond, Virginia

The Honorable Thomas K. Norment, Jr.
Chairman, Joint Legislative Audit
and Review Commission
General Assembly Building
Richmond, Virginia

INDEPENDENT AUDITOR'S REPORT

We have completed a **Review of the Budget and Appropriation Processing Control System** administered by the Department of Planning and Budget for the year ended June 30, 2007. We conducted our audit in accordance with Government Auditing Standards, issued by the Comptroller General of the United States.

Audit Objectives

The overall purpose of our audit was to evaluate the adequacy of statewide budget and appropriation processing controls. The following objectives satisfy the audit's purpose by determining whether policies and procedures were adequate to ensure:

1. Planning and Budget is in compliance with requirements in the Appropriations Act and the Code of Virginia that could materially affect the Commonwealth's annual financial statements;
2. The budget approved by the General Assembly is properly recorded in the Commonwealth Accounting and Reporting System (CARS);
3. Appropriation controls in CARS are adequate to ensure program expenses do not exceed appropriations;
4. Budget adjustments processed by Planning and Budget in the Form 27 Automated Transaction System (FATS) are properly approved, documented, and reconciled to CARS at the statewide level; and
5. User access to FATS is reasonable.

We also reviewed corrective actions of audit findings from the prior year audit report.

Audit Scope and Methodology

Planning and Budget'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.

We gained an understanding of the overall internal controls, automated and manual, sufficient to plan the audit. We considered materiality and control risk in determining the nature and extent of our audit procedures. Our review encompassed controls over the significant cycles, classes of transactions, and account balances.

We performed audit tests to determine whether Planning and Budget'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. Our audit procedures included inquiries of appropriate personnel, inspection of documents and records, and observation of Planning and Budget's operations.

We tested transactions and performed analytical procedures, as we considered necessary to achieve audit objectives. Our review included research of relevant sections of the Code of Virginia, the Appropriation Act, and applicable policies and procedures at Planning and Budget and the Department of Accounts. It included gaining an understanding of the budget process, including reconciling, and monitoring the budget approved by the General Assembly. In addition, we reviewed and analyzed adjustments made to the budget, appropriation controls in CARS, and access to budget systems.

Conclusions

We found that Planning and Budget's policies and procedures for the budget and appropriation process control system were adequate to ensure that:

1. Planning and Budget is in compliance with requirements in the Act and the Code of Virginia that could materially affect the Commonwealth's annual financial statements;
2. The budget approved by the General Assembly is properly recorded in CARS;
3. Appropriation controls in CARS are adequate to ensure program expenses do not exceed appropriations;
4. Budget adjustments processed by Planning and Budget in the Form 27 Automated Transaction System (FATS) are properly approved, documented, and reconciled to CARS at the statewide level; and
5. User access to FATS is reasonable.

We noted certain matters involving internal control and its operation and compliance that require management's attention and corrective action. These matters are described in the section entitled "Findings and Recommendations."

The results of our test of compliance with applicable laws and regulations disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

Planning and Budget has taken adequate corrective action with respect to those audit findings reported in the prior year that are not repeated in this letter.

Exit Conference and Report Distribution

We discussed this report with Planning and Budget management on March 21, 2008. Management's response has been included at the end of 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.

AUDITOR OF PUBLIC ACCOUNTS

LCW/wdh



COMMONWEALTH of VIRGINIA
Department of Planning and Budget

Richard D. Brown
Director

1111 E. Broad St., Room 5040
Richmond, VA. 23219

March 31, 2008

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

Dear Mr. Kucharski:

I have reviewed the Auditor of Public Accounts' 2007 audit of the Department of Planning and Budget's (DPB) Budget and Appropriation Processing Control System. Each audit finding is addressed below.

APA Finding: Address Budget Transparency Issues

In our previous report, we reported significant budget transparency issues that affect the ability of citizens to understand the Commonwealth's budget and how resources are used. Given the emphasis, both in Virginia and nationwide, on greater accountability and transparency in government, we think these issues should be a priority. We originally recommended these issues be addressed as part of the enterprise application project; however, the status of this system development effort is uncertain. The Governor and Planning and Budget are in the process of developing a request for proposal for a new performance budgeting system for budget development activities. These issues should be considered as they move forward with this initiative.

In the interim period, we recommend that the Governor and Planning and Budget develop alternative solutions to address these issues. A transparent budget process allows any informed citizen sufficient ease in understanding and following the budget process without having any special training. This term describes a budget process which is clear, visible, and understandable to a citizen with an interest in the information. We discuss below two practices which affect the transparency of the Commonwealth's budget as well as recommendations for consideration.

Significant transfers of General Funds to Other Funds

Significant transfers of General Funds to various non-general funds occur after the budget's approval for certain programs making it difficult to identify the source of funds for these programs in the accounting records. The two largest transfers are for the Personal Property Tax Relief Program and higher education operating funds. Together, these two programs result in almost \$3 billion in general funds being transferred to non-general funds after the budget is approved.

In the case of the Personal Property Tax Relief program, these transfers occur to comply with various requirements in the Appropriation Act, which require setting aside and

spending these funds from a separate fund. In an effort to satisfy the legislative requirements, the current practice is to move these General Fund amounts to non-general fund accounts, in order to separate the funds to monitor and control the spending of the appropriation. The creation of these funds changes the nature of how both the accounting and budget systems show these funds.

While the current statewide accounting system, the Commonwealth Accounting and Reporting System (CARS), could accommodate creating separate sub-funds within the General Fund, the Department of Accounts (Accounts) has not attempted to do this. We recommend Accounts and Planning and Budget determine whether a separate sub-fund of the General Fund could be established to account for the Personal Property Tax Relief program. The creation of a sub-fund would improve the budget transparency of close to \$1 billion in General Funds.

In the case of the transfer of general funds to higher education operating funds, this practice originated over twenty years ago to simplify accounting for these funds at each university. Given that technology has advanced since then, we recommend that the Commonwealth re-examine this practice and determine whether or not this transfer is still necessary given the capabilities of current financial systems. Most of the Commonwealth's colleges and universities have financial management systems that can process transactions with multiple funding sources, making the current practice of transferring general funds outdated. The elimination of this practice would improve the budget transparency of \$1.5 billion in General Funds.

Aside from the two programs discussed above, the practice also affects several other programs including water quality improvement, some transportation programs, and the Governor's Opportunity Fund. These programs should also be considered when examining the current practice.

Lack of a Reporting Mechanism for Budget Adjustments

The current reporting mechanisms for administrative adjustments processed during the year need to be improved. While the Comptroller's year-end preliminary financial report does show some original and final budget information, it focuses primarily on the General Fund. Other than the Comptroller's report, our Data Point website, and FATS reports sent to Senate Finance and House Appropriations monthly, there is no comprehensive statewide budget information reported that includes the administrative budget adjustments. Without a formal reporting mechanism in place, legislators and the average citizen have no means to understand changes to the budget after its approval.

DPB's Response:

The Department of Planning and Budget (DPB) generally agrees that the transfer of general fund appropriations to various nongeneral fund accounts hinders transparency in tracking expenditures versus appropriations. However, the implementation of the APA's recommended changes involves numerous state agencies and accordingly, cannot be unilaterally directed by DPB. In order to have successful statewide implementation of these changes, it will be necessary to bring together several agencies in the decision-making process and to tailor the recommended changes to address legitimate agency concerns.

To aid in the solution, DPB will solicit buy-in from key state agencies, interest groups, and other vital stakeholders by forming and leading a task force to address the identified transparency concerns. The Auditor of Public Accounts will be invited to participate on this task force team, and it is envisioned that the team will convene by July 1, 2008. The recommendations developed by this task force will be forwarded by DPB to the Governor and General Assembly staff for consideration and further action on both the administrative and statutory fronts. Any proposed legislation would be introduced to the 2009 General Assembly for consideration.

APA Finding: Update the FATS Manual

Planning and Budget needs to review and update the Form 27 Automated Transaction (FATS) Manual (Manual) to reflect current practices and changes in authority. The last comprehensive revision to the Manual was in 1998. Numerous changes have occurred since, including substantial changes in the authority delegated to Planning and Budget as provided in the Act. As a result, the Manual is out of date, incomplete, or irrelevant in the current environment.

The Manual is the primary resource for policies, operational procedures, and analytical criteria for budget analysts to follow when processing administrative budget adjustments. Planning and Budget also uses the Manual as a training and reference resource for both Planning and Budget and other agency budget staff.

We reviewed a sample of 50 operating budget adjustments from fiscal year 2007, and identified five (10 percent) transactions where the transaction brief did not meet the criteria in the Manual. We identified the following specific shortcomings in the Manual and have included the reference to the specific adjustment type.

- The Manual does not require analysts to include a reference to the authorizing legislation in the transaction brief. (Special legislative adjustment, type C)
- The Manual does not document operating policies or procedures for adjustments initiated by Planning and Budget ProBud Services staff. Examples would be increases from Central Appropriations for salary and fringe benefit increases.
- Planning and Budget analysts frequently gather additional data that support certain adjustments; however, analysts do not summarize or reference this information in the FATS transaction brief. Further, the Manual does not provide complete instructions for gathering, evaluating, and documenting the supporting data.
- The Manual does not provide instructions for sum sufficient transactions related to internal service funds.
- The criteria specified in the Manual is no longer relevant for transfers that are executed pursuant to language in the Act or for technical reasons specified in Part 4 of the Act.

We recommend Planning and Budget allocate resources to update the current Manual or implement an alternative solution for providing policies and procedures to Planning and Budget staff.

Walter J. Kucharski
March 31, 2008
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Reliance by analysts on the existing Manual could cause errors in transaction processing due to outdated requirements.

DPB's Response:

The Department of Planning and Budget (DPB) agrees with the finding and will take steps to address the Auditor of Public Accounts concerns during the summer months of 2008.

Sincerely,

A handwritten signature in black ink, appearing to read "Richard D. Brown".

Richard D. Brown

c: Don Darr
Paul Bender

OFFICIALS PAGE

As of June 30, 2007

Jody M. Wagner
Secretary of Finance

Richard D. Brown
Director, Department of Planning and Budget

David A. Von Moll
State Comptroller, Department of Accounts