VIRGINIA EMPLOYMENT COMMISSION

REPORT ON AUDIT

FOR THE YEAR ENDED

JUNE 30, 2012

APA
Auditor of
Public Accounts
COMMONWEALTH OF VIRGINIA

AUDIT SUMMARY

Our audit of the Virginia Employment Commission (Employment Commission) for the fiscal year ended June 30, 2012 found:

- proper recording and reporting of all transactions, in all material respects, in the Commonwealth Accounting and Reporting System and in the Employment Commission's Tax and Benefits Systems;

- two matters involving internal control and its operations necessary to bring to management's attention;

- no instances of noncompliance with applicable laws and regulations or other matters that are required to be reported; and

- the Employment Commission has made progress, but has not completely resolved our prior year findings "Resolve Employer Wage Discrepancies Timely" and "Follow Timekeeping and Payroll Procedures."

The Employment Commission is currently involved in several system development initiatives, which will replace multiple outdated systems and significantly change the agency's current business processes. The Financial Management Systems Project will replace the current financial system and the Unemployment Insurance Modernization (UI Mod) Project will replace multiple legacy mainframe-based systems changing the way employers interact with the Employment Commission. The Employment Commission is planning to implement these new systems over the next two years and is devoting significant resources to these projects.

We have periodically reported on the status of these projects with the most recent update in our *Progress Report on Selected System Development Projects in the Commonwealth* issued in March 2012. We have also summarized these system development projects in this report.

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INTERNAL CONTROL AND COMPLIANCE FINDINGS AND RECOMMENDATIONS

Resolve Employer Wage Discrepancies Timely

As we reported in our last audit, the Tax Reconciliation Unit and the Tax and Wage Information Processing (TWIP) Unit are not consistently reviewing and resolving wage discrepancies in a timely manner. Employers report wages paid to employees to the Employment Commission, which verifies the amounts reported against other sources of information such as tax returns. Differences between the amounts reported to the Employment Commission appear on various wage discrepancy reports and the TWIP Unit reviews and resolves discrepancies that meet certain thresholds.

During our review, we found the Tax Reconciliation Unit did not adequately resolve two out of 16 (12.5 percent) wage discrepancies tested in a timely manner. These discrepancies date from the third and fourth quarters of calendar year 2011 and remain unresolved as of October 2012. During this timeframe, the Tax Reconciliation Unit experienced significant turnover including the reassignment of several key staff to the Commission's system implementation projects. As a result, the policies and procedures established by the Tax Reconciliation Unit were not being followed to resolve these discrepancies. In addition, the Tax Reconciliation Unit has not established polices for what constitutes timely resolution of identified discrepancies.

We recommend Management continue to review staffing levels of the Reconciliations Unit so that the Unit has adequate and appropriately trained resources. The Unit is currently implementing a new system and this is an opportunity for them to review their business processes as well as their policies and procedures. They should ensure their policies and procedures address what constitutes timely resolution of identified discrepancies as well as information necessary to track and monitor the status of discrepancies under review. Unresolved wage discrepancies could impact the amounts employers pay in Unemployment Insurance taxes as well as the amount of benefits employees can receive.

Follow Timekeeping and Payroll Procedures

As we reported in our previous audit, Employment Commission supervisors are not consistently following internal policies, which require advance approval for overtime. During our review, we found that supervisors for six out of 16 employees (37.5 percent) tested did not obtain advance approval for overtime worked. In addition, four of these employees worked more overtime hours than had been approved.

To address an increased workload over the last several years, the Employment Commission has hired additional personnel and required overtime for many staff. The Employment Commission's policies require the employee's supervisor obtain advance approval from the Division head for overtime including the specific dates and hours of overtime. Although management has emphasized this policy within the agency, we continued to find instances where supervisors are not following the policy.

We recommend Management continue to emphasize the policy to ensure all supervisors are aware of the requirement and hold supervisors accountable who are not following the requirement. Given the additional workload, the agency has experienced over the last several years, effective overtime controls are essential to minimize the opportunity for abuse and increase the efficient use of federal operating funds.

STATUS OF SYSTEMS DEVELOPMENT PROJECTS

The Employment Commission is currently involved in several system development initiatives, which will replace multiple outdated systems and significantly change the agency's current business processes. We have periodically reported on the status of these projects in our *Progress Report on Selected System Development Projects in the Commonwealth*, with the most recent report issued in March 2012. We summarize these projects and the status below.

Unemployment Insurance Modernization (UI Mod) Project

The Unemployment Insurance Modernization Project (UI Mod) will replace multiple existing mainframe-based software systems with a web-based platform, changing the way employers interact with the Employment Commission. UI Mod will support payment of benefits to unemployed workers, collection of taxes from employers, and the accumulation of wage data. The total budget for UI Mod is $58.5 million with $49.1 million coming from the Reed Act funds and the remaining $9.4 million coming from the Employment Commission's penalty and interest fund. The Employment Commission has spent approximately $18.6 million as of October 2012.

The first phase, Imaging and Workflow, went into production successfully and under budget in December of 2011. However, the Employment Commission and HCLA, the vendor for the UI Mod project, have extended the implementation dates of both the Tax and Benefit phases from December 2012 and May 2013 to May 2013 and August2013, respectively.

Although the project continues to move forward steadily, UI Mod continues to encounter hurdles such as resource availability and vendor staff attrition, including the resignation of the HCLA Project Manager. In addition, HCLA and the Employment Commission have already contractually adjusted the project schedule, therefore extending the implementation dates one time and HCLA has indicated the desire to adjust the schedule again.

Financial Management System

The Financial Management System Project is a modern, integrated financial management system that will replace an outdated mainframe batch system and databases. The Employment Commission signed a contract with Strategic Information Solutions in May of 2012 for the implementation of the Financial Management System's Oracle application. The total project cost is $4.9 million with funding coming primarily from Reed Act funds and the Employment Commission plans to implement the new system in October 2013.

AGENCY BACKGROUND AND FINANCIAL INFORMATION

The Employment Commission's mission is to promote economic growth and stability by delivering and coordinating workforce services that include policy development, job placement services, temporary income support, workforce information, and transition and training services.

The Employment Commission's funding for unemployment benefits comes primarily from unemployment taxes collected from employers, which go into the Unemployment Trust Fund (Trust Fund). The Employment Commission also receives some federal grants used primarily to fund administrative activities. With the economic downturn in recent years, these traditional funding sources have not been sufficient to fund benefit payments, and the Employment Commission has had to borrow money from the federal government to fund the Trust Fund. We discuss Trust Fund borrowing and activity in more detail later in this report.

The Employment Commission has also received additional federal funding for several extensions of unemployment benefits approved by the federal government in the last several years. In fiscal year 2012, the Employment Commission received additional federal funding of approximately $550 million for unemployment extensions approved by the federal government in 2010. The Employment Commission also continued to receive federal stimulus funds although the amount decreased significantly from 2011 due to the gradual phase out of the stimulus funding.

The Employment Commission budgets their funding in two programs: Workforce Systems Services and Economic Development Services. The Workforce Systems Services program is the Commission's primary program, as shown in the following table of budget and actual activity for fiscal year 2012. For purposes of this table, we present the Workforce Systems Services program by service area to provide more detailed program information.

Budget and Actual Activity for Fiscal Year 2012

Program and Service Area	Original Budget	Final Budget	Expenses
Workforce Systems Services:			
Job Placement Services	$31,846,184	$34,346,184	$31,531,619
Unemployment Insurance Services	787,661,047	1,346,361,047	1,246,814,408
Workforce Development Services	2,700,000	2,700,000	1,022,456
Economic Development Services	3,373,144	3,573,144	3,224,729
Total	$825,580,375	$1,386,980,375	$1,282,593,212

The largest of these program service areas is the Unemployment Insurance Services, under which the Employment Commission makes benefit payments to unemployed workers. The budget and expenses increased significantly during the year due to the additional federal funds for benefit extensions already discussed. Due to the significance of the Unemployment Insurance Services program, we provide more information on this program below including a discussion of unemployment benefits, unemployment taxes and the Trust Fund.

Unemployment Insurance Services Program

Unemployment Benefits

Under the Unemployment Insurance Services program, the Employment Commission makes unemployment benefit payments to unemployed workers who lost their employment through no fault of their own. The unemployment benefit payments provide workers with minimal income during the course of a job search.

Generally, the amount and length of benefits an individual is eligible for is based on wages an individual earned while employed. The Governor and the General Assembly have the ability to adjust unemployment benefit payments although there have not been any significant changes in benefit amounts for the last several years as seen in the following chart.

Minimum and Maximum Unemployment Benefit Amounts
Fiscal Years 2007-2012

Effective Dates	Minimum Benefit	Maximum Benefit
July 3, 2006 – June 30, 2007	$54	$347
July 1, 2007 – July 5, 2008	$54	$363
July 6, 2008 – June 30, 2012	$54	$378

The State's unemployment insurance program pays benefits for up to 26 weeks; however, as we have discussed, the federal government has approved several benefit extensions over the last several years. The chart on the following page shows the most significant state and federal benefit programs applicable during the fiscal year and the amount of weeks benefit payments that are included under each.

Summary of Available Benefit Types in Fiscal Year 2012

State Unemployment Benefits	Federal Emergency Unemployment Benefits (scheduled to expire December 29, 2012)		
26	Tier 1	Tier 2	Tier 3
Maximum weeks in most states	Up to 20 weeks available nationwide; reduced to 14 weeks available as of September 9, 2012	Up to an extra 13 weeks paid in "high unemployment state", 14th week added by Congress effective 11/2009	Up to 13 additional weeks of benefits paid in "high unemployment" states if other benefits exhausted

In fiscal year 2012, the Employment Commission paid out more than $1 billion in unemployment benefit payments. Overall, benefit payments decreased between 2011 and 2012 as the unemployment rate decreased, extended benefits began expiring, and claimants began exhausting their benefits and became ineligible to file a new claim due to the length of time they have been unemployed. The following table shows benefit payments by type made in fiscal years 2011 and 2012, including the benefit programs discussed above.

Unemployment Benefit Payments by Type
Fiscal Years 2011 and 2012

Type of Unemployment Benefit	Fiscal Year 2012 Amount	Fiscal Year 2011 Amount
State Unemployment Insurance Benefits	$624,351,290	$666,936,329
Federal Unemployment Insurance Benefits	37,022,653	32,532,391
Federal Emergency Unemployment Benefits – Tier I	255,722,859	304,552,464
Federal Emergency Unemployment Benefits – Tier II	126,986,137	157,337,316
Federal Emergency Unemployment Benefits – Tier III	111,127,601	144,222,576
Federal Extended Benefits and Additional Compensation	1,518,536	123,206,428
Total	$1,156,729,076	$1,428,787,504

Unemployment Taxes

The Employment Commission pays unemployment insurance benefit payments from unemployment taxes collected from Commonwealth employers if the employer meets certain criteria set forth in the Code of Virginia. The Employment Commission classifies employers as one of two types - taxable or reimbursable employers. Taxable employers pay an unemployment tax to the Employment Commission based on a set tax while reimbursable employers reimburse the Employment Commission dollar-for-dollar for their proportionate share of benefits paid. There are approximately 188,000 taxable employers and 1,300 reimbursable employers in Virginia.

Under current law, employers pay taxes only on the first $8,000 of each employee’s wages. The Employment Commission collects these taxes throughout the year and transfers the amount collected to the Trust Fund, which the federal government maintains. The Employment Commission is the trustee and uses the fund to pay State unemployment insurance benefit payments.

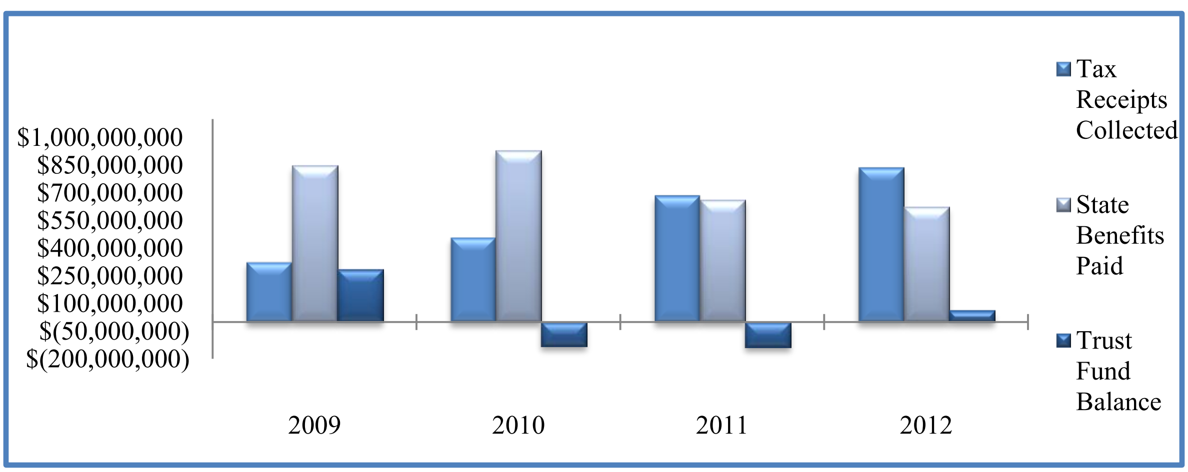
Trust Fund

Generally, in times of low unemployment, the Trust Fund builds up a balance to pay benefits in times of higher unemployment. The unemployment rate has increased significantly over the last several years due to the economic downturn, but has decreased during fiscal year 2012.

Fiscal Year	Unemployment Rate
2009	5.60%
2010	7.10%
2011	6.50%
2012	6.00%

The unemployment rate impacts the amount of unemployment benefits paid which affects the Trust Fund balance. Trust Fund activity, specifically significant changes in the Trust Fund balance, can in turn affect future tax rates paid by employers. The chart below shows the relationship between benefits paid, taxes collected, and the trust fund balance over the last several years. The trust fund balance shown below is the balance at fiscal year-end and includes any borrowed funds, which we discuss in more detail on the following page.

Summary of Trust Fund Activity – Fiscal Years 2009 - 2012



The Trust Fund balance has decreased significantly over the last several years due to a high unemployment rate causing the increased volume of unemployment benefits. During fiscal years 2009 and 2010, the Employment Commission had to pay significantly more in benefits than it was collecting in taxes, causing the Trust Fund to run a deficit.

When the Trust Fund incurs a deficit, Section 1201 of the Social Security Act (Act) provides for temporary loans from the federal government to ensure the continuation of benefit payments. The Act requires repayment of any loans from future employer contributions, but does not allow the Employment Commission to use employer contributions to pay any interest owed on the outstanding loan balance.

The Employment Commission began borrowing from the federal government in October 2009 and has periodically borrowed since that time. During fiscal year 2012, the Employment Commission was able to repay the loan and ended the fiscal year with no balance due to the federal government with the exception of an interest payment due in September 2012.

Summary of Loan Activity – Fiscal Year 2012

Beginning Balance at July 1, 2011	$182,219,000
Advances received during the year	$263,730,684
Repayments made during the year	$445,949,684
Ending Balance at June 30, 2012	0

The Employment Commission was able to reduce the loan balance to the federal government through increased tax collections over the last several years. These increased collections were primarily the result of automatically triggered changes in the tax rates required to maintain the Trust Fund's solvency.

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 Trust Fund's solvency rate has an inverse relationship to employer tax rates, meaning, as the solvency decreases, the unemployment tax rates generally increase.

When the Trust Fund solvency remains at or above 100 percent, state law sets the lowest tax rate at zero. If the solvency rate falls below 100 percent, all required employers must pay unemployment tax. The tax rates imposed on employers take into account the solvency rate as well as the employment histories of individual businesses. Generally, employers with a history of higher unemployment claims pay a greater rate, while those with fewer claims pay less.

State law requires additional adjustments to the tax rate when trust fund solvency declines. The pool tax is an adjustment to the tax rate that represents a levy to recover benefits not chargeable to a specific employer, known as pool costs. When trust fund solvency exceeds 50 percent, interest income from the Trust Fund offsets pool costs; however, the Employment Commission adds the pool tax to the tax rate when interest income does not cover pool costs. In addition, state law requires a fund-building tax rate of 0.2 percent increase to employer tax rates if the Trust Fund balance drops below 50 percent.

The Employment Commission annually sets the tax rates on a calendar year basis and the following table details the various tax rate components in effect for calendar years 2009 through 2012. As shown below, tax rates have steadily increased over the last four years due to increases triggered based on the trust fund solvency as discussed above. The Employment Commission will calculate and publish the calendar year 2013 rates in December 2012 so these are not included in the table below.

Unemployment Tax Rates

	Calendar Year 2009		Calendar Year 2010		Calendar Year 2011		Calendar Year 2012	
	Minimum	Maximum	Minimum	Maximum	Minimum	Maximum	Minimum	Maximum
Tax rate	0.10%	6.20%	0.10%	6.20%	0.10%	6.20%	0.10%	6.20%
Pool tax	0.08%	0.08%	0.28%	0.28%	0.47%	0.47%	0.53%	0.53%
Fund-building tax	-	-	0.20%	0.20%	0.20%	0.20%	0.20%	0.20%
Total	0.18%	6.28%	0.58%	6.68%	0.77%	6.87%	0.83%	6.93%

Trust Fund Issues in Future Years

The Employment Commission anticipates continuing high unemployment levels in Virginia will result in the need for short-term borrowing to continue to pay unemployment benefits over the next year. The Employment Commission estimates they will have to borrow an additional $175 million through April 2013, which they anticipate repaying by May 2013. A number of different factors including changes in the economic conditions, the unemployment rates, and any additional actions taken by the federal government can affect these projections.

In order to minimize interest owed to the federal government, the Employment Commission has obtained a treasury loan through the Virginia Department of Treasury in fiscal year 2013. The Employment Commission estimates borrowing $63 million from the treasury loan between October and December 2012 and borrowing the remaining $112 million from the federal government between January and April 2013.

The Employment Commission cannot use employer contributions to pay interest on any outstanding federal loan balance, and the Appropriation Act requires they use penalty and interest collections to pay the interest to the federal government before using these funds for other purposes. The Employment Commission made their second interest payment on September 30, 2012 using penalty and interest collections. The Employment Commission originally owed $5.6 million, but the federal government forgave $667,000 providing that Virginia does not borrow additional funds from the federal government before January 1, 2013.

Commonwealth of Virginia

Auditor of Public Accounts

Walter J. Kucharski
Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218

November 16, 2012

The Honorable Robert F. McDonnell
Governor of Virginia

The Honorable John M. O'Bannon, III
Chairman, Joint Legislative Audit
and Review Commission

We have audited the financial records and operations of the **Virginia Employment Commission** for the year ended June 30, 2012. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Audit Objectives

Our audit's primary objective was to evaluate the accuracy of Employment Commission's financial transactions as reported in the Comprehensive Annual Financial Report for the Commonwealth of Virginia for the year ended June 30, 2012. In support of this objective, we evaluated the accuracy of recording financial transactions in 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, regulations, contracts, and grant agreements, and reviewed corrective actions of audit findings from prior year reports.

Audit Scope and Methodology

The Employment Commission'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, both automated and manual, sufficient to plan the audit. We considered significance and risk in determining the nature and extent of our audit procedures. Our review encompassed controls over the following significant cycles, classes of transactions, and account balances.

Unemployment Benefits Payments
Taxes and Cash Receipts
Payroll Expenses
Small Purchase Charge Card
Information System Security
Accounts Receivable
Accounts Payable

We performed audit tests to determine whether the Employment Commission'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, records, and contracts, and observation of the Employment Commission's operations. We tested transactions and performed analytical procedures, including budgetary and trend analyses.

Conclusions

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. The Employment Commission 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 the Commonwealth Accounting and Reporting System and the Employment Commission's Tax and Benefit Systems.

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

The Employment Commission has taken adequate corrective action with respect to audit findings reported in the prior year that are not repeated in this letter.

Exit Conference and Report Distribution

We discussed this report with management on December 10, 2012. Management's response to the findings identified in our audit is included in the section titled "Agency Response." We did not audit management's response and, accordingly, we express no opinion on it.

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/clj

John R. Broadway
Commissioner

Post Office Box 1358
703 East Main Street
Richmond, Virginia 23218-1358

December 10, 2012

Mr. Walter J. Kucharski
Auditor of Public Accounts
Post Office Box 1295
Richmond, Virginia 23218

Dear Mr. Kucharski:

Thank you for the opportunity to review the Auditor of Public Accounts' audit report for the year ended June 30, 2012. Your comments and recommendations are appreciated and are given the highest level of importance and consideration as we continue to review and improve our practices and procedures.

We are in general concurrence with the findings and recommendations identified in your report and we plan to take appropriate action to address them.

Again, we appreciate the opportunity to provide comments as part of your office's report of the financial records and operations of the Virginia Employment Commission for the year ended June 30, 2012.

Sincerely,

John R Broadway

John R. Broadway
Commissioner

VIRGINIA EMPLOYMENT COMMISSION OFFICIALS

John R. Broadway
Commissioner