

**STATE CORPORATION COMMISSION**

**REPORT ON AUDIT  
FOR THE TWO-YEAR PERIOD ENDED  
JUNE 30, 2004**



## **AUDIT SUMMARY**

Our audit of the State Corporation Commission for the two-year period ended June 30, 2004, found:

- proper recording and reporting of transactions, in all material respects, in the Commonwealth Accounting and Reporting System and in the Commission's accounting records;
- an internal control matter that we consider to be a reportable condition; however, we do not consider this finding to be a material weakness; and
- no instances of noncompliance or other matters that required reporting.

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## AGENCY BACKGROUND AND FINANCIAL HIGHLIGHTS

The State Corporation Commission is an independent agency directed by three commissioners, each elected by the General Assembly for six-year terms. The commissioners rotate the chairmanship annually, and the Commission chairman assumes the role of chief operating officer for the agency. The Commission has both regulatory and non-regulatory divisions, and all 16 divisions report directly to the chairman. The regulatory divisions monitor such industries as utilities, banks, securities, retail franchising, insurance, and corporations. The non-regulatory divisions provide administrative and legal support. The Commission funds its operations from certain regulatory assessments and fees set by statute. The Commission collects revenues for the General Fund, other special funds, localities, and other state entities. The Commission collected a total of \$439,649,407 and \$426,664,556 in revenue for the General Fund for fiscal years 2004 and 2003, respectively.

The regulatory and non-regulatory divisions are show below.

### Regulatory Divisions

Insurance  
Securities and Retail Franchising  
Financial Institutions  
Public Service Taxation  
Public Utility Accounting  
Communications  
Energy Regulation  
Economics and Finance  
Utility and Railroad Safety  
Clerk of the Commission

### Non-Regulatory Divisions

Commissioners' Offices  
General Counsel  
Hearing Examiners  
Commission Comptroller  
Information Resources  
Human Resources  
Information Technology

### Regulatory Divisions

#### *Bureau of Insurance*

The Bureau of Insurance regulates over 1,600 insurance companies and 100,000 agents authorized to operate in Virginia. The Bureau examines the financial affairs of each domestic (Virginia-based) insurance company at least once every five years and requires annual statements from all insurance companies licensed to do business in Virginia. The Bureau also assists the public in resolving disputes with insurance companies.

The Bureau collects revenue through a gross premium tax from insurance companies, which totaled \$351,277,969 and \$333,003,967 in General Fund revenue in fiscal years 2004 and 2003, respectively. The Bureau also collects special revenue comprised of assessments and license, application, appointment, and other fees. Additionally, the Bureau collects an assessment from Fire and Casualty Insurance companies, which it transfers to the Department of Fire Programs. In fiscal years 2004 and 2003, the Bureau transferred over \$22.2 million and \$19.4 million, respectively.

The Bureau collects special assessments for the Virginia Department of State Police to investigate insurance fraud. Each licensed insurer doing business in the Commonwealth by writing any type of property and casualty insurance, except title insurance, pays a special assessment fee equal to a percentage of its direct gross premium income during the preceding calendar year. The Bureau can impose a late payment penalty of ten percent of the assessment and retains a portion of the special assessment to cover its administrative expenses. In fiscal year 2003, the Bureau deferred the transfer to the following year. As a result, the Bureau transferred no funds in fiscal year 2003 and transferred \$4 million in fiscal year 2004.

The Bureau also receives uninsured motorist fees collected by the Department of Motor Vehicles (Motor Vehicles). In accordance with the Code of Virginia, the Bureau distributes these funds to the insurance companies who write automobile liability insurance. Motor Vehicles transferred uninsured motorist fees to the Bureau totaling \$7.3 million and \$12.3 million, in fiscal years 2004 and 2003, respectively.

#### *Division of Securities and Retail Franchising*

The Division of Securities and Retail Franchising regulates security brokers and investment advisors in Virginia. The Division also registers franchises and trademarks in Virginia and investigates any reports of securities or franchising law violations or misconduct. The Division collected \$7.74 million and \$7.69 million in special revenue during fiscal years 2004 and 2003, respectively.

#### *Bureau of Financial Institutions*

The Bureau of Financial Institutions regulates and examines state-chartered banks, savings and loans, and credit unions. The Bureau also licenses and examines mortgage lenders and brokers, and licenses and regulates money transmitters, money order sellers, payday lenders, check cashers, consumer finance companies, and credit counseling services. The Bureau collects revenue from these entities for application fees, license fees, annual assessment fees, examination fees, and investigation fees. In fiscal years 2004 and 2003, the Bureau collected \$11.3 million and \$9.9 million, respectively.

#### *Division of Public Service Taxation*

The Division of Public Service Taxation collects state taxes on revenues and assessments on property of public service companies (e.g., electricity, water, and other power companies; telecommunications companies; and railroads). The Division collects taxes on electricity and natural gas based on consumption by the customers. In fiscal years 2004 and 2003, the Division collected \$81.7 million and \$86.2 million in General Fund revenue and \$30.9 million and \$33.0 million in special revenue, respectively.

#### *Division of Public Utility Accounting*

The Division of Public Utility Accounting provides the Commission with accounting and financial information. The Commission uses this information when considering utility cases involving rates and services; affiliate transactions, mergers and acquisitions; certificates of public convenience and necessity; alternative regulatory plans; and the restructuring of utility markets.

#### *Division of Communications*

The Division of Communications regulates Virginia's telecommunications industry (other than cellular and wireless, which the federal government regulates). The Division reviews rates and costs, evaluates telephone companies' performance, investigates consumer complaints regarding communications service, and oversees the implementation of telecommunications market competition.

#### *Division of Energy Regulation*

The Division of Energy Regulation regulates Virginia's investor-owned water and sewer, electric and natural gas utilities and member-owned electric cooperatives. The Division's responsibilities include reviewing rate applications filed by investor-owned utilities and member-owned cooperatives; monitoring utility construction projects; and responding to consumer complaints regarding electric, gas, and water and

sewer utilities under the Commission's jurisdiction. The focus of electricity regulation is shifting from setting rates to implementing the restructuring law under the guise of the General Assembly.

#### *Division of Economics and Finance*

The Division of Economics and Finance advises the Commission on economic and finance issues related to public utilities, conducts research, and develops special studies and forecasts.

#### *Division of Utility and Railroad Safety*

The Division of Utility and Railroad Safety works to ensure safe operation of railroads within the Commonwealth by inspecting facilities, tracks and equipment. To promote natural gas and hazardous liquid pipeline safety, the Division conducts pipeline facilities inspections, reviews records, and investigates incidents. The Division also investigates all reports of probable violations of the Underground Utility Damage Prevention Act.

#### *The Clerk of the Commission*

The Clerk is the Commission's official custodian of judicial and administrative records. The Clerk's Office also serves as the central filing office for Uniform Commercial Code financing statements and federal tax liens, as well as for thousands of corporations, partnerships, and limited liability companies doing business in Virginia. The Clerk's Office collects various fees from corporations, partnerships, and limited liability companies that register with the Commission. In fiscal years 2004 and 2003, the Clerk's Office collected \$6.4 million and \$6.3 million in General Fund revenue and \$38.8 million and \$36.7 million in special revenue, respectively.

#### Non-Regulatory Divisions

The non-regulatory divisions provide the Commission with administrative and legal support.

### **FINANCIAL ACTIVITY**

Table 1 compares the Commission's original and adjusted budgets with actual expenses. The Commission and Department of Planning and Budget establish an original budget based on the prior biennium budget amount and adjusts for certain items. For special revenue funds, the increase from original to adjusted budget occurs for two reasons. First, the Commission carries forward unexpended appropriations. Additionally, the Commission transfers appropriations from special revenue to dedicated special revenue funds for budgeting purposes. While the state system allows an increase of dedicated special revenue funds, it does not permit a corresponding decrease in the special revenue funds.

Rather than using the biennial budget, the Commission uses prior year expenses to determine their internal budget for non-personal expenses and adjusts for one-time expenses. For personal services, the Commission bases their internal budget on 100 percent staffing levels. These methodologies account for the difference between the adjusted budget and actual expenses for special revenue funds.

In fiscal year 2004, Motor Vehicles collected less uninsured motorist fees than expected, thus transferring less to the Commission for distribution to insurance companies. This accounts for the variance between the adjusted budget and actual expenses for trust and agency funds.

Table 1

Budget to Actual Expenses

<u>Fund</u>	<u>Original Budget</u>		<u>Adjusted Budget</u>		<u>Actual Expenses</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Special	\$82,461,096	\$80,815,533	\$85,309,824	\$82,007,840	\$63,807,284	\$65,336,786
Trust and agency	10,690,367	11,681,130	10,690,367	12,805,832	7,809,954	12,805,830
Federal	-	-	412,267	401,216	377,100	398,074
Total	<u>\$93,151,463</u>	<u>\$92,496,663</u>	<u>\$96,412,458</u>	<u>\$95,214,888</u>	<u>\$71,994,338</u>	<u>\$78,540,690</u>

As illustrated in Table 2, the Commission funds its operations from certain regulatory assessments and fees set by statute and records this activity primarily in four special revenue funds. The Commission maintains a cash balance in these funds as a reserve to prevent a large fluctuation in rates. Depending on the revenue source, the agency collects revenue annually, quarterly, or monthly. The Commission has determined that the reserve maintained should roughly equal to expenses for six months. In an effort to reduce the cash balance, the Commission has reduced fiscal year 2005 rates for some activities, which will reduce cash balances in special revenue funds over the next three years.

Table 2

Primary Special Revenue Funds

	<u>Bureau of Insurance</u>		<u>Financial Institutions</u>		<u>Clerks Office and Securities</u>		<u>Public Utilities</u>	
	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>	<u>2004</u>	<u>2003</u>
Balance as of								
July 1	\$15,011,821	\$14,068,437	\$7,755,204	\$7,707,399	\$14,922,590	\$12,509,732	\$53,676,506	\$48,811,687
Revenue	21,262,347	21,842,519	11,288,421	9,888,284	46,522,610	44,344,121	30,902,216	33,098,472
Less:								
Operating expenses	<u>19,733,269</u>	<u>19,712,074</u>	<u>9,364,914</u>	<u>9,094,323</u>	<u>11,229,041</u>	<u>10,937,339</u>	<u>22,412,505</u>	<u>24,400,743</u>
Subtotal	16,540,899	16,198,882	9,678,711	8,501,360	50,216,159	45,916,514	62,166,217	57,509,416
Transfer in	-	-	-	-	20,000	-	-	-
Transfer out:								
General fund	(544,196)	(927,005)	(242,184)	(428,457)	(32,224,944)	(30,493,832)	(6,932,663)	(2,652,589)
Other	(260,184)	(260,445)	(315,785)	(316,099)	(513,056)	(513,569)	(1,019,237)	(1,181,221)
Adjustments	<u>(149)</u>	<u>389</u>	<u>(400)</u>	<u>(1,600)</u>	<u>80,994</u>	<u>13,477</u>	<u>-</u>	<u>900</u>
Balance as of								
June 30	<u>\$15,736,370</u>	<u>\$15,011,821</u>	<u>\$9,120,342</u>	<u>\$7,755,204</u>	<u>\$17,579,153</u>	<u>\$14,922,590</u>	<u>\$54,214,317</u>	<u>\$53,676,506</u>

Personal services account for 57 and 51 percent of total expenses for fiscal years 2004 and 2003, respectively. Expenses decreased from fiscal year 2003 to 2004 because the Commission received and distributed less uninsured motorist fees and reduced the Energy Choice Education Program.

Table 3

<u>Expenses by Type</u>		
<u>Expense Type</u>	<u>2004</u>	<u>2003</u>
Personal services	\$40,824,033	\$39,748,383
Contractual services	20,251,562	23,690,503
Transfer payments	7,898,725	12,928,644
Equipment	1,880,928	991,723
Continuous charges including rent	774,383	780,491
Supplies and materials	<u>364,707</u>	<u>400,946</u>
Total	<u>\$71,994,338</u>	<u>\$78,540,690</u>



## **INTERNAL CONTROL AND COMPLIANCE FINDING AND RECOMMENDATION**

### **Improve Security Controls for the Cisco External Internet Router**

The Commission has not implemented the proper security configurations on its Edge Router. After upgrading to Cisco version 12.3 in January 2005, the agency did not change many of the default factory security settings. During the fiscal year 2002 audit, we recommended that the Commission change many of the same default settings and add other security controls for the older version of the router. Failure to recognize the importance of these security settings makes the network vulnerable to possible attacks, unauthorized access, and disclosure of confidential or sensitive data.

In response to our findings, the Commission has updated its Firewall, Switch and Router Security Policy and modified its router configuration file to tighten security for incoming and outgoing network traffic. In addition, the Commission is in negotiations with a vendor to conduct a Security Infrastructure Program Assessment. This assessment will be a high-level review of their current infrastructure and a draft implementation plan for policies, procedures, and standards.

The Commission should document and update standard configuration settings for its network and security devices as necessary to reflect changes in its computing environment and industry best practices. This documentation will serve as a guideline of standards and controls for agency routers, firewalls, and switches and the detail to ensure proper controls remain in place after the configuration management process.



# Commonwealth of Virginia

**Walter J. Kucharski, Auditor**

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

April 22, 2005

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

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

## INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE

We have audited the financial records and operations of the **State Corporation Commission** (Commission) for the two-year period ended June 30, 2004. We conducted our audit in accordance with Government Auditing Standards, issued by the Comptroller General of the United States.

### Audit Objectives, Scope, and Methodology

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

Our audit procedures included inquiries of appropriate personnel, inspection of documents and records, and observation of the Commission's operations. We also tested transactions and performed such other auditing procedures as we considered necessary to achieve our objectives. We reviewed the overall internal accounting controls, including controls for administering compliance with applicable laws, regulations, and contracts. Our review encompassed controls over the following significant cycles, classes of transactions, and account balances.

Revenues  
Expenditures  
General Controls over Information Systems

We gained an understanding of the overall internal controls, both automated and manual, sufficient to plan the audit. We considered materiality and control risk in determining the nature and extent of our audit procedures. We performed audit tests to determine whether the Commission's controls were adequate, had been placed in operation, and were being followed.

Management has responsibility for establishing and maintaining internal control and complying with applicable laws and regulations. Internal control is a process designed to provide reasonable, but not absolute, assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

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

### Audit Conclusions

We found that the Commission properly stated, in all material respects, the amounts recorded and reported in the Commonwealth Accounting and Reporting System and in the Commission's accounting records. The Commission records its financial transactions on the cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles in the United States of America. The financial information presented in this report came directly from the Commonwealth Accounting and Reporting System and the Commission's accounting records.

We noted a certain matter involving internal control and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the Commission's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial records. The reportable condition is described in the subsection entitled "Internal Control Finding and Recommendation." We believe that the reportable condition is not a material weakness.

The results of our tests 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.

The Commission has not taken adequate corrective action with respect to the previously reported finding "Improve Security Controls for the Cisco External Internet Router." Accordingly, we included this finding in the subsection entitled "Internal Control Finding and Recommendation." The Commission has taken adequate corrective action with respect to the audit findings reported in the prior year that are not repeated in this report.

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

### EXIT CONFERENCE

We discussed this letter with management at an exit conference held on July 6, 2005.

AUDITOR OF PUBLIC ACCOUNTS

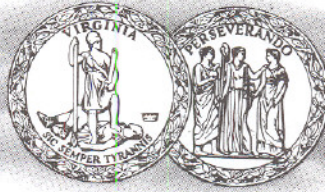
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CLINTON MILLER  
CHAIRMAN

MARK C. CHRISTIE  
COMMISSIONER

THEODORE V. MORRISON, JR.  
COMMISSIONER

# COMMONWEALTH OF VIRGINIA



JOEL H. PECK  
CLERK OF THE COMMISSION  
P. O. BOX 1197  
RICHMOND, VIRGINIA 23218-1197

## STATE CORPORATION COMMISSION

July 5, 2005

### MEMORANDUM

**TO:** Walter J. Kucharski  
Auditor of Public Accounts

Subsequent to discussing your Internal Control and Compliance Finding and Recommendation with our Director of Information Technology the Commission agrees with the Finding. Please note the following additional information.

The Commission added two local user accounts for router configuration management on March 15, 2005. Passwords for both, as well as the administrator account, have been encrypted. Our Firewall/Router/Switch Security Management Policy has been updated to reflect this change. Our Information Technology division maintains configuration documentation for the Commission's network and its security devices and updates are made to reflect changes to the environment.

As documented in your report the Commission is conducting a Security Infrastructure Program Assessment using an independent consulting organization. This project is currently underway and is expected to be completed within the first quarter of fiscal year 2006. The Commission will then prioritize the recommendations and implement any required changes in accordance with Commission policies based on risk and impact and using industry-best practices.

A handwritten signature in dark ink, appearing to read 'Clinton Miller'.

Clinton Miller  
Chairman

A handwritten signature in dark ink, appearing to read 'Welton H. Jones, Jr.'.

Welton H. Jones, Jr.  
Comptroller

STATE CORPORATION COMMISSION

COMMISSION OFFICIALS

Clinton Miller, Chairman

Theodore V. Morrison, Jr.

Mark C. Christie