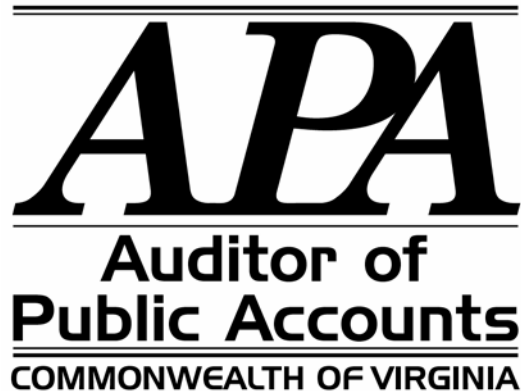


**DEPARTMENT OF TRANSPORTATION
RICHMOND, VIRGINIA**

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



AUDIT SUMMARY

Our audit of the Department of Transportation for the year ended June 30, 2003, found:

- internal control matters that we consider to be reportable conditions, one of which we consider to be a material weakness;
- proper recording and reporting of transactions, in all material respects, in the Commonwealth Accounting and Reporting System and Transportation's accounting records;
- issues of noncompliance with laws and regulations tested that are required to be reported; and
- inadequate corrective action on prior year audit findings.

We found that Transportation has not assigned central responsibility for and does not have adequate internal controls surrounding the recording and reporting of capital assets. In addition, Transportation has not developed a method to capture and capitalize the costs of improvements other than buildings for existing assets so that they can capitalize this information by 2006. Transportation's Equipment Management System is antiquated and inefficient in providing financial data for the majority of Transportation's equipment. Transportation has not taken a complete inventory of its computer equipment and updated the Fixed Asset Accounting and Control System since fiscal year 2000. Transportation did not properly perform inventories over major equipment. We included some of these same issues in last year's report. We believe the controls surrounding capital assets are inadequate and that these issues are so pervasive that they represent a material weakness in Transportation's internal controls.

We also found weaknesses in internal controls surrounding materials and supplies inventory, disclosures for future lease payments and contractual commitments, user access to information systems, written agreements with other agencies to use Transportation's information systems, and monitoring of federal funds passed through to localities.

Transportation has begun a re-organization of its financial operations and hired a consultant to also assist management in addressing the findings related to capital asset management. To resolve these issues, management will need long term solutions, which will take time to implement.

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AGENCY HIGHLIGHTS

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

Transportation is one of the three largest agencies in the Commonwealth with over 10,200 employees and a fiscal year 2003 budget of approximately \$3.4 billion. Transportation is a highly decentralized agency comprised of nine districts and a central office. The districts contain 42 residencies, and each county has at least one area maintenance headquarters. The central office is headquarters for approximately 30 operational and administrative units.

In the recent past, Transportation has faced numerous challenges and obstacles, from an extensive reorganization of the agency to statewide budgetary shortfalls. Transportation has worked to restore fiscal accountability and to implement sound business practices, and it continues to do so. During the prior fiscal year, Transportation revised its Six-Year Improvement Program to be a more realistic plan, thus reducing it by nearly \$2.8 billion. The fiscal year 2003 Six-Year Improvement Program went a step further and eliminated all deficit-financing practices and all project deficits, with the major exception of the Route 288 Project in the Richmond area.

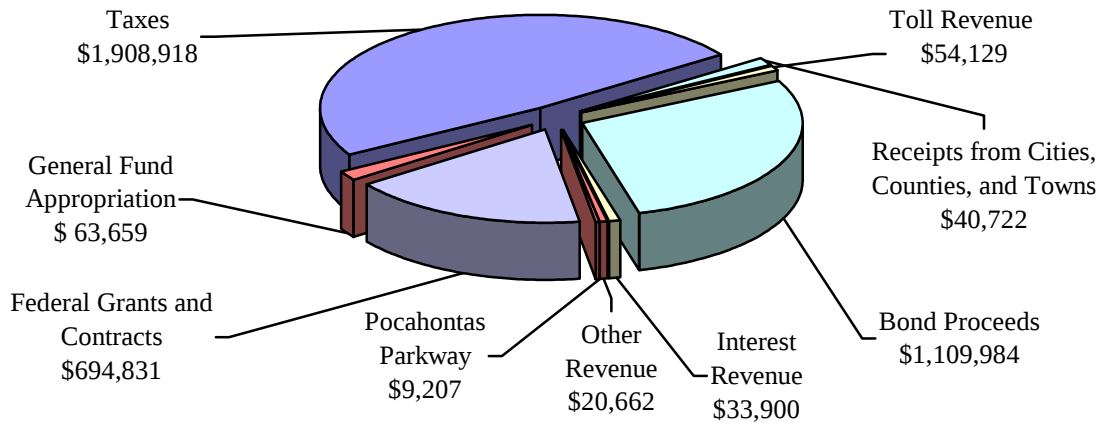
During the 2003 General Assembly session, the Governor proposed a reform agenda for Transportation. In summary, the Governor's legislative package required Transportation to adopt a detailed financial plan for all construction projects in excess of \$100 million, to report to the public and General Assembly on a quarterly basis on the status of every state highway construction project, to take a more proactive approach in working with local governments, and for Transportation and the Department of Rail and Public Transportation to develop an innovative congestion relief program in the most heavily traveled areas of the Commonwealth. Legislation passed and Transportation prepared to meet the requirements of the new legislation.

Also, effective for fiscal year 2003, the General Assembly diverted a portion of Transportation's dedicated sales tax revenue to the General Fund and authorized Transportation to replace the revenue with additional debt. The revenue estimate was \$317 million, but collections were less than estimated; therefore, Transportation transferred \$295.6 million to the General Fund for this purpose.

Transportation's main sources of revenue are Bond revenues, the Highway Maintenance and Operating Fund, and the Transportation Trust Fund. The Bond revenues primarily come from FRANs, which we discuss below, and several refunding bonds issued in fiscal year 2003. Revenues collected by the Departments of Motor Vehicles and Taxation from taxes, licenses, and vehicle registrations support both of the Transportation Funds. Highway Maintenance and Operating Fund revenues provide road maintenance funding, while Transportation Trust Fund revenues primarily support road construction. Transportation receives an allocation of 78.7 percent of the Transportation Trust Fund revenues collected. For fiscal year 2003, Transportation's allocation totaled \$573.3 million, of which \$295.6 million was transferred to the General Fund of the Commonwealth. The remaining 21.3 percent of Transportation Trust Fund revenues provide funding for the Mass Transit, Port, and Airport Funds. Transportation also receives a substantial portion of its highway funding from the Federal Highway Administration (FHWA) in the form of federal grants.

Transportation's funding sources, including the Transportation Trust Fund allocation, totaled over \$3.9 billion and are illustrated below:

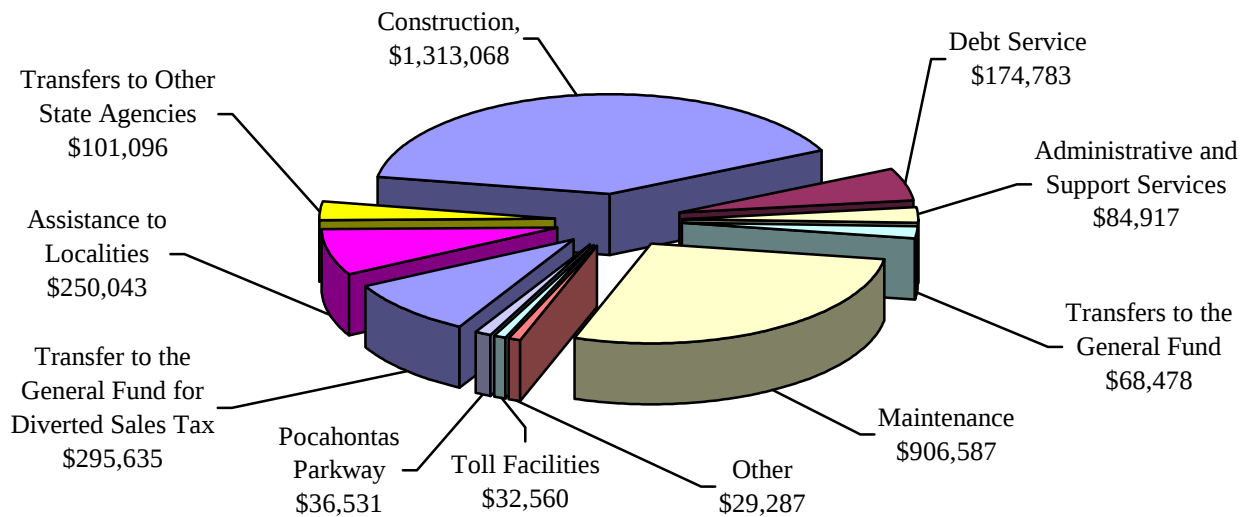
Sources of Revenue – Fiscal Year 2003
(in thousands)



(Source: Cash basis trial balances from FMS II. Pocahontas Parkway revenues were obtained from the component unit's financial statements, which an independent CPA firm audited.)

Transportation expended over \$2.8 billion in fiscal year 2003 and transferred \$295 million to the General Fund of the Commonwealth for the diverted sales tax, \$69 million to the General Fund of the Commonwealth for Appropriation Act Transfers, and \$101 million to other state agencies. Of the total expended and transferred out, 75 percent went towards construction, maintenance, and assistance to localities, 14 percent was transferred out, the remaining 11 percent was expended for administration, toll facilities, debt service, and other expenses as illustrated in the following chart:

Uses of Funds – Fiscal Year 2003
(in thousands)



(Source: Cash basis trial balances from FMS II. Pocahontas Parkway expenses were obtained from the component unit's financial statements, which an independent CPA firm audited.)

FRANs

Over the past several years, Transportation's total debt has increased. Federal Reimbursement Anticipation Notes (FRANs) make up a major portion of this debt. As the name implies, federal reimbursements support FRANs, which are short-term debt instruments with a maximum ten-year term. The General Assembly authorized Transportation to have \$1.2 billion in outstanding FRANs at any one time. Thus far, Transportation has issued \$898.3 million in FRANS, with \$523.3 million of that amount issued during fiscal year 2003. In the current Six-Year Improvement Program, Transportation assumes the following future sales of FRANs:

FY04	\$167.5 million
FY05	\$139.5 million
FY06	\$68.0 million
FY07	\$30.5 million
FY08	\$127.0 million

Transportation assumes no FRAN sales in fiscal year 2009. According to Transportation's calculations, FRAN debt service alone, including these future sales, consumes nearly 22 percent of estimated future federal and Priority Transportation Fund revenues. For fiscal year 2003, the Appropriation Act called for the allocation of \$7,132,500 of general fund deposits to the Priority Transportation Fund to offset the FRAN debt service payment requirements.

Transportation debt, with the major exception of FRANs, is included in the Commonwealth's debt capacity model. However, due to differences between FRANs and traditional debt, the Commonwealth's debt capacity model is not fitting for FRANs. Other than the maximum outstanding limitation of \$1.2 billion, no additional General Assembly action is necessary for Transportation to issue additional FRAN debt. Therefore, as a result of the recommendation in our Special Review issued in 2002, the Governor's 2003 reform package included legislation that required that the Commonwealth Transportation Board (CTB) work with the Debt Capacity Advisory Committee and the Department of Treasury to develop a debt capacity model for Transportation by January 2004. The CTB adopted such a policy at its November 2003 meeting. Transportation plans to use the adopted debt capacity policy and model in its development of the next Six-Year Improvement Program.

MAINTENANCE BUDGET

The Code of Virginia requires that the CTB first allocate reasonable and necessary funding for highway maintenance, including maintenance payments to localities. For fiscal year 2003, the CTB approved \$878.4 million for Transportation maintenance spending. Due to fourteen cited snow storms and other major emergencies, maintenance expenses exceeded projected spending levels. Storms of this nature cause immediate maintenance needs and require that Transportation make repairs within a short time frame to bring the roadway to an acceptable level of service. To address this situation, Transportation identified its maintenance priorities as safety repairs, pavements, and bridge inspection and repairs, and it reduced maintenance spending on such items as mowing, fencing, litter pickup, equipment purchasing, and tree trimming. The Governor requested federal disaster aid in the amount of \$6 to \$8 million for some of the localities hardest hit, but these reimbursements usually occur two to four years after the event.

Transportation determined that it needed \$41.8 million in additional allocations for maintenance for fiscal year 2003 in order for priority maintenance work to proceed. The \$41.8 would come from the increased fiscal year 2003 Highway Maintenance and Operating Fund (HMOF) revenues in the December 20, 2002, official revenue estimate, which included a \$108.6 million increase in HMOF revenues. Transportation's

original assumption was that the entire \$108.6 million would be available for the fiscal year 2004 construction program. In April 2003, the Department of Planning and Budget approved the CTB's request to use \$41.8 million of the \$108.6 million for maintenance instead of construction. Transportation refers to this practice as 'crossover,' which is the point at which maintenance funding takes dollars out of the construction program. Maintenance expenses for fiscal year 2003 totaled \$906.6 million.

Several unplanned events occurred after the CTB approved Transportation's fiscal year 2004 budget in June 2003 that prompted Transportation to adjust its fiscal year 2004 budget. In September 2003, Hurricane Isabel caused extensive damage to a major portion of the Commonwealth. As of November 2003, Transportation estimated that direct costs for cleanup and repair associated with Hurricane Isabel would total \$70 million. Transportation also identified immediate maintenance needs for all of the water and mountain tunnels statewide after the flooding of the Midtown Tunnel in Hampton Roads. Transportation estimated that tunnel maintenance to address immediate safety issues, such as fire suppression systems and floodgate operability, would cost \$5 million. Transportation also felt that it was necessary to take this opportunity and increase the fiscal year 2004 snow budget to better prepare for the possibility of severe snow and other major emergencies, as was the case during fiscal year 2003 as discussed above. Transportation recommended adding \$22 million to the snow budget. Due to summer flooding, Transportation had already depleted its budget contingency account of \$16 million for emergencies, which typically fills any funding gap.

Transportation recommended to the CTB that the total adjustment of \$97 million in funding for the abovementioned events come from three sources: additional state and federal revenues, debt service savings, and other reductions and deferrals of operations. More specifically, Transportation received \$15.5 million in un-forecasted revenue from the fourth quarter fiscal year 2003 Accelerated Sales Tax. Transportation also anticipates \$15 million in revenue collections from the Federal Highway Administration and the Federal Emergency Management Agency during fiscal year 2004 related to Hurricane Isabel. As for debt service savings, Transportation delayed its planned fall 2003 sale of FRANs to later in the year for savings of \$11.9 million. Lastly, Transportation proposed taking \$16.7 million from administrative and agency-wide activities and transferring the funds to maintenance. In addition, Transportation will defer equipment purchases, delay roadside improvements, and reduce routine maintenance activities such as landscaping, litter pickup, and mowing to free up \$37.9 million in the maintenance budget for priority maintenance work. The CTB approved these budget adjustments at its November 2003 meeting.

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

The Auditor of Public Accounts published a review of Transportation's cash management and capital budgeting practices in July 2002. The review included recommendations for Transportation, the CTB, the Governor, and the General Assembly. The Secretary of Transportation designated a CTB committee to address the 12 recommendations addressed to the CTB, the Governor, and the General Assembly. Transportation is specifically responsible for implementing 50 recommendations. Transportation has developed a work plan with 'deliverables' needed to fully implement the recommendations.

Although Transportation has documented substantial progress towards implementation of the recommendations, we have not 'audited' the actual implementation. Transportation provided JLARC with the status of each recommendation on October 31, 2003. According to this update, the CTB, Governor, and General Assembly had implemented 7 of their recommendations and are in the process of implementing the remaining 5. Of the 50 recommendations within Transportation's control, Transportation had implemented 33 and was actively working on the remaining 17.

FINDINGS AND RECOMMENDATIONS

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

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

FINANCIAL DISCLOSURES

Capital Assets

Transportation maintains and reports a majority of the Commonwealth's infrastructure, which consists of highways, bridges, tunnels, and right-of-way land, as well as a substantial portion of the Commonwealth's capital assets, including buildings and equipment. For fiscal year 2003, Transportation's infrastructure and other capital assets totaled \$11.1 billion, net of accumulated depreciation.

Finding: Improve Capital Asset Management and Reporting

Transportation does not have a designated individual, a capital asset manager, responsible for proper recording, managing, inventorying, and reporting of all of its capital assets. Transportation groups its fixed assets into many smaller categories. Transportation records and tracks the different categories of capital assets using several different systems and an Access database. Transportation's use of multiple systems and schedules makes tracking capital assets extremely difficult. Multiple individuals, divisions, and districts have varying responsibility for recording, managing, inventorying, and reporting these assets. There is limited communication between these individuals, divisions, and districts and the Fiscal division and no consistent set of policies and procedures.

Transportation reports financial information, including asset values and depreciation, related to all of its capital assets for inclusion in the Commonwealth's Comprehensive Annual Financial Report (CAFR). Currently the Controller's Senior Accountant compiles all of this information from multiple individuals and sources as part of the annual reporting process. However, Transportation needs a capital asset manager that can monitor, coordinate, and manage its assets throughout the year as well as compile financial information at year end. The capital asset manager could assist in creating open lines of communication between all divisions and positions responsible for capital asset management. The capital asset manager should be knowledgeable in all laws, regulations, and financial reporting standards for capital assets. With this understanding, the capital asset manager could ensure that Transportation properly and consistently records capital asset transactions throughout the year to increase the efficiency and accuracy of the year end compilation of financial information for CAFR and Transportation's own financial reporting purposes. The capital asset manager should prepare written agency-wide policies and procedures for recording and reporting capital assets and ensure compliance with these policies. The policies should include uniform financial recording procedures so that Transportation can readily identify all asset acquisition expenses, capture all asset additions and disposals, and depreciate capitalized assets in accordance with state accounting policies. The capital asset manager should also provide appropriate training to all individuals and divisions responsible for capital asset management and reporting.

We identified several issues related to capital assets described in the findings "Improve Internal Controls over Capital Assets," "Evaluate and Improve the Equipment Management System," "Improve

Controls over Computer Equipment,” and “Improve Controls over Major Equipment Inventory.” Some of these findings are repeat findings from the previous year and others are new issues. Given the vast amount of assets that Transportation owns and the issues we found, we recommend that they designate a capital asset manager to oversee and coordinate all aspects of capital asset management and financial reporting. In addition, we believe the controls surrounding capital assets are inadequate and that these issues are so pervasive that they represent a material weakness in Transportation’s internal controls.

Finding: Improve Internal Controls over Capital Assets

Due to a lack of oversight and management of Transportation’s capital assets, we found several internal control weaknesses and errors, including an issue from the prior year that remains unresolved, that support the need for a central capital asset manager.

- As reported in fiscal year 2002, Transportation was not recording improvements other than buildings before fiscal year 2002 since it had an exemption from the Department of Accounts prior to the implementation of Governmental Accounting Standards Board Statement No. 34 *Basic Financial Statement – and Management’s Discussion and Analysis – for State and Local Governments*. This exemption is no longer valid since GASB Statement No. 34 requires the capitalization of infrastructure. GASB Statement No. 34 allows governmental entities to report infrastructure prospectively for the fiscal years 2002 through 2005. By 2006, governments must report infrastructure retroactively back to 1980. Transportation properly recorded current year improvements other than buildings for fiscal year 2003. However, Transportation still has not developed a method to capture and capitalize the costs of improvements other than buildings for existing assets so that they can capitalize this information by 2006. This methodology must allow Transportation to determine and record accumulated depreciation on those assets based on year of acquisition and useful life.
- Transportation does not have consistent and updated methodologies to assign salvage values and useful lives to all of its assets. For some asset categories, Transportation does not have a methodology and for other classes Transportation established the method 30 to 40 years ago. The Commonwealth’s accounting policies require agencies to develop and periodically update a methodology for estimating salvage value that considers the type of asset, its obsolescence and degree of usefulness at disposal, and the nature of the disposal process. Agencies should also develop and periodically update a methodology for assigning asset useful lives that considers actual use patterns for different types of assets and takes into account the actual length of time the agency has used different assets over time.
- In July 2002, Transportation began a pilot program for the Automated Fuel Management Program (AFMP), which automated the fueling, tracking, and billing of fuel consumption for VDOT employees as well as other state agencies. As part of the implementation, the vendor installed Fuel Control Terminals at each fueling site. The terminals range in cost from \$7,700 to \$8,700. There are approximately 284 fuel sites across the state. The vendor installed 80 terminals before the end of fiscal year 2003. However, Transportation did not record the terminals as assets in any of its asset systems. The Asset Management Division is overseeing the implementation of AFMP. This division also manages the Equipment

Management System which records equipment that districts and residencies use, such as vehicles, tractors, and lawn mowers. However, the fuel terminals should be in a different asset system, the Access database for major equipment which the Administrative Services Division manages. Due to a lack of controls to ensure capitalization of all equipment purchases, a lack of communication between divisions, and a lack of oversight by one responsible individual, Transportation did not capitalize the fuel terminals in any system.

Transportation should develop a method to capture and capitalize the costs of improvements other than buildings for existing assets so that they can capitalize this information by 2006. Transportation should develop and update its methodologies for assigning asset salvage values and useful lives in accordance with Commonwealth policies. As recommended in the finding “Improve Capital Asset Management and Reporting,” Transportation needs a capital asset manager to develop and enforce controls over capital assets and improve coordination between the various individuals and divisions responsible for asset management and reporting.

Finding: Evaluate and Improve the Equipment Management System

Transportation originally developed its Equipment Management System (EMS) as an asset maintenance and management system. Transportation records over \$194 million of its \$200 million of capitalized equipment in EMS. This is equipment that districts and residencies use, such as vehicles, tractors, and lawn mowers. When Transportation implemented GASB Statement No. 34, Transportation needed depreciation information for the assets maintained in EMS. However, due to its original design, EMS could not easily or efficiently provide the information necessary for financial reporting. In the fiscal year 2002 report, we noted that Transportation did not record or report accumulated depreciation or depreciation expense for one category of equipment. This depreciation related to some of the equipment maintained in EMS for which the system did not calculate depreciation. For fiscal year 2002 and 2003, the Controller’s Senior Accountant estimated the depreciation for these assets to provide accurate financial information for the Commonwealth. However, Transportation needs to evaluate and modify EMS so that it can calculate depreciation for these assets to provide a more accurate and efficient method of obtaining this information. This information should be obtainable from EMS and compiled by the capital asset manager.

During fiscal year 2003, the Commonwealth elected to change the capitalization threshold for reporting capital assets. The Commonwealth increased the capitalization threshold from \$5,000 for all classes of assets to \$50,000 for equipment and \$100,000 for land, buildings, infrastructure, and construction in progress. Since Transportation owns a substantial portion of the Commonwealth’s assets, the change in threshold had a significant impact on how Transportation reported its capital asset information for financial reporting purposes. Transportation experienced difficulty implementing this change due to system constraints in the Equipment Management System. EMS is an old system and Transportation cannot easily query information out of the system. As a result, the Controller’s Senior Accountant had to calculate the amounts using reports generated for the \$5,000 threshold and manually remove assets between \$5,000 and \$50,000. This was a very inefficient and time consuming process, and the capital asset manager should coordinate it rather than the Senior Accountant. Transportation should develop a way to extract the financial information from EMS necessary to meet the Commonwealth’s requirements in the future.

Transportation, specifically a capital asset manager, should determine the financial reporting needs and assist in the review of the EMS. In addition the capital asset manager should determine how to increase efficiencies in generating, accumulating, and reporting financial information from EMS as we noted throughout this finding.

Finding: Improve Controls over Computer Equipment

Transportation does not have adequate controls over the accounting and managing of computer equipment. Transportation has not taken a complete inventory of its computer equipment and updated the Fixed Asset Accounting and Control System (FAACS) since fiscal year 2000. During that time, Transportation entered into an operating lease for Seat Management which provides computer hardware and software from a single source. Seat Management services include hardware, software, support, and disposal. As a result, Transportation no longer owns many desktops and laptops. During this transition, Transportation did not update its inventory records to account for the transfer and disposal of its inventory of desktops and laptops. In addition, during fiscal year 2003, responsibility for computer equipment changed from a contractor to two Transportation employees. These employees did not receive adequate training or guidance on how to manage and account for the computer equipment. Therefore, these employees did not understand the concepts of controlled and capitalized assets, reporting thresholds, or the functionality of FAACS. In addition, Transportation does not have written policies and procedures for them to follow related to the recording, inventorying, and reporting of these assets.

As a result of this lack of controls over computer equipment, there is currently \$9.8 million in computer equipment on FAACS that is either passed its useful life or that Transportation no longer owns due to the Seat Management lease. In response to issues that we noted in the prior year, Transportation has already removed over \$7 million in computer equipment that they had disposed of or surplussed but not removed from the system. Furthermore, there is over \$3.8 million in computer equipment related to the implementation of the Financial Management System in 1997 that Transportation never recorded or reported as part of its computer equipment inventory.

In response to this finding, Transportation planned to develop policies and procedures for computer equipment and conduct a complete inventory of all computer equipment in November 2003. We recommend that Transportation update its inventory records to reflect the outcome of this inventory. A complete and accurate record of computer equipment is increasingly important as Transportation prepares for the transfer of all computer equipment to the Virginia Information Technologies Agency during the next year. Transportation should provide the employees responsible for computer equipment the appropriate training and guidance. This should be the role of the capital asset manager recommended in the finding “Improve Capital Asset Management.”

Finding: Improve Controls over Major Equipment Inventory

Transportation did not properly perform inventories over major equipment and did not adequately record changes in assets throughout the fiscal year. The Commonwealth’s accounting policies require Transportation to perform a complete inventory every two years. As previously reported, Transportation attempted to perform a complete inventory in fiscal year 2002; however, four divisions and one district did not complete the inventory, resulting in ten percent of the asset inventory not being counted. For fiscal year 2003, Transportation only performed a partial inventory, counting approximately one-third of the items in inventory. Of the divisions and district that did not perform an inventory in fiscal year 2002, the Construction division and the Northern Virginia district only completed a partial inventory in fiscal year 2003. The partial inventory was not a statistical inventory; therefore, these two areas did not perform complete physical inventories within the two year period set by the Commonwealth’s accounting policies. In addition, some districts and divisions did not follow directions or document the inventory process to the point where the auditor could not determine what items they had counted. Several districts and divisions were late performing the inventory.

The results of the inventories taken demonstrate that personnel are not properly monitoring, tracking, and recording changes to equipment during the year. In the Central Office, 22.1 percent of the items counted required a change in location, change in tag number, or had been disposed of but not recorded in the system. In the districts, 7.0 percent of the items counted required similar changes. In addition, during the count, personnel identified at least ten assets purchased during the year which they had not recorded.

The Administrative Service Division, which oversees the major equipment database and administers the yearly inventory counts, does not appear to have the authority or influence to ensure that the districts and divisions properly perform the annual inventories. Transportation should delegate this authority to the capital asset manager recommended in the finding entitled “Improve Capital Asset Management.” The capital asset manager would be able to monitor, coordinate, and manage the assets within the major equipment database and throughout Transportation on a continual basis therefore lowering the risk that improper annual inventories could occur.

Inventory

Transportation has 28,000 stock items in inventory at over 500 stock locations statewide that vary in size from the Central Warehouse with approximately 2,000 different stock items, to a temporary stock location with only one stock item. Transportation uses the Inventory Management System (IMS) to track \$32.7 million of its inventory, which is valued in total at \$39.2 million for fiscal year 2003 and is material to the Commonwealth’s Comprehensive Annual Financial Report (CAFR).

Transportation maintains both Regular and Stores Stock on IMS. Regular stock consists of those items stockpiled widely around the state at district, residency, and area headquarter locations, such as gravel and sand, and is not always easily maintained in a stockroom environment. Store stock items are those that Transportation has traditionally stored at the Central Warehouse in Richmond and at district and residency equipment shops throughout the state. This classification includes such items as equipment and tires.

Finding: *Improve Internal Controls over Inventory*

Transportation has two critical internal controls to ensure that it properly maintains and records materials and supplies inventory. These controls include periodic inventory counts and annual compliance reviews.

Transportation performs monthly stratified inventory counts to validate and update the inventory information in IMS. We observed these counts at four locations and found the following issues:

- At one location, the primary IMS data entry person participated in the inventory count. This practice violates Transportation’s inventory policies and prevents proper segregation of duties. Allowing the primary data entry person to participate in the inventory count increases the risk that the individual could falsify counts.
- Counters were aware of and researched incorrect counts before entering the counts into the system. Counters should not know that the counts do not agree with the system, requiring a recount, until personnel have entered the first count into the system.
- Counters did not sign the count reports before the data entry person entered the counts into the system. IMS policies and procedures require that the counter sign

and date all inventory count reports before keying them into the system. This provides evidence that the counts were performed

- The IMS recount report shows the initial counts recorded in the system, contains the system value, the count value, and the difference in value. This report should not contain the system or difference value. It should only identify the items that need recounting. Providing this information to the counters increases the risk that the individual could falsify the count and record the system value.
- Transportation personnel identified several obsolete items. These items have been obsolete for several years, but Transportation continues to carry the items in inventory instead of surplussing the items.
- At two of the four locations observed, Transportation personnel did not properly count and adjust bulk items in the system. Bulk items are materials such as gravel and sand. Personnel do not usually count the bulk items. Instead, they just enter the system balance. As a result, personnel do not adjust the value for bulk items in the system to equal actual amounts on hand. Not counting or estimating bulk items increases the risk of theft and misstatement in IMS for financial reporting purposes.

Transportation performs compliance reviews annually in each district to monitor compliance with IMS policies and procedures. However, the district personnel are not consistently documenting the reviews. In addition, the compliance reviews identified numerous non-compliance issues, but the districts are not resolving and fixing these issues as evidenced by the compliance reviews noting the same issues from year to year. As a result, the compliance reviews are ineffective, which increases the risk associated with the proper accounting of inventory.

Briefly we found:

- District personnel document compliance review results inconsistently. Districts have a compliance review form that they use to perform the reviews. However, there is no consistent method to report the results to the District Business Administrator or the Division Administrator. Districts either submit the detailed compliance review form or a summary of the compliance review form. In addition, the forms are not always complete, and the summaries vary in the amount and type of information reported. As a result, the compliance reviews are not comparable statewide, which eliminates the ability to look for pervasive statewide issues.
- The District Inventory Analyst signed all of the compliance reviews tested. Since the nine District Administrators have ultimate responsibility for the recording and management of inventory in their district, IMS policies require that the District Administrator or District Business Administrator sign the compliance reviews, evidencing review and approval. Without a signature from the District Administrator or District Business Administrator, this evidence is lost. The District Administrators use the compliance reviews to monitor compliance within their respective districts. If the District Administrators do not monitor the compliance reviews and ensure that district personnel take corrective action on the issues cited, the compliance reviews are useless.

- The compliance reviews tested site numerous non-compliance issues, including an inventory turnover rate of less than 3.0; evidence of obsolete, surplus, or slow-moving stock on hand; items being removed from stock locations but not updated in the system; locations not maintaining a key list; forecast usage needing to be updated; improperly completed inventory transfer forms; and improperly labeled stock items. These weaknesses increase the risk of theft and misstatement for financial reporting purposes.

To ensure proper accounting and management of inventory, Transportation should improve controls over periodic inventory counts and compliance reviews. Many of the internal compliance reviews identified the same weaknesses that we are including in this report.

The District Administrator or District Business Administrator should review, sign, and monitor the compliance reviews. The District Administrator should implement procedures to ensure that district personnel follow up and resolve compliance review recommendations which should lead to resolving the inventory issues included in this report.

Leases

Finding: *Properly Track and Record Leases*

As reported in the fiscal year 2002 audit, Transportation still does not have a consistent, documented methodology to calculate future lease payments for the Seat Management lease. In this lease, the monthly payments fluctuate based on the total equipment rented. In addition, Transportation renegotiates the Seat Management lease, which has resulted in cost savings each year. Transportation inconsistently calculated the future lease payments between fiscal years 2002 and 2003. This inconsistency resulted in an audit adjustment to increase the future lease payments by \$12.4 million, which was important information for the Commonwealth's Comprehensive Annual Financial Report. Transportation should develop and document a consistent methodology to calculate future lease payments for Seat Management.

Contractual Commitments

Transportation did not properly disclose its contractual commitment obligations for fiscal year 2003. Contractual commitments represent Transportation's remaining monetary obligations under all current contracts. A contractual commitment is the difference between the original value of a contract and all payments made through year-end on a contract. Because of Transportation's substantial number of contracts, the commitment balance is included in the Commonwealth's CAFR disclosures.

Finding: *Properly Record and Update Contracts in the Financial Management System*

Transportation continues to not properly record or track its commitments for current or ongoing highway contracts, as we reported in the prior year audit. When Transportation enters into a contract for goods or services, personnel record the total value of the contract in the Financial Management System (FMSII). As Transportation makes payments, processes change orders against the contract, and closes contracts, the remaining commitment of the contract changes if personnel properly record the information in FMSII. At fiscal year end, Central Office personnel perform a manual reconciliation of the highway contractual commitment liabilities to develop the contractual commitment balance for inclusion in the Commonwealth's Comprehensive Annual Financial Report (CAFR). As of June 30, 2003, Transportation's contractual commitments totaled over \$1.9 billion. We found the following internal control weaknesses

related to the recording of contract payments and the preparation of the contractual commitment disclosure that caused material adjustments to Transportation's fiscal year end contractual commitment disclosure in the CAFR.

- Transportation personnel did not properly close contracts in FMSII at the end of the contract. We selected a sample of contracts that Transportation signed prior to 1997, and fifty-five percent of the contracts tested had ended but were not properly closed out in FMSII, resulting in a \$20 million adjustment to reduce the commitment liability. Transportation executed the majority of these contracts in the 1980's and early 1990's, and the contracts ended several years ago.
- Transportation did not include some new contracts executed in fiscal year 2003 in the contractual commitment balance. Since construction and maintenance contracts originate in Transportation's Trans*Port System, FMSII does not receive the contractual information until after the first payment on the contract. Therefore, if Transportation has executed a contract but has not made a payment at the time Transportation prepares the contractual commitment liabilities amount, the new contract liability is not included. As a result, we increased the contractual commitment liability by \$31.7 million to include these new contracts.
- Transportation's personnel improperly included non-highway contracts in the highway contractual commitments. Two of the contracts tested were improperly recorded as a highway contract, totaling an \$8.5 million dollar overstatement.
- As we reported in the prior year audit, Transportation still does not have proper procedures for tracking outstanding contractual commitments. Due to internal control weaknesses documented above, FMSII cannot generate an accurate contractual commitment figure and Central Office personnel must perform a manual reconciliation of the contractual commitment liability. The manual reconciliation, which is labor intensive and ineffective, resulted in over \$145 million in internal adjustments to Transportations contractual commitments listed in FMSII. The \$145 million adjustment was the result of Central Office personnel reversing negative balances and researching contracts that had ended but were still included in the contractual commitment value. Adjustments for expired contracts are the result of agency personnel not properly processing a final voucher in FMSII to close out the contract in the system.

Transportation needs to ensure the financial and contractual information included in FMSII is accurate and complete. Transportation also needs to develop policies and procedures to ensure that personnel properly record new information in FMSII. Transportation needs to review all contracts in FMSII executed before 1995 to determine whether the contracts are still active and update FMSII accordingly. Implementing these recommendations should improve the reconciliation process at fiscal year end, decrease the risk of incorrectly reporting the contractual commitment liability to the CAFR, and improve the accuracy and reliability of financial information in FMSII.

ACCOUNTING AND INFORMATION SYSTEMS

Transportation relies heavily on the data generated by its information systems. To audit Transportation's financial account balances, we also rely heavily on our ability to test and validate the data

contained in those systems. Our ability to audit through a system is integral to our ability to provide assurance that controls are functioning and financial information is reasonably accurate. For the first time during the fiscal year 2003 audit, we obtained a complete download of fiscal data from FMS II for offline query and analysis.

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

Finding: Properly Manage and Maintain User Access to Information Systems

Transportation does not properly maintain and manage user access to information systems. According to Transportation's IT Policy SEC 2002-01.1 (2.9.2 User Account Maintenance and Monitoring), when a user's status changes (due to termination, resignation, or retirement) Transportation should disable the user's account within 30 days and after three months, either remove or delete the account. We found 60 terminated employees with active access to the Equipment Management System (EMS) with terminated dates ranging from April 2002 through June 2003. Also, we found 69 terminated employees with active access to the Financial Management System (FMS II), including four employees terminated during fiscal year 2002. Transportation did reduce the risk surrounding this inappropriate access by inactivating the network access for these users. However, the risk still exists that the individual could obtain access to a computer terminal already logged on the Transportation network and improperly use these financial systems. In addition, Transportation does not remove or delete inactive accounts. Having inactive accounts demonstrates Transportation's lack of user access maintenance and makes the maintenance process more difficult to manage.

Transportation should develop procedures to monitor employee terminations and ensure their system access is disabled and eventually removed and deleted. These procedures will enable Transportation to comply with its own policies and eliminate the risk of inappropriate individuals having access to critical systems.

Finding: Comply with COV ITRM Standard SEC2001-01.1

Transportation failed to maintain adequate control over and procedures for access to the computer center. The COV ITRM Standard SEC2001-01.1 states that mission critical system facilities must be located in a secure location that is locked and restricted to authorized personnel only, and that access to critical computer hardware, wiring, displays, and networks must be controlled by rules of least privilege.

During fiscal year 2003, over 200 employees at Transportation had access to the computer center. Physical security safeguards provide a first line of defense for information resources against physical damage, physical theft, unauthorized disclosure of information, loss of control over system integrity, and interruption to computer services.

Transportation should improve procedures and controls over access to the computer center to include the following:

- Establish written policies governing access to the computer center. The policies should name the person who is responsible for approving employee access to the computer center.
- Limit access to the computer center to computer operators, network engineers, certain IT managers, and certain facilities personnel.
- Remove computer center door access as a default access for certain security levels.

Further, Transportation's own Information Security Policy states that for system and data access that Transportation shares with another agency, Transportation will maintain written agreements signed by both agencies which confirm acknowledgement of the same security safeguards. This coincides with the COV ITRM Standard SEC 2001-01.1 (G.1.b.) that states that agencies must establish auditable user agreements between the agencies sharing data, which clearly state the degree of authentication and levels of protection required. However, we found that no such agreements exist. The following entities have a connection to Transportation's network: Division of Motor Vehicles, Virginia State Police, Federal Highways Administration, Department of Rail and Public Transportation, Department of General Services Fleet Management, Auditor of Public Accounts, George Mason University, Department of Emergency Management, Potomac Crossing Consultants, Verizon Wireless, Hanover County, Chesterfield County, and Bechtel Corporation. Transportation also could not provide documentation of the purpose for each of these entities' access.

Transportation should develop and execute agreements with all agencies that currently use Transportation's systems. These agreements should contain the degree of authentication and level of protection as well as the justification for the access.

FEDERAL SUBRECIPIENT MONITORING

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

Finding: Perform Subrecipient Monitoring of Localities

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

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

- Consider whether subrecipient audits necessitate adjustment of the pass-through entity's own records.

Transportation has still not established procedures to determine which subrecipients must receive an audit, whether these applicable subrecipients have been audited, or what findings in their audit reports require follow up or adjustment to Transportation's records. We noted this lack of procedures in the fiscal year 2002 audit; however, Transportation did not implement new procedures to correct this weakness.

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



Commonwealth of Virginia

Walter J. Kucharski, Auditor

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

January 23, 2004

The Honorable Mark R. Warner
Governor of Virginia
State Capital
Richmond VA

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

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

We have audited the financial records and operations of the **Virginia Department of Transportation** for the year ended June 30, 2003. We conducted our audit in accordance with Government Auditing Standards, issued by the Comptroller General of the United States.

Audit Objective, Scope, and Methodology

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

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

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

We obtained an understanding of the relevant internal control components sufficient to plan the audit. We considered materiality and control risk in determining the nature and extent of our audit procedures. We performed audit tests to determine whether Transportation's controls were adequate, had been placed in

operation, and were being followed. Our audit also included tests of compliance with provisions of applicable laws and regulations.

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

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

Audit Conclusions

We found that Transportation properly stated, in all material respects, the amounts recorded and reported in the Commonwealth Accounting and Reporting System (CARS) and in Transportation's accounting records. Transportation records its 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 from Transportation's accounting records.

We noted certain matters involving internal control and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect Transportation's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial records. Reportable conditions are included in the section entitled "Findings and Recommendations."

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

The results of our tests of compliance with applicable laws and regulations disclosed instances of noncompliance that are required to be reported under Government Auditing Standards. The instances of noncompliance are described in the findings entitled "Comply with COV ITRM Standard SEC2001-01.1" and "Perform Subrecipient Monitoring of Localities" in the section entitled "Findings and Recommendations."

Transportation has not taken adequate corrective action with respect to the previously reported findings "Improve Internal Controls over Assets to Prevent Capital Asset Misstatements," "Properly Track and Record Leases and Lease Payments," "Develop Procedures to Properly Track Contractual Commitments," and "Perform Subrecipient Monitoring of Localities." Accordingly, we included these findings in the findings entitled "Improve Capital Asset Management and Reporting," "Improve Internal Controls over Capital Assets," "Improve Controls over Major Equipment Inventory," "Properly Track and Record Leases," "Properly Record and Update Contracts in the Financial Management System," and

“Perform Subrecipient Monitoring of Localities” in the section entitled “Findings and Recommendations.” Transportation has taken adequate corrective action with respect to audit findings reported in the prior year that are not repeated in this report.

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

EXIT CONFERENCE

We discussed this report with management at an exit conference held on February 12, 2003.

AUDITOR OF PUBLIC ACCOUNTS

DBC:whb
whb:42



COMMONWEALTH of VIRGINIA

DEPARTMENT OF TRANSPORTATION

1401 EAST BROAD STREET
RICHMOND, VIRGINIA 23219-2000

PHILIP A. SHUCET
COMMISSIONER

February 20, 2004

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

Dear Mr. Kucharski:

Thank you for taking the time to meet with me last week and this opportunity to respond to the issues raised in your financial audit of the Department of Transportation for the fiscal year ending June 30, 2003. While we have made tremendous strides in many areas, the audit confirms that much work remains to be done by the leadership of the Department.

As the audit states, the Department has taken a number of steps during the past year to improve aspects of financial management – implementation of a project cost estimating system, the development of the integrated six-year program process, improved cash forecasting and budgeting. I made a commitment that these aspects of financial management would improve and they did. Now, I am making the same commitment to address the issues and their fundamental reasons in this audit.

Because of the breadth of the fixed asset concerns, many of which are in our field organization, KPMG is working with the Chief Financial Officer on organizational and internal control structure recommendations. This work is to be completed late this spring. Implementation will take time but I want to assure you that steps are already underway to remedy the issues the report raises.

I also want to thank your staff for their work this year.

Sincerely,

A handwritten signature in blue ink, appearing to read "P. Shucet".

Philip A. Shucet
Commissioner

DEPARTMENT OF TRANSPORTATION

Richmond, Virginia

As of June 30, 2003

Whittington W. Clement, Secretary of Transportation

Philip Shucet, Commissioner

Barbara Reese, Chief Financial Officer

Stacy D. McCracken, Controller

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