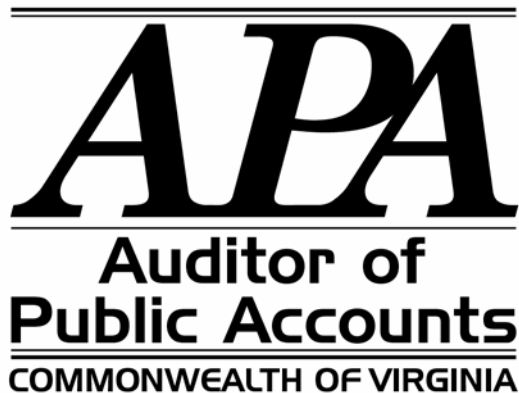


VIRGINIA EMPLOYMENT COMMISSION

**REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2005**



AUDIT SUMMARY

Our audit of the Virginia Employment Commission for the year ended June 30, 2005, found the following.

- for the first time in eight years, taxes collected exceeded benefits paid, resulting in the Trust Fund balance increasing from \$296 million over the previous year to \$479 million at the end of fiscal year 2005. In the previous three years, benefit payments exceeded tax collections by more than \$1 billion; however, the application of a mandated fund-building tax rate, increased tax rates, lower level of claims in calendar years 2004 and 2005, and a pool tax rate contributed to the increase in the fund for the current year.
- proper recording and reporting of transactions, in all material respects, in the Commonwealth Accounting and Reporting System and in the Employment Commission's Tax and Benefits Systems;
- two internal control matters that we consider reportable conditions, neither of which are material weaknesses; and
- one instance of noncompliance that is required to be reported under Government Auditing Standards.

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AUDIT FINDINGS AND RECOMMENDATIONS

Complete Information Systems Risk Assessment and Business Impact Analysis

The Virginia Employment Commission has not completed a current risk assessment and the business impact analysis is not comprehensive of the Commission's network. State standard, COV ITRM Security 2001-01.1, mandates that all state agencies develop these policies and update them at least every three years.

In 2003, consultants performing an information technology controls review recommended the Employment Commission develop a formal and continuous risk management program. The Employment Commission received a grant and is working with the Information Technology Services Center to develop a risk assessment. However, as of our review date, the Employment Commission has not completed the risk assessment. Furthermore, the Employment Commission's business impact analysis is incomplete, as it does not incorporate the local area network or the economical and operational impact on the Employment Commission if any of the systems or functions fail.

It is essential for the Employment Commission to identify, rank, and document its risks and critical business functions in order to ensure appropriate protection of critical information resources. Employment Commission management should ensure that a risk assessment and business impact analysis are complete and approved by management as soon as possible.

Obtain Assurance over Security of Information Technology Infrastructure

State policy makes the Employment Commissioner responsible for the security and safeguard of all of the Employment Commission's databases, information, and information technology assets. Over the past two years, the Commonwealth has moved the information technology infrastructure supporting these databases and information to the Virginia Information Technologies Agency (VITA). As part of this transfer, the Employment Commission also transferred many of the staff who had the expertise to advise the Commissioner on these matters.

We believe that the Employment Commission cannot solely ensure that their data has the proper level of security to protect it from unauthorized changes, disclosure, or loss. Since VITA has assumed responsibility for the information technology infrastructure, the Commissioner must have VITA provide assurance that their infrastructure would provide the safeguards to protect information and databases under state policy.

The Commissioner needs to evaluate the Employment Commission's capabilities for determining the level of assurance needed from VITA. If the systems operate in a shared environment, the provider of the services would need to inform the Commissioner of the adequacy of those controls. This shared environment is the same as the mainframe data center operation that VITA and its predecessors offered. While the Employment Commission and VITA are working on a memorandum of understanding (MOU) that defines service level responsibilities in this shared environment, this MOU does not address the security levels required by the Employment Commission.

For the transmission of information to and from the database, the Commissioner must address whether the Employment Commission has the expertise to assess this issue. Inherent within this issue is whether the Employment Commission has the resources to maintain the level of expertise capable of adapting to the changing infrastructure environment. There are two approaches to this issue. The first assumes the Employment Commission has the expertise and the resources to understand the changing infrastructure and can therefore specifically address all security needs.

The second approach only requires that the Employment Commission explain, in detail, the security needs for each of its systems and databases along with what access controls it currently provides. VITA then must provide the Commissioner assurance that the infrastructure provides the level and depth of security necessary to meet state policy.

Under this second approach, VITA and the Commissioner clearly share responsibility for the security of information and databases. It is our opinion that while the Employment Commission may currently have the resources to undertake the first approach, the long-term change at VITA dictates that the Commissioner use the second approach. Additionally, we believe that VITA should at least annually provide these assurances in writing, so the Commissioner and the Employment Commission can fulfill their responsibilities related to security requirements.

Hold Local Areas Accountable for Untimely or Unreliable Participant Data Entered into VWNIS

The Employment Commission administers the federal Workforce Investment Act through 17 Local Workforce Investment Areas (Local Areas). Each Local Area is a county, city, or a combination of localities, which cover the entire Commonwealth. Each Local Area receives federal Workforce Investment Act monies and spends it at the discretion of a Local Workforce Investment Board to promote workforce training and employment.

The Employment Commission performs annual reviews of the Local Areas' compliance with the Workforce Investment Act. These reviews identified that the Local Areas are not complying with the Employment Commission's internal policy to enter participant data into the Virginia Workforce Network Information System (VWNIS) within five working days from completion of a transaction. The reviews further showed that the data entered was incorrect or inconsistent. The reviewers found that this is a recurring issue from fiscal year 2004. This untimeliness, inaccuracy, and inconsistency can adversely affect the Local Areas' reported performance to the state and, when summarized by the state, to the U.S. Department of Labor.

Workforce Investment Act section 184 allows the Employment Commission to impose sanctions on its subrecipients for noncompliance. Because the Local Areas have consistently shown their failure to timely, accurately, and consistently input data into the VWNIS for the second year, the Employment Commission should require corrective action to ensure compliance and impose sanctions as deemed necessary in the event of noncompliance by the Local Areas.

The Employment Commission and Local Areas identified employee turnover and system flaws as variables that contribute to these issues. In an effort to resolve these issues, the Employment Commission developed a querying capacity in VWNIS to help pinpoint the source of data error and provide VWNIS training to Local Areas upon request. However, the querying feature and current training plan has not improved or removed the timeliness or inaccuracy issues. On November 29, 2005, the Employment Commission also proposed to the Commission on Unemployment Compensation to replace VWNIS in fiscal year 2007. Until corrective action is in place, the Employment Commission will continue to be noncompliant with internal requirements and will increase their risk of misstating their reports.

The Employment Commission should hold the Local Areas accountable for their failure to comply with known policies and procedures in order to ensure that the Employment Commission is able to remain compliant in reporting of accurate performance statistics to the U.S. Department of Labor in accordance with the Workforce Investment Act.

SELECTED AGENCY INFORMATION

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

The Unemployment Insurance program makes benefit payments to workers who are unemployed through no fault of their own, ensuring they have minimal income during the course of a job search. The Employment Commission collects unemployment taxes from employers and uses these taxes to pay benefit claims. The tax collections go into the Unemployment Trust Fund for which the Employment Commission is the trustee. The Employment Commission pays all unemployment insurance benefit payments from the Trust Fund.

UNEMPLOYMENT TRUST FUND

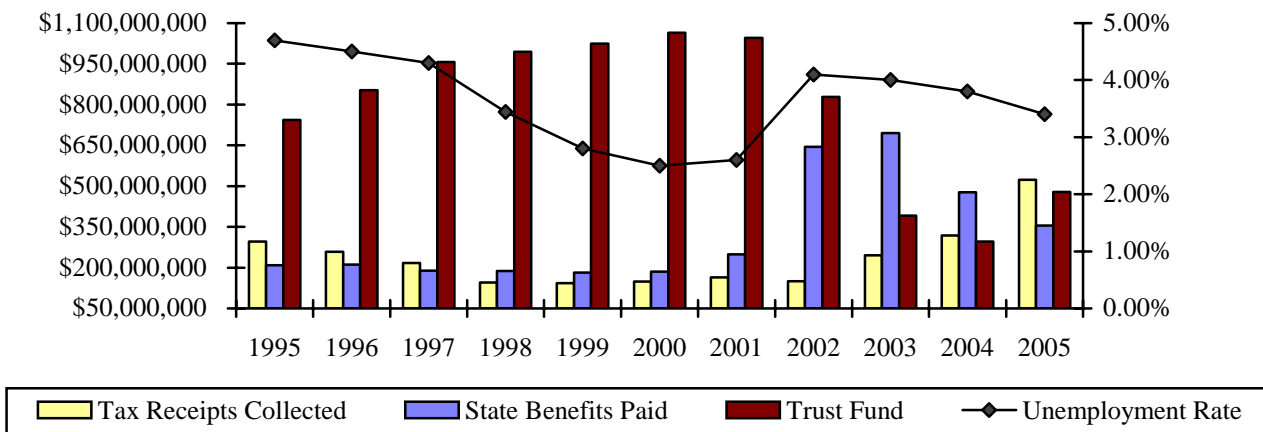
The Unemployment Trust Fund's solvency factor applicable for calendar year 2006 rose to 54.9 percent after two years of being below 50 percent. The solvency factors for calendar years 2004 and 2005 were the only times the factor fell below 50 percent since 1984. For the first time in eight years, taxes collected exceeded benefits paid, resulting in the Trust Fund balance increasing from \$296 million in the previous year to \$479 million at the end of fiscal year 2005. In the previous three years, benefit payments exceeded tax collections by more than \$1 billion; however, the application of a mandated fund-building tax rate, increased tax rates, lower level of claims in calendar years 2004 and 2005, and a pool tax rate contributed to the increase in the fund for the current year.

As a result of the economic downturn in 2001, the Governor issued, on November 14, 2001, an Executive Order increasing all unemployment benefits by 37.3 percent for a six month period starting September 9, 2001. In 2002, the General Assembly extended these benefit amounts through January 4, 2003, and, as the economy worked towards recovery, reduced the increased benefit levels over the next year and a half. In 2003, and again in 2005, the General Assembly passed legislation increasing the benefit levels. The following chart summarizes these changes in the benefit amounts.

	<u>Minimum Weekly Benefit</u>	<u>Maximum Weekly Benefit</u>
September 9, 2001 - January 4, 2003	\$69	\$368
January 5, 2003 - July 5, 2003	59	318
July 6, 2003 - July 3, 2004	50	316
July 4, 2004 - July 2, 2005	50	326
July 3, 2005 - current	54	330

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

Trends in the Unemployment Trust Fund



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

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

The Unemployment Compensation Act sets the lowest tax rate at zero as long as the Trust Fund solvency remains at or above 100 percent. Since fiscal year end 2002, the Trust Fund solvency has remained below 100 percent; therefore, all employers paid unemployment taxes during calendar years 2003 through 2005. For calendar year 2005, the minimum rate that an employer could be required to pay on taxable wages was 0.52 percent, while the maximum rate was 6.62 percent.

An additional adjustment to the tax rate for calendar years 2003 through 2005 was the inclusion of the pool tax. The pool tax represents a levy to recover benefits not chargeable to a specific employer, known as pool costs. Interest income earned from the Trust Fund can offset the total pool costs when the solvency is above 50 percent. Interest income did not exceed pool costs in fiscal year 2002; therefore, the Employment Commission added a pool tax rate of 0.03 percent to the employer tax rates for calendar year 2003. Because the Trust Fund solvency fell below 50 percent in calendar year 2004, the Employment Commission could not offset the total pool costs and employers paid the full tax rate. The pool tax rate increased to 0.14 percent and 0.22 percent for calendar years 2004 and 2005 (included in the minimum and maximum rates above), respectively. This rate will decrease to 0.19 percent for calendar year 2006.

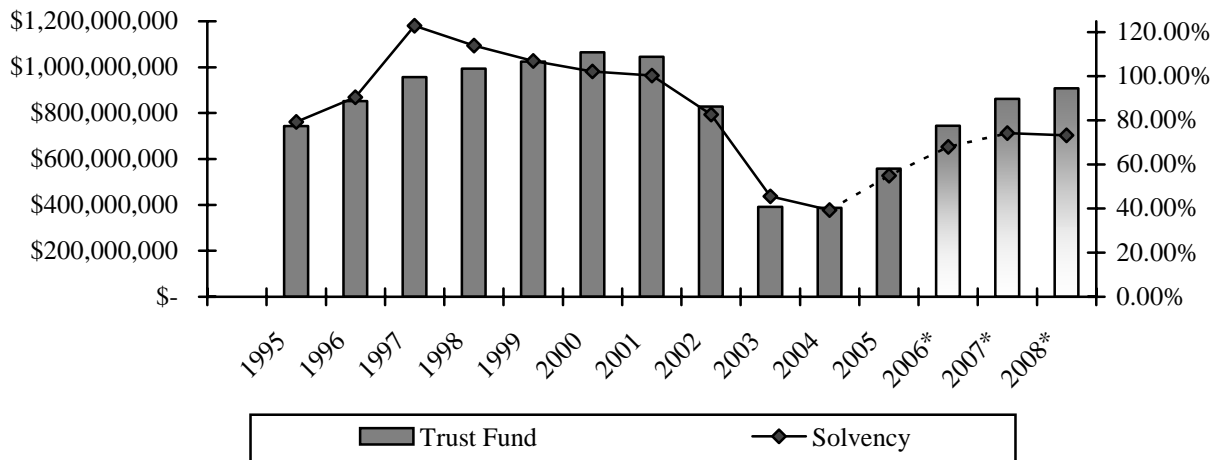
As mentioned above, the Trust Fund solvency for calendar year 2005 was below 50 percent, but will increase in 2006 to 54.9 percent. State law requires a fund-building tax rate of 0.2 percent to the employer tax rates if the fund balance drops below 50 percent, which helps the Trust Fund to remain solvent. The 0.2 percent was included in the minimum and maximum rates above for calendar year 2005, but will not be in effect for calendar year 2006 since the Trust Fund solvency will be above 50 percent.

The following table compares the various taxes for calendar years 2005 and 2006.

	Calendar Year 2005 Tax Rates		Calendar Year 2006 Tax Rates	
	<u>Minimum</u>	<u>Maximum</u>	<u>Minimum</u>	<u>Maximum</u>
Tax rate	0.10%	6.20%	0.10%	6.20%
Pool tax	0.22%	0.22%	0.19%	0.19%
Fund-building tax	0.20%	0.20%	0.00%	0.00%
Total	<u>0.52%</u>	<u>6.62%</u>	<u>0.29%</u>	<u>6.39%</u>

In 2005, the Employment Commission calculated the Trust Fund solvency as 54.9 percent for calendar year 2006. The Trust Fund has a projected balance of approximately \$744.5 million by the end of fiscal year 2006 with the solvency rate at 68.0 percent. In the 2007 calculation for calendar year 2008, the Employment Commission anticipates that the solvency will increase to 74.2 percent. The Trust Fund balance at fiscal year end 2008 should reach \$907.7 million. The following illustration presents the projections for the Trust Fund balance and solvency as projected by the Employment Commission.

Unemployment Trust Fund Balance and Solvency



* Projected figures

Note: Trust Fund solvency is an indicator of the Fund's ability to pay benefits during periods of high unemployment. The solvency indicator compares the Trust Fund's actual balance to the calculated balance needed to pay these benefits for 16.5 months. The formula that calculates the balance uses historical benefit and wages data. Trust Fund solvency does not directly relate to current year tax collections or benefits paid. Since June 1996, the computation of solvency uses a modified accrual basis as stipulated in §60.2-533 of the Code of Virginia. Both the Trust Fund balance and solvency rate calculations are for the state fiscal year. Solvency rates at fiscal year end determine tax rates for the next calendar year. The above Trust Fund Balance and solvency projections do not reflect any proposed funding changes until these changes become law. A proposal currently exists to request additional administrative funding from the Reed Act Funds of \$6.45 million in fiscal years 2007 and 2008 and from penalty and interest funds of \$5.35 million in fiscal year 2008.

EMPLOYMENT COMMISSION ADMINISTRATIVE FUNDING

The Employment Commission's funding comes entirely from federal funds, mostly from the Unemployment Insurance, Job Services, and Workforce Investment Act. This funding makes the Employment Commission susceptible to increases and decreases in funding based on the economy. When the economy is poor and unemployment is high, benefits administered and funding to administer them increases. As the economy improves and unemployment decreases, the funding for the Employment Commission also decreases. This funding puts the Employment Commission on a cyclical basis with the economy, requiring the Employment Commission to either increase spending to support increased services or cut costs due to decreased services.

Currently, the Employment Commission is experiencing a downturn in their funding level as the economy continues to improve. During fiscal year 2005, funding for the administration of Unemployment Insurance decreased approximately \$11 million and funding for Job Services decreased approximately \$400,000. In order to operate with decreased funding, the Employment Commission laid off part-time and wage employees and combined several locality offices. The Employment Commission expects funding to decrease another \$10 million for Unemployment Insurance and \$3 million for Job Services in fiscal year 2006.

Although the Employment Commission experienced cuts in administrative funding for Unemployment Insurance, the Employment Commission has implemented several new methods for providing services to citizens. Over the last three years, the Employment Commission implemented the option to obtain services over the Internet and opened two call centers, which allows citizens to file claims over the phone. As of June 2005, 65 percent of all claims are filed through the Internet or call centers allowing the Employment Commission to administer services without having to maintain large offices.



Commonwealth of Virginia

Walter J. Kucharski, Auditor

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

December 21, 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

We have audited selected financial records and operations of the **Virginia Employment Commission** for the year ended June 30, 2005, in support of the Comprehensive Annual Financial and Statewide Single Audit Reports for the Commonwealth of Virginia. 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 objective was to evaluate the accuracy of the Employment Commission's financial transactions as reported in the Comprehensive Annual Financial and Statewide Single Audit Reports for the Commonwealth of Virginia for the year ended June 30, 2005. In support of this objective, we evaluated the accuracy of recording financial transactions on the Commonwealth Accounting and Reporting System and in the Employment Commission's Tax and Benefits Systems, reviewed the adequacy of the Employment Commission's internal control, tested for compliance with applicable laws and regulations, and reviewed corrective actions of audit findings from prior year reports. Our review encompassed controls over the following significant cycles, classes of transactions, and account balances:

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

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

Unemployment Benefit Processing	Expenditures
Employment Tax Collections	Financial Reporting

Management has responsibility for establishing and maintaining internal control and complying with applicable laws and regulations. Internal control is a process designed to provide reasonable, but not absolute,

assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. We tested transactions and controls and performed other audit tests we deemed necessary to determine whether the Employment Commission's controls were adequate, had been placed in operation, and were being followed.

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

Audit 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.

We noted certain matters involving internal control and its operation that require management's attention and corrective action. Additionally, we noted one instance of noncompliance with applicable laws and regulations that are required to be reported under Government Auditing Standards. These matters are described in the section entitled, "Audit Findings and Recommendations."

We discussed this letter with management on January 10, 2006. Management's response is included at the end of 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.

AUDITOR OF PUBLIC ACCOUNTS

KSA/kva



COMMONWEALTH of VIRGINIA

Virginia Employment Commission

Dolores A. Esser
Commissioner

703 East Main Street

Post Office Box 1358
Richmond, Virginia 23218-1358

January 17, 2006

Mr. Walter J. Kucharski
Auditor of Public Accounts
James Monroe Building
101 N. 14th Street
Richmond, Virginia 23219

Dear Mr. Kucharski:

Thank you for the opportunity to offer our response to your audit report.

We would like to add the following information relative to the Unemployment Trust Fund narrative contained in your report so that readers of the report can have a more complete picture of the factors affecting the Unemployment Compensation benefit levels.

Unemployment Trust Fund

Benefit levels are established by the General Assembly and are periodically adjusted by legislative action. At the time of the terrorist attacks in 2001, Virginia's maximum benefit amount for the unemployed had not been adjusted since 1999 and was just \$268, or 38% of the state's average weekly wage (AWW). Governor Warner's predecessor corrected that inequity by issuing an Executive Order that increased the maximum by \$100 (or 37.7%) to \$368, bringing the maximum to 52% of the AWW. Unfortunately, he not only increased the maximum by 37.3%, he increased all benefits in the schedule by 37.3%, making the effective rate for many of the unemployed in excess of 80%.

Working with the Joint Sub-Committee Studying the Funding Requirements of the UI Trust Fund and its Chairman, Senator John Watkins, and in concert with a Joint Resolution of the General Assembly, Governor Warner directed the VEC to engage an outside consultant to undertake a comprehensive review of the unemployment compensation system. That study, conducted by the Urban Institute, provided the backdrop for a remarkable string of initiatives that the Governor moved through the legislature to address deficiencies in Virginia's Unemployment Compensation system.

The study found that Virginia's UI Trust Fund had declined sharply from its level at the end of 2000. This occurred despite Virginia's UI program having very low benefit reciprocity rates (among the lowest in the nation) and below average wage loss replacement rates.

The legislative initiatives that Governor Warner embarked on included a permanent increase in the maximum weekly benefit amount and a restoration of all other benefits to the historical target of 52% of lost wages, the introduction of the alternate base period, and the elimination of the benefit offset for the receipt of Social Security benefits.

The VEC management has developed corrective actions to address the audit findings and recommendations identified in your report. The following is our response to your findings:

1. Complete Information Systems Risk Assessment and Business Impact Analysis

VEC Response:

We concur with this finding. We have currently scheduled Information Technology Services Center (ITSC) to conduct a risk assessment of Unemployment Insurance (UI) in March 2006. Upon the completion of ITSC's assessment and Business Impact Analysis we will have completed the identification, ranking and documenting of the agency's business functions.

2. Obtain Assurance over Security of Information Technology Infrastructure

VEC Response:

We concur with this finding. We are in the process of negotiating a new MOU with VITA. We plan to include details on our Information Security requirements for our systems and databases in the final version of this MOU. This will include both governance and technical controls requirements. We also plan to require VITA to provide us with periodic assurances that VEC's information, databases, and equipment are safeguarded in accordance with our requirements.

3. Hold Local Areas Accountable for Untimely or Unreliable Participant Data Entered into the Workforce Network Information System

VEC Response:

We concur with this finding. The WIA Division will develop a draft administrative policy on "Data Management" for the Commissioner's consideration, which will address a number of data related issues, including those cited by the APA. In addition, the Policy will identify administrative sanctions so that the consequences of not meeting policy are clearly understood by all involved and consistently applied. As a part of the process, we may revisit the five workday data entry requirement for reasonableness. Also, Division monitors will continue to review files for compliance, issue appropriate findings, and require corrective action. Staff will

Mr. Walter J. Kucharski
January 17, 2006
Page 3

also provide training, especially on the use of the querying process as it relates to data management and performance.

Again, I appreciate the opportunity to provide the VEC's comments as part of your office's report of VEC's financial records and operations for the year ended June 30, 2005.

Sincerely,

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

Dolores A. Esser

VIRGINIA EMPLOYMENT COMMISSION

Dolores Esser
Commissioner

James Ellenberger
Deputy Commissioner