COMMONWEALTH of VIRGINIA

Joint Legislative Audit and Review Commission
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December 13, 2016

MEMORANDUM

TO: Members of the Joint Legislative Audit and Review Commission

CC: Robert Vaughn, Staff Director, House Appropriations Committee
Betsey Daley, Staff Director, Senate Finance Committee

FROM: Kimberly Sarte, Mark Gribbin

SUBJECT: Annual Review of Internal Service Funds

The Joint Legislative Audit and Review Commission (JLARC) is vested with responsibility for overseeing the internal service funds (ISFs) managed by the Virginia Information Technologies Agency (VITA), Department of General Services (DGS), and Department of Accounts (DOA). JLARC's oversight is generally limited to monitoring the health of these funds, including whether they are maintaining appropriate balances, making reasonable projections of future revenues and expenditures, and charging appropriate rates to recover the anticipated costs of services. This memo comments on the financial status of the funds. JLARC staff separately review fund projections and rates. The funds overseen by JLARC had appropriations of $562 million in FY17.

JLARC staff did not identify any major concerns regarding the financial status of the ISFs. Financial status reported here is as of the close of FY16. Most funds have adequately recovered expenses and appear to be maintaining appropriate cash reserves. JLARC staff identified only minor concerns with a few funds.

- VITA's fund experienced a small operating loss in FY16. The loss is not a major concern, but VITA should continue refining its forecasting model to avoid future losses.
- One DGS fund experienced small operating losses in consecutive years and its balance is approaching zero. If the balance continues to decline in FY17, DGS should review the fund's rate structure and identify changes needed to ensure the fund collects sufficient revenue to cover its operating expenses.

- Two DOA funds have negative fund balances incurred from up-front investments, but the funds are collecting sufficient revenue to cover expenses and are paying off their debts.

Background

Internal services funds (ISFs) are a financial mechanism used to recoup costs incurred by one agency when performing services or procuring goods on behalf of other agencies. For example, DGS leases office space in downtown Richmond to several customer agencies, which pay rent to DGS through an ISF. Likewise, VITA's IT services to customer agencies are paid through an ISF, as are DOA enterprise applications and payroll processing services. Agencies pay the ISF agencies through established service rates, and ISF spending is approved in the annual Appropriation Act.[1]

JLARC staff recommend that ISFs maintain positive fund balances. A positive fund balance indicates that a fund has regularly collected sufficient revenue to pay its expenses. Some funds have negative fund balances because they are carrying long-term debt. Debt can be incurred for a variety of reasons, including borrowing to cover operating expenses or borrowing to pay for capital investments. These funds should make steady progress toward reducing their debt.

Agencies that manage ISFs should maintain a cash reserve for unexpected expenses and revenue shortfalls. The appropriate reserve amount depends on the fund and its unique cash requirements. Some ISF agencies have access to lines of credit with the state and so can maintain smaller reserves.

Federal government guidelines allow agencies to keep ISF cash reserves equivalent to 60 days of operating expenses. The Department of Planning and Budget (DPB) has adopted this standard as a benchmark for Virginia's ISFs. Prepayments and other restrictions on cash held in an ISF should be taken into account when the reserve is calculated.

Virginia Information Technologies Agency

The Virginia Information Technologies Agency (VITA) provides IT goods and services to most executive branch agencies. VITA provides IT infrastructure services, such as data center services, personal computers, and internet connectivity, through third-party vendors such as Northrop Grumman. VITA also provides security oversight and central support services directly to agencies. VITA collects revenues for all of these services through its Information Technology and Management ISF. VITA charges over 400 unique rates for its services.

VITA's total budgeted ISF appropriations for FY17 are $368 million (2016 Appropriation Act, Chapter 780). The services under this fund fall into four different budget programs (Table 1). Almost 90

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[1] ISF rate changes for "overhead surcharges" are approved in the Appropriation Act and all other rate changes are approved administratively by DPB (§ 4-5.03). JLARC approved rates up until they were incorporated into the budget process in 2015. JLARC staff continue to review proposed rates but no longer issue formal rate approvals or recommendations. Rates are based on projections of future service demand from agency customers and the revenues they are expected to generate compared to projected expenses. Projected expenses also form the basis of ISF agencies' appropriation requests.

TABLE 1
VITA services paid through the Information Technology and Management ISF

		Appropriation (millions)	
Program within fund	**Services**	**FY17**	**FY18**
Vendor IT infrastructure services	Data center, personal computing, internet, and telecommunications services from Northrop Grumman and other vendors	$320	$314
VITA administrative overhead	Agency operations costs not related to direct services or security, including staff costs for contract oversight, customer relations, and administrative functions	27	28
VITA central support services	Support services provided directly by VITA, including support for the Medicaid Information Technology Architecture initiative, collaborative software applications, and applications security testing	12	12
VITA security oversight	Security oversight services provided directly by VITA, including incident response and IT security audit reviews	8	8
Total all programs		**$368**	**$361**

SOURCE: 2016 Appropriation Act, Chapter 780.
NOTE: Appropriation amounts may not add due to rounding.

percent of appropriations for VITA's fund are "pass-through" payments to Northrop Grumman and other vendors that provide IT infrastructure services to state agencies.

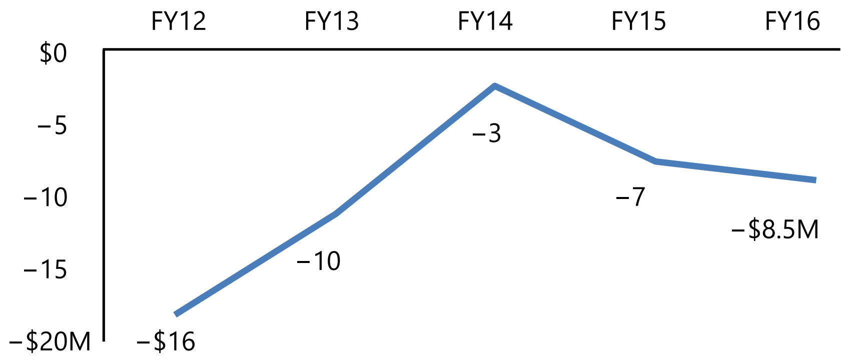
VITA's fund had a balance of −$8.5 million as of the end of FY16 (Figure 1). The fund's balance has been negative since FY10, when VITA recorded a substantial operating loss as it was transitioning to a new rate structure. The fund made progress toward a positive balance until FY15, when VITA was required to transfer $4.5 million out of the fund. The transfer was directed by the Appropriation Act to alleviate an anticipated shortfall in the state budget.

The fund experienced a minor operating loss of $1.4 million in FY16, its first since FY10. The FY16 loss occurred because demand for some major services was not as high as expected, particularly Unisys services. Starting in FY16, the demand for Unisys services, which are scheduled for termination in FY17, decreased and at a faster rate than what was projected. Although VITA generated higher-than-expected revenues under several of its other services, this was not enough to offset the loss. The loss was small relative to the total fund's expenses, representing less than half a percent of costs. The small scale of the loss indicates that rates are generally sufficient to recover expenses but that some refinements may be needed.

VITA should continue to refine its forecasting model to avoid future losses. VITA staff indicated that they expect to do so, although there may be additional challenges in predicting demand as the state makes the transition from Northrop Grumman to new service providers.

FIGURE 1
Key ISF status indicators

Fund balance



Cash reserve[a] as of June 30, 2016 — **$31 million**
Equivalent to 32 days of operating expenses

SOURCE: VITA financial statements.
[a] Cash reserve is equal to cash on hand less deferred revenue from agency prepayments. Operating expenses used to calculate cash reserve equivalent in days are equal to total operating expenses less non-cash depreciation expenses. Operating expenses do not include repayment of working capital advances or Treasury loans. Calculation methodology used in this report is different from methodology used in JLARC's 2015 Annual Review of Internal Service Funds, so the numbers from that report are not comparable; methodology also differs from the methodology used by DPB to calculate the cash reserve for budgeting purposes. DPB uses cash-basis financial statements, whereas JLARC staff use accrual-basis statements. Operating expenses include VITA's vendor pass-through and other non-administrative costs.

A second measure of ISF status is whether a fund has a sufficient cash reserve to cover short-term operating expenses. At the close of FY16, the VITA fund had a $31 million cash reserve, which was sufficient to cover 32 days of operating expenses (Figure 1). The cash reserve was below the 60-day cash equivalent benchmark, but not low enough to be of concern. In addition to the cash reserve, VITA has access to a line of credit with the state that it can use to help cover unexpected costs. VITA drew down $10 million from its line of credit in FY16, which contributed to the cash reserve. VITA had to draw down funds from the line of credit to fund VITA's normal day-to-day operations. The line of credit had to be used because the fund does not have a positive balance that could be drawn down instead.

Department of General Services

The Department of General Services (DGS) provides a variety of goods and services to executive branch agencies. These services are provided under nine different ISFs (Table 2). DGS charges hundreds of unique rates for the services it offers.

DGS's total budgeted ISF appropriations for FY17 are $167 million (2016 Appropriation Act, Chapter 780). Four DGS funds account for 93 percent of ISF appropriations: Real Estate Services, Statewide Building Management, Virginia Distribution Center, and Fleet Management. The five other DGS funds are substantially smaller and account for the remaining seven percent of appropriations.

TABLE 2
DGS services paid through ISFs

Fund	Services	Appropriation (millions) FY17	FY18
Real Estate Services	Administration of leases for agencies that rent office space that is not owned by the state	$63	$63
Statewide Building Management	Lease and maintenance activities on state-owned property under the Bureau of Facilities Management	41	41
Virginia Distribution Center	Sale of food and housekeeping products	32	32
Fleet Management	Management of cars, trucks, and fuel programs used by state agencies	19	19
Statewide Engineering and Architectural Services	Assistance planning and procuring construction services provided by the Bureau of Capital Outlay Management	5	5
Analytical Testing Services	Laboratory testing of environmental, agricultural, and other samples	5	5
State Surplus Property	Sale or donation of state surplus items to agencies, nonprofits, and the public	2	2
Federal Surplus Property	Sale or donation of federal surplus items to agencies, nonprofits, and certain small businesses	1	1
Graphic Communications	Printing and graphic design services	0.1	0.1
Total all funds		**$167**	**$168**

SOURCE: 2016 Appropriation Act, Chapter 780.
NOTE: Appropriation amounts may not add due to rounding. Total FY18 appropriation was slightly higher than FY17 due to rounding. DGS provides procurement services to state agencies and others through the eVA system under an enterprise fund.

The Statewide Building Management fund was the only fund with a negative balance, which was −$7.4 million at the end of FY16 (Table 3). The negative balance is attributable to debt remaining on a Treasury loan for the purchase of the Old City Hall building in Richmond ($2.2 million remaining) and a contractual financing arrangement with a private company for projects to improve the energy efficiency of state buildings ($11.8 million remaining). Although the fund balance is negative, it is trending in the right direction. The fund increased by $3.2 million in FY16. DGS staff indicated that revenues continue to outpace expenses because of cost reduction measures taken by DGS in prior years and because of a shift to using the DGS maintenance reserve fund to pay for some repairs and improvements, as authorized in the Appropriation Act.

Three of the small funds have balances that are approaching zero and have experienced repeated operating losses. DGS changed the rate structures for two of these funds, Analytical Testing Services and Graphic Communications, in FY17. Their fund balances should stop declining now that new rates have been implemented. DGS has not changed the rate structure of the third fund, State Surplus Property, in 10 years. The fund has been depleted by consecutive years of operating losses and a FY15 transfer of $0.7 million to the general fund. The transfer was directed by the Appropriation Act to alleviate an anticipated shortfall in the state budget. The operating losses were partially due to a one-time $300,000 warehouse renovation project. DGS staff expect the fund balance will stop declining

Table 3
Key ISF status indicators as of June 30, 2016

Fund	Fund balance ($ millions)	Cash reserve[a] ($ millions)	Cash reserve equivalent[a] (days of operating expenses)
Real Estate Services	$3.7 million	$1.4 million	8 days
Statewide Building Management	−7.4	7.8	74
Virginia Distribution Center	11.3	2.8	34
Fleet Management	24.6	3.1	124
Statewide Engineering and Architectural Services	1.1	1.1	94
Analytical Testing Services	0.2	0.4	34
State Surplus Property	0.03	0.1	36
Federal Surplus Property	1.7	1.4	1,631
Graphic Communications	0.1	0.1	214
Total all funds	**$35.3 million**	**$18.3 million**	not applicable

SOURCE: DGS financial statements.
[a] Cash reserve is equal to cash on hand less deferred revenue from agency prepayments and cash held by DGS from sales of third-party property that is pending distribution. Operating expenses used to calculate cash reserve equivalent in days are equal to total operating expenses plus leasing activity costs and costs of goods sold, less non-cash depreciation and bad debt expenses. Operating expenses do not include repayment of working capital advances or Treasury loans. Calculation methodology used in this report is different from the methodology used in JLARC's 2015 Annual Review of Internal Service Funds, so the numbers from that report are not comparable; methodology also differs from the methodology used by DPB to calculate the cash reserve for budgeting purposes. DPB uses cash-basis financial statements, whereas JLARC staff use accrual-basis statements.

now that transfers and the warehouse project are complete. However, if the fund balance continues to decline in FY17, DGS should review the fund's rate structure and identify changes that are necessary to ensure that it adequately recovers expenses.

The DGS funds had cumulative cash reserves of $18.3 million at the close of FY16, which is up $1.6 million from last year. On a fund-by-fund basis, cash reserves were sufficient to cover from 8 to 1,631 days of operating expenses (Table 3). Although some funds had relatively high cash reserves, most reserves were close to or below the 60-day cash equivalent benchmark.

Real Estate Services was the only fund with a cash reserve that would cover less than 30 days of operating expenses. The fund's reserve was equal to eight days of expenses, which was down from 12 days last year. DGS staff indicated that the low reserve in this fund is not a cause for concern because the fund has a steady cash flow and does not experience large, unexpected expenses.

The Fleet Management fund had a relatively large cash reserve (124 days). DGS indicated that this fund requires a large reserve because of how vehicles are purchased and the need to pay for maintenance projects at the fleet management facility.

Two of the small funds had large cash reserves relative to operating expenses, but the amounts are not a cause for concern. The Federal Surplus Property fund had a $1.4 million cash reserve, sufficient to cover 1,631 days of operations. The fund collects proceeds from DGS-administered sales of federally owned property. Cash cannot be removed from the fund except for specific purposes, which is why the cash reserve is large relative to the fund's operating expenses. The Graphic Communications fund had a $57,259 cash reserve, which was a small dollar amount but was sufficient to cover 214 days of operating expenses.

Department of Accounts

The Department of Accounts (DOA) oversees ISFs that support financial services provided to state agencies. The costs for these financial services are recovered through two enterprise applications funds and the Payroll Services Bureau fund (Table 4). The enterprise applications funds recover costs related to the development, implementation, and operations of the Cardinal accounting system and the Performance Budgeting system. The Payroll Services Bureau is a shared services center for processing payroll, leave, and other employee benefits at over 50 state agencies. An additional enterprise payroll application is under development to replace the Commonwealth Integrated Payroll/Personnel System, (CIPPS) but no fund has yet been established for it.

DOA's total budgeted ISF appropriation for FY17 is $27 million (2016 Appropriation Act, Chapter 780). The Cardinal fund accounts for three-fourths of the appropriation.

DOA's two enterprise application funds had negative fund balances at the end of FY16 (Figure 2). The Cardinal fund balance was −$1.6 million and the Performance Budgeting fund was −$1.2 million. The negative balances reflect debt used to pay for development and implementation of the respective systems. The Cardinal fund balance decreased by $1.1 million in FY16, but this was expected because DOA borrowed from its working capital advance to complete system implementation. The fund's balance is expected to improve in FY17 because new rates went into effect that collect additional revenue to repay system development and implementation debts. The Performance Budgeting fund balance increased by $0.45 million in FY16. DOA has already implemented the rate changes needed to repay the debts that were incurred for this system.

Cardinal had a $1.5 million cash reserve and Performance Budgeting had a $0.5 million reserve at the close of FY16. Cardinal's reserve was sufficient to cover 31 days of operating expenses, and Performance Budgeting's reserve was sufficient to cover 89 days. Each fund's reserve was close to or below the 60-day benchmark. The Appropriation Act authorizes a Treasury loan in the event that these funds do not have sufficient cash to cover expenses.

TABLE 4
DOA services provided under ISFs

Fund	Services	Appropriation (millions) FY17	FY18
Cardinal enterprise application	Central financial reporting services	$20	$21
Performance Budgeting enterprise application	Central budget reporting services	4	4
Payroll Service Bureau	Agency payroll, leave, and other employee benefits processing services	3	3
Total all funds		**$27**	**$28**

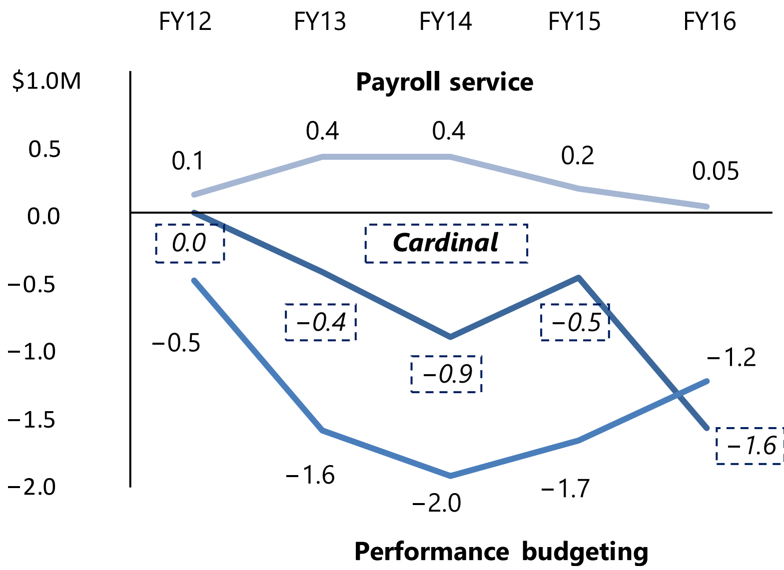
Source: 2016 Appropriation Act, Chapter 780.
Note: Appropriation amounts may not add due to rounding.

The Payroll Service Bureau fund, which is more established than the enterprise application funds, has maintained a positive balance. However, the balance declined in FY15 and FY16 because the fund experienced operating losses. DOA implemented rate changes in FY17 to address this issue, and the fund balance is expected to stop declining.

The Payroll Service Bureau fund had a $0.1 million cash reserve. The reserve was sufficient to cover 16 days of operating expenses, which was well below the 60-day benchmark. The cash position of the fund should improve under the new rate structure. The Appropriation Act authorizes DOA to use a $400,000 line of credit in the event that the fund does not have sufficient cash to cover expenses.

FIGURE 2
Key ISF status indicators

Fund balance



Cash reserve[a]
as of June 30, 2015

Cardinal
$1.5 million
Equivalent to 31 days of operating expenses

Performance Budgeting
$0.5 million
Equivalent to 89 days of operating expenses

Payroll Service
$0.1 million
Equivalent to 16 days of operating expenses

SOURCE: DOA financial statements.
[a] Cash reserve equal to cash on hand less deferred revenue from agency prepayments and anticipated repayments owed to the federal government. Operating expenses used to calculate cash reserve equivalent in days are equal to total operating expenses less non-cash depreciation expenses. Operating expenses do not include repayment of working capital advances or Treasury loans. Calculation methodology used in this report is different from the methodology used in JLARC's 2015 Annual Review of Internal Service Funds, so the numbers from that report are not comparable; methodology also differs from the methodology used by DPB to calculate the cash reserve for budgeting purposes. DPB uses cash-basis financial statements, whereas JLARC staff use accrual-basis statements.