December 14, 2017

MEMORANDUM

TO: Members of the Joint Legislative Audit and Review Commission

CC: Robert Vaughn, Staff Director, House Appropriations Committee
April Kees, Interim Co-Director, Senate Finance Committee
Jason Powell, Interim Co-Director, Senate Finance Committee

FROM: Kimberly Sarte, Joe McMahon

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). The funds overseen by JLARC had appropriations of $556 million in FY18.

JLARC's oversight is generally limited to monitoring the financial status of the funds, and in particular whether agencies maintain appropriate fund balances and cash reserves. This memo focuses on the financial status of the funds as of the close of FY17.

JLARC staff did not identify any major concerns regarding the financial status of the ISFs. 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 operating losses in FY17. The losses are not a major concern, but VITA should continue refining its forecasting model to avoid future losses. VITA must continue to closely monitor the effect that the ongoing transition of state IT infrastructure will have on the fund. Additional unexpected costs would adversely impact fund health and increase reliance on VITA's line of credit.
- One DGS fund experienced small operating losses in consecutive years and its balance is approaching zero. DGS should review the fund's revenue, expenses, and rate structure and identify changes needed to ensure the fund collects sufficient revenue to cover its operating expenses.
- One DOA fund has a negative fund balance incurred from up-front investments, but the fund is collecting sufficient revenue to cover expenses and is paying off its debts.

JLARC has oversight responsibility for two new ISFs managed by Department of Human Resource Management (DHRM). The two new ISFs will be included in the annual review for next year.

## 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]

Agencies that manage ISFs should maintain positive fund balances and, when debt is incurred, make steady progress toward reducing their debt. 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.

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 and DXC Technology. VITA also provides IT 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 approximately 350 unique rates for its services.

VITA's total budgeted ISF appropriations for FY18 are $350 million (2017Appropriation Act, Chapter 836). The services under this fund fall into five different budget programs (Table 1). Almost 90 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. The appropriation for VITA central support services decreased from $12 million to $7 million as a result of the discontinuation of two services in that area. IT Planning and Quality Control—which are costs associated with development

[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.

of the Commonwealth Strategic Plan for Technology and other technology planning and procedures—were previously classified as administrative costs and paid for with general funds, but were included as a program within the VITA ISF beginning in FY18.

**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 | $308 |
| 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 | 7 |
| VITA security oversight | Security oversight services provided directly by VITA, including incident response and IT security audit reviews | 6 | 5 |
| IT Planning and Quality Control | Development of the Commonwealth Strategic Plan for Technology and other technology planning and procedures | 0 | 2 |
| **Total all programs** | | **$364** | **$350** |

SOURCE: 2017 Appropriation Act, Chapter 836.
NOTE: Appropriation amounts may not add due to rounding.

VITA's fund had a balance of −$14.9 million as of the end of FY17 (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 moved further into a negative balance in FY17 because of an operating loss of $6.2 million further reduced the fund's cash position.

The FY17 operating loss occurred primarily because of higher-than-expected costs, including delays, related to the transition of IT infrastructure services from Northrop Grumman to new providers. The largest of such costs were in the IBM mainframe service area. In addition, some of the operating loss can be attributed to "unfavorable pricing structures," which occur when Northrop Grumman increases the unit price for services in response to a reduction in usage of that particular service by state agencies. This price increase can offset any agency savings related to the reduction in usage. When implementing rates, it is difficult for VITA to project the extent to which agency use will change and the timing of when those changes will occur. VITA staff indicated that under collections can occur because VITA uses conservative estimates in an effort to avoid over collection from agencies and there is a time lag between when agency use changes and when rates can be adjusted.

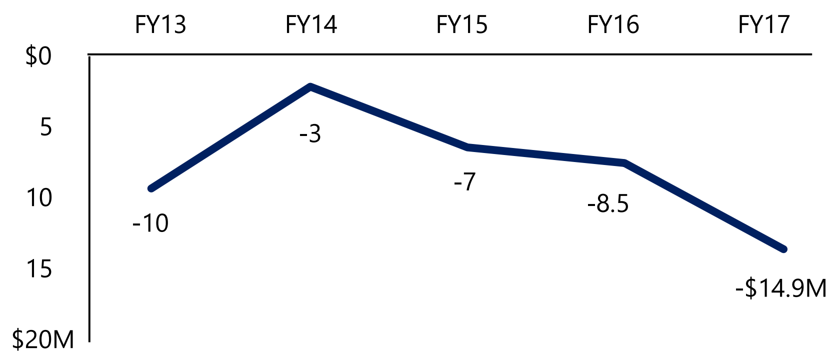
Although VITA generated higher-than-expected revenues under several of its other services, this was not enough to offset the $6.2 million loss. The loss was small relative to the total fund's expenses, representing 1.7 percent of costs. The small scale of the loss indicates that rates are generally sufficient to recover expenses but that additional refinements may be needed.

VITA should continue to refine its forecasting model to avoid future losses. The transition to new service providers has created major challenges to forecasting, at least in the short term. Two factors in particular create cost uncertainty:

- The separation from Northrop Grumman may have unexpected costs resulting from additional delays, unexpected fees, and the outcome of ongoing litigation.
- In a number of service areas, contracts have not yet been awarded to new providers, therefore the final costs of these new services has not been established.

**FIGURE 1**
**Key status indicators for VITA ISFs**

**Fund balance**




**Cash reserve** as of June 30, 2017 — $−6.2 million
Equivalent to 0 days of operating expenses

SOURCE: VITA financial statements.
NOTE: 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. Methodology 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 negative $6.2 million cash reserve, which was insufficient to cover a single day of the fund's approximately $1 million daily operating expenses (Figure 1).

VITA has access to a line of credit with the state that can be drawn upon to contribute to the cash reserve and fund day-to-day operations and cover unexpected costs. VITA had drawn $26 million on its line of credit in FY17, which it paid off before the end of the fiscal year. VITA has once again drawn down from its line of credit in FY18 ($25 million) to fund day-to-day operations and unexpected costs because the fund does not have a positive cash balance.

## 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 FY18 are $170 million (2017 Appropriation Act, Chapter 836). 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 much smaller and account for the remaining seven percent of appropriations.

**TABLE 2**
**DGS services paid through ISFs**

| Fund | Services | Appropriation ($ millions) FY17 | Appropriation ($ millions) FY18 |
|---|---|---|---|
| Real Estate Services | Administration of leases for agencies that rent office space that is not owned by the state | $66 | $66 |
| Statewide Building Management | Lease and maintenance activities on state-owned property under the Bureau of Facilities Management | 41 | 42 |
| 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** | **$171** | **$170** |

SOURCE: 2017 Appropriation Act, Chapter 836.
NOTE: Appropriation amounts do not add 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 −$7.3 million at the end of FY17 (Table 3). The negative balance is attributable to a contractual financing arrangement with a private company for projects to improve the energy efficiency of state buildings ($10.9 million remaining). Although the fund balance is negative, it is trending in the positive direction; the fund has increased in each of the past four fiscal years. 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.

The Real Estate Services fund balance experienced a relatively large increase, from $3.7 million to $4.3 million (18 percent), from FY16 to FY17. This was primarily due to the anticipated reduction in costs for implementing the new real estate management information system (COVAtrax).

The fund balances for the Virginia Distribution Center fund and the fleet management fund remained relatively stable from FY16 to FY17, decreasing by just 4 percent and 2 percent respectively.

The Statewide Engineering and Architectural Services fund balance decreased from $1.1 million to $0.8 million (28 percent) from FY16 to FY17. DGS indicated that the Bureau of Capital Outlay Management (BCOM), like several other internal service funds, had an additional VRS assessment ($158,000) in FY17. Because the BCOM fund is relatively small and is comprised mostly of personnel expenses, the VRS assessment had a greater negative impact on BCOM relative to its impact on other funds. Furthermore, BCOM experienced unexpected employee absences that led to more unbilled hours and less revenue than anticipated. DGS anticipates that billable hours will increase going forward and that the fund balance will stabilize and recover.

Last year, three small funds were identified as having decreasing fund balances. For FY17, DGS changed the rate structures for two of these funds, Analytical Testing Services and Graphic Communications, and as a result, their fund balances stopped declining. DGS will continue to monitor the volume at which these services are used, as reduced volume can have a negative impact on fund revenue. 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, due in part to a $300,000 warehouse renovation project. In addition, $700,000 was transferred to the general fund in FY15 (directed by the Appropriation Act) to alleviate an anticipated shortfall in the state budget. DGS is currently studying fund activity and considering improvements through rate adjustment, cost reduction, and increased efficiency.

**TABLE 3**
**Key ISF status indicators as of June 30, 2017**

| Fund | Fund balance ($ millions) | Cash reserve ($ millions) | Cash reserve equivalent (days of operating expenses) |
|---|---|---|---|
| Real Estate Services | $4.3 million | $2.9 million | 16 days |
| Statewide Building Management | −7.3 | 4.6 | 41 |
| Virginia Distribution Center | 10.8 | 3.4 | 43 |
| Fleet Management | 24.0 | 4.0 | 77 |
| Statewide Engineering & Architectural Services | 0.8 | 0.8 | 68 |
| Analytical Testing Services | 0.3 | 0.3 | 25 |
| State Surplus Property | 0.03 | 0.1 | 39 |
| Federal Surplus Property | 1.4 | 1.2 | 739 |
| Graphic Communications | 0.1 | 0.05 | 128 |
| **Total all funds** | **$34.3 million** | **$17.3 million** | not applicable |

SOURCE: DGS financial statements.
NOTE: Cash reserve is equal to cash on hand less deferred revenue. Methodology differs from the methodology used by DPB to calculate the fund balance and cash reserve for budgeting purposes. DPB uses cash-basis financial statements, whereas JLARC staff use accrual-basis statements.

The DGS funds had cumulative cash reserves of $17.3 million at the close of FY17, which is down $1.0 million from last year. On a fund-by-fund basis, cash reserves were sufficient to cover from 16 to 739 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 significantly less than 30 days of operating expenses. The fund's reserve was equal to 16 days of expenses, which was up from eight 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.

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 $1.2 million cash reserve, sufficient to cover 739 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 $51,188 cash reserve, which was a small dollar amount but was sufficient to cover 128 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 for over 50 state agencies. An additional enterprise payroll application is under development to replace the Commonwealth Integrated Payroll/Personnel System.

A fund for that replacement system will be established and begin to collect revenue once the application is complete and begins serving agencies. This is projected to occur by the final quarter of FY19.

DOA's total budgeted ISF appropriation for FY18 is $28 million (2017 Appropriation Act, Chapter 836). The Cardinal fund accounts for three-fourths of the appropriation.

DOA's two enterprise application funds had mixed results in terms of fund balance for FY17. The Cardinal fund had a positive fund balance of $3.0 million to end FY17, an increase of $4.6 million over the previous year. This occurred because VDOT was required to pay a portion of the Cardinal upgrade project in FY17, which in turn reduced DOA's costs associated with the upgrade project as compared to the previous year. DOA's other enterprise fund, the Performance Budgeting fund, had a fund balance of −$1.2 million, which remains nearly unchanged from the previous fiscal year. DOA indicates that the negative balance reflects debt used to pay for development and implementation of the system, and the fund balance will become positive once the loan is paid off.

**TABLE 4**
**DOA services provided under ISFs**

| | | Appropriation (millions) | |
|---|---|---|---|
| **Fund** | **Services** | **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: 2017 Appropriation Act, Chapter 836.
NOTE: Appropriation amounts may not add due to rounding.

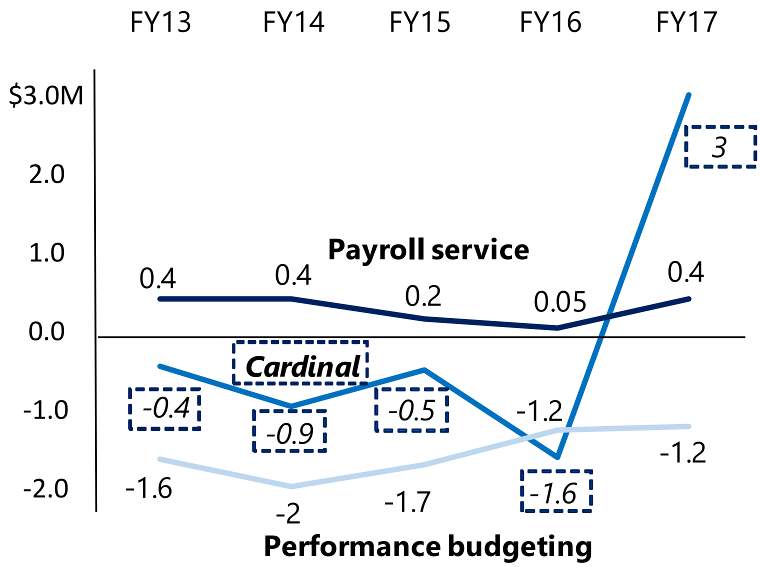
Cardinal had a $1.6 million cash reserve and Performance Budgeting had a $0.5 million reserve at the close of FY17. Cardinal's reserve was sufficient to cover 30 days of operating expenses, and Performance Budgeting's reserve was sufficient to cover 79 days. Each fund's reserve was close to or below 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.

The Payroll Service Bureau fund, which is more established than the enterprise application funds, has maintained a positive balance. The balance declined in FY15 and FY16 because the fund experienced operating losses. However, vacancies in the Payroll Service Bureau that resulted in lower personnel costs and the introduction of new rates increased the fund balance for FY17. The fund balance is now expected to stabilize as vacancies are filled.

The Payroll Service Bureau fund had a $0.5 million cash reserve. The reserve was sufficient to cover 72 days of operating expenses, which is near the 60-day benchmark. The cash position of the fund was just 16 days at the end of FY16, but has been improved under the new rate structure and in light of the personnel vacancies in FY17. 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 status indicators for DOA ISFs**

**Fund balance**




**Cash reserve**
as of June 30, 2015

**Cardinal**
$1.6 million
Equivalent to 30 days of operating expenses

**Performance Budgeting**
$0.5 million
Equivalent to 79 days of operating expenses

**Payroll Service**
$0.5 million
Equivalent to 72 days of operating expenses

SOURCE: DOA financial statements.
NOTE: 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. Methodology 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.

## Department of Human Resource Management

Two new internal services funds have been established in FY18 for the Department of Human Resource Management. Similar to the other agencies that manage ISFs, DHRM performs services on the behalf of other agencies. Beginning in FY18, DHRM will manage the Personnel Management Information System (PMIS) fund as an ISF. DHRM is authorized, via DOA, to collect payment from agencies that report their employee data in PMIS. At the same time, agencies have been provided general fund revenue to pay PMIS rates. The PMIS fund was appropriated $1.8 million for FY18.

DHRM now also manages the Administration of Health Insurance Benefits fund as an ISF. This fund is used to pay DHRM's personnel and non-personnel expenses for administering the state employee health insurance plan. Revenue for the fund will come from drawdowns of the Administration of

Health Insurance fund, which is the large fund that pays for costs of the state employee health insurance plan, such as member claims and Anthem expenses. The Administration of Health Insurance Benefits fund was appropriated $5.8 million in FY18.

JLARC staff will conduct analysis of fund balances and cash reserves for the two DHRM internal service funds starting next year, at which point each fund will have had time for financial balances to evolve and mature.