

December 14, 2018

MEMORANDUM

TO: Members of the Joint Legislative Audit and Review Commission

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

FROM: Kimberly Sarte, Lauren Axselle, Elizabeth Gibbs, and Joe McMahon

SUBJECT: Annual Review of Internal Service Funds

The Joint Legislative Audit and Review Commission (JLARC) is authorized to oversee the internal service funds (ISFs) managed by the Virginia Information Technologies Agency (VITA), the Department of General Services (DGS), the Department of Accounts (DOA), and the Department of Human Resource Management (DHRM). The funds overseen by JLARC had appropriations of \$580 million in FY19.

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 FY18.

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 FY18. The losses are not a major concern because VITA has a plan to address them. However, additional unexpected costs could adversely impact fund health and increase reliance on VITA's line of credit. VITA should continue refining its forecasting model, particularly in light of its contracts with new IT service providers and the legal settlement with Northrop Grumman.
- One DGS fund experienced small operating losses in consecutive years due to lower-than-anticipated revenue as a result of staff vacancies that have reduced the number of billable service hours. Another small DGS fund experienced a large increase in its cash reserves due to increases in revenue and a reduction in expenses. DGS should review these funds' revenue, expenses, and rate structures to identify whether changes are needed to ensure the funds collect appropriate revenue to cover their 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.

- Beginning in 2018, JLARC began reviewing two new DHRM funds. One fund has an appropriate fund balance and cash reserve. The other fund is reimbursed via year-end transfer, by design, and therefore does not carry a fund balance or cash reserve.

Background

Internal service 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 ISFs 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 Perspecta, Tempus Nova, and Verizon. VITA also provides IT security oversight and central support services directly to agencies. VITA collects revenues for all these services through its Information Technology and Management ISF. VITA charges approximately 360 unique rates for its services.

VITA's total budgeted ISF appropriations for FY19 are \$376 million (2018 Special Session I, Appropriation Act, Chapter 2). The services under this fund fall into four different budget programs (Table 1). Almost 90 percent of appropriations for VITA's fund are "pass-through" payments to vendors that provide IT infrastructure services to state agencies.

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). 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 form the basis of ISF agencies' appropriation requests.

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

Program within fund	Services	Appropriation (\$ millions)	
		FY19	FY20
Vendor IT infrastructure services	Data center, personal computing, internet, and telecommunications services provided by vendors	\$329	\$329
VITA administrative overhead	Agency operations costs not related to direct services or security, including staff costs for contract oversight, customer relations, and administrative functions	34	32
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	7	7
VITA security oversight	Security oversight services provided directly by VITA, including incident response and IT security audit reviews	6	6
Total all programs		\$376	\$374

SOURCE: 2018 Special Session I, Appropriation Act, Chapter 2.
 NOTE: Appropriation amounts may not sum due to rounding.

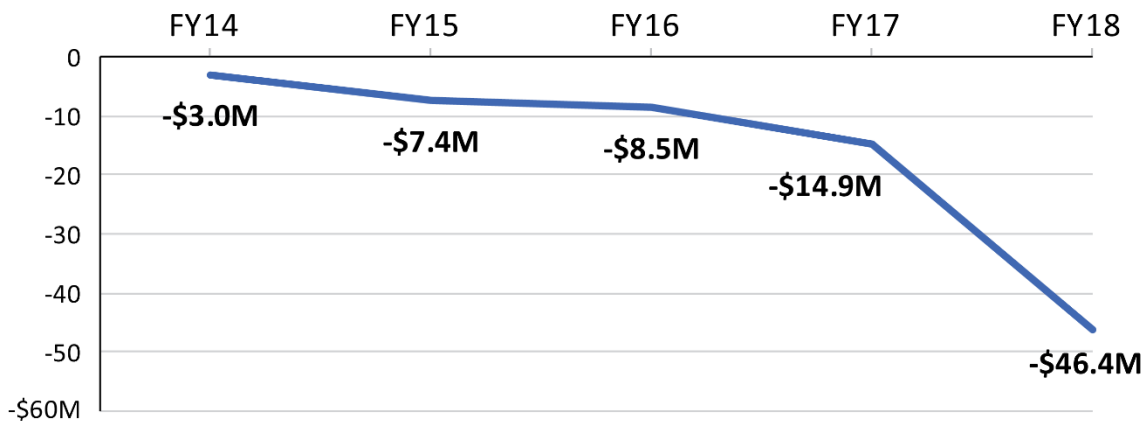
VITA's fund had a negative balance of -\$46.4 million as of the end of FY18 (Figure 1). The fund's balance has been negative since FY10, when VITA recorded a substantial operating loss as it was transitioning to a new rate structure. The fund made progress toward a positive balance until FY15, when VITA 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 FY16, FY17, and FY18. In FY18, the fund had a negative balance of \$46.4 million, and an operating loss of \$26.1 million.

Unplanned expenses were the primary cause of VITA's operating loss at the end of FY18. The largest unplanned expense was related to servers and storage (\$8.1 million). VITA experienced higher-than-expected expenses because agencies reduced server and storage consumption beyond what VITA had anticipated, and VITA no longer receives a \$3.2 million credit for servers each year as a result of the partial termination of mainframe services. As a result, VITA was unable to recover all server-related expenses through existing IT service rates. Another large, unplanned expense was related to the transition of IT infrastructure services from Northrop Grumman to new providers (\$7.8 million). VITA incurred expenses to have a new service provider take over IT infrastructure services from Northrop Grumman and was unable to recover these expenses through existing IT service rates. Additional unplanned expenses that VITA experienced in FY18 include expenses related to server storage (\$4.3 million), messaging resolution (\$4.0 million), and desktops and laptops (\$4.0 million).

Although VITA generated higher-than-expected revenues under several of its other services, this was not enough to offset the \$26.1 million loss. The loss was relatively small compared to the total fund's expenses, representing 6.7 percent of costs. The small scale of the loss indicates that rates are generally sufficient to recover expenses but that additional refinements are needed.

FIGURE 1
Key status indicators for VITA ISFs

Fund balance



Cash reserve **\$-27.6 million**
as of June 30, 2018 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.

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 has resulted in unexpected costs due to delays and fees, and the legal settlement with Northrop Grumman has generated additional costs.
- VITA staff are currently developing FY20 rates, which must account for the new pricing structures of service providers and recover current expenses on VITA's line of credit.

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 FY18, the VITA fund had a negative \$27.6 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 drew down \$26 million in FY17 and \$25 million in FY18 on its line of credit, which it paid off before the end of each fiscal year. As of August 2018, VITA had approximately \$125 million on its line of credit due to anticipated

IT infrastructure transition costs, unanticipated IT infrastructure transition costs, and shortfalls from yearly operating revenue. This represents approximately three-fourths [76 percent] of VITA's total line of credit, which was increased to \$165 million in FY19. The legal settlement with Northrop Grumman will likely result in additional costs being placed on VITA's line of credit.

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 FY19 are \$168 million (2018 Appropriation Act, Chapter 2). 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)	
		FY19	FY20
Real Estate Services	Administration of leases for agencies that rent office space that is not owned by the state	\$67	\$67
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	29	29
Fleet Management	Management of cars, trucks, and fuel programs used by state agencies	20	20
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	4	4
State Surplus Property	Sale or donation of state surplus items to agencies, nonprofits, and the public	1	1
Federal Surplus Property	Sale or donation of federal surplus items to agencies, nonprofits, and certain small businesses	0.6	0.6
Graphic Communications	Printing and graphic design services	0.2	0.2
Total all funds		\$168M	\$169M

SOURCE: 2018 Special Session I, Appropriation Act, Chapter 2.

NOTE: Appropriation amounts do not sum due to rounding. DGS provides procurement services to state agencies and others through the eVA system under an enterprise fund.

The Statewide Building Management ISF was the only fund with a negative balance, which was -\$4.8 million at the end of FY18 (Table 3). Its fund balance improved from -\$7.3 million at the end

of FY17. The negative balance is attributable to a contractual financing arrangement with a private company for projects to improve the energy efficiency of state buildings (\$12.7 million remaining). Although the fund balance is negative, it is trending in the positive direction; the fund has increased in each of the past five 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 fund balance remained relatively stable for DGS's three other large funds. The Real Estate Services fund balance experienced an increase, from \$4.3 million to \$5.3 million (twenty-three percent), from FY17 to FY18. The fund balances for the Virginia Distribution Center fund and the fleet management fund remained relatively stable, but with a small downward trend from FY17 to FY18, decreasing by nine percent and four percent respectively.

The Statewide Engineering and Architectural Services ISF, referred to as the Bureau of Capital Outlay Management balance, decreased by 21 percent (\$0.8 million to \$0.6 million) from FY17 to FY18. This fund balance has decreased for two consecutive years. DGS indicated that the decrease in the fund balance is primarily due to vacant positions, which caused a decrease in hours billed and therefore lower-than-anticipated revenue. Capital outlay management staff were assigned to participate in a number of studies or other special assignments that could not be billed to specific agencies. DGS anticipates that billable hours will increase after vacant positions are filled, and the fund balance will stabilize and recover. However, DGS staff cautioned that attracting licensed engineers with the necessary experience is often difficult due to the agency's inability to match salaries of similar professionals in the private sector. Therefore, staff vacancies and low billable hours may continue to be an issue in future years.

The other four small DGS funds had varying levels of change in FY18, none of which have resulted in fund balances that are cause for concern. The State Surplus Property fund balance increased substantially from \$29,000 in FY17 to \$219,000 in FY18. According to DGS staff, this was due to additional revenue from auctions and online sales, and a reduction in operating expenses prompted by a low fund balance at the end of the FY17. The Analytical Testing Services fund balance increased by 67 percent (\$173,000) mainly due to the lower expenses in FY18 following a purchase of lab equipment the previous year. The Federal Surplus Property fund remained relatively stable, while the Graphic Communications fund had a relatively small \$23,000 increase in fund balance.

TABLE 3
Key ISF status indicators as of June 30, 2018

Fund	Fund balance (\$ millions)	Cash reserve (\$ millions)	Cash reserve equivalent (days of operating expenses)
Real Estate Services	\$5.3 million	\$3.4 million	19 days
Statewide Building Management	-4.8	6.3	59
Virginia Distribution Center	9.9	2.7	34
Fleet Management	23.0	2.1	42
Statewide Engineering & Architectural Services	0.6	0.5	39
Analytical Testing Services	0.4	0.7	56
State Surplus Property	0.2	0.5	153
Federal Surplus Property	1.2	1.0	839
Graphic Communications	0.1	0.07	163
Total all funds	\$36 million	\$17.1 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 \$17.1 million at the close of FY18, which is down \$200,000 from last year. On a fund-by-fund basis, cash reserves were sufficient to cover from 19 to 839 days of operating expenses (Table 3). Although some funds had relatively high cash reserves, a majority of funds had reserves that 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 19 days of expenses, but according to DGS staff, the low reserve is not a cause for concern because the fund has a steady cash flow and does not experience large, unexpected expenses.

Three of the small funds had large cash reserves relative to operating expenses, but the amounts are generally not a cause for concern. The Federal Surplus Property fund had a \$1 million cash reserve, sufficient to cover 839 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 State Surplus Property fund experienced an increase in cash reserves, from 39 days of operating expenses in FY17 to 153 days of operating expenses in FY18. This resulted from the increase in revenue and a decrease in expenses referenced previously. DGS staff should monitor the State Surplus Property cash reserve as it is currently well above the guideline of 60 days of operating expenses. The Graphic Communications fund had a \$65,103 cash reserve, which was sufficient to cover 163 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 Cardinal Financial ISF and the Performance Budgeting ISF recover costs related to the development, implementation, and operations of the accounting, financial reporting, and budgeting enterprise applications. The Payroll Services Bureau ISF recovers the costs of services for payroll, leave, and other employee benefits for over 50 state agencies. The new Cardinal Payroll ISF will begin to collect revenue when the new payroll system, which is under development, begins serving agencies. This is projected to occur by the final quarter of FY21.

DOA's total budgeted ISF appropriation for FY19 is \$29 million (2018 Special Session I, Appropriation Act, Chapter 2). The Cardinal Financial ISF and the Performance Budgeting ISF together account for 72.4 percent of the appropriation.

The Cardinal Financial ISF and the Performance Budgeting ISF had mixed results in terms of fund balance for FY18. The Cardinal Financial ISF had a positive fund balance of \$3.8 million to end FY18, an increase of \$0.8 million over the previous year. According to DOA staff, the increase occurred because actual collections via rates charged to customer agencies exceeded budgeted expenses. The Performance Budgeting ISF had a fund balance of -\$1 million in FY18, which is an improvement of \$165,000 from the previous fiscal year. DOA indicates that the negative balance reflects debt for development and implementation of the Performance Budgeting system, and the fund balance will become positive once the loan is paid off.

TABLE 4
DOA services provided under ISFs

Fund	Services	Appropriation (\$ millions)	
		FY19	FY20
Cardinal Financial System	Central financial reporting services	\$18	\$19
Cardinal Payroll System	Central payroll services	5	14
Performance Budgeting System	Central budget reporting services	3	3
Payroll Service Bureau	Agency payroll, leave, and other employee benefits processing services	3	3
Total all funds		\$29	\$39

SOURCE: 2018 Appropriation Act, Chapter 2.

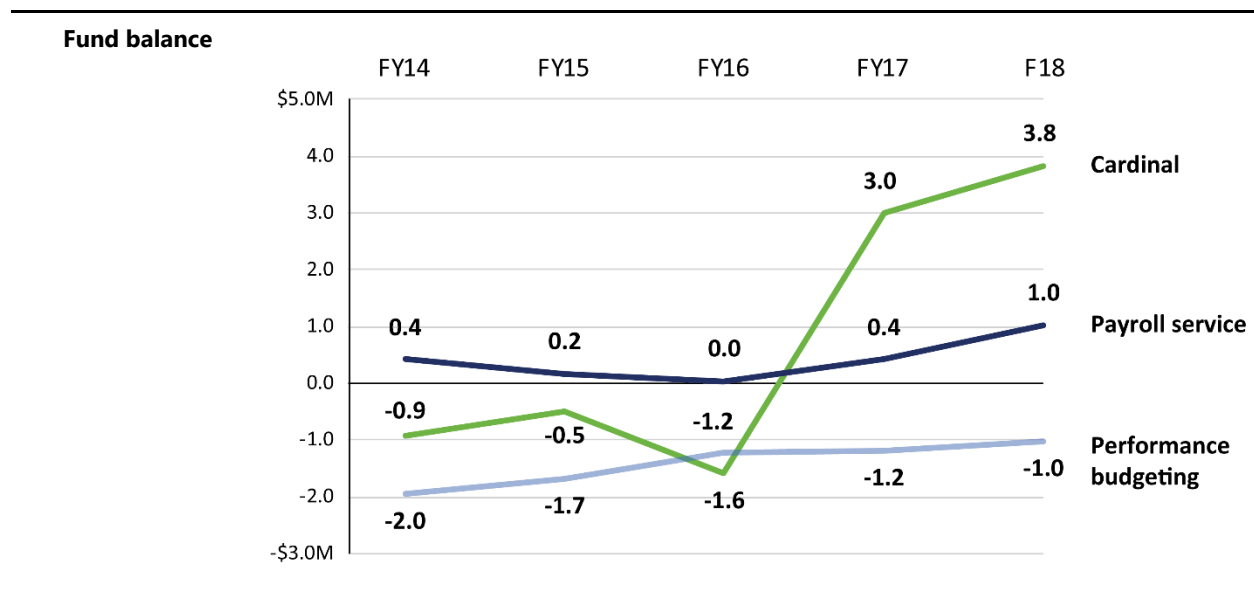
NOTE: Appropriation amounts may not sum due to rounding.

Cardinal had a \$2.9 million cash reserve and Performance Budgeting had a \$0.6 million reserve at the close of FY18. Cardinal's reserve was sufficient to cover 55 days of operating expenses, and Performance Budgeting's reserve was sufficient to cover 84 days. Each fund's reserve was close to or slightly above 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 over the past several years. The fund balance was \$1 million in FY18, an increase of about \$600,000 from the previous year. DOA staff explained that this increase in fund balance is due to lower-than-anticipated expenditures, mainly personnel costs, caused by vacancies in the Payroll Service Bureau.

The Payroll Service Bureau fund had a \$1 million cash reserve, sufficient to cover 175 days of operating expenses, which is substantially over the 60-day benchmark. However, DOA projects that the cash reserve will be lowered to approximately 60 days for FY19 and FY20. 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



Cash reserve as of June 30, 2018	Cardinal \$2.9 million Equivalent to 55 days of operating expenses
	Performance Budgeting \$0.6 million Equivalent to 84 days of operating expenses
	Payroll Service \$1 million Equivalent to 175 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.

The Cardinal Payroll fund will be used to operate the future Cardinal Human Capital Management system, which will include DOA's new Cardinal Payroll system. The fund was appropriated \$5 million for FY19, but since the system is not yet in operation, the fund has no established fund balance or cash reserve.²

Department of Human Resource Management

Two new internal service funds were 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 managed 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 FY19.

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 payments to Anthem. The Administration of Health Insurance Benefits fund was appropriated \$5.5 million in FY19.

TABLE 5
DHRM services provided under ISFs

Fund	Services	Appropriation (\$ millions)	
		FY19	FY20
Administration of Health Insurance Benefits	Administration of state employee health insurance plan	\$5.5	\$5.5
Personnel Management Information System	Central employee data management system	1.8	1.9
Total all funds		\$7.3	\$7.4

SOURCE: 2018 Appropriation Act, Chapter 2.
 NOTE: Appropriation amounts may not sum due to rounding.

The personnel management system (PMIS) completed FY18 with a fund balance of \$137,000. Because this is the first year that the fund has been in operation, the cash reserve is also \$137,000. This cash reserve was sufficient for 30 days of operating expenses and falls within the acceptable limit of 30 to 60 days of reserve.

² In April 2018, the Cardinal Payroll project was expanded to include a full Human Resource (HR) and Benefits module replacing the Commonwealth's Personnel Management Information System and Benefits Eligibility System. Analysis and planning to incorporate this change began in July 2018 and will conclude in April 2019. The estimated implementation date for the more comprehensive Cardinal Human Capital Management (HCM) system will be in FY 2021. The HCM system will encompass payroll, time and labor, absence management, HR, benefits, and employee self service.

The Administration of Health Benefits fund completed FY18 with a fund balance of \$0. This is intentional; the fund is reimbursed by the Administration of Health Insurance fund only for the expenses incurred during the year. Because a year-end transfer covers all fund costs, the Administration of Health Benefits fund does not need a cash reserve to cover unanticipated expenses. Therefore, the cash reserve is also \$0.