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Board of Supervisors
County of Loudoun, Virginia:

We have audited the fiscal year 2004 basic financial statements of the County of Loudoun, Virginia (the County), and have issued our report thereon, dated October 29, 2004. We have also audited the compliance of the County with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2004, and have issued our report thereon, dated October 29, 2004. We have not considered internal control since the date of our reports.

In planning and performing our audits, we considered the County's internal control over financial reporting. We determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of design and tests of operating effectiveness of these controls in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements, not to provide assurance on internal control over financial reporting.

During our audits, we noted certain matters involving internal control over financial reporting, and other operational matters that are not considered to be reportable conditions. Our observations and recommendations with respect to these matters are presented in appendix A to this letter for the County's consideration, and are intended to improve internal control over financial reporting or result in other operating efficiencies. Our audit procedures were designed primarily to enable us to form an opinion on the County's financial statements and therefore may not bring to light all weaknesses in policies or procedures that exist. The County's response to our observations and recommendations are also presented in Appendix A.

This letter is intended solely for the information and use of the board of supervisors, County management, the Auditor of Public Accounts, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

February 25, 2005

COUNTY OF LOUDOUN, VIRGINIA

Observations and Recommended Improvements to the County's
Internal Controls over Financial Reporting
Fiscal Year 2004 – Management Letter

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County of Loudoun, Virginia

Observations and Recommended Improvements to the County's
Internal Controls over Financial Reporting
Fiscal Year 2004 – Management Letter

Human Resources Management

A.1 Monitoring controls over the third party organizations that assist the Loudoun County Government (the County) and Loudoun County Public Schools (LCPS) with risk management should be improved

During our test work over self insurance, we noted that neither the County nor LCPS have a complete set of policies and procedures that provide for the proper monitoring of their third party service organizations that process claims for the workers compensation and healthcare self-insurance plans (e.g. Mid Atlantic Medical Services, Inc., Delta Dental Plan, etc.). Neither of the entities require the third party organizations to obtain a SAS 70 review of internal controls, and they do not conduct on-site reviews of the service organizations, or perform other procedures to ensure that the loss data provided is processed completely and accurately.

The AICPA has promulgated SAS No. 70, *Audits of Service Organizations*, to provide guidance for reviewing the controls in place at service organizations. A SAS 70 report provides an opinion on the assertions made by a service organization's management about their internal controls. These reports are intended for use by the organization's clients and their auditors in assessing control risk.

In order to assure itself that effective internal controls are in place at the third party service organizations, we recommend that the County and LCPS require the service organizations to provide a SAS 70 report on the design and operation of internal controls related to the processing of the outsourced transactions. The expression of such client request may help ensure that the third party service organizations subject themselves to SAS 70 audit procedures for providing assurance to their customers that their internal control systems are adequately designed and operate effectively. Despite the outcome of this request, it is incumbent upon the management of the County and LCPS to sufficiently assess control risk at the third party service organizations and establish an adequate internal control system within their respective entities for ensuring that the financial transactions reported by the service organizations are complete and reasonable in the circumstances, prior to being recorded in the general ledger.

Management's Response: The County and LCPS management concur. In Request for Proposals involving third party services both entities are currently requiring the vendor to either have a SAS 70 report or allow the County to take measures necessary to assure itself that effective internal controls are in place at the third party organization. The vendor for the new health insurance contract for the County and LCPS will be SAS 70 compliant.

Revenue Management

B.1 Controls over the revenue process in the Building and Development Department should be strengthened

During our process analysis and control test work over the revenue process at the Building and Development Department, we reviewed the management controls in place that address the risk of an employee fraudulently or erroneously changing or waiving permit fees in the Land Management Information System (LMIS system). We also reviewed controls over system access and segregation of duties between employees having system access to enter, waive, and/or change permit fees and employees reviewing the transmittal reports.

We noted that all the employees in the Building and Development Department have system access to waive permit fees and five of them have system access to change permit fees. Management review controls aim to ensure that permit fees are accurately entered into the LMIS system and changes are warranted. Per inquiry of department personnel, transmittal forms are being reviewed on a daily basis prior to remittance to the Treasurer. Only one employee reviews the transmittal reports. However, the reviewer also has system access to enter, waive, and change permit fees and he does not document his review of the transmittal report. Therefore, we concluded that the controls over permit fees are not adequately designed.

We recommend that the employee reviewing the transmittal reports should not have access to enter, change, or waive permit fees. Alternatively, the transmittal reports should undergo a second level of review to ensure that the processing of all permit fees, including the permits processed by the first reviewer, is accurate. Further, the review of the transmittal reports should be documented in such a way that the reviewer is identified and the report's accuracy is confirmed.

Management's Response: Management concurs. The County Government is reviewing internal controls in this area. Management agrees that this comment should be implemented through changes in procedures and security systems. The County Government has a budget enhancement position approved in the fiscal year 2006 adopted budget for auditing and submitting the revenue transmittals. That position will not have access to the money collecting process or be able to change fees. This should eliminate any internal control concerns.

Information Technology

C.1 Segregation of duties and access controls for the Department of Information Technology (DIT) staff should be further improved

During our review of the general information technology controls at the County, we noted that programmers/developers within DIT are not prevented from accessing data and software in the production environment, nor are they prevented from implementing changes directly into the production environment. As a result, there is a risk that unauthorized program changes can be made. Further, the ability to make program changes directly in the production environment de-emphasizes the importance of user testing, threatens data integrity, and can potentially affect system performance.

Loudoun County personnel stated that the County has an established policy that limits access to the production libraries and Job Control Language (JCL) to the minimum number of DIT staff, as authorized by the owner of each application. In addition, a procedure is in place to monitor on a periodic basis the modifications implemented into the production environment. DIT staff noted that, based upon current resources, DIT has assigned programmers with ownership for all the planned changes.

We believe these policies should be enhanced by the implementation of controls that enforce greater segregation of duties between the programmers/developers and operations personnel. Programmers/Developers should not be allowed to access, change, or move changes directly into the production environment without adequate supervision from operations personnel. The County should consider the following:

- Re-allocating resources in a manner that would segregate logistically and physically development staff and operation staff.
- Creating quality assurance controls that would require management authorization on all changes to production.

Management's Response: Management recognizes the importance of segregation of duties and improvements in this area have been incrementally implemented. Working within the limitations of available resources, management continues to review and develop procedures that improve security and segregation of duties. Physical access by development staff to the operations area is recorded by card key card control and video recordation of the area is being implemented. In addition, management is currently conducting a review of need for staff members with operations area access with the intent to reduce staff access.

Controls and procedures that minimize risks of unauthorized data and program changes have been improved and tightened during the past twelve months. Management will investigate options for further improvements as recommended.

C.2 *The Disaster Recovery Plan for Loudoun County should be documented and should properly address logistical risk*

During the fiscal year 2003 audit, we noted that the Loudoun County Disaster Recovery Plan was in development. As part of the procedures performed for determining whether the County has the ability to resume effective operations in the event of a disaster, we noted that the offsite storage facility was located only one fourth of a mile from the DIT data center, which, in our opinion, represents a significant logistical risk. Furthermore, there were no arrangements for an alternate processing site, although the County was considering the need for such an arrangement. We communicated to County management that this consideration takes an added importance due to the fact that the DIT data center facility is located within one mile of a municipal airport.

During the fiscal year 2004 audit, we noted that DIT has set forth several initiatives to resolve the issues noted during the prior year audit. One such initiative is the attempt to coordinate with other counties in the region to set up a regional contingency plan. However, this has proved to be a challenge and has not yet materialized. Nevertheless, DIT is in the process of developing and documenting a detailed disaster recovery plan, which will include a reciprocal agreement with the new LCPS main building.

As noted in the prior year, lack of a comprehensive disaster recovery/business continuity plan poses a risk on the County's ability to provide customary services to its constituents, and provide leadership in the event of a real disaster. It also prevents the County from utilizing a uniform approach in restoring data and achieving continuity of operations. Recent industry surveys show that the majority of entities without an up-to-date disaster recovery plan fail to recover operations within one year of that disaster.

We recommend that the County relocate its off-site storage facility to a secured location that is at least five miles away from the DIT data center. Preferably, the off-site storage facility should be a licensed and bonded third party vendor who specializes in the storage and security of back-up tapes.

DIT should also continue and expedite its efforts to develop and implement the County's Disaster Recovery Plan as recommended in our prior year letter to management.

Management's Response: DIT continues planning with the LCPS to establish a back-up data center facility at one of their facilities. Construction delays have prevented further activities. DIT intends to begin development of the back-up data center site in fiscal year 2006.

DIT is currently reviewing options for the relocation of off-site data storage. The County Administrator's Emergency Management Coordination Committee will provide oversight to an initiative to update the county's disaster recovery/business continuity plans.

Contingency Management

D.1 The Department of Social Services should have a valid contingency management plan

During our compliance test work in accordance with the *Specifications for Audits of Counties, Cities, and Towns* (Specifications) issued by the Auditor of Public Accounts of the Commonwealth of Virginia, we noted that the County's Department of Social Services does not have a formal contingency management plan that would ensure the resumption of critical activities in the event of a business disruption.

Section 3-17 of the Specifications stipulates that each local agency is responsible for developing, implementing, and testing a contingency management plan that ensures the resumption of critical activities in the event of a business disruption.

We recommend that a written contingency management plan be developed and implemented by the Loudoun County Department of Social Services. Additionally, the plan should be tested periodically to ensure its adequacy for providing continued services in the event of a business disruption or other emergency.

Management's Response: Management concurs. The Department of Social Services and the Department of Management and Financial Services will work together to ensure that this critical issue is brought before the County Administrator's Emergency Management Coordination Committee. This committee has oversight of the county's disaster recovery/business continuity plans.

Procurement

E.1 Segregation of duties principles should be observed between the function of approving vendors and creating purchase orders at the LCPS

During the fiscal year 2004 audit, we noted that there are six users at LCPS who can create vendors within the system and approve purchase orders. A similar observation was noted for the County during the fiscal year 2003 audit, however, that observation was corrected in fiscal year 2004.

We recommend that LCPS implement controls that enforce proper segregation of duties between users who can approve vendors and users who can create purchase orders. These two functions should be separated.

Enforcing proper segregation of duties between the approval of vendors and the creation of purchase orders decreases the risk of fraud.

Management's Response: The identified users have the ability to create vendors and post purchase orders approved through the procurement process to the financial management system. Compensating controls

Appendix A

include daily review of all posted transactions; the requirement for all account managers to respond positively, on a monthly basis, to confirm that all financial transactions recorded are valid expenditures; and approval of all purchase orders prior to posting through the procurement process. During fiscal year 2005 a project timeline has been developed to implement an e-procurement solution to further segregate the responsibilities of users and provide efficiencies to the procurement process.