OLA

OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Management Letter

Department of Revenue

Fiscal Year Ended June 30, 2002

JANUARY 30, 2003 **03-06**

Financial Audit Division

The Office of the Legislative Auditor (OLA) is a professional, nonpartisan office in the legislative branch of Minnesota State government. Its principal responsibility is to audit and evaluate the agencies and programs of state government (the State Auditor audits local governments).

OLA's Financial Audit Division annually audits the state's financial statements and, on a rotating schedule, audits agencies in the executive and judicial branches of state government, three metropolitan agencies, and several "semi-state" organizations. The division also investigates allegations that state resources have been used inappropriately.

The division has a staff of approximately fifty auditors, most of whom are CPAs. The division conducts audits in accordance with standards established by the American Institute of Certified Public Accountants and the Comptroller General of the United States.

Consistent with OLA's mission, the Financial Audit Division works to:

- Promote Accountability,
- Strengthen Legislative Oversight, and
- Support Good Financial Management.

Through its Program Evaluation Division, OLA conducts several evaluations each year and one best practices review.

OLA is under the direction of the Legislative Auditor, who is appointed for a six-year term by the Legislative Audit Commission (LAC). The LAC is a bipartisan commission of Representatives and Senators. It annually selects topics for the Program Evaluation Division, but is generally not involved in scheduling financial audits.

All findings, conclusions, and recommendations in reports issued by the Office of the Legislative Auditor are solely the responsibility of the office and may not reflect the views of the LAC, its individual members, or other members of the Minnesota Legislature.

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All OLA reports are available at our Web Site: http://www.auditor.leg.state.mn.us

If you have comments about our work, or you want to suggest an audit, investigation, evaluation, or best practices review, please contact us at 651-296-4708 or by e-mail at auditor@state.mn.us

Table of Contents

	Page
Report Summary	1
Management Letter	2
Status of Prior Audit Issues	5
Agency Response	6

Audit Participation

The following members of the Office of the Legislative Auditor prepared this report:

Claudia Gudvangen, CPA	Deputy Legislative Auditor
David Poliseno, CPA, CISA	Audit Manager
Tony Toscano	Auditor-in-Charge
Pat Ryan	Team Leader
George Deden, CPA	Senior Auditor
Ching-Huei Chen, CPA	Senior Auditor
Kathy Fisher	Senior Auditor
John Hakes, CPA	Senior Auditor
Marisa Isenberg	Senior Auditor

Exit Conference

We discussed the finding and recommendation with the following representatives of the Department of Revenue at the exit conference held on January 21, 2003:

Dan Salomone	Commissioner
Dennis Erno	Deputy Commissioner
Terese Mitchell	Legal Services
Fekade Cherinet	Internal Audit
Steve Krovitz	Internal Audit
Jerry Silkey	Property Tax
Jason Nord	Property Tax
Wayne Haerer, Jr.	Property Tax

Report Summary

Key Finding and Recommendations

The Department of Revenue incorrectly calculated the uniform tax rate for the 2002 state property tax because of erroneous information submitted by two counties. The abstracts of assessment values submitted by Hennepin and Ramsey counties erroneously included airport land. As a result, the statewide tax rate was understated, and the 87 counties, in total, assessed approximately $3,000,000 less than the law required. The department did not detect the error in time to adjust the tax rate or the amounts to be assessed by the counties for 2002. We recommended that the department seek legislative authority to adjust future assessments when calculation errors are discovered. We also recommended that the department expand its review of county assessment abstracts to verify compliance with applicable statutes.

Management letters address internal control weaknesses and noncompliance issues found during our annual audit of the state's financial statements and federally funded programs. The scope of work in individual agencies is limited. During the fiscal year 2002 audit, our work at the Department of Revenue focused on the material tax revenues, such as individual income, corporate income, sales, fuel, state property, mortgage and deed, health care, gross earnings, tobacco, and gift and estate. Our work also focused on the material expenditure programs such as local government aids, homestead and agricultural credit aid, and police and fire state aid.

Senator Ann H. Rest, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. Dan Salomone, Commissioner
Department of Revenue

We have performed certain audit procedures at the Department of Revenue as part of our audit of the financial statements of the State of Minnesota as of and for the year ended June 30, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. We emphasize that this has not been a comprehensive audit of the Department of Revenue.

Table 1 identifies the financial activities within the Department of Revenue that were material to the state's financial statements. We performed certain audit procedures on these programs as part of our objective to obtain reasonable assurance about whether the State of Minnesota's financial statements for the year ended June 30, 2002, were free of material misstatement.

Table 1
Department of Revenue
Programs Material to the State's Financial Statements
Fiscal Year 2002 (in thousands)

	Amount
Revenue Areas	
Individual Income Taxes	$5,419,220
Sales Tax	3,777,259
Fuel Tax	614,285
Corporate Income Taxes	428,614
State Property Tax	308,337
Mortgage and Deed Tax	229,781
Health Care Tax	186,832
Gross Earnings Tax	177,220
Tobacco Tax	177,202
Gift and Estate Tax	121,206
Expenditure Areas	
Homestead and Agricultural Credit Aid (HACA)	470,327
Local Government Aid (LGA)	411,926
Police and Fire State Aid	54,907

Source: *State of Minnesota Comprehensive Annual Financial Report* for fiscal year 2002.

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Department of Revenue

Conclusions

Our December 6, 2002, report included an unqualified opinion on the State of Minnesota's general purpose financial statements. In accordance with *Government Auditing Standards*, we have also issued our report, dated December 6, 2002, on our consideration of the State of Minnesota's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.

As a result of our audit work, we identified the following instance of noncompliance with program legal requirements:

1. The Department of Revenue incorrectly calculated the state general levy to be assessed by the counties for the 2002 state property tax because of erroneous information submitted by two counties.

During the 2001 first special session, the state Legislature enacted a state general levy against commercial-industrial property and seasonal recreational property. The Legislature passed this law as part of its overall plan to fund part of higher education at the state level rather than at the local level. The state general levy amount for taxes payable in 2002 was $592 million. The Department of Revenue calculated a uniform tax rate to be used by each county when levying the tax. The county treasurers collected the state property tax and remitted the amounts to the State Treasurer in June and December of 2002.

The Department of Revenue calculated the tax rate based on the amount of the levy and the net tax capacity base of the property to be assessed. Each county submitted assessment abstracts to the department to be used in calculating the 2002 tax rate. The department then applied the rate against each of the 87 counties' net tax capacity base to arrive at the amounts to be levied by each county. However, Hennepin and Ramsey counties erroneously included airport land in their abstracts of assessment values resulting in an understated tax rate. Based on data submitted by the counties, the department calculated a 2002 state general property tax rate of 57.933 percent. The correct rate should have been 58.230 percent. This resulted in the counties, in total, assessing approximately $3,000,000 less than the law required.

Although the counties are responsible for submitting accurate information, the department needs to review the assessment abstracts to ensure the integrity of the information. The department did not detect the error in time to adjust the rate or the amounts to be assessed by the counties for 2002. Further, the department does not have the legal authority to adjust future billings to correct errors it detects.

Recommendations

- *The Department of Revenue should seek legislative authority to adjust future assessments when calculation errors are identified.*
- *The Department of Revenue should expand its review of county assessment abstracts to verify compliance with applicable statutes.*

Department of Revenue

This report is intended for the information of the Legislative Audit Commission and the management of the Department of Revenue. This restriction is not intended to limit the distribution of this report, which was released as a public document on January 30, 2003.

/s/ James R. Nobles	*/s/ Claudia J. Gudvangen*
James R. Nobles Legislative Auditor	Claudia J. Gudvangen, CPA Deputy Legislative Auditor

End of Fieldwork: December 6, 2002

Report Signed On: January 27, 2003

Status of Prior Audit Issues
As of December 6, 2002

Legislative Audit Report 02-28, issued in May 2002, examined the Department of Revenue's activities and programs material to the *State of Minnesota's Comprehensive Annual Financial Report* for the year ended June 30, 2001. The purpose of the audit was to render an opinion on the State of Minnesota's financial statements for fiscal year 2001. We issued an unqualified opinion on the *State of Minnesota's Comprehensive Annual Financial Report* for the year ended June 30, 2001, dated December 7, 2001. As part of that audit, we audited certain administrative expenditures, including payroll, professional/technical services, rent, supplies, and equipment. We did not identify any findings or concerns as a result of our work at the Department of Revenue.

State of Minnesota Audit Follow-Up Process

The Department of Finance, on behalf of the Governor, maintains a quarterly process for following up on issues cited in financial audit reports issued by the Legislative Auditor. The process consists of an exchange of written correspondence that documents the status of audit findings. The follow-up process continues until Finance is satisfied that the issues have been resolved. It covers entities headed by gubernatorial appointees, including most state agencies, boards, commissions, and Minnesota state colleges and universities. It is not applied to audits of the University of Minnesota, any quasi-state organizations, such as metropolitan agencies or the State Agricultural Society, the state constitutional officers, or the judicial branch.

MINNESOTA · REVENUE

DATE: January 21, 2003

TO: James R. Nobles
Office of Legislative Auditor

FROM: Dennis Erno, Deputy Commissioner

RE: OLA Finding of Error in Calculation of State General Tax Levy

This is in reply to the Office of Legislative Auditor's (OLA) finding that an error occurred in the calculation of the state general tax levy assessed by the counties for the 2002 state property tax. This finding is accurate.

The state general tax rate for taxes payable in 2002 was calculated using property values reported by counties on the Abstract of Assessment. Hennepin and Ramsey counties erroneously included the values of the Minneapolis and St. Paul airports, which are exempt from the tax base used to calculate the state tax rate. This caused the base to be too large and resulted in the rate being set too low. The rate used was 57.933% but should have been 58.230% had the airport values been excluded. The result was a shortfall in state tax collections equaling approximately $3 million.

The department in calculating the rate used the correct procedures and data sources and it made the correct mathematical calculations. In addition, instructions issued by the department specifically directed counties not to include airport property in the tax base. The error results solely from inaccurate reports certified by Hennepin and Ramsey counties.

The department does take some responsibility for the error, as it should have reviewed the data more extensively to ensure its accuracy. In fact, the department has since adopted more extensive audit procedures to reduce the probability of errors in the future. In addition, the exceptionally late legislative activity in the 2001 session hampered the department's ability, as well as that of the counties, to perform lengthy and in depth audits of the data.

The department identified the error in June—tax statements went out in March for first half payments due in May. Trying to change the rate and adjust the second half payments would have been costly and impractical, if not impossible. Generally, errors found at this point are more effectively addressed by subsequent year adjustments.

Under current law, the department does not have the authority to make such corrections. Therefore, the department is exploring legislative changes that would permit it to make such adjustments and to answer a number of other questions linked the state general tax.

The department has already taken steps to address the issues cited in the report. Namely, greater scrutiny of the reports from counties and new audit steps have been put into effect to ensure that airports are properly excluded from the state tax base. In addition, the department has been active in developing legislative improvements to the state tax, including more explicit direction for dealing with errors.

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