



OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Financial Audit Division Report

Department of Revenue
July 1, 2003, through December 31, 2006



August 30, 2007

07-22

Financial Audit Division

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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.

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

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State of Minnesota • James Nobles, Legislative Auditor

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OFFICE OF THE LEGISLATIVE AUDITOR
State of Minnesota • James Nobles, Legislative Auditor

Representative Rick Hansen, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. Ward Einess, Commissioner
Department of Revenue

We audited Department of Revenue for the period July 1, 2003, through December 31, 2006. Our audit scope included expenditures for payroll, travel, rent, repair, and the department's process for seized property and abatements. Our objectives focused on a review of the department's internal controls over these financial activities and its compliance with applicable legal provisions. In addition, our office conducted a separate audit of security access and professional/technical services at several agencies, including the Department of Revenue. We report the results from that audit in Chapter 4, Professional/Technical Service Contracts.

The enclosed Report Summary highlights our overall audit conclusions. The specific audit objectives and conclusions for each area are contained in the individual chapters of this report.

We thank staff from the Department of Revenue for their cooperation during this audit.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Cecile M. Ferkul

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

End of Fieldwork: May 4, 2007

Report Signed On: August 27, 2007

Department of Revenue

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Audit Participation

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

Cecile Ferkul, CPA, CISA	Deputy Legislative Auditor
David Polisenno, CPA, CISA, CFE	Audit Manager
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Marla Conroy, CPA, CISA	Audit Coordinator
Zach Yzermans	Auditor
Jamie Majerus	Auditor
Melanie Greufe	Auditor

Exit Conference

We discussed the results of the audit with the following representatives of the Department of Revenue at an exit conference on August 20, 2007:

Dan Salomone	Deputy Commissioner
Carole Wald	Assistant Commissioner, Income Taxes
Steve Kraatz	Chief Information Officer
Bruce Showel	Chief Information Security Officer
Dan Ostdiek	Financial Management Director
Mary Ann Novotny	Financial Management
Fekade Cherinet	Internal Auditor
Stanley Radosevich	Internal Audit

Report Summary

Conclusions:

Except for payroll expenditures, the Department of Revenue's internal controls provided reasonable assurance that it accurately recorded financial activity in the state's accounting system. The department generally complied with the finance-related legal requirements we tested, but the department should improve its compliance with requirements related to employee travel, protection of not public data, and contracting for professional/technical services.

This report contains eight findings relating to internal control and legal compliance.

Key Findings:

- The department did not accurately pay employees for time worked. ([Finding 1, page 6](#))
- The department did not adequately safeguard its fixed assets. ([Finding 3, page 10](#))
- The department did not adequately protect not public data. ([Finding 4, page 12](#))
- The department gave excessive computer security access to four employees. ([Finding 6, page 17](#))
- The department did not complete performance reports for some professional/technical contracts, as required by statute. ([Finding 7, page 17](#))
- The department did not retain key documentation to support its legal compliance for abatement activity. ([Finding 8, page 22](#))

Audit Scope:

Period Audited:

- Security Access Controls as of January 2007.
- July 1, 2005, through June 30, 2006, for Professional/Technical Expenditures.
- July 1, 2003, through December 31, 2006, for all other activity.

Activities Audited:

- Payroll and Travel Expenditures
 - Selected Administrative Expenditures
 - Professional/Technical Services
 - Seized Property Activity
 - Abatement Activity
-

Agency Background:

The Department of Revenue administers Minnesota's revenue system, which manages 28 state taxes (including individual income, sales, corporate franchise, petroleum, environmental, gambling, cigarette/tobacco, alcohol, insurance, and health care provider taxes) and property taxes collected by local government. The department collected about \$15.5 billion in state taxes for fiscal year 2006 and oversaw the uniform application of the property tax laws.

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Chapter 1. Introduction

The Minnesota Department of Revenue manages the state's tax systems. Governor Pawlenty appointed Ward Einess on December 7, 2006, to succeed Dan Salomone as commissioner.

During fiscal years 2004 through 2006, the department annually collected approximately \$15.5 billion from various tax sources, such as individual income, sales, corporate franchise, petroleum, property, charitable gambling, cigarette/tobacco, alcohol, insurance and health care provider taxes. These revenues help support the state's overall budget. The department also paid about \$1.4 billion annually in state aid to counties, cities, towns, and special taxing districts. The department funds its operations primarily from General Fund appropriations, totaling about \$100 million annually.

This audit focused on selected administrative expenditures, including payroll, travel, and rent, repair, and maintenance. We also audited the department's process for seized property and abatements. In addition, our office conducted a separate audit of professional/technical activities at several agencies, including the Department of Revenue. We report the results of that audit that relate to the Department of Revenue in Chapter 4.

Table 1-1 shows the department's financial activity by budget fiscal year 2004 – 2006.

	<u>2004</u>	<u>2005</u>	<u>2006</u>
Sources of Funds:			
Appropriations	\$95,315,562	\$100,079,204	\$104,002,192
Cancellations	0	(2,175)	(813)
Budget Reduction	(1,458,000)	0	0
Receipts ¹	2,852,066	2,969,658	2,724,774
Transfers In	375,000	533,000	0
Balance Forward In from Prior Fiscal Year	<u>1,443,616</u>	<u>5,278,975</u>	<u>4,506,483</u>
Total Sources	<u>\$98,528,244</u>	<u>\$108,858,662</u>	<u>\$111,232,636</u>
Uses of Funds:			
Payroll	\$71,031,439	\$73,862,640	\$78,869,016
Rent, Repair, and Maintenance	7,019,878	7,068,448	5,082,126
Computer/Communication Services	3,867,709	6,653,411	4,176,524
Professional/Technical Services	5,062,447	4,312,011	3,398,531
Equipment/Supplies	2,665,561	5,619,716	2,657,312
Other	3,602,235	6,835,953	6,493,186
Balance Forward Out to Next Fiscal Year	<u>5,278,975</u>	<u>4,506,483</u>	<u>10,555,941</u>
Total Uses	<u>\$98,528,244</u>	<u>\$108,858,662</u>	<u>\$111,232,636</u>

¹The majority of the receipts are related to seized property, as discussed in Chapter 5.

Source: Minnesota Accounting and Procurement System by budget fiscal year as of December 31, 2006.

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The Office of the Legislative Auditor selected the Department of Revenue for audit based on an annual assessment of state agencies and programs. We used various criteria to determine the entities to audit, including the size and type of each agency's financial operations, length of time since the last audit, changes in organizational structure and key personnel, and available audit resources. Although we annually audit the department's tax operations as part of our audit of the state's financial statements, it had been five years since our last audit of the department's operations.

Audit Approach

We conducted our audit in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we obtain an understanding of the department's internal controls relevant to the audit objectives. We used the guidance contained in *Internal Control-Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission,¹ as our criteria to evaluate agency controls. The standards also require that we plan the audit to provide reasonable assurance that the department complied with financial-related legal provisions that are significant to the audit. In determining the department's compliance with legal provisions, we considered requirements of laws, regulations, contracts, and grant agreements.

To meet the audit objectives, we gained an understanding of the department's financial policies and procedures. We considered the risk of errors in the accounting records and noncompliance with relevant legal provisions. We analyzed accounting data to identify unusual trends or significant changes in financial operations. We examined documents supporting the agency's internal controls and compliance with laws, regulations, contracts, and grant provisions.

¹ The Treadway Commission and its Committee of Sponsoring Organizations (COSO) were established in the mid-1980s by the major national associations of accountants. One of their primary tasks was to identify the components of internal control that organizations should have in place to prevent inappropriate financial activity.

Chapter 2. Employee Payroll and Travel Expenditures

Chapter Conclusions

The Department of Revenue’s internal controls did not provide reasonable assurance that it accurately recorded payroll expenditures in the state’s accounting records. As a result, the department did not accurately pay employees for the time worked, as discussed in Finding 1. Also, the department did not comply with certain legal requirements related to travel benefits, as discussed in Finding 2.

Audit Objectives

Our audit of payroll and travel expenditures focused on the following questions:

- Did the department properly record payroll and travel expenditures in the state’s accounting records?
- Did the department have an adequate process to authorize and approve all payroll and travel related costs?
- Did the department comply with material finance-related legal requirements?

Background

Payroll is the department’s largest administrative expenditure. As of May 2007, the department had about 1,200 employees. Most department employees² record their time electronically through the state’s self service time entry system. The self service time entry system automates employee timesheets and allows supervisors to approve timesheets on-line. Most divisions have an administrative assistant who reviews the timesheets before a supervisor does. The administrative assistant compares hours worked, vacation, sick, and holiday pay with “request for leave” slips. The employee’s supervisor then reviews and electronically approves the timesheet. At the end of the bi-weekly pay period, the department’s Financial Management Division releases the electronic payroll data into the state’s central personnel and payroll system. The Department of Employee Relations requires agencies to review specific payroll reports to verify the accuracy of pay codes charged, hours entered, and supervisory approval.

² Employees of the Information Systems Division record their time manually.

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Table 2-1 shows total payroll expenditures by budget fiscal year for 2004 - 2006.

<u>Earnings Type</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Full Time	\$65,888,104	\$68,841,034	\$73,774,954
Part Time, Seasonal, Labor Service	3,773,030	3,767,738	3,828,706
Overtime Pay	93,343	61,319	127,167
Premium Pay	25,759	25,506	27,681
Other Benefits	<u>1,251,203</u>	<u>1,167,043</u>	<u>1,110,508</u>
Total	<u>\$71,031,439</u>	<u>\$73,862,640</u>	<u>\$78,869,016</u>

Source: Minnesota Accounting and Procurement System as of December 31, 2006.

The department also uses the state's payroll system to pay employee expenses. An employee completes an expense reimbursement form and attaches the proper receipts. The employee then signs the form and has it approved by the supervisor. The supervisor routes the form to the payroll unit, where staff review and enter the expense into the payroll system for payment. The department does not allow payroll employees to process their own reimbursements.

Table 2-2 shows total travel expenditures by budget fiscal year for 2004 - 2006.

<u>Travel Type</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Travel In-state	\$524,110	\$ 698,694	\$ 833,577
Travel Out-state	<u>421,733</u>	<u>491,258</u>	<u>526,938</u>
Total	<u>\$945,843</u>	<u>\$1,189,952</u>	<u>\$1,360,515</u>

Source: Minnesota Accounting and Procurement System as of December 31, 2006.

Current Findings and Recommendations

1. The department did not accurately pay employees for the time worked.

The department did not have controls in place to ensure that it only paid employees for the actual time worked. For example:

- The department erroneously paid 29 employees for holidays they were not entitled to receive. These employees coded their time to holiday pay instead of some other pay code, such as vacation. One employee charged 58.5 hours to holiday pay in one pay period instead of vacation. As a result, the payroll system did not reduce the employee's vacation leave balance by 58.5 hours. The employees' supervisors did not detect the

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errors and authorized the timesheets for payment. Had the supervisors carefully reviewed the timesheets, they could have detected these errors.

- The department paid an employee for six weeks after the employee left state service. The department's process failed; staff did not record the resignation on the state's personnel/payroll system. Although the employee's supervisor completed a personnel transaction request, the payroll unit did not process it until approximately seven weeks after the effective date. The department paid the employee without a timesheet or supervisory approval based on a default work schedule. The department discovered its mistake, and the former employee repaid the amount received in error approximately one month after the department issued the third paycheck.
- The department did not verify the accuracy of its payroll transactions. The department did not review the self service time entry audit report and did not review the payroll register report to verify that staff accurately entered the payroll transactions into the state's payroll system. The state requires³ agencies to complete a comprehensive review or, if not possible, review a representative sample each pay period, and obtain an explanation of exceptions to the self service time entry process. In addition, agencies are required to review the payroll register each pay period to verify that time and amounts paid were at the correct rate, and any necessary adjustments were processed accurately.

Without proper supervisory reviews, errors could occur and not be detected. Further, without reviewing output reports such as the self service time entry audit report and payroll register, the department cannot determine if the payroll was input correctly or if unauthorized transactions were processed.

Recommendations

- *The department should ensure that supervisors adequately review employee time records for accuracy before authorizing the time worked.*
- *The department should correct the employees' leave records it erroneously coded holiday pay.*
- *The department should improve its process for monitoring changes to employee status.*
- *The department should review the self service time entry audit report and payroll register each pay period to verify the accuracy of transactions recorded on the state's personnel and payroll system.*

2. The department did not ensure that employees complied with statutes that prohibit travel-related benefits.

Three employees did not comply with legal provisions that prohibit employees from deriving certain benefits from state employment.

³ Department of Finance, PAY0017 "Employee Self Service Time Entry" and PAY0028 "Agency Verification of Payroll and Human Services Transactions."

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- *Minnesota Statutes*⁴ require that whenever public funds are used to pay for airline travel by a public employee, any credits or other benefits issued by any airline must accrue to the benefit of the public body providing the funding. The statute also requires that employees report to the “public body” paying for the travel within 90 days of receipt of the benefit. Two out of eight employees tested violated this statute. One employee was unaware of the miles being accrued and unaware of the Minnesota statute. The other employee was aware of the airline travel credit prohibition, but was unaware of the requirement to report the benefits accrued within 90 days of receipt.
- In addition, the department allowed two employees, including an employee receiving airline travel credits as discussed above, to accrue hotel rewards while conducting state business. *Minnesota Statutes*⁵ prohibit state employees from receiving any compensation, reward, or future benefit from any source except from the state for any activity related to the duties of the employee while on state business.

The department did not monitor certain aspects of employee expense reimbursements. The department established written travel policies for its employees that prohibited them from accepting benefits issued by lodging facilities, airlines, or other enterprises. The department included part of this language on its employee expense reimbursement forms so that employees certified compliance with the travel requirements each time they submitted a claim. However, staff often submitted travel expense forms that did not include this language.

Recommendations

- *The department should ensure that employees are aware of all legal provisions related to state employment.*
- *The department should monitor employees’ business expense reimbursements to ensure compliance with statutes that prohibit travel-related benefits.*

⁴ *Minnesota Statutes* 2006, 15.435.

⁵ *Minnesota Statutes* 2006, 43A.38, subd. 2.

Chapter 3. Selected Administrative Expenditures

Chapter Conclusions

Generally, the Department of Revenue’s internal controls provided reasonable assurance that it accurately recorded administrative expenditures in the accounting records. However, the department did not safeguard its personal computers and other fixed assets, as discussed in Finding 3, or adequately protect its not public data, as discussed in Finding 4. In addition, the department incorrectly coded certain transactions, as discussed in Finding 5. Except for the lack of controls over not public data, as discussed in Finding 4, for the items tested, the department complied with material finance-related legal provisions.

Audit Objectives

Our audit of administrative expenditures focused on the following questions:

- Did the department properly record the transactions in the accounting records at the correct amount?
- For computer related equipment, did the department have a reasonable process to ensure that it was complying with not public data requirements?
- For items tested, did the department comply, in all material respects, with the significant finance-related legal provisions concerning administrative expenditures?

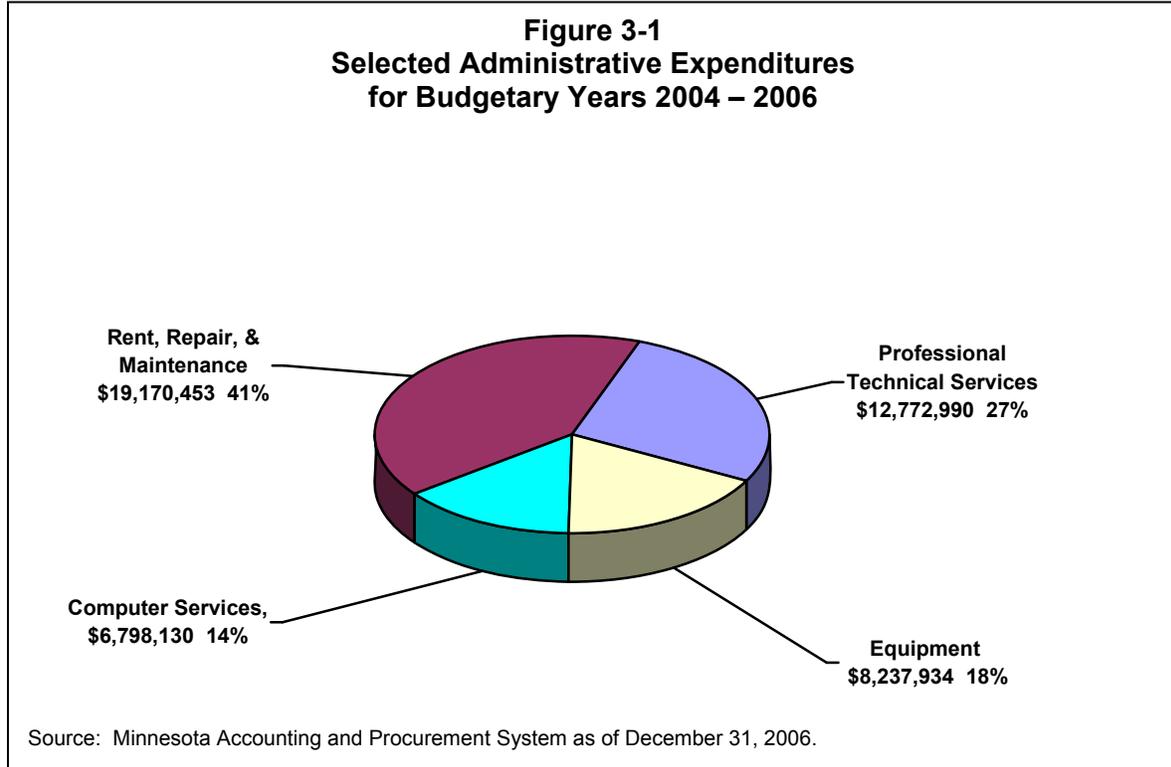
Background

The Department of Revenue incurs various administrative expenditures in conducting its business. The department is subject to state policies and procedures for purchasing goods and services.⁶ The department uses the state’s accounting and procurement system for most of its purchases, including the use of state contracts and local purchasing authority. The department uses the state’s Fixed Assets Inventory System to monitor and control its equipment and fixed assets that exceed \$500 or that the department considers to be sensitive.

⁶ *Authority for Local Purchase (ALP) Manual -- Policy and Procedures for Goods and Non-Professional Services or Professional/Technical (P/T) Services Contract Manual*, both developed by the Department of Administration.

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Figure 3-1 shows selected administrative expenditures for budget fiscal years 2004 - 2006.



Current Findings and Recommendations

3. The department did not adequately safeguard its fixed assets.

The department had the following weaknesses in its internal controls over fixed assets:

- The department did not always conduct an annual physical inventory of its fixed assets. The department did not do an inventory in 2006. The Department of Administration's *Property Management User Guide*⁷ requires agencies to conduct a physical inventory of capital assets at a minimum biennially. The Department of Revenue developed a more stringent policy requiring an annual inventory because of the sensitive nature of some of its assets, such as computers, flash-drives, printers, monitors, server equipment, telephones, and selected cellular phones. Computers, flash-drives, and other electronic devices are high-risk, sensitive items because they are portable and may contain not public data.
- The department did not comply with all of the requirements for the state's *Stolen, Lost, Damaged or Recovered Property Report*. Although the department promptly completed the report for stolen assets, including computers and flash-drives, the department waited

⁷ Department of Administration Policy ADMIN 06-03 *Property Management User Guide*

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three or more years to report an item as lost or missing. During fiscal years 2003 through 2005 inventories, the department identified as missing 75 assets, including 21 computers and 3 flash drives, items that could contain not-public data. The department inquired about the missing assets, but if it did not ultimately locate the item, it noted the item as missing and looked for it at the next three annual inventories. If, after these four attempts to locate the item, staff could not find the item, then the department wrote it off and reported it missing. In April 2006, the department reported 26 assets, totaling about \$31,000 as missing on a *Stolen, Lost, Damaged or Recovered Property Report*; about half of these assets were laptop and desktop computers valued at about \$26,000. The department had not located these 26 missing items since inventories conducted in April 2000 through December 2003.

- The department did not submit the *Stolen, Lost, Damaged or Recovered Property Report* to the proper authorities as required by the statute.⁴ The department must submit a copy of the report to the agency's human resources director, the Department of Administration's Surplus Services and, if the item was stolen, to the Legislative Auditor's Office. In addition, the department did not properly notify the Office of the Legislative Auditor for lost or stolen assets, as required by *Minnesota Statutes* 2006, 609.456, subd. 2. Instead, the department filed the report with its tax operation division. The department sent a copy of the report to the department's computer disclosure and security division, if the asset potentially contained not public data.
- The department did not have an up to date list of its fixed assets. We had difficulty locating 7 of the 19 sample items selected during our fixed asset testing because the department's divisions frequently moved assets without updating the inventory list with the assets' current locations.

Without complete and accurate records, the department is unable to adequately manage, track, and report its fixed assets. The department is aware that it did not complete a physical inventory in 2006, and its fixed asset location lists are not accurate. The department is in the process of reassigning the inventory responsibility to another division to improve both situations.

Recommendations

- *The department should maintain an up to date record of its fixed assets and conduct periodic physical inventories to ensure that the fixed asset list is accurate.*
- *The department needs to complete and submit Stolen, Lost, Damaged or Recovered Property Reports in a timely and appropriate manner for all assets.*

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4. The department did not adequately protect not public data.

The department did not adequately protect not public data on its laptop computers, as required by *Minnesota Statutes*.⁸ The department used laptops for storing data used in audits or investigations of taxpayer activity. The department permitted employees to store not public data on their laptops while they actively worked on an audit or investigation. The department required employees to transfer all not public data to a secure computer within 30 days after completing their work. The department's controls over not public data had the following vulnerabilities:

- The department did not comply with the state's encryption and security requirements for laptop computers. The department started the process to encrypt all department issued laptop computers in the fall of 2006. As of May 2007, the department had encrypted about 80 percent of the 500 laptops that had connected to its network since it started the encryption process. However, the department did not know the encryption status of nearly 300 other computers on its inventory list that had not logged onto the network. Further, the department did not provide employees with security cables or any other comparable physical security device, as required by state policy,⁹ to reduce the risk of laptop theft. The department felt the cables were inconvenient to use.

The state's Office of Enterprise Technology (OET) requires that if not public data is temporarily stored on a portable computing device, such as a laptop, it must be encrypted using approved encryption techniques in compliance with the not public data statute. Encryption converts readable text or data into a format that cannot be read by unauthorized persons. This ensures that the department safeguards not public data and reduces the risk that it could inappropriately disclose data held on laptop computers.

- The department did not retain lists it created of potential or actual security breaches and the appropriate action it took to notify taxpayers whose data may have been compromised. When an employee reports a computer or flash drive as missing or stolen, the department requires the employee to list all of the data contained on the equipment. The department then decides if the situation warrants notifying the taxpayers. Without supporting documentation, the department could not demonstrate that it performed all of the required procedures, including notifying those affected. In addition, the department did not identify the information contained on the items that it noted as missing during its inventories.

⁸ *Minnesota Statutes* 2006, 13.05, subd. 5(a)(2).

⁹ State of Minnesota CIO Policy 2006-04 4 *Enterprise Security Policy on Portable Computing Devices*.

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Recommendations

- *The department needs to encrypt and physically secure all of its portable computing devices.*
- *The department needs to retain supporting documentation for the work it performs on portable computing devices when not public data is compromised.*

5. The department did not accurately record certain transactions in the state's accounting system.

The department erroneously coded the following transactions in the state's accounting system:

- The department did not assign the correct record date to certain administrative expenditures. The department miscoded 53 of 54 transactions tested for maintenance, equipment, and computer service purchases. The accounts payable division usually used the invoice date as the record date to the transactions. Record dates identify when the state incurred an obligation and should represent the date that it received the goods or services. This is especially important for determining year-end liabilities. Failure to use the proper record date could result in an understatement of liabilities in the state's financial statements.
- The department incorrectly coded motor vehicle purchases to equipment. During our audit period, the department purchased eight vehicles costing about \$200,000. However, the department only coded about \$1,700 to motor vehicle purchases on the state's accounting system. The department incorrectly recorded the motor vehicle purchases as equipment, which is the default object code for these types of purchases.

The department is responsible for the proper recording of its transactions in the state's accounting system. Record dates should reflect the date the goods were received; object codes should accurately reflect the nature of the expenditure.

Recommendation

- *The department should ensure that it records all financial activity in the state's accounting system with the correct record dates and object codes.*

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Chapter 4. Professional/Technical Service Contracts

Chapter Conclusions

For professional/technical services contracts, the department's internal controls provided reasonable assurance that it paid for contractual services actually received; that amounts paid were reasonable and within the terms of the contract; and that it accurately recorded the payments in the accounting system. However, the department did not adequately segregate incompatible duties in the accounting system and provided excessive access for some employees, as discussed in Finding 6. For the items tested, the department complied with finance-related legal requirements, except that for completed contracts exceeding \$50,000, it did not prepare performance evaluation reports or submit the required reports to the Department of Administration, as required by statute, as discussed in Finding 7.

Audit Objectives, Scope, and Methodology

The primary objectives of our audit of professional/technical service contract expenditures were to answer the following questions:

- Did the department's internal controls provide reasonable assurance that the department actually received contractual services it paid for, amounts paid were reasonable and within the terms of the contract, and that it accurately recorded payments in the accounting system?
- For the items reviewed, did the department comply with significant finance-related legal provisions, including bidding requirements?

In fiscal year 2006, the Department of Revenue's spending for professional/technical service contracts totaled \$3.4 million. Table 4-1 shows the department's total professional/technical service expenditures by type of service for fiscal year 2006.

Table 4-1
Professional/Technical Contract Expenditures by Type of Service
Budgetary Fiscal Year 2006

<u>Professional/Technical Services</u>	
Information Technology Development	\$2,858,260
General Management and Fiscal Services	429,598
Other Services	<u>110,673</u>
Total Expenditures	<u>\$3,398,531</u>

Source: Minnesota Accounting and Procurement System as of December 31, 2006.

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Based on the department's professional/technical services expenditures during fiscal year 2006, we selected the following four contracts for testing:

Table 4-2
Contracts Selected for Audit¹

Contractor	<u>Contract Amount</u>	<u>2006 Expenditures²</u>
CSC Consulting Group, Inc.	\$ 559,985	\$233,623
On Demand Group, Inc.	289,320	131,490
TSG Consulting, Inc.	734,400	108,360
OSI Collections, Inc.	<u>475,000</u>	<u>104,175</u>
Total	<u>\$2,058,705</u>	<u>\$577,648</u>

¹We selected these contracts based on their dollar amount, the type of service contracted for, and the method the department used to contract with the vendor.

²Expenditures recorded in the state's accounting system from July 1, 2005, through June 30, 2006.

Source: Minnesota Accounting and Procurement System.

Background

Concurrently with this audit of the Department of Revenue, we audited the state's processes for professional/technical service contracts. The scope of that audit included a review of professional/technical service contracts administered by several state agencies, including the Department of Revenue, for the period from July 1, 2005, through June 30, 2006. In addition to the professional/technical service contracts' findings and recommendations addressed in this report, we will issue a separate report at a later date that will identify the most significant problems we found across the agencies we reviewed.

Contracts for professional/technical services are for services that are intellectual in nature and include consultation, analysis, evaluation, prediction, planning, programming, or recommendation and result in the production of a report or completion of a task. Generally, agency personnel are unable to perform the needed services, and the agency must contract with outside vendors.

Minnesota Statutes give the commissioner of Administration broad authority to oversee and approve the professional/technical services contracts entered into by state agencies. Consequently, for contracts over \$5,000, Revenue submits certain information to Administration before contracts are executed, including a certification that the work is necessary to advance the mission of the department, that state personnel are unable to provide the services, an explanation of how the proposed contract will be publicized, and how the department plans to manage the contract. Also, at the completion of contracts exceeding \$50,000, state agencies must submit performance evaluation reports to the Department of Administration.

The commissioner of Administration can delegate contracting duties to specific employees in other agencies; however, Revenue employees do not have delegated authority. Therefore, employees of the Department of Administration must review and authorize all of Revenue's contracts.

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Current Findings and Recommendations

6. The department did not adequately segregate incompatible duties in the accounting system and allowed certain employees excessive access to the accounting system, thereby increasing the risk of errors or misstatements.

Five of twenty-five department employees had incompatible security profiles that allowed them to create and process contracts and purchase orders, encumber funds, and pay invoices. Also, four department employees had excessive access to security profiles in the accounting system in relation to their job duties. Generally, the security profiles that grant access to authorize purchases of goods and services and payment of invoices should be segregated between employees so that there are internal checks and balances that would prevent or timely detect errors or irregularities from being processed in the accounting system. Also, the access granted should be limited to only the level necessary for employees to perform their job duties.

The state's accounting system has distinct security profiles that provide the ability to separate incompatible duties and help prevent erroneous or fraudulent transactions. If it is not feasible to segregate duties, for example, because of limited staff, the Department of Finance's policy¹⁰ requires that state agencies develop a written plan identifying compensating controls. The department had not developed the required plan or implemented any compensating controls. Typically, such controls should require an independent person to review transactions entered by the individual with access to perform incompatible duties and obtain sufficient evidence to ensure transactions were authorized and appropriate.

Recommendations

- *The department should eliminate employee access to incompatible duties in the accounting system, or develop mitigating controls that provide independent scrutiny and review of the activity processed by those employees.*
- *The department should periodically review employees' security profiles in the accounting system to ensure that access is limited to only the profiles necessary for their assigned job responsibilities.*

7. The department did not prepare performance evaluation reports for completed professional/technical service contracts, as required by statute.

The department did not prepare the required performance evaluation report for the completed contract with On Demand Group, Inc. Department employees were not aware that statutes¹¹ require them to submit to the Department of Administration a performance evaluation report within 30 days of completion of contracts that exceeded \$50,000. The required one-page report summarizes the purpose of the contract, the amount spent on the contract, and a written

¹⁰ Department of Finance Policy 1101-07.

¹¹ *Minnesota Statutes* 2006, 16C.08, subd. 4(c).

Department of Revenue

evaluation of the contractor's performance. The evaluation report is intended to provide other state agencies with useful information when evaluating future proposals submitted by the contractor.

Recommendation

- *For contracts over \$50,000, the department should complete the performance evaluation report and submit a copy to the Department of Administration.*

Chapter 5. Seized Property Activity

Chapter Conclusions

The Department of Revenue's internal controls provided reasonable assurance that it properly deposited seized property receipts in the state treasury and recorded the transactions in the state's accounting system. The department established adequate collection procedures. For the items tested, the department established policies and procedures in accordance with applicable Minnesota Statutes.

Audit Objectives

Our audit of seized property activity focused on the following questions:

- Did the department's internal controls provide reasonable assurance that it properly deposited seized property receipts in the state treasury and recorded the transactions in the state's accounting system and in accordance with management's authorization?
- Did the department have adequate collection procedures?
- Did the department properly establish policies and procedures in accordance with *Minnesota Statutes* 2006, 270C.16, 270C.15, and 270C.7101?

Background

The department collects tax and nontax debts on behalf of the department and other state and county agencies. Collecting debt includes locating and contacting debtors, invoicing and monitoring payment plans, locating and evaluating assets, issuing liens and levies and, finally, seizing assets. The department mainly seizes land, with or without houses on the property; but the department will seize automobiles, boats, and recreational vehicles.

When seizing assets, the department must ensure that the estimated amount collected from the sale will cover the amount of the debt and the estimated cost of the seizure and the subsequent disposal of the seized property. In fiscal years 2004 through 2006, the department paid counties, mortgage institutions, lien-holders, sheriffs, attorneys, and maintenance companies approximately \$1.6 million per fiscal year from recovered funds.

There were no findings in this area.

Department of Revenue

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Chapter 6. Abatement Activity

Chapter Conclusions

For the items tested, the Department of Revenue complied with significant finance-related legal requirements related to tax abatements. However, the department did not comply with its record retention policy, as discussed in Finding 8.

Audit Objective

Our audit of abatement activity focused on the following question:

- Did the department comply with material legal compliance requirements?

Background

*Minnesota Statutes*¹² allow the commissioner to abate, reduce, or refund any penalties or interest resulting from a late payment of tax or the late filing of a return. The Department of Revenue further defined¹³ requirements a taxpayer must meet to be eligible for abatement of penalties and interest:

- 1) The abatement request must be received within 60 days of the first written notification received by the taxpayer of the of the penalty assessment.
- 2) The reason for the late payment or late filing that resulted in the assessment of the penalty or interest assessed was due to reasonable cause, defined as circumstances beyond the taxpayer's control, such as death or serious illness.

To promote quicker responses to taxpayer requests, the department allowed staff in its various tax divisions to approve or deny abatement decisions about penalties and interest those divisions had assessed.

¹² *Minnesota Statutes* 2006 270C.34.

¹³ Department of Revenue Notice #97-01.

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Table 6-1 shows total abatement activity by tax type for budget fiscal years 2004 – 2006.

Tax Division	<u>2004</u>	<u>2005</u>	<u>2006</u>
Individual Income Tax	\$ 354,990	\$ 163,577	211,457
Sales	1,272,415	556,090	588,586
Withholding	228,236	190,272	147,024
Corporate	236,769	1,052,512	289,692
Other	<u>359,780</u>	<u>336,041</u>	<u>353,676</u>
Total	<u>\$2,452,190</u>	<u>\$2,298,492</u>	<u>\$1,590,436</u>

Source: Minnesota Department of Revenue's tax payer accounting subsystem as of April 2007.

Current Finding and Recommendation

8. The department did not comply with its record retention policy related to taxpayer abatements.

The department's collection division did not retain supporting documentation for abatement decisions for the required amount of time. The department could not support documentation for 5 out of 44 abatement cases tested, or \$111,000 out of the \$1,319,739 in transactions tested. The division's case management system automatically purged taxpayer cases, including abatement records, after 18 months if there is no further activity in the case. However, the department's record retention schedule requires that it retain such documentation for at least three and one-half years. Without the supporting documentation, the department cannot support the propriety of its abatement decisions.

Recommendation

- *The department should retain supporting documentation for its abatement cases in compliance with its record retention policy.*

**Status of Prior Audit Issues
As of May 4, 2007**

March 22, 2007, Legislative Audit Report 07-04 reported on our consideration of the State of Minnesota's internal control over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts, and grants related to our audit of the state's financial statements. The report included several issues related to the Department of Revenue's process for estimating accrual amounts.

May 2, 2002, Legislative Audit Report 02-28 covered selected Department of Revenue activities for the two years ended June 30, 2001. The audit scope included payroll, rent, professional/technical services, supplies, equipment, and travel. There were no findings.

March 2, 2006, Legislative Audit - Program Evaluation Report, Tax Compliance examined the department's tax compliance programs. The report identified significant compliance problems with the state's two largest taxes – the individual income tax and the sales and use tax. The report concluded that while the department is using appropriate taxpayer assistance and enforcement strategies, it could make better use of its resources to detect errors and collect taxes due.

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.

Department of Revenue

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MINNESOTA • REVENUE

August 27, 2007

James R. Nobles
Legislative Auditor
Office of the Legislative Auditor
658 Cedar Street
140 Centennial Office Building
St. Paul, Minnesota 55155-1603

Dear Mr. Nobles:

This letter contains our responses to the Office of Legislative Auditor's findings and recommendations contained in a draft report we received on August 14, 2007. The report covered the period from July 1, 2003 to December 31, 2006.

The audit report focuses on selected administrative expenditures, including payroll, travel, rent, repair and maintenance, processes for seized property, abatements, and professional and technical contract administration.

We were pleased to note that the report found that "the Department of Revenue's internal controls provided reasonable assurance that it accurately recorded financial activity in the state's accounting system," and that "the department generally complied with the finance-related legal requirements we tested."

However, the report calls to our attention a number of areas that need improvement. We take these findings very seriously, and have already begun the process of addressing them.

Our responses to each of the specific findings requiring corrective action follow:

Finding (1): *The department did not accurately pay employees for time worked (Page 6).*

Response:

When an employee needs to report hours other than regular hours worked, the first step is to add a new line to the self-entry payroll system. The new line automatically appears with the same earnings code as the previous line (regular hours). When the

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Minnesota Relay 711 (TTY)
An equal opportunity employer

employee enters hours on the new line, he or she often forgets to insert the appropriate earnings code before closing the software, thus resulting in the recording of hours with an incorrect earnings code.

The payroll unit of the Department of Revenue has sent educational notices on this item reminding supervisors to review the timesheets more diligently. (Resolution: Dan Ostdiek by Jan. 1, 2008)

We will encourage the Department of Finance to modify the Self-Time Entry system software so that the likelihood of this kind of error could be minimized.

In the meantime, our payroll unit will develop new processes and reports to verify payroll transactions. It will also develop processes to review employee status and make sure employees are not paid after their employment has ended with the Department.

Finding (2): *The department did not ensure that employees complied with statutes that prohibit travel-related benefits (page 7).*

Response:

The Department's travel policy prohibits employees from accepting travel-related benefits such as frequent flyer miles. To prevent this, we are adding reminder language to our employee business expense forms which employees must sign as a condition of reimbursement. Further, we will send a business notice to all employees educating them on this area of policy. We will continue to send out periodic notices in the future, referencing our travel policy. (Resolution: Dan Ostdiek by Jan. 1, 2008)

Finding (3): *The department did not adequately safeguard its fixed assets (page 10) .*

Response:

We agree that the department needs to do a better job of safeguarding its assets. Recently this responsibility was transferred to our Financial Management Division and they are reviewing our fixed asset policies and procedures with the goal of making recommendations to our Senior Management Team in early October. The department will have its next physical inventory in October which is within the two years that is suggested in the Department of Administration's Property Management Guide.

The department will develop procedures to ensure the timely reporting of stolen, lost, damaged or recovered property to the appropriate authorities. (Resolution: Dan Ostdiek by Jan. 1, 2008)

Finding (4): *The department did not adequately protect not public data (page 12).*

Response:

We agree that the department needs to encrypt and physically secure all of its portable computing devices. This is our highest priority. Accordingly, we are proceeding with efforts to ensure that 100% of its portable computing devices are encrypted. We will also deploy additional measures to ensure the physical security of those devices from theft or loss.

We also agree that the Department needs to document the procedures it performs on portable computing devices when not public data is compromised. Procedures and documentation standards will be established and implemented. (Resolution: Bruce Showel by July 1, 2008)

Finding (5): *The department did not accurately record certain transactions in the state's accounting system (page 13).*

Response:

The accounts payable section is changing the way it records the record date of transactions to ensure that the correct date is used.

The audit finding that we miscoded the purchase of cars in the accounting system might best be addressed with a small change in the state's accounting system. Currently when one selects the commodity (250 01) for an automobile purchase the menu of object codes from which a purchasing agent can select does not include the object code that the legislative auditor would like us to use (2K50).

For now, the department will do an expenditure correction on any car purchases in the future. The department plans to discuss this issue further with the Department of Administration for a permanent solution. (Resolution: Dan Ostdiek by Jan. 1, 2008)

Finding (6): *The department did not adequately segregate incompatible duties in the accounting system and allowed certain employees excessive access to the accounting system, thereby increasing the risk of errors or misstatements (page 17).*

Response:

Since the legislative audit, we have been in the process of correcting security profiles and putting into place a quarterly review of our security profiles. (Resolution: Dan Ostdiek by Jan. 1, 2008)

Finding (7): *The department did not prepare performance evaluation reports for completed professional/technical service contracts, as required by statute (page 17).*

Response:

The department was unaware of this requirement and will complete a performance evaluation report and submit a copy to the Department of Administration in the future. (Resolution: Dan Ostdiek by Jan. 1, 2008)

Finding (8): *The department did not comply with its record retention policy related to taxpayer abatements (page 22).*

Response:

Our aged collection system (CACS+) automatically purges cases from the system once they reach a zero balance and it has been 18 months. To change this would require engaging an outside vendor and expending scarce funds on a system that will soon be replaced with a modern, integrated tax system recently funded by the 2007 Legislature.

Anticipating the installation of the new system over the next few years, we are deliberately avoiding costly investments in the old systems it will replace.

In the meantime, we are in the process of reassessing and potentially revising our internal retention policy for abatements to align it with the 18 month period used by CACS+. (Resolution: Terri Steenblock by Jan. 1, 2008)

Sincerely,



Ward Einess
Commissioner