



OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Management Letter

Department of Revenue
Fiscal Year Ended June 30, 2003



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 forty 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.

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

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Audit Participation

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

Claudia Gudvangen, CPA	Deputy Legislative Auditor
David Polisen, CPA, CISA	Audit Manager
Tony Toscano	Auditor-in-Charge
Carl Otto, CPA, CISA	Team Leader
George Deden, CPA	Senior Auditor
Ching-Huei Chen, CPA	Senior Auditor
Kathy Fisher, CPA	Senior Auditor
John Hakes, CPA	Senior Auditor
Connie Stein	Senior Auditor
Sally Tefera	Auditor

Exit Conference

We discussed the findings and recommendations with the following representatives of the Department of Revenue at the exit conference held on March 8, 2004:

Dan Salomone	Commissioner
Dennis Erno	Deputy Commissioner
Stephen Stedman	Chief Information Officer
Steve Krovitz	Auditor, Internal Audit
Dan Ost diek	Financial Management Director
Jean Jochim	Accounting Director

Report Summary

Key Findings and Recommendations:

The Department of Revenue did not properly monitor its sales tax clearing account and resolve the excess cash balance in the account. As of June 30, 2003, the account contained approximately \$5 million that should have been transferred to another fund. The department uses the clearing account to process the sales tax receipts it collects on behalf of the cities and counties. However, the department did not monitor fund level activity to ensure that the account did not accumulate an unauthorized balance. We recommended that the department monitor the account on a periodic basis and transfer any excess cash to the appropriate fund.

The Department of Revenue has not reconciled its Individual Tax Return System (ITRS) to the Refunds Processing Module (RPM) since January 2003. The department began using the ITRS in 2002 to process individual and property tax returns. Although the department monthly reconciled RPM to MAPS, it has not reconciled ITRS to RPM since January 2003. The department needs to complete the monthly reconciliations between ITRS and RPM.

Our office also conducted an information technology audit of selected components of the systems that support individual income tax processing. The Legislative Audit Report 04-16 contained nine findings related to computer security weaknesses.

<p>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 2003 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, and tobacco. Our work also focused on the material expenditure programs, such as property tax refunds, local government aids, homestead and agricultural credit aid, county criminal justice aid, family preservation aid, and police and fire state aid.</p>



OFFICE OF THE LEGISLATIVE AUDITOR

State of Minnesota • James Nobles, Legislative Auditor

Representative Tim Wilkin, 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, 2003. 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.

We also conducted an information technology audit of selected components of the systems that support individual income tax processing (Legislative Audit Report 04-16). The primary purpose of this audit was to determine if the Department of Revenue had controls to protect the integrity and confidentiality of individual income tax data. However, the audit also examined selected controls over the depositing and recording of individual income tax revenues. The scope included a review of internal controls as of November 2003.

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, 2003, were free of material misstatement.

Department of Revenue

Table 1
Department of Revenue
Programs Material to the State's Financial Statements
Fiscal Year 2003 (in thousands)

	Amount
Revenue Areas	
Individual Income Taxes	\$5,497,328
Sales Tax	3,924,424
Fuel Tax	656,326
Corporate Income Taxes	636,214
State Property Tax	594,094
Mortgage and Deed Tax	309,387
Health Care Tax	208,376
Gross Earnings Tax	232,276
Tobacco Tax	179,910
Expenditure Areas	
Local Government Aid (LGA)	\$564,991
Homestead and Agricultural Credit Aid (HACA)	475,886
Police and Fire State Aid	61,756
County Criminal Justice Aid	31,516
Family Preservation Aid	23,406

Source: *State of Minnesota Comprehensive Annual Financial Report* for fiscal year 2003.

Conclusions

Our December 5, 2003, report included an unqualified opinion on the State of Minnesota's basic financial statements. In accordance with *Government Auditing Standards*, we have also issued our report, dated December 5, 2003, 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 internal control weaknesses:

1. The Department of Revenue did not properly monitor balances in its sales tax clearing account.

The Department of Revenue has allowed excess cash balances to accumulate in its sales tax clearing account. At June 30, 2003, the account contained approximately \$5 million that was owed to another fund. The department collects sales tax from businesses that make retail sales in Minnesota. The department also administers and collects any local sales taxes applied to retail sales made and taxable services provided within certain cities or counties. Each city or county sets its own sales tax rate. The businesses collect both the statewide and local sales taxes and remit them monthly to the state along with a sales tax return identifying the local sales tax portion.

Department of Revenue

The department deposits the sales tax collections in the state treasury. The local sales tax is recorded in an agency fund account and then remitted to the appropriate city or county. Because the agency fund serves only as a clearing account to process the collection and remittance of local sales taxes, its balance should always reconcile to zero. However, as of June 30, 2003, the account reported a cash balance of \$6,228, 638 and a fund balance of \$4,675,499.

The clearing account problems date back to the mid-1990s when the state implemented a new accounting system. For a short period after the state's conversion to MAPS in 1995, the department processed the local sales tax receipts through the Miscellaneous Agency Fund (Fund 610). To help the department better administer local sales taxes, the Department of Finance created the Taxes Clearing Agency Fund (Fund 612) for the department to process the tax receipts. Between April and September 1996, the department attempted to transfer the \$5,214,092 between the funds. However, the department encountered errors during this process, which resulted in excess cash in Fund 612. The department disbursed the correct amount to the cities and counties, but did not properly record the transaction in Fund 612. As a result, the Taxes Clearing Agency Fund contains cash that does not belong to that fund. Each month the department ensures that the cities and counties receive the correct amount due them, but does not monitor the fund level activity in the clearing account.

Recommendations

- *The Department of Revenue should determine the amount of excess cash in the fund and transfer it to the appropriate fund.*
- *The Department of Revenue should periodically review the Taxes Clearing Agency Fund to ensure that it does not contain excess cash.*

2. The Department of Revenue did not reconcile its Individual Tax Return System to its Refunds Processing Module on a regular basis.

The Department of Revenue has not reconciled its Individual Tax Return System (ITRS) to its Refunds Processing Module (RPM) since January 2003. The department began using the ITRS in 2002 to process individual and property tax returns. The department scans the individual and property tax returns into ITRS. For returns that identify a refund, the department uploads that information from ITRS to RPM. The department then uses RPM to generate the refund and update the state's accounting system (MAPS). Although the department monthly reconciled RPM to MAPS, it has not reconciled ITRS to RPM since January 2003.

In fiscal year 2003, the department paid out \$1.1 billion for individual income tax refunds and \$200 million for property tax refunds. Without reconciling ITRS to RPM, the department cannot ensure that the department properly paid and recorded the correct individual income tax and property tax refunds. The department needs to complete the monthly reconciliations between ITRS and RPM in a timely manner.

Department of Revenue

Recommendation

- *The Department of Revenue should ensure that it completes the reconciliation of its ITRS system to its RPM system each month.*

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 March 18, 2004.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Claudia J. Gudvangen

Claudia J. Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: December 5, 2003

Report Signed On: March 15, 2004

Status of Prior Audit Issues As of December 5, 2003

Legislative Audit Report 03-06, issued in January 2003, examined the Department of Revenue's activities and programs material to the State of Minnesota's basic financial statements for the year ended June 30, 2002. The purpose of the audit was to render an opinion on the State of Minnesota's financial statements for fiscal year 2002. The audit report cited one audit finding relating to property tax collections. The department implemented the recommendations related to the finding.

Legislative Audit Report 04-16, issued in March 2004, reviewed selected components of the systems that support individual income tax processing. The report contained nine findings related to computer security weaknesses. This report was issued simultaneously with this statewide audit management letter and, therefore, no follow-up has been conducted on those nine issues.

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

March 12, 2004

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 is in reply to the Office of Legislative Auditor's (OLA) recommendations in connection with its annual audit of the Department of Revenue's financial operations. This audit was undertaken as part of the OLA's effort to verify the accuracy of the state's financial statements.

Here is the department's response to the two recommendations that resulted from this audit.

1. The Department of Revenue did not properly monitor balances in its sales tax clearing account.

Background: The department routinely balances the local option sales tax clearing account at the transaction and appropriation level but not at the fund level. The erroneous balance in fund 612 resulted from a flaw in the Minnesota Accounting and Procurement System (MAPS).

In 1996, the department initiated a change to move local sales tax activity from fund 610 to a newly created fund 612. In doing so, MAPS did not require that an indicator be set that would properly update the cash balance. Accordingly, at the end of each fiscal year it appears that the same dollar amount remains in fund 610. An appropriation transfer was entered to move the amount from fund 610 to fund 612. This created an erroneous fund balance in fund 612 and a shortage in fund 610. In 2003, a system change was implemented in MAPS that requires the cash indicator be set. Implementation of this change eliminates the possibility of this error reoccurring in the future.

Recommendations:

The Department of Revenue should determine the amount of excess cash in the fund and transfer it to the appropriate fund.

The Department of Revenue should periodically review the Taxes Clearing Agency Fund to ensure that it does not contain excess cash.

Response: Jean Jochim of the department's Financial Management Division met with representatives from the Department of Finance to resolve this issue. The agencies have determined that the error is between fund 612 and fund 610. A correction will be made by April 1, transferring funds from fund 612 to fund 610. Jean Jochim will take responsibility for ensuring that this correction is made.

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In addition, the Department of Revenue will review the Taxes Clearing Agency Fund before the close of each fiscal year. Jean Jochim will take responsibility for adding this step to the department's year end procedures.

2. The Department of Revenue did not reconcile its Individual Tax Return System to its Refunds Processing Module on a regular basis.

Background: The department does not perform monthly reconciliations between the Income Tax Return System (ITRS) and the Refund Processing Module (RPM) in a timely manner. The department agrees that this reconciliation should be completed in a timely manner. However, daily controls between ITRS and RPM are performed timely. This minimizes the risk of any refunds not being properly paid and recorded.

Recommendation: *The Department of Revenue should ensure that it completes the reconciliation of its ITRS system to its RPM system each month.*

Response: The department's Financial Management Division will complete the reconciliation of the ITRS to RPM system each month. The reconciliation for fiscal year 2003 is complete and fiscal year 2004 reconciliations are in progress. We will be timely with current reconciliations by April 30, 2004. Jean Jochim will take responsibility for ensuring that this goal is met.

On behalf of the department, I would like to thank you and your staff for the helpful recommendations and assistance provided to our agency.

Sincerely,

/s/ Dennis Erno

Dennis Erno
Deputy Commissioner