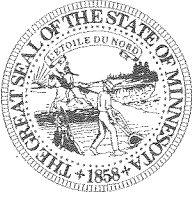


**DEPARTMENT OF REVENUE
MANAGEMENT LETTER
FISCAL YEAR ENDED JUNE 30, 1986**

FEBRUARY 1987

Financial Audit Division
Office of the Legislative Auditor
State of Minnesota



STATE OF MINNESOTA

OFFICE OF THE LEGISLATIVE AUDITOR

VETERANS SERVICE BUILDING, ST. PAUL, MN 55155 • 612/296-4708

JAMES R. NOBLES, LEGISLATIVE AUDITOR

Mr. Thomas Triplett, Commissioner
Department of Revenue
Centennial Office Building
658 Cedar Street
St. Paul, Minnesota 55155

Dear Commissioner Triplett:

We have reviewed certain accounting procedures and controls for your department as part of our financial audit of the State of Minnesota's fiscal year 1986 financial statements. The scope of our work has been limited to:

- those aspects of your department which have material impact on any of the state's various funds and account groups;
- certain general EDP controls for the department, including organization and operation controls, system development and documentation controls, access controls, data and procedural controls (hardware and system software controls were not included in this review); and
- status of prior audit recommendations.

We emphasize that this has not been a complete financial and compliance audit of all programs within your department.

The main text of this management letter contains both our recommendations developed during this audit and prior recommendations which have not yet been implemented. Prior audit recommendations repeated in this text are denoted under the caption "PRIOR RECOMMENDATIONS NOT IMPLEMENTED."

Attached to your management letter is a summary of the progress of all audit recommendations developed during our financial audit of Minnesota's fiscal year 1985 financial statements. The recommendations included in this letter are presented to assist you in improving accounting procedures and controls. Progress on implementing these recommendations will be reviewed during our audit next year.

Department of Revenue controls authorizing access to its computer systems need to be improved.

Access to the departments computer systems is controlled through the department's security officers who create and assign logonIDs to authorized users. The authorization process begins with an authorization form completed and signed by the user's supervisor. The logonIDs which allow the user access to the system, are protected by the use of a secret pass

word established by the individual for which the logonID was created. Each logonID should be used immediately by the assigned user when it is created in order to establish password protection. We noted that approximately ten percent of such logonIDs have never been used and are not protected. If a password has never been assigned, the logonID can be used by anyone. Many of these unprotected logonIDs have clearance to major Revenue systems. We noted one that had the ability to enter payment transactions into the statewide accounting system. IMB security personnel recommend that logonIDs be suspended if they are not used within a 90 day period. There is an IMB report available to the department's security officers which indicates when a logonID was last used or if it was used at all. We believe that Revenue should suspend any logonIDs which remain unused after a reasonable time period.

For specific programs and files, the department's security officers write appropriate access rules which may allow the user to read, write or change the programs and files within the systems being accessed. The access rules are written utilizing the Access Control Facility (ACF2), a computer software package maintained and administered by the Department of Administration's Information Management Bureau (IMB).

The issue of responsibility for authorizing systems access, which involves knowing what information is contained in the files, who should have access to it, and for what purpose, has not been addressed. Currently, the security officers in most cases have been authorizing systems access. However, while the security officers should be in a position to question whether access is valid, they may or may not be in the best position to grant authorization. To strengthen controls over computer access to Revenue programs and files, the department should designate personnel responsible for authorizing access to each system. These individuals should have a working knowledge of what information is contained in the files, who should have access to it and for what purpose so that access authorization is limited accordingly. A listing of such individuals should also be provided to the security officers so that access authorizations could be challenged when errors or other security violations occur.

Problems can also occur if Revenue security officers are not notified of employees who have either left state service or changed departments. If such an employee's logonID is not cancelled or suspended, the employee would continue to have access to the system. Currently, there is no positive reporting system which allows the security officers to cancel the logonIDs of employees at the time they terminate employment. Perhaps the supervisors of those employees could be given the responsibility for notifying the department's security officers when they become aware of an employee's pending job change.

Programmers and operators sometimes need a logonID change because they have forgotten their passwords. Under these circumstances a logonID change is currently provided based on telephone conversations between the security officer, the user, and the user's supervisor. However, these verbal authorizations from the supervisor are not followed up with written

supporting documentation. The absence of documentation could allow a possible unauthorized access to the computer system. A daily log of verbal authorizations could be a helpful tool to ensure that subsequent written documentation is obtained.

RECOMMENDATIONS:

1. *Revenue should assign the responsibility of authorizing access to its computer systems to knowledgeable individuals. This assignment should be documented to the extent that all individuals are identified and known to the security officers.*
2. *Revenue should suspend any logonIDs which remain unused after a reasonable length of time and require new logonIDs to be used when created.*
3. *Revenue should develop procedures for identifying employees with active logonIDs that have left or changed employment so that those logonIDs can be suspended or deleted.*
4. *The Revenue Security officers should obtain written documentation to support all assigned logonIDs, including those granted through verbal authorizations.*

Computer tapes for major systems are not backed up offsite.

Files for major Revenue systems are kept mainly on tape and handled by the Information Management Bureau. Typically, a backup or duplicate tape is made for use in case of a hardware or program error. In some cases, these backup tapes are kept offsite. For example, the Individual Income Tax System, whose system designator is TAXM, stores backup tapes offsite. However, there are numerous systems that do not have an offsite backup. These systems include Corporation Income Tax (TAXL), Declarations Match (TAXD), and Cash (TAXB) as well as others.

For the systems that do not have offsite backup, both the original tape and the backup is stored in the Centennial Building. If a fire or construction failure occurred at this location, both the original tape and the backup could be lost. Recovery of these systems would thus be extremely difficult if not impossible.

Offsite backup can be handled by IMB by requesting that tapes be stored in a vault located separately from the Centennial Building. This storage would ensure that systems could be recovered if the original tape file was lost or destroyed.

RECOMMENDATION:

5. *The department should obtain adequate offsite backup for all of its major systems.*

Accounting controls over the Enterprise Zone Program (EZP) need to be strengthened.

Enterprise zones are geographically defined areas in which state and local tax credits and refunds are available to encourage business retention and development. In 1983, the Minnesota Legislature set aside \$32 million in foregone tax revenues over an eight year period for a state funded Enterprise Zone Program (EZP). In 1984, the Legislature set aside an additional \$3.6 million for the program. The 1985 Legislature added another \$800,000 bringing the total amount of taxes to be forgone over the life of the program to \$36.4 million.

The program operates under the joint cooperation of the Department of Energy and Economic Development (DEED) and the Department of Revenue. DEED is responsible for designating and selecting the enterprise zones and allocating tax credits to qualifying businesses within the zones. The Department of Revenue is responsible for the tax classifications of industrial employment property within the designated enterprise zones and to implement the tax reductions.

Minn. Stat. Sections 273.1312 through 273.1314 provided for the establishment of three types of zones: border city, competitive city, and federally designated zones. During the two years ended December 31, 1985, \$5,300,194 in state funded credits were allocated between border and competitive city enterprise zones.

The Enterprise Zone Program has the following weaknesses:

- No method has been developed to account for or reconcile tax credits actually taken against credits granted or allocated.
- Documentation to support credits actually taken is not adequately maintained (i.e. misfiled, lost or not submitted).
- Tax credits taken are not recorded on the financial statements as grant payments or properly accrued to the correct fiscal year.

During fiscal year 1986, we determined that approximately \$7,722,527 in enterprise zone tax credits were taken. Of this amount, \$5,461,500 was actually refunded and \$2,261,027 in credits were used to reduce corporate income taxes. We did not determine the credits which were applied to Sales and Property taxes.

Unless some record is maintained to account for actual credits taken, the department is not in a position to provide reliable information about the status of the program or if it has paid out or allowed more credits than were allocated under statute. Additionally, no individual within the department has been given the responsibility to either fiscally monitor the program or monitor its statutory requirements. There appears to be a general assumption that DEED is performing these functions and vice versa.

We attempted to trace two large credits taken on two tax returns to the required supporting schedules. This supporting documentation should consist of an Enterprise Zone Credit Schedule EPC which is to be attached to

the tax return. Although it was finally located, the Schedule EPC for the \$5,461,500 refund was not readily available. Revenue could not produce the enterprise zone file for the other company or the Schedule EPC to support a \$50,000 credit taken.

Credits or refunds taken should be reported on the state's financial statements as grant payments. Presently credits that reduce taxes are not reported. In addition, we noted that a \$5,461,500 credit mentioned above was not accrued to the appropriate fiscal year. The credit which was on a 1985 tax return was received on June 12, 1986. Revenue issued a warrant for payment of the credit on October 26, 1986 from a fiscal year 1987 account. This credit and similar credits should be accrued to the fiscal year in which the liability is incurred.

RECOMMENDATIONS:

6. *The department should establish clear lines of responsibility concerning its joint ownership of the Enterprise Zone Program.*
7. *The department should accumulate and account for EZP credits taken by tax type, and to reconcile credits allowed and taken within the parameters specified under statute.*
8. *The department should develop an adequate document retrieval system so that the documentation to support enterprise zone credits taken are properly accounted for. No credits should be allowed without the appropriate documentation.*
9. *Credits taken should be reported as grant payments on the state's financial statements. All credits payable should be accrued at June 30 according to the department's accrual procedures.*

Not all claims for refunds of taxes received prior to the fiscal year end are being properly accrued.

The "Governmental Accounting And Financial Reporting" standards require that fund expenditures be recognized on the modified accrual basis. Expenditures should be recognized in the accounting period in which the fund liability is incurred.

The Department of Revenue accrual procedures require that all refunds on original returns received on or before June 30 will be accrued. Procedure "G" requires that:

- (1) The income tax division must keep strict control over their inventory of claims and orders. They should process them in receive date order. All closing fiscal year items should be completed before new fiscal year items are processed.
- (2) The income tax division is not to batch claims and refund orders that have a review date of June 30 or earlier with those that have a review date of July 1 or later. Every batch must be labeled by writing the appropriate fiscal year after the batch recap number.

Revenue did accrue approximately \$8 million of income tax refunds that were made during the period of July 1 through July 15, 1986. Our testing revealed that the July 15 cutoff was an arbitrary one and that approximately an additional \$3 million of refunds received prior to July 1 were processed after July 15. This is a material understatement of accounts payable at June 30.

RECOMMENDATION:

10. *The department should accrue all claims for refunds received prior to the fiscal year-end cutoff.*

The Petroleum Division does not maintain an adequate audit trail to identify taxpayers and amounts included in the year end accrual of accounts receivable.

The "Governmental Accounting And Financial Reporting" standards require that fund revenues be recognized on the modified accrual basis. Revenues should be recognized in the accounting period in which they become available and measurable.

A proper accrual should provide a built-in audit trail necessary for reasonable assurance of the integrity of the accrual. The Petroleum Division does not identify and list accounts receivable. It should at minimum document the accrual date, taxpayer license number, and amount of each receivable.

RECOMMENDATION:

11. *The Petroleum Division should develop proper documentation and audit trails to support the accrual of the fiscal year-end receivables.*

The Petroleum Division's refund system lacks sufficient accounting controls to assure that duplicate refund warrants are not issued.

The American Institute Of Certified Public Accountant's Statements On Auditing Standards Number 320.26 provides in part that, "Accounting control comprises the plan of organization and the procedures and records that are concerned with the safeguarding of assets. . . ." Consequently, accounting controls are designed to provide reasonable assurance that items like duplicate payments do not occur.

Our review of the Petroleum Division's refunds made during fiscal year 1986 disclosed that five payments totaling \$13,461 were duplicates. The largest duplicate payment was for \$9,133. The Petroleum Division is relying on taxpayer honesty for returning duplicate refunds.

Procedures which could reduce the possibility of producing duplicate warrants include:

- Verifying the taxpayer file prior to making the refund.

- Obtaining additional payment information from the EDP refund system, such as cumulative payments by taxpayer within fiscal year.

RECOMMENDATION:

12. *The Petroleum Division should develop accounting procedures to ensure that duplicate payments are not made.*

PRIOR RECOMMENDATION NOT IMPLEMENTED: Inadequate controls exist over the accounting and processing of unclaimed refund warrants.

Unclaimed refund warrants consist of tax refunds returned to the department's refund unit by the U.S. Postal Service as undeliverable. The warrants are currently filed alphabetically in an unlocked file cabinet for easy accessibility to all refund unit staff. The refund unit does not maintain a record of the warrants on file until they are at least six months old. After six months, the revenue accounting section enters the yet unclaimed refunds on the unclaimed warrant system. Unclaimed warrants one year old or older are redeposited into SWA and taken off the system.

As of November 30, 1986, 6,365 warrants totaling \$1,126,600 were on the unclaimed warrant system. This compares to 1,210 warrants totaling \$233,022 on the system one year ago. We did not try to assess the dollar amount for warrants less than six months old. This environment surrounding the unclaimed refund warrants makes it highly susceptible to improprieties. While no improprieties were noted, the risk of loss due to either theft or conversion is high.

Duties within the refund unit should be realigned so that a separation of responsibilities exists to ensure that no one individual is involved in the entire process. For example, the person given responsibility for the physical custody of the warrants should not be given the authority to prepare the delete cards or maintain the accounting records for the warrants. Those individuals given the authority to prepare delete cards or maintain the accounting records should not have access to the warrants.

Control over returned warrants should be established as soon after they enter the refund unit as possible. All such unclaimed refund warrants should be recorded on the unclaimed warrant system as soon as possible. No warrant should be remailed until it has been recorded in the unclaimed warrant system.

The department had indicated in its response to our 1985 Management Letter that it was in agreement with the recommendations and would be developing procedures to comply with them.

RECOMMENDATIONS:

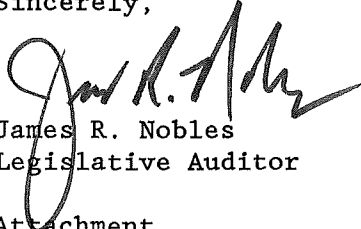
13. *The department's refund unit should establish lines of authority and responsibility over unclaimed refund warrants to ensure an adequate separation of duties throughout the process.*

Mr. Thomas Triplett, Commissioner
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14. *All returned refund warrants should be entered on the unclaimed warrant system as received.*

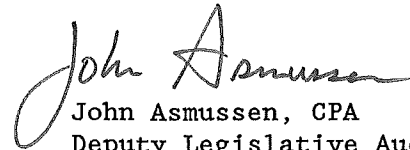
Thank you for the cooperation extended to our staff during this audit.

Sincerely,



James R. Nobles
Legislative Auditor

Attachment



John Asmussen, CPA
Deputy Legislative Auditor

February 24, 1987

DEPARTMENT OF REVENUE

STATUS OF PRIOR AUDIT RECOMMENDATIONS
AND
PROGRESS TOWARD IMPLEMENTATION

PRIOR RECOMMENDATION MODIFIED: Certain tax receipts are not deposited in accordance with Minn. Stat. Section 16A.275.

1. The Department of Revenue should comply with Minn. Stat. Section 16A.275 and deposit receipts totaling \$250 or more in the state treasury daily.

RECOMMENDATION IMPLEMENTED. This recommendation was directed toward the department's Master Business Section. Our observations indicated that MBS is in substantial compliance with the recommendation and has also improved its controls over receipts obtained from the cashier section for follow up.

Inadequate controls exist over the accounting and processing of unclaimed refund warrants.

2. The department's refund unit should establish lines of authority and responsibility over unclaimed refund warrants to ensure an adequate separation of duties throughout the process.

RECOMMENDATION NOT IMPLEMENTED. See current recommendation #13.

3. All returned refund warrants should be entered on the unclaimed warrant system as received.

RECOMMENDATION NOT IMPLEMENTED. See current recommendation #14.



STATE OF MINNESOTA
DEPARTMENT OF REVENUE

February 24, 1987

Mr. James Nobles
Legislative Auditor
Office of the Legislative Auditor
Veterans Service Building
St. Paul, Minnesota 55155

Dear Mr. Nobles:

The following are our responses to the findings and recommendation contained in the draft of your FY'86 statewide audit report.

RECOMMENDATION #1: Revenue should assign the responsibility of authorizing access to its computer systems to knowledgeable individuals. This assignment should be documented to the extent that all individuals are identified and known to the security officers.

RESPONSE: We concur with this recommendation. Steps will be initiated to establish responsibility for data files by program and division. We currently have a Request for logonIDs signed off by the employees supervisor. The Data Access form will be modified to allow approval by the person or persons responsible for the data file. This has been initiated. We are investigating the feasibility of instituting training courses and refresher seminars or instructions for persons who require logonIDs. John Asmus is responsible for the implementation of this recommendation.

RECOMMENDATION #2: Revenue should suspend any logonIDs which remain unused after a reasonable length of time and require new logonIDs to be used when created.

RESPONSE: We concur with this recommendation. We are currently suspending logonIDs which have been inactive 90 days or longer. John Asmus is responsible for the implementation of this recommendation.

Mr. James Nobles
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RECOMMENDATION #3: Revenue should develop procedures for identifying employees with active logonIDs that have left or changed employment so that those logonIDs can be suspended or deleted.

RESPONSE: We concur with this recommendation. We currently receive notification from personnel on people who have left the Department or transferred, but are not aware of people on extended leave. The information has not always been timely and we are in the process of reviewing supplemental and improved ways of getting all the data in a timely manner. John Asmus is responsible for the implementation of this recommendation.

RECOMMENDATION #4: The Revenue Security Officers should obtain written documentation to support all assigned logonIDs, including those granted through verbal authorizations.

RESPONSE: We concur with this recommendation. We are currently getting signed documents for logonIDs. These procedures were instituted in January, 1987. John Asmus is responsible for the implementation of this recommendation.

RECOMMENDATION #5: The department should obtain adequate off-site backup for all of its major systems.

RESPONSE: We concur with this recommendation. We are currently investigating which data tapes are not being stored off site. The off site storage list will be reviewed with IMB and updated accordingly. John Asmus is responsible for the implementation of this recommendation.

RECOMMENDATION #6: The department should establish clear lines of responsibility concerning its joint ownership of the Enterprise Zone Program.

RECOMMENDATION #7: The department should accumulate and account for EZP credits taken by tax type, and to reconcile credits allowed and taken within the parameters specified under statute.

RECOMMENDATION #8: The department should develop an adequate document retrieval system so that the documentation to support enterprise zone credits taken are properly accounted for. No credits should be allowed without the appropriate documentation.

RECOMMENDATION #9: Credits taken should be reported as grant payments on the state's financial statements. All credits payable should be accrued at June 30 according to the department's accrual procedures.

RESPONSES: We concur with recommendations #6 through #9. Revenue will meet with representatives from DEED to discuss coordination between DEED and DOR. Responsibilities will be clarified and clearly affixed to the appropriate agency. The feasibility of reconciling credits allowed will be discussed.

Returns claiming EGP credits will be checked for appropriate documentation.

The Revenue Accounting Division will change the EGP credit from a Revenue and Expense account to a Balance Sheet account, "Grant Payments," and will begin accruing these credits for FY'87.

CynDee Hawbaker is responsible for the implementation of recommendations #6 through #9.

RECOMMENDATION #10: The department should accrue all claims for refunds received prior to the fiscal year-end cutoff.

RESPONSE: We concur with this recommendation. The Department will develop a microcomputer based "Inventory Control System," which will be maintained by the Amended Return Unit of the Individual Tax Group. This system will maintain various information on both "claims for refunds" and "amended returns for less" (taxpayer claiming a refund of taxes via an amended return), including the name and account number of the taxpayer, the date received, the amount of the claim, the date completed and the amount actually refunded. This information will be maintained on a fiscal year basis and will allow us to accrue the proper amounts at the fiscal year-end cutoff.

Implementation of this recommendation will begin immediately and should be completed in time to provide the proper FY'87 accrual amounts. John James is responsible for the implementation of this recommendation.

RECOMMENDATION #11: The Petroleum Division should develop proper documentation and audit trails to support the accrual of the fiscal year-end receivables.

RECOMMENDATION #12: The Petroleum Division should develop accounting procedures to ensure that duplicate payments are not made.

RESPONSE: We concur with recommendations #11 and #12. The Department's system development efforts anticipate correcting the noted deficiencies; however, due the low volume of Petroleum transaction and higher priorities in the Systems Development Plan, this may not be accomplished for at least several years. As an interim measure, we will explore the feasibility of developing a microcomputer based system to comply with the recommendations.

The study should be completed by approximately April 1, 1987 and, if deemed feasible, development and implementation will commence immediately thereafter. If deemed not feasible, other alternatives will be explored.

Dennis Erno is responsible for the implementation of recommendations #11 and #12.

RECOMMENDATION #13: The department's refund unit should establish lines of authority and responsibility over unclaimed refund warrants to ensure an adequate separation of duties throughout the process.

RECOMMENDATION #14: All returned refund warrants should be entered on the unclaimed warrant system as received.

RESPONSE: We concur with recommendations #13 and #14. A system to provide better control over unclaimed refund warrants has been implemented. This system, along with the following procedural changes, should satisfy these recommendations.

1. Warrants are delivered to the Refund Section in a locked cash bag.
2. One clerk has physical custody of the warrants. They are stored in a locked cabinet in the Refund Section vault.
3. Warrants are entered into the system as received. Those clerks who update the system do not have access to the warrants.
4. Warrants cannot be removed from the vault until the correct status has been updated on the system.

Mr. James Nobles
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5. Information regarding unclaimed warrants in the system is available on-line to Refund Section personnel.

6. Warrants are redeposited to SWA after six (6) months.

CynDee Hawbaker is responsible for the implementation of recommendations #13 and #14.

Please advise me if you think that any of our responses will not meet the recommendations of your report.

Sincerely,


Ray Dore
Deputy Commissioner

cc: Tom Triplett, Commissioner
CynDee Hawbaker, Assistant Commissioner
John James, Assistant Commissioner
Dennis Erno, Assistant Commissioner
John Asmus, Revenue Systems Director