DEPARTMENT OF REVENUE

FINANCIAL AND COMPLIANCE AUDIT

FOR THE FOUR YEARS ENDED JUNE 30, 1988

APRIL 1989

89-27

STATE OF MINNESOTA
OFFICE OF THE LEGISLATIVE AUDITOR
VETERANS SERVICE BUILDING, ST. PAUL, MN 55155 • 612/296-4708
JAMES R. NOBLES, LEGISLATIVE AUDITOR

Senator Randolph W. Peterson, Vice-Chairman
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. John James, Commissioner
Department of Revenue

Audit Scope

We have completed a financial and compliance audit of the Department of Revenue for the four years ended June 30, 1988. We have issued separate management letters, dated February 12, 1986, February 24, 1987, and February 16, 1988, as part of our Statewide Financial Audit work in the department for fiscal years 1985, 1986, and 1987, respectively. Section I provides a brief description of the department's activities and finances. Our audit was made in accordance with generally accepted auditing standards, and the standards for financial and compliance audits contained in the U.S. General Accounting Office Government Auditing Standards, and accordingly, included such audit procedures as we considered necessary in the circumstances. Fieldwork was completed on December 30, 1988.

The objectives of the audit were to:

- express an opinion on the state's financial statements for the year ended June 30, 1988;
- study and evaluate the department's internal control systems, including revenues, expenditures, assets, and liabilities;
- verify that financial transactions were made in accordance with applicable laws, regulations, and policies, including Minn. Stat. Chapter 270, and other finance-related laws and regulations; and
- determine the status of prior audit recommendations.

Management Responsibilities

The management of the Department of Revenue is responsible for establishing and maintaining a system of internal accounting control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a control system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that the procedures may become inadequate because of the changes in conditions, or that the degree of compliance with the procedures may deteriorate.

The management of the Department of Revenue is also responsible for compliance with laws and regulations. In connection with our audit, we selected and tested transactions and records from the programs administered by the department. The purpose of our testing transactions was to obtain reasonable assurance that management had, in all material respects, administered its programs in compliance with applicable laws and regulations.

Audit Techniques

During our audit we employed a variety of audit techniques. These included, but were not limited to, auditor observation, interviews with department staff, analytical reviews to identify unusual transactions or trends, and the examination of documentation supporting a representative number of transactions. Random sampling techniques were used to assure that representative samples of transactions were chosen. However, the use of random sampling did not prohibit us from reviewing additional transactions which may have come to our attention during the audit.

Status of Prior Audit Findings

We reviewed the status of findings included in our audit report of the department for the period July 1, 1983 to June 30, 1984 (report dated June 19, 1985) and consider them implemented. In addition, we reviewed the status of findings included in our management letters for the 1985, 1986, and 1987 Statewide Financial Audits and consider them implemented except for finding #1 of the 1987 management letter. We concur with the corrective action taken for a portion of finding #1 dealing with controls authorizing access to the department's computer systems. The remainder of that finding is repeated in Section II, finding #5 of this report.

Conclusions

We have issued an unqualified opinion on the State of Minnesota's general purpose financial statements for the year ended June 30, 1988. Our audit opinion, dated December 1, 1988, is included in the state's Comprehensive Annual Financial Report prepared by the Department of Finance.

In our opinion, except for the issues discussed in Section II, findings 1-5, the Department of Revenue's system of internal accounting control in effect on June 30, 1988, taken as a whole, was sufficient to provide management with reasonable, but not absolute assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly.

In our opinion, except for the issues raised in Section II, findings 1-3, for the four years ended June 30, 1988, the department administered its programs in compliance, in all material respects, with applicable finance-related and regulations.

Section II of this report contains the findings we developed during this audit. The recommendations are presented to assist the Department of Revenue in resolving the audit findings and in improving accounting procedures and controls. We will be monitoring and reviewing the department's progress on resolving these findings after the dates projected for completion as identified in the response to this report.

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

James R. Nobles
Legislative Auditor

John Asmussen, CPA
Deputy Legislative Auditor

December 30, 1988

DEPARTMENT OF REVENUE

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AUDIT PARTICIPATION

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

John Asmussen, CPA	Deputy Legislative Auditor
Tom Donahue	Audit Manager
Charlie Gill	Auditor-in-Charge
Mary Annala	Staff Auditor
Jean Mellett, CPA	Staff Auditor
Lois McGuire	Staff Auditor
Pat Ryan	Staff Auditor
Eric Jacobson	Auditor Intern
Janet Knox	Auditor Intern
Dan Quandt	Auditor Intern

EXIT CONFERENCE

The findings and recommendations in this report were discussed with the following officials of Department of Revenue at the exit conference held on January 13, 1989:

John James	Commissioner
Babak Armajani	Deputy Commissioner
Connie Nelson	Assistant Commissioner, Administration Program
CynDee Hawbaker	Assistant Commissioner, Operations Program
Dwight Lahti	Assistant Commissioner, Tax Compliance Program
Dennis Erno	Assistant Commissioner, Taxpayer Services Program
Steve Kraatz	Revenue Accounting
Jim Maurer	Internal Auditor

I. INTRODUCTION

The Department of Revenue is responsible for providing administrative and enforcement services in the areas of tax collection and assessment. The primary clients of the department are individuals and organizations who are required to pay taxes to the state and local governments. Five major program units carry out those responsibilities. The Administration Program manages and provides support services to all programs, and serves as the focus of communication with the public and with other units and branches of government. The Tax Policy Program provides technical and legal analysis of tax laws and proposed changes to them, and calculates and pays aids to local governments. The Taxpayer Service Program provides information and service to taxpayers, supervised the classification and appraisal of properties for assessment of property taxes and administers state commodity taxes. The Operations Program processes tax returns and remittances, and provides accounting, records management, and administrative services. The Tax Compliance Program audits tax returns and records, and collects delinquent taxes.

The department operates under the direction of a commissioner who is appointed by the Governor. John James is the current Commissioner of Revenue.

Department operations are primarily financed through General Fund appropriations. Fiscal year 1988 administrative expenditures for these programs are highlighted in the following schedule.

PROGRAM	GENERAL FUND
Administration	$10,962,551
Tax Policy	2,661,603
Taxpayer Service	8,259,672
Operations	10,619,124
Tax Compliance	20,491,859
TOTAL	$52,994,809

II. CURRENT FINDINGS AND RECOMMENDATIONS

1. There is a general lack of controls over the department's contracts.

Department of Finance Operating Policy and Procedure 06:04:05 requires agencies to requisition funds for encumbrance before contracts and amendments are signed. Administration Policy and Procedure ADM-188 states that the accounting unit should enter an encumbrance transaction before it sends the contract to the contractor for signing.

The various divisions within the department are allowed to initiate their own contracts. However, in the early stages of the process the contracts have been sent to the contractors for their signatures instead of to fiscal services. The Fiscal Services Division, according to DOF procedures, is to enter the requisition for encumbrance and then to send the contract to the contractor for signatures. Of the 16 contracts and amendments tested, 13 were signed before the funds were requisitioned for encumbrance. In one case, the department added a provision to the contract negating the state's standard contract provision which ensures that contracts are not effective until funds are encumbered. Testing also indicated that in at least four cases work was performed before funds were encumbered.

In addition, the department did not complete evaluations for 15 of 16 applicable contracts. Minn. Stat. Section 16B.17, Subd. 4 and Adm. 188 Section XXV requires agencies to send contract evaluations to the Contract Management Division of the Department of Administration within 30 days after the completion date of the contract. Other agencies cannot obtain information regarding contractor's performance unless these evaluations are completed.

The department needs to gain some accounting control over the contracts that are entered into by its various divisions. It is suggested within ADM-188 that an agency assign the responsibility of contract coordination to an individual. Since the accounting function is a key function within the contract process the department should consider assigning this responsibility to the Fiscal Services Division.

RECOMMENDATIONS

- **The department should follow contract management procedure Adm-188.**

- **The department should complete the required contract evaluations and send them to the Contract Management Division within 30 days of the contract completion date.**

2. The Department of Revenue does not contract with collection agencies in an equitable manner.

Currently, the department has contracts with three collection agencies for the purposes of collecting delinquent Minnesota taxes. The contractors are paid based on a percentage of delinquent taxes that they collect not to exceed a contract amount. The amounts of the three collection agency contracts are $200,000, $200,000 and $50,000. The department has indicated that these contracts may never have been bid out.

Administration Policy and Procedure ADM-188 sets forth the following requirements for the preparation and negotiation of contracts for professional, technical, and purchased services:

- if payments to the contractor will be $500 or more during the fiscal year, a contract must be processed according to the prescribed procedures;
- all proposed contracts in excess of $2,000 are subject to special negotiation procedures, such as completion and approval of the Certification of Internal Contract Negotiation form; and
- the availability of all consultant and professional/technical services contracts in excess of $10,000 shall be published in the State Register.

In addition, Minn. Stat. Section 270.063 provides in part that, "For the purpose of collecting delinquent state tax liabilities, there is appropriated to the commissioner of revenue an amount representing the cost of collection, not to exceed one-third of the amount collected by contract with collection agencies. . . ." The department should reconsider its nonbid requirement position concerning the collection agencies currently under contract. The statute provides up to 33 percent of the amounts collected to agencies that recover delinquent state taxes. Such an incentive may induce some competitive bidding among various collection agencies for the right to collect delinquent taxes for the state.

RECOMMENDATION

- **The department should establish a bid selection process for contracting with collection agencies for recovering delinquent state taxes.**

3. The Department of Revenue is not assessing penalties on delinquent corporate tax returns.

The department did not assess penalties on delinquent corporate tax returns for either 1986 or 1987. According to Minn. Stat. Section 290.37, Subd. 1, "Every corporation shall file a return." To encourage corporations to file a return, regardless of whether or not a tax or refund is due, Minn. Stat. Section 290.53, Subd. 2, provides in part that, ". . .

failure to file a return . . . within 60 days of the date prescribed . . . there shall be added to the tax or subtracted from the refund the lesser of (i) $100 or (ii) 100 percent of either the amount of tax which is due or the amount of the refund. . . ." The statute was amended by Minnesota Laws 1987, Chapter 268, Article 17, Subd. 2, effective for 1987 returns provided that, ". . . failure to file a return . . . within 60 days of the date prescribed . . . the addition to tax under this subdivision shall not be less than the lesser of (i) $200 or (ii) the greater of (a) 25 percent of the amount required to be shown as tax on the return without reduction for any payments made or refundable credits allowable against the tax or (b) $50. . . ."

We reviewed 32 delinquent corporate tax returns for which a total of $3,620 in penalties could have been assessed. Because of the way we selected the corporate returns for review, we are unable to project our tests to the population. The staff were not aware of the statute and consequently did not assess any penalties. As a result, no delinquent corporate return file is maintained and no other information exists to determine the magnitude of the problem.

RECOMMENDATION

- **The department should assess penalties against corporations filing late returns as provided in Minn. Stat. Section 290.53.**

4. There are no significant controls over long-distance telephone calling cards or subsequent billings.

The department's central services unit is responsible for issuing long-distance telephone calling cards to appropriate individuals. It also maintains a list of those individuals having a card. However, there are no procedures in effect to monitor the status of outstanding cards or to review the charges made on those cards. As a result, it would be possible for an individual to leave the department and still be able to charge calls to the calling card issued. Some individuals have been on the list since 1982.

In addition, telephone calling card invoices are mailed directly to the Fiscal Services Division for payment. No review is made to determine the accuracy of the billing. The invoices are paid as submitted. Although our testing focussed on telephone calling cards, this control weakness can apply to any long-distance telephone calls made from the department's telephones.

Adequate internal controls over the long distance telephone calling cards would require that they be issued to authorized personnel, used for state business only, and that the liability incurred by the state due to misuse or loss be minimized. Without adequate controls, the state may be incurring unnecessary expenses.

RECOMMENDATION

- **The department should control long-distance telephone calling cards. The status of calling card accounts should be monitored on an ongoing basis. The Fiscal Services Division should pay all long-distance telephone invoices after they have been approved by an authorized individual.**

5. PRIOR FINDING PARTIALLY RESOLVED: Department of Revenue controls authorizing access to its computer systems need to be improved.

Access to the department's computer systems is controlled through the department's security officers who create and assign logonIDs to authorized users. The logonIDs which allow the user access to the system, are protected by the use of a secret password established by the individual for which the logonID was created. 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 system's 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 department has not fully addressed the issue of responsibility for authorizing systems access. This duty requires a knowledge of what information is contained in the files, who should have access to it, and for what purpose. Currently, the security officers in most cases have been authorizing systems access. The security officer should be in a position to question whether access is valid. However, they should not be in a position to grant authorization.

Revenue should designate personnel responsible for authorizing access to each system. This would strengthen controls over access to computer programs and files. 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 be provided to the security officers so that access authorizations could be challenged when errors or other security violations occur.

RECOMMENDATION

- **The department 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.**

STATE OF MINNESOTA

DEPARTMENT OF REVENUE

April 6, 1989

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 recommendations, concerning the Department of Revenue, that are contained in your FY'88 statewide audit report.

FINDING #1: There is a general lack of controls over the department's contracts. Recommendations: The department should follow contract management procedure Adm-188; The department should complete the required contract evaluations and send them to the Contract Management Division within 30 days of the contract completion date.

RESPONSE: The department agrees with the audit report findings and recommendations on contract administration. The fiscal year 1989 contract process is much improved over Fiscal Year 1988 because of an increased awareness of the responsibilities of a contract manager. The department is also in the process of establishing and communicating a policy and procedures for contract management. It describes the contract administrator's responsibilities for contract management (i.e. holding contractors accountable for promised services and deliverables); for encumbering funds before incurring obligations to assure funds are available; and for ongoing and post evaluation of the contract work. Requirements of Adm-188, including the evaluation phase, are contained in the policy. Attached is a draft copy. Dick Ristow, director of Fiscal Services, will be responsible for monitoring compliance with the policy.

AN EQUAL OPPORTUNITY EMPLOYER

FINDING #2: The Department of Revenue does not contract with collection agencies in an equitable manner. Recommendation: The department should establish a bid selection process for contracting with collection agencies for recovering delinquent state taxes.

RESPONSE: We will review our process of contracting with private collection agencies and will work with the Department of Administration's Office of Professional, Technical, and Service Contracts to resolve this issue by July 1, 1989. Assistant Commissioner Dwight Lahti is responsible.

FINDING #3: The Department of Revenue is not assessing penalties on delinquent corporate tax returns. Recommendation: The department should assess penalties against corporations filing late returns as provided in Minn. Stat. Section 290.53.

RESPONSE: The Penalty and Interest Calculation (PIC) System was not ready at the time the new statute on penalty and interest was passed. The PIC system became operational in March, 1988. The new assessment procedures were then instituted on "balance due" and "no remit" returns. Through an oversight, we did not assess the new penalty and interest on "refund" and "no tax" returns. Assistant Commissioner Dwight Lahti is responsible.

When we became aware of our failure to properly assess penalty and interest, we initiated measures to correct the problem. We are currently assessing penalties on all corporate "no tax" and "refund" returns, effective September, 1988.

FINDING #4: There are no significant controls over long-distance telephone calling cards or subsequent billings. Recommendation: The department should control long-distance telephone calling cards. The status of calling card accounts should be monitored on an ongoing basis. The Fiscal Services Division should pay all long-distance telephone invoices after they have been approved by an authorized individual.

RESPONSE: We agree that we should periodically update our list of all issued telephone calling cards. During April, we plan to publish a list of all calling cards and cancel those individuals who do not contact us to keep activated. We partially agree with the recommendation regarding payment. We plan to continue paying the bills in order to meet our prompt payment responsibilities under the law. However, we will be sending copies to each supervisor of their calling card, WATTS, and regular long distance billings each month. Unauthorized use by an employee can be handled by the supervisor. Administrative Services will work with the issuing vendor to correct other questionable use. From a fiscal point of view, our ongoing relationship with these accounts allows us to adjust improper billings in a subsequent month.

FINDING #5: Department of Revenue controls authorizing access to its computer systems need to be improved. Recommendation: The Department 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: The department considers appropriate and secure access to information a serious responsibility. In FY 1989 we created a new six-person unit, separate organizationally from any other operational unit in the department, to help provide that "check and balance" free from conflicts of interest. Access to our new integrated data base is governed by the "owners" of the data base to help ensure that the integrity of the data is maintained. Where we need to do additional work is with regard to older, existing data bases. We need to better identify which files contain which data elements, when and how the data is changed, and how it interacts with other data. Additionally, "ownership" of the files and data must be determined. This is NOT an easy or quick process. However, we have efforts currently underway which will help us accomplish the vast majority of this recommendation by the end of FY 1990. Don Saelens, director of Revenue Information Systems Division, and Charlie Anderson, director of Information Access and Security Section, will be responsible for continued improvement regarding this recommendation.

Sincerely,

Babak Armajani
Deputy Commissioner

c.c. John James, Commissioner
Connie Nelson, Assistant Commissioner
Dwight Lahti, Assistant Commissioner
CynDee Hawbaker, Assistant Commissioner
Jim Maurer, Internal Audit Manager