

DEPARTMENT OF REVENUE

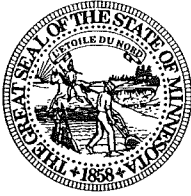
FINANCIAL AUDIT

FOR THE YEAR ENDED JUNE 30, 1992

JUNE 1993

Financial Audit Division
Office of the Legislative Auditor
State of Minnesota

93-31



STATE OF MINNESOTA

OFFICE OF THE LEGISLATIVE AUDITOR

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

JAMES R. NOBLES, LEGISLATIVE AUDITOR

Senator Phil Riveness, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. Morrie Anderson, Commissioner
Department of Revenue

Audit Scope

We have conducted a financial related audit of the Department of Revenue for the year ended June 30, 1992. Our audit was limited to only that portion of the State of Minnesota financial activities attributable to the transactions of the Department of Revenue. Specifically, we reviewed tax assessments and collections, and cash receipts and disbursements. We have also made a study and evaluation of the internal control structure of the Department of Revenue in effect as of June 30, 1992.

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial activities attributable to the transactions of the Department of Revenue are free of material misstatements.

As part of our study and evaluation of the internal control structure, we performed tests of the Department of Revenue's compliance with certain provisions of laws and regulations. However, our objective was not to provide an opinion on overall compliance with such provisions.

Management Responsibilities

The management of the Department of Revenue is responsible for establishing and maintaining an internal control structure. This responsibility includes compliance with applicable laws and regulations. In fulfilling this responsibility, estimates and judgements by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that:

- assets are safeguarded against loss from unauthorized use or disposition;
- transactions are executed in accordance with applicable legal and regulatory provisions, as well as management's authorization; and

- transactions are recorded properly on the statewide accounting system in accordance with Department of Finance policies and procedures.

Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

Internal Control Structure

For purposes of this report, we have classified the significant internal control structure policies and procedures in the following categories:

Revenues:

- individual income and withholding taxes;
- corporate income taxes;
- sales taxes; and
- gas and special fuel taxes.

Expenditures:

- individual, corporate, and property tax refunds;
- local government aid; and
- homestead/agricultural credit aid.

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

Conclusions

Our study and evaluation disclosed the conditions discussed in findings 1 to 6 involving the internal control structure of the Department of Revenue. We consider these conditions to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in financial statements.

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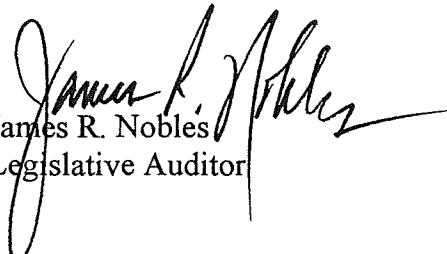
A material weakness is a reportable condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We believe the reportable condition described in finding 1 is a material weakness.

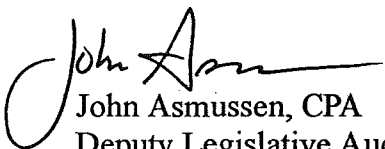
We also noted other matters involving the internal control structure and its operation that we reported to the management of the Department of Revenue in a meeting held on January 26, 1993.

The results of our tests indicate that, except for the issue discussed in finding 7, with respect to the items tested, the Department of Revenue complied, in all material respects, with the provisions referred to in the audit scope paragraphs. With respect to items not tested, nothing came to our attention that caused us to believe that the Department of Revenue had not complied, in all material respects, with those provisions.

This report is intended for the information of the Legislative Audit Commission and 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 June 10, 1993.

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


James R. Nobles
Legislative Auditor


John Asmussen, CPA
Deputy Legislative Auditor

End of Fieldwork: January 12, 1993

Report Signed On: June 4, 1993

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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, CPA	Audit Manager
Ken Vandermeer, CPA	Auditor Supervisor
Dave Poliseno, CPA	Senior Auditor
Ron Mavetz, CPA	Senior Auditor
Amy Jorgenson	Senior Auditor
Todd Froelich	Auditor Intern

Exit Conference

The findings and recommendations in this report were discussed with the following officials of the Department of Revenue at the exit conference held on January 26, 1993:

John Lally	Deputy Commissioner
Larry Wilke	Director, Audit Division
Brin Rauscher	Auditor, Petroleum Division
Jerry Silkey	Assistant Director, Local Government Services
Kris Caulfield	Local Government Services
Jean Jochim	Revenue Accounting
Dennis Louis	Director, Document Processing
Jim Maurer	Director, Internal Audit
Steve Krovitz	Auditor, Internal Audit
Carole Wald	Manager, Income Tax System
Heather Wisniewski	Manager, Information Access and Security

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Introduction

The Department of Revenue is responsible for providing administrative and enforcement services in the areas of tax collection and assessment. The department serves individuals and organizations that are required to pay taxes to the state and local governments. The department is undergoing a reengineering process that started in fiscal year 1990. A renewed emphasis has been placed on educating taxpayers on the tax requirements through various methods of taxpayer services and communications.

The department operated under the direction of Dorothy McClung in fiscal year 1992. In January, 1993, Morrie Anderson was appointed as the new commissioner.

The financial activity of the department during fiscal year 1992 is summarized as follows:

Revenues:

Income taxes	\$3,504,124,655
Corporate taxes	498,945,150
Sales taxes	2,224,014,230
Other receipts	<u>1,100,047,277</u>
Total	<u>\$7,327,131,312</u>

Expenditures:

Tax refunds	\$ 582,479,236
Local government aid	285,220,459
Homestead/agricultural credit aid	340,955,560
Other expenditures	<u>268,875,267</u>
Total	<u>\$1,477,530,522</u>

Source: Estimated/Actual Receipts Report, Fiscal Year 1992 and the
Managers Financial Report, Fiscal Year 1992.

The Revenue Information Systems Division (RISD) provides computer support for the department's operations. It provides the department with timely, accurate information needed to operate the integrated tax system effectively. The main tax types include individual, corporation, sales, and withholding. The various systems include TPA, TPR, and CACS, among others. RISD has responsibility for planning, designing and implementing new information systems and for operating new and existing systems. The tax systems primarily reside on the state's mainframe at Intertech with RISD supporting its activity.

Current Findings and Recommendations

1. The department does not adequately secure critical programs.

The department does not use its security package, ACF2, to control and monitor the use of some critical programs. The Information Access and Security Division has responsibility for ensuring that data security requirements are satisfied. The department uses the Access Control Facility (ACF2) to control access to the mainframe. Intertech primarily controls ACF2, but has granted Revenue expanded authority and responsibility.

The Revenue Information System Division (RISD) developed a navigation program to route users through the integrated system. It developed a program, security dispatch, to verify that users had the proper authority to make the transactions on the system. When a user enters a transaction on the system, the program normally seeks access authority from ACF2. However, if the program becomes inactive or disabled, the system automatically allows the transaction. This program resides in the library under the control of the librarian, who would grant access to RISD programmers for authorized purposes. However, the security officer is not aware when this program is accessed or what was done with it. The department should restrict and log the use of this program by ACF2 and have the security officer follow up on its usage.

Under certain circumstances, the department allows users to override ACF2 access controls. SUPRA, the department's database application, allows users batch access to the database which can circumvent the normal processing edits. Batch access was intended for use on an infrequent, emergency type basis to avoid processing delays. However, the department is using the batch access capability on a frequent basis. Without ACF2 controls in effect, these users could make unauthorized transactions.

Recommendations

- *The department should ensure that ACF2 controls access to all the programs and restricts and logs the more critical ones.*
- *The security officer should review all activity logged by ACF2 and take appropriate action.*

2. The department does not properly monitor ACF2 violation reports.

The security officer is not informed of action taken to resolve security violations. The ACF2 security officer accumulates the violations made by the users. The security officer reviews the violation reports and follows up on the more severe ones immediately. The security officer also prepares quarterly violation reports and sends them to the users' supervisors.

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The supervisors are to review the reports and take appropriate action with the users. However, the supervisors do not inform the security officer of the review or actions taken, if any.

Without the communication to the security officer, there is no assurance that the supervisors reviewed the reports or took appropriate action. Users could continue to incur violations that would be preventable had the supervisor taken appropriate action such as user training.

Recommendation

- *The department should require that supervisors respond whether they reviewed the reports and took appropriate action.*

3. Controls over the assignment of temporary passwords are inadequate.

The security officer does not always obtain proper authorization or verification when assigning temporary passwords. The system logs users off the system after 15 minutes of inactivity. To continue, the user must reenter the password at the appropriate prompt. If the user enters the wrong password, the system suspends them immediately. The user must then request the security officer to reinstate them. Access clearances normally require the supervisor to complete a request form and submit it to the security officer. However, because of the volume of requests, the security officer routinely reinstates users with a phone call from the user and no authorization from the supervisor. The security officer assigns the user a temporary password over the phone.

The current practice of suspending users after one incorrect attempt has created an excessive number of violations. This practice weakens the system by increasing the risk that passwords are given out to unauthorized users or that users will share passwords. The department should review their time-out process and ensure that it does not conflict with password security.

Recommendation

- *The security officer should only assign passwords to users after obtaining proper authorization and verification by the users' supervisor or log off system entirely.*

4. The Department does not perform adequate control procedures over the review of certain withholding tax information.

Based on our review of withholding tax information we noted that the department has omitted certain control procedures concerning the verification of that information. Currently, employers withhold income taxes from employee payroll and submit the withheld amount to the department for deposit. Employers submit withholding taxes on a special form authorized by the department (MW-5 coupon) or through special wire transfer methods. The amount submitted may be either actual taxes withheld or estimates. The department verifies

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the amount deposited to the MW-5 coupon or wire transfer reports and enters the information onto its computer system.

The department requires all employers to submit quarterly MW-1 reports which are also entered onto its computer system. The quarterly MW-1 report summarizes the employer's withholding and depositing activity. Computer edits identify any differences between the quarterly reports and the actual payments (MW-5 coupons or wire transfers). The department resolves the discrepancies and enters the necessary adjusting entries.

However, we have identified a control weakness in the department's current verification procedures over income tax withholding. The department recognizes the control weakness but believes that a more detailed explanation of the weakness would reveal information that is currently classified as protected nonpublic data under Minn. Stat. Chapter 270B.

Minn. Stat. Section 270B addresses tax data and its classification and disclosure. Specifically, Subd. 2, provides in part that "The following are protected nonpublic data...(1) criteria for determining which computer processed returns are selected for audit; (2) criteria for determining which returns are selected for an in-depth audit..."

As a result of the control issue raised, the department cannot ensure that adequate safeguards are in place to detect certain cases where additional taxes may be due or refunds may be payable.

Recommendation

- *The Department of Revenue should establish appropriate control procedures to resolve this issue.*

5. Controls over receipts need improvement.

Reconciliations were not performed on a monthly basis. Also, reconciliations did not balance amounts deposited on SWA with amounts posted to the department's accounting system. It is the department's responsibility to collect and process income and sales tax receipts for the state of Minnesota. Tax receipts arrive at the department directly through the mail and indirectly through electronic fund transfers. The department's cash processing unit is responsible for depositing receipts and accurately recording the deposits on the statewide accounting system (SWA). SWA is used to report the state's financial activity on the annual financial statements. The tax processing unit receives the tax information after cash processing deposits the receipts. The tax processing unit enters the receipt information, along with other information provided on the tax forms, onto the department's accounting system. The department's accounting system is used internally to record the amount billed and received for each taxpayer. The accounting unit is responsible for reconciling the department's accounting system to SWA to verify the accuracy of amounts posted to the department's accounting system.

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Currently, the accounting unit does not reconcile directly to SWA reports. Instead, it receives a report from the cash processing unit. However, the cash processing unit's report did not agree with SWA starting in July, 1991. Therefore, the accounting unit was not able to reconcile the department's receipt records to the cash processing unit's report. Although the reconciliations should be done on a monthly basis, the department did not complete them until October, 1992.

In fiscal year 1992, the department collected \$3.5 billion in income and \$2.2 billion in sales tax revenues. Accurate information is important for reporting on the state's financial statements. Timely reconciliations are an essential control in detecting errors and irregularities in the receipts process.

Recommendation

- *The department should reconcile income and sales tax receipts on the department's system to SWA on a monthly basis.*

6. Controls over outstate deposits need improvement.

The department does not deposit revenues received by outstate collection offices promptly. Currently, outstate collection offices mail receipts to the central office, thereby creating a two to four day time lag. The secondary mailing of receipts creates an unnecessary deposit time lag and exposes the receipts to unnecessary risks. The department's satellite offices collected \$29.7 million in tax receipts during Fiscal Year 1992.

The department has ten satellite collection offices located in Minnesota. Four offices are located in the metro area and six are located outstate. The satellite offices contact delinquent taxpayers and inform them of their overdue taxes. Satellite offices receive delinquent tax payments to speed recognition of the receipt process and prevent unnecessary billings. The offices then mail, or ship via truck, the receipts to the central office for deposit.

The majority of outstate collections are processed at the satellite office in Ely. When the office was first established, the local banks in Ely could not provide a sufficient level of deposit insurance. This obstacle is no longer a factor, since the banks are capable of meeting the state's deposit insurance requirements. The department could create depositories for outstate collection satellites. Local depositories would allow the department to make daily deposits which would decrease the risk of lost or misplaced receipts. The state could also earn more interest on the timely depositing of receipts.

Recommendation

- *The department's satellite collection offices should deposit receipts at local depositories.*

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7. Corporate income tax processing controls need improvement.

The department's review of estimated taxes paid by corporations is weak in two areas. First, the department does not charge interest to corporations who underpay estimated taxes. Second, the department does not perform adequate control procedures over the review of certain amounts reported on corporate tax returns.

Minn. Stat. Section 289A.26, Subd. 4 requires the department to charge corporations interest on the underpayment of estimated taxes. The department's billing system has capabilities of assessing interest on the underpayment of estimated taxes. However, the department is not utilizing the system to assess interest on the underpayments. The department should develop a system which would accurately assess interest on underpaid estimated taxes. Corporations would calculate estimated tax liabilities more accurately if the department enforced the interest provisions of the law. This would encourage the timeliness of corporate income tax revenues. Also, the interest penalties would help increase revenues. The department collected \$431,869,462 in estimated receipts during fiscal year 1992.

Based on our review of corporate income tax returns, we noted that the department has omitted certain control procedures concerning the verification of that information. Currently, there are a number of computer edits in place which are designed to verify corporate tax information.

However, we have identified a control weakness in the department's current verification procedures over corporate income tax information. The department recognizes the control weakness but believes that a more detailed explanation of the weakness would reveal information that is currently classified as protected nonpublic data under Minn. Stat. Chapter 270B.

Minn. Stat. Section 270B addresses tax data and its classification and disclosure. Specifically, Subd. 2, provides in part that "The following are protected nonpublic data...(1) criteria for determining which computer processed returns are selected for audit; (2) criteria for determining which returns are selected for an in-depth audit..."

As a result of the control issue raised, the department cannot ensure that adequate safeguards are in place to detect certain cases where additional taxes may be due or refunds may be payable.

Recommendations

- *The Department of Revenue should establish appropriate control procedures to resolve this issue.*
- *The department should develop controls to ensure interest is charged on the underpayment of estimated taxes.*

June 1, 1993

Mr. James Nobles
Legislative Auditor
Office of the Legislative Auditor
1st. Floor, Centennial Office Building
658 Cedar Street
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'92 statewide audit report.

FINDING #1: The department does not adequately secure critical programs.

RECOMMENDATIONS:

- *The department should ensure that ACF2 controls access to all the programs and restricts and logs the more critical ones.*
- *The security officer should review all activity logged by ACF2 and take appropriate action.*

RESPONSE: We basically agree that these are issues that could be improved. We plan to work with the Department of Administration (InterTech) to make Security Dispatch a restricted program. Access would then be limited and accesses that were allowed would be logged.

FINDING #2: The Department does not properly monitor ACF2 violation reports.

RECOMMENDATION:

- *The department should require that supervisors respond whether they reviewed the reports and took appropriate action.*

RESPONSE: The ACF2 violation reports are reviewed daily by the security officer. Many entries which show up as a violation are keying mistakes, which is understandable since we use more than 850 different processes. Any problem that is apparent to the security officer is pursued immediately and, if deemed serious, an investigation is conducted involving either the Human Resource Management Division or Internal Audit, as appropriate.

Quarterly, the violation reports are sent out to the supervisors for their review and follow-up. We have provided instructions to the supervisors regarding what to look for in reviewing the violation reports. We do not feel that having the supervisors confirm in writing that they have reviewed the reports and taken appropriate action will improve the outcome. Such a procedure would require constant follow-up to get confirmation back from the supervisors; we do not have the resources to enforce such a requirement. Since we have limited resources, we must be particular in setting our strategies. Additionally, we feel that implementing this recommendation would create the appearance of control without real substance.

FINDING #3: Controls over the assignment of temporary passwords are inadequate.

RECOMMENDATION:

- *The security officer should only assign passwords to users after obtaining proper authorization and verification by the users' supervisor or log off system entirely.*

RESPONSE: This recommendation has been implemented. Supervisors have been notified that they (rather than the employee) will be required to contact the security officer before re-activation of suspended passwords could occur. Also, a bulletin was sent to all employees, informing them of this requirement.

FINDING #4: The Department does not perform adequate control procedures over the review of certain withholding tax information.

RECOMMENDATION:

- *The Department of Revenue should establish appropriate control procedures to resolve this issue.*

RESPONSE: We are in the process of developing appropriate control procedures to resolve this issue.

FINDING #5: Controls over receipts need improvement.

RECOMMENDATION:

- *The department should reconcile income and sales tax receipts on the department's system to SWA on a monthly basis.*

RESPONSE: This reconciliation function had been done in the past; however, due to key staff turnover, it was temporarily discontinued. That position has subsequently been filled and the reconciliation function reinstated.

FINDING #6: Controls over Outstate deposits need improvement.

RECOMMENDATION:

- *The department's satellite collection offices should deposit receipts at local depositories.*

RESPONSE: There is no simple solution to this finding. The potential interest-bearing time gained by local depositing must be weighed against the costs of establishing and maintaining out-state depositories, wire transfer fees, controls, reconciliations, etc. We will be reviewing this matter and investigating alternatives. Implementation of this recommendation will be deferred until we have a cost effective solution that will produce some really meaningful improvements.

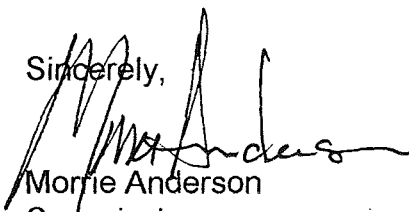
FINDING #7: Corporate income tax processing controls need improvement.

RECOMMENDATIONS:

- *The department should establish appropriate control procedures to resolve this issue.*
- *The department should develop controls to ensure interest is charged on the underpayment of estimated taxes.*

RESPONSE: These recommendations have been implemented. The Audit Division has proceeded to implement the recommended control procedures. When situations of tax underpayments are detected, the taxpayer is now being billed the appropriate penalties and interest.

Sincerely,



Morrie Anderson
Commissioner

c.c. John Lally, Deputy Commissioner
Heather Wisniewski, Information Access & Data Security Management
Dennis Louis, Document Processing Division
Larry Wilkie, Audit Division
Jim Maurer, Office of Internal Audit