

DEPARTMENT OF REVENUE

FINANCIAL AUDIT

FOR THE YEAR ENDED JUNE 30, 1993

MAY 1994

Financial Audit Division
Office of the Legislative Auditor
State of Minnesota

94-17



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, 1993. 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, 1993.

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, regulations and contracts. 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 judgments 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;
- sales taxes;
- corporate income taxes;
- gas and special fuel taxes.
- insurance premiums taxes; and

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 through 6, 8, and 9 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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Members of the Legislative Audit Commission
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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.

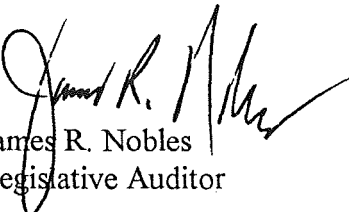
We also noted other matters involving the internal control structure and its operation that we reported to the management of the Department of Revenue in a meeting held on March 17, 1994.

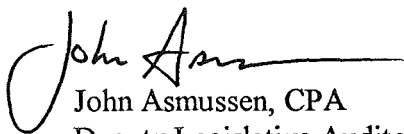
The results of our tests indicate that, except for the issues discussed in findings 6, 7, 8, 9, and 10 with respect to the items tested, the Department of Revenue complied, in all material respects, with the provisions referred to in the audit scope paragraphs. With respect to items not tested, nothing came to our attention that caused us to believe that the Department of Revenue had not complied, in all material respects, with those provisions.

Pursuant to Minn. Stat. Section 3.975, finding 10 of this report shall be referred to the Legislative Audit Commission and the Attorney General. The Attorney General has the responsibility to ensure the recovery of state funds and in fulfilling that role may negotiate the propriety of individual claims.

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 May 4, 1994.

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 31, 1994

Report Signed On: April 28, 1994

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, CPA	Audit Manager
Ken Vandermeer, CPA	Auditor Supervisor
Amy Jorgenson, CPA	Senior Auditor
Steve Pyan, CPA	Senior Auditor
Ron Mavetz, CPA	Senior Auditor
Dale Ogren	Staff Auditor

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 March 17, 1994:

Morrie Anderson	Commissioner
John Lally	Deputy Commissioner
Don Trimble	Assistant Commissioner
Debra McMartin	Assistant Commissioner
Bev Driscoll	Assistant to the Commissioner
George Hoyum	Director, Special Taxes
Larry Trimble	Director, Petroleum Tax
Steve Kraatz	Director, Financial Accounting
Jean Jochim	Revenue Accounting
Jim Maurer	Director, Internal Audit
Steve Krovitz	Auditor, Internal Audit
Keith Getschel	Tax Manager
Art Janota	Manager, RISD
Jeff Vogt	Supervisor
Jack Mansun	Tax System Manager
Carole Wald	Income Tax System Manager
Vicki Dickinson	Supervisor

Department of Revenue

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 required to pay taxes to the state and local governments. The department is undergoing a re-engineering process that started in fiscal year 1990. It placed a renewed emphasis 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, the Governor appointed Morrie Anderson as the new commissioner.

The financial activity of the department during fiscal year 1993 is summarized in the following table:

Department of Revenue	
Financial Activity	
Fiscal Year 1993	
Revenues:	
Income taxes	3,889,064,368
Sales taxes	2,427,419,072
Corporate taxes	569,626,380
Gas and special fuel taxes	468,390,312
Insurance premium taxes	\$ 138,532,367
Other receipts	<u>517,400,060</u>
Total	<u>\$8,010,432,559</u>
Expenditures and Tax Refunds:	
Individual refunds	388,185,680
Property tax refunds	148,574,438
Corporate refunds	66,024,278
Local government aid	305,906,238
Homestead/agricultural credit aid	370,296,812
Other expenditures	<u>294,743,699</u>
Total	<u>\$1,573,731,145</u>

Source: Estimated/Actual Receipts Report, Fiscal Year 1993 and the Managers Financial Report, Fiscal Year 1993.

Current Findings and Recommendations

1. PRIOR AUDIT RECOMMENDATION: The department does not adequately secure critical computer programs.

The department does not monitor and control the use of some critical computer programs. The Information Access and Security Division has responsibility for ensuring data security requirements. The department uses the Access Control Facility (ACF2) to control access to the mainframe. The Department of Administration's Intertechnologies Group (Intertech) primarily controls ACF2, but has granted Revenue expanded authority and responsibility.

The Revenue Information System Division (RISD) developed a navigation program called security dispatch to route users through the integrated system. It developed the program to verify that users had the proper authority to enter transactions on the system. When a user enters a transaction on the system, the program seeks access authority from ACF2. However, if security dispatch becomes inactive or disabled, ACF2 automatically allows the transaction. The security dispatch program resides in the library under the control of the librarian, who is responsible for screening access to RISD programmers.

The department responded to this problem last year stating they would work with Intertech to make security dispatch a restricted program and accesses that were allowed would be logged. In fiscal year 1993, the department created a log to record the use of this program, but failed to indicate program changes. More importantly, the security officer did not review the log.

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 security officer should review activity logged on the use of security dispatch and determine if the activity was proper.*
- *The department should ensure that ACF2 controls access to programs and restricts and logs the more critical ones.*

2. PRIOR AUDIT RECOMMENDATION: 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

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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 immediate need, 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 unauthorized users obtain passwords or that users will share passwords. In fiscal year 1993, the department required supervisors to make the phone call to request reinstatement of suspended users. Although the department did not obtain complete compliance, control improved. However, the supervisors did not follow-up their request for immediate reinstatement with a written request. Another alternative would be to increase the number of attempts allowed from the current practice of one to two or three.

Recommendation

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

3. PRIOR AUDIT RECOMMENDATION: The Department does not adequately review certain withholding tax information.

Our review of withholding tax information indicated the department 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 the amount deposited to the MW-5 coupon or wire transfer reports and enters the information onto its computer system.

The department requires employers to submit quarterly MW-1 reports, and enters the information 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.

In response to our prior year audit recommendation, the department made minimal progress towards improving the annual reconciliation procedures. During fiscal year 1993, the department compared amounts reported on the annual returns to the quarterly returns and identified differences exceeding \$500. However, the department only verified amounts posted and did not investigate amounts overclaimed.

The department also requires employers to submit annual MW-3 reports that reconciled withholding tax submitted for the calendar year. However, we discovered that the department could not account for approximately 15,000 or 15 percent of the MW-3 reports for calendar year 1992.

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The department could compare the population of withholding filers to annual reconciliations received, but has not done this for several years. As a result of the control issues 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 over the review of withholding tax information.*

4. PRIOR AUDIT RECOMMENDATION: Controls over receipts need improvement.

The accounting unit does not reconcile tax receipts deposited on SWA with tax receipts posted to the department's tax payer accounting (TPA) system. Also, the department does not reconcile accounts monthly. It is the department's responsibility to collect and process various tax receipts for the state of Minnesota. Tax receipts arrive at the department directly through the mail, and indirectly through electronic fund transfers (EFT) and interagency transfers. EFT's originate from banks and interagency transfers are from other state agencies. The department's cash processing unit is responsible for depositing receipts and accurately recording the deposits on the statewide accounting system (SWA). Various tax processing units receive the tax information after the cash processing unit deposits the receipts. The tax processing units enter the receipt information, along with other information provided on the tax forms, onto the department's accounting systems. The department's accounting systems internally record the amount billed and received for each taxpayer. TPA is the main accounting system, but there are several other supporting systems.

Prior to January 1994, the accounting unit did not reconcile to SWA reports. In addition, documentation to support nonTPA accounting system balances was missing. The accounting unit is responsible for reconciling the department's accounting systems to SWA to verify the accuracy of amounts posted to the various accounting systems. However, the department did not complete reconciliations on a routine basis shortly after the end of each month. Untimely reconciliations make the department susceptible to intentional and unintentional errors.

Recommendation

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

5. PRIOR AUDIT RECOMMENDATION: Controls over outstate deposits need improvement.

The department does not deposit revenues received by outstate collection offices promptly. Currently, outstate collection offices mail their receipts to the central office, thereby creating a two to four day time lag. The secondary mailing of receipts creates an unnecessary deposit time

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lag and exposes the receipts to unnecessary risks. The department's satellite offices collected \$49.6 million in tax receipts during fiscal year 1993.

The department has ten satellite collection offices located in Minnesota. Four offices are in the metro area and six are 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.

Ely, the largest satellite office, collected \$23.8 million in receipts. 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.

The department responded to this problem by indicating it would defer implementation until it studied the costs of establishing and maintaining outstate depositories, wire transfer fees, controls and reconciliations. The department stated it would weigh the potential interest bearing time gained by local deposits against the additional costs. The department has initiated use of a local depository in Ely. However, this is used for only one receipt type. The other receipt types remain under consideration. Other alternatives, such as centralizing the receipt process in one location in the central office are also under consideration.

Recommendation

- *The department's satellite collection offices should deposit receipts at local depositories or possibly centralize the receipt process in the central office.*

6. PRIOR AUDIT RECOMMENDATION: Corporate income tax processing controls need improvement.

The department does not charge interest to corporations who underpay estimated taxes. In addition, 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 is capable 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 created a temporary position during fiscal year 1993 to manually calculate the interest charges. The department abolished the position even though its records indicated that this position recovered over \$350,000 in lost charges. The department reinstated the position to resume testing in January of 1994, but has not finalized its selection criteria at this time.

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We noted that the department has omitted certain control procedures concerning the verification of corporate income tax returns. The department recognizes the control weakness and intends to resolve the control issue raised with the new position. Until the department resolves the control issue, it 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 should develop controls to charge interest on the underpayment of estimated taxes.*
- *The department should establish appropriate control procedures to verify corporate income tax returns.*

7. Penalties and interest on Electronic Funds Transfer (EFT) tax payments are not assessed.

The department does not consistently identify and assess penalties and interest against taxpayers that submit a late tax payment using the EFT payment method. During our testing, we noted four sales tax payments paid beyond the due date, but processed as if they were timely. The combined interest and penalties on these four payments would have been \$10,276. The department should also assess late payment charges on all tax types as discussed in Minn. Stat. Section 289A.60, Subd. 1 and Section 270.75

Minn. Stat. Section 289A.26, Subd. 2a, requires businesses with an annual tax liability of \$80,000 or more to submit their tax payments using EFT. Under Minn. Stat. Section 270.07, the department waived the enforcement of the interest and penalty charges for late payments for ten months. It waived charges based on the need for taxpayers to become familiar with the new reporting requirements.

Since October of 1992 when the department removed the waiver, the EFT processing section tries to manually determine if payments are beyond the due date. However, because of the large number of EFT filers, it is difficult to detect every late payment. Furthermore, the department has not formally delegated the responsibility to detect late EFT payments to the EFT processing section. The EFT section believes it is the responsibility of each tax processing area to identify late payments. The number of taxpayers required to use the EFT method will increase substantially in fiscal year 1994, making manual detection of late payments even more cumbersome.

Recommendations

- *The department should develop procedures to routinely identify late EFT tax payments.*
- *The department should assess penalties and interest on EFT payments as required by Minn. Stat. Sections 289A.60, Subd. 1 and Section 270.75.*

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8. Controls over transferring sales tax revenue to the Local Government Trust Fund need improvement.

The department inappropriately transferred \$66 million in sales tax revenue to the Local Government Trust Fund. In addition, the department omitted some adjustments, and reported other adjustments after the reporting deadlines. Minn. Stat. Section 297A.44, Subd. 4, requires the department to transfer a percentage of sales tax revenue from the General Fund to the Local Government Trust Fund. The state uses this fund to pay its obligations to local governments. During fiscal year 1993, the department transferred funds on a sporadic basis. Sometimes daily, weekly, biweekly, and even on a monthly basis. This inconsistent basis led to double transfers and calculation errors that the department did not detect. As a result, the department transferred \$66 million into the Trust Fund that was not allowed by statute. When notified of this control weakness, the department took steps to correct the problem and also transferred the funds back to the General Fund.

Recommendation

- *The department should ensure that transfers made to the Local Government Trust Fund are in proportion to total sales tax collections on a consistent basis.*

9. The department's review of insurance premium tax returns is insufficient.

Insurance premium tax audits conducted by the department have several weaknesses. First, we question the department's method used in selecting returns for audit. Minn. Stat. Chapter 270B classifies the criteria used to select returns for audit as protected nonpublic data. Therefore, we omitted a detailed explanation of this weakness.

In addition, interest and penalty charges for late payments and underpayment of the tax liability are not properly assessed. Currently, the department only assesses interest and penalties on audited returns. State statutes direct the department to assess interest and penalties for returns that do not meet certain requirements. Interest and penalties help control the timely reporting and payment of taxes. Without proper enforcement, the effectiveness of the control diminishes.

Recommendations

- *The department should develop meaningful criteria for the selection of returns for audit.*
- *The department should charge interest and penalties for either late returns or underpayments.*

10. A consultant was overpaid under a price contract agreement.

The department's internal auditor recently concluded that the department overpaid the Computer Power Group (CPG) \$45,787.50 more in consultant service fees than allowed by contract. The

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internal auditor indicated that CPG billed and received \$123,112.50 for consultant services when the maximum amount billable under the master contract should have been \$77,325. The overpayment was on a Customer Service Center Project plan covering the period May 1992 to September 1992.

The internal auditor calculated the overpayment based on the application of consultant rates for services specified within the master contract, a price contract agreement. CPG actually charged and billed the department at the higher consultant rates identified in its work plan for the Customer Service Center (CSC) Project. For example, CPG billed out its three consultants at the rate of \$187.50 per hour. The maximum billable rates under the contract for these consultant positions was \$75 per hour. It was the internal auditor's finding that the language in the master contract should prevail since the CSC project document was a work plan and not a contract. Additionally, no revisions or amendments to the original master contract were made.

The department acknowledged that it made some administrative mistakes in overseeing the CSC project but believe it is inappropriate to force CPG to pay for those mistakes. Accordingly, we are referring this finding to the Attorney General. The Attorney General has the responsibility to ensure the recovery of state funds and in fulfilling that role may negotiate the propriety of individual claims.

We reviewed the internal auditors work papers, including a review of the master contract, the customer service center project plan and CPG's billings for the period May 1992 through September 1992. We concur with the internal auditors conclusion that the department overpaid CPG by \$45,787.50 during the period May 1992 through September 1992.

Recommendation

- *The department should recover \$45,787.50 from the Computer Power Group for overpayments the CPG was not entitled to receive under a price contract agreement with the department.*

April 20, 1994

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'93 statewide audit report.

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

RECOMMENDATIONS:

- *The security officer should review activity logged on the use of security dispatch and determine if the activity was proper.*
- *The department should ensure that ACF2 controls access to programs and restricts and logs the more critical ones.*

RESPONSE: The controls recommended by the Legislative Auditor are in place. The Revenue Information Systems Division has restricted security dispatch, and maintains a log for any use of this program. This log will now be reviewed by a member of the Information Access & Security Unit.

FINDING #2: 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 the system entirely.*

RESPONSE: The number of user incorrect attempts has been increased from one to three. In addition, through installation of the TCP/IP address, each PC is tied to a particular employee with unique passwords. This mechanism should enable more rapid, written follow-up by supervisors requesting reinstatement of suspended users. We have also extended the authority to request reinstatement to divisional work group managers, provided their supervisor provide the Security Unit with a written authorization to extend this authority.

FINDING #3: The Department does not adequately review certain withholding tax information.

RECOMMENDATION:

- *The Department of Revenue should establish appropriate control procedures over the review of withholding tax information.*

RESPONSE: We agree with the audit finding. As noted, the department made minimal progress last year in comparing annual returns to quarterly returns to identify and resolve differences.

During the next fiscal year, we intend to account for the estimated 15 percent of missing MW-3 reconciliations by identifying which returns are actually missing and which ones are simply here in the department but not processed, assessing appropriate penalties, and measuring the revenue impact of the missing returns, at least on a sample basis.

FINDING #4: Controls over receipts need improvement.

RECOMMENDATION:

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

RESPONSE: Our reconciliation process is now timely. We are just completing March 1994 and will continue to maintain a 30 day standard (reconciliations will be complete within 30 days after month end). In order to maintain this standard and add the Minnesota Care tax types, we will be filling a vacant position. We have modified our reconciliation to tie in receipts from SWA, our internal remittance processing systems, TPA and our return processing systems. When our reconciliations for FY'94 are reviewed, they will reflect compliance with this recommendation.

FINDING #5: Controls over Outstate deposits need improvement.

RECOMMENDATION:

- *The department's satellite collection offices should deposit receipts at local depositories or possibly centralize the receipt process in the central office.*

RESPONSE: The Collection Division has been addressing the problem of delayed depositing of delinquent tax receipts received by out-state collection offices. Beginning May 1, 1994 all delinquent tax receipts for the Ely office [which comprises approximately 50% of out-state collections] will be received at a central office P.O. box. Three metro offices, located outside the central office, account for another 35% of the out-state receipts. These offices process the payments daily and should be received in the central office the next day. While we realize that this "solution" does not address the entire problem, we feel that it is substantial.

FINDING #6: Corporate income tax processing controls need improvement.

RECOMMENDATIONS:

- *The department should develop controls to charge interest on the underpayment of estimated taxes.*
- *The department should establish appropriate control procedures to verify corporate income tax returns.*

RESPONSE: Effective December 1993, the department began charging penalty and interest on the underpayment of estimated taxes. The appropriate control procedures to verify corporate income tax returns have also been implemented. We originally hired a part-time person to handle this verification process; we have since hired a full-time person for this function.

FINDING #7: Penalties and interest on Electronic Funds Transfer (EFT) tax payments are not assessed.

RECOMMENDATIONS:

- *The department should develop procedures to routinely identify late EFT tax payments.*
- *The department should assess penalties and interest on EFT payments as required by Minn. Stat. Sections 289A.60, Subd. 1 and Section 270.75.*

RESPONSE:

The DOR Executive Team met on March 17, 1994 and approved the following guidelines for the application of EFT penalties, effective for EFT payments due, beginning in March, 1994:

- Payments must be received on the due date in order to avoid penalties. No grace period will be allowed. The taxpayers will have to initiate the action early enough on the processing day to ensure funds are actually received at DOR on the due date.
- If late EFT payments are due to computer software problems at either the bank or at DOR, no penalty will be assessed.
- All EFT taxpayers will be allowed a one-time abatement of late filing penalties after they meet the requirements for electronic payment.

FINDING #8: Controls over transferring sales tax revenue to the Local Government Trust Fund need improvement.

RECOMMENDATION:

- *The department should ensure that transfers made to the Local Government Trust Fund are in proportion to total sales tax collections on a consistent basis.*

RESPONSE: The Revenue Accounting Division, Research Division and Sales Tax System Manager met in October 1993 to develop procedures to ensure that this procedure is completed timely and accurately. The Revenue Accounting Division was assigned responsibility to review transfers made in July through October 1993 for accuracy and to begin making monthly transfers to the Local Government Trust Fund in November 1993 based on data from the new Sales Tax System. We are currently performing this function. At fiscal year end, the Revenue Accounting and Research Divisions will collaborate to determine the

appropriate adjustments to the funds. These adjustments will be completed prior to the fiscal year closing in August 1994.

FINDING #9: The department's review of insurance premium tax returns is insufficient.

RECOMMENDATIONS:

- *The department should develop meaningful criteria for the selection of returns for audit.*
- *The department should charge interest and penalties for either late returns or underpayments.*

RESPONSE: We have been in the process of developing a computer system for insurance taxes for some time and expect to be able to execute the appropriate programs, within 90 days, to rectify the shortcomings cited by the Legislative Auditor. We also now have access to the National Association of Insurance Commissioner's (NAIC) database, which contains insurance company financial data. With this system, we will be able to develop sophisticated audit selectors not previously possible as well as compare the tax returns with the insurance companies financial data on the NAIC database. Additionally, we will soon be running penalty and interest calculations for prior years and will be able to maintain currency on these calculations in the future.

FINDING #10: a consultant was overpaid under a price contract agreement.

RECOMMENDATION:

- *The department should recover \$45,787.50 from the Computer Power Group for overpayments that CPG was not entitled to receive under a price contract agreement with the department.*

RESPONSE: The department's master contract for systems services was competitively bid in 1993. It allows the department to draw on the expertise and staff resources of six successful approved vendors for a variety of consulting and labor services. We have two engagement options under the contract. The simplest method is paying for services on a straight time-and-materials basis. This approach is primarily useful for engaging professional staff to bring specific skills into the department as a temporary supplement to our regular employee base. We also have the option of negotiating a fixed project fee for a specific work plan with one of the approved vendors. This approach is generally most valuable for short, intense projects or, conversely, for very long and complex projects.

In the case of the service center project, RISD negotiated a fixed fee price for the project with CPG. In all of the work papers, purchase orders and meetings, this was the understood arrangement. However, the actual boilerplate cover document for the project mistakenly referred to this as a time-and-materials contract. In the opinion of our internal auditor, this document was the controlling document for the project and not the work papers and project plan.

It was the deputy commissioner's judgment that the contractor had negotiated in good faith with us, had delivered a quality product according to budget and schedule, and was not at fault for the technical inconsistency of the project documentation. From an ethical standpoint, he believed that the contractor is in fairness entitled to full payment for the project. From a legal standpoint, our understanding is that the state's legal position is open to question under the contract theory, and that we would be subjected to costly litigation if we attempted to enforce the auditor's opinion. For both practical and ethical reasons, then, the auditor's recommendation was not followed and we ordered the contract fee to be paid.

The legislative auditor has accepted the internal audit opinion and referred this matter to the Attorney General's office for resolution. The vendor does not agree that an overpayment occurred, but indicated a willingness to seek a compromise that will avoid costly litigation for both sides. With the help of the Attorney General's office, a satisfactory settlement was reached in this dispute and a final settlement agreement signed.

We brought this item to the attention of the OLA last year, and acknowledged last summer that the error in contract documentation is ours. This experience was to us an indication of the need for a final internal, substantive contract review process to complement the existing interagency review as to form and financing. An executive task force is reviewing best practices and contract management processes at the current time. The report of this task force is due in May and will result in operational improvements to contract administration at the department level.

Sincerely,



Morrie Anderson
Commissioner

c.c. John Lally, Deputy Commissioner
Dwight Lahti, Assistant Commissioner
Bev Driscoll, Assistant Commissioner
Don Trimble, Assistant Commissioner
Deb McMartin, Assistant Commissioner
Jim Maurer, Office of Internal Audit