Department of Revenue

For the Year Ended
June 30, 2001

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STATE OF TENNESSEE
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John G. Morgan
Comptroller

July 30, 2002

The Honorable Don Sundquist, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
The Honorable Ruth E. Johnson, Commissioner
Department of Revenue
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Department of Revenue for the year ended June 30, 2001.

The review of management's controls and compliance with policies, procedures, laws, and regulations resulted in certain findings which are detailed in the Objectives, Methodologies, and Conclusions section of this report.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/mb
02/019

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April 8, 2002

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have conducted a financial and compliance audit of selected programs and activities of the Department of Revenue for the year ended June 30, 2001.

We conducted our audit in accordance with government auditing standards generally accepted in the United States of America. These standards require that we obtain an understanding of management controls relevant to the audit and that we design the audit to provide reasonable assurance of the Department of Revenue's compliance with the provisions of policies, procedures, laws, and regulations significant to the audit. Management of the Department of Revenue is responsible for establishing and maintaining internal control and for complying with applicable laws and regulations.

Our audit disclosed certain findings which are detailed in the Objectives, Methodologies, and Conclusions section of this report. The department's administration has responded to the audit findings; we have included the responses following each finding. We will follow up the audit to examine the application of the procedures instituted because of the audit findings.

We have reported other less significant matters involving the department's internal controls and/or instances of noncompliance to the Department of Revenue's management in a separate letter.

Sincerely,

Arthur A. Hayes, Jr., CPA,
Director

AAH/mb

State of Tennessee

Audit Highlights

Comptroller of the Treasury Division of State Audit

Financial and Compliance Audit
Department of Revenue
For the Year Ended June 30, 2001

AUDIT SCOPE

We have audited the Department of Revenue for the period July 1, 2000, through June 30, 2001. Our audit scope included a review of management's controls and compliance with policies, procedures, laws, and regulations in the areas of Information Technology Resources, Processing, Taxpayer Services, Tax Enforcement, Expenditures, Equipment, Taxpayer Accounting, Revenue Accounting, and compliance with the Financial Integrity Act. The audit was conducted in accordance with government auditing standards generally accepted in the United States of America.

AUDIT FINDINGS

The Department Lacks Adequate Control Over Write-Offs of Tax Liabilities
Numerous employees in the Fiscal Administration and Taxpayer Services divisions have access capabilities within the Revenue Integrated Tax System (RITS) to write off large liabilities without obtaining approval or maintaining documentation for each tax write-off.

Deposit Dates of Payments Requiring Special Processing Are Not Always Recorded Correctly *
Deposit dates on RITS automatically change when the account is updated, resulting in inaccurate information recorded in RITS.

Supervisors Do Not Properly Review Changes to Taxpayers' Account Balances
The department is not reviewing account balance changes as required by the Department of Revenue's "Guidelines for Changing Account Balances and Approving Those Changes." According to guidelines, supervisors are required to initial, date, and make comments on certain adjustments on the Employee Transaction Activity Reports.

Tax Bonds Held by the Department Lack Proper Signature Approval
Fifty-nine of 60 motor fuel tax bond accounts tested and 24 of 25 tobacco tax bond accounts tested did not contain the signature approval of the Commissioner.

The Department Lacks Control Over Refunds and Does Not Minimize Interest Paid **
Refunds are not sent to the Attorney General's office or processed within 45 days, and interest calculations are not accurate.

Approval of Refund Claims Was Not Always Documented
Depending on the dollar amount of refund requests, the department is required to document approval from the Attorney General's office or from departmental supervisors. However, documentation of these approvals was not located.

* This finding is repeated from the prior audit.
** This finding is repeated from prior audits.

"Audit Highlights" is a summary of the audit report. To obtain the complete audit report, which contains all findings, recommendations, and management comments, please contact

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Audit Report
Department of Revenue
For the Year Ended June 30, 2001

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For the Year Ended June 30, 2001

INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Department of Revenue. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated,* which authorizes the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

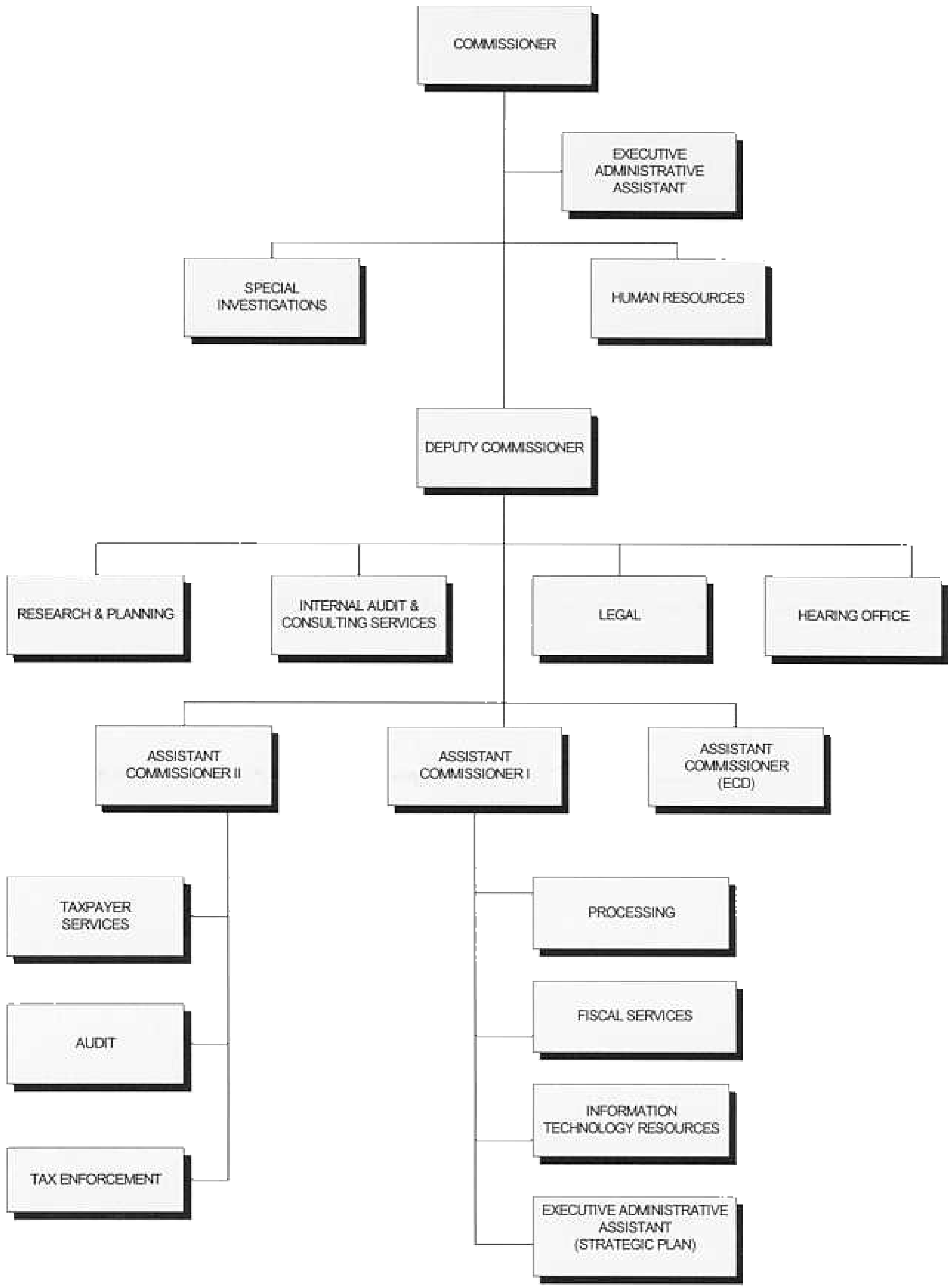
The mission of the Department of Revenue is to collect state revenue. Specifically, the department is responsible for the collection of most state taxes and fees, for enforcing the revenue statutes of the state to ensure that taxpayers are in compliance with all tax laws, and for preparing the monthly apportionment of revenue collections for distribution to various state funds and local units of government. The department also offers taxpayer assistance and taxpayer education. In an effort to perform its duties, the department has divided these functions into six divisions: Administration, Tax Enforcement, Information Technology Resources, Taxpayer Services, Audit, and Processing.

An organization chart of the department is on the following page.

AUDIT SCOPE

We have audited the Department of Revenue for the period July 1, 2000, through June 30, 2001. Our audit scope included a review of management’s internal control and compliance with policies, procedures, laws, and regulations in the areas of Information Technology Resources, Processing, Taxpayer Services, Tax Enforcement, Expenditures, Equipment, Taxpayer Accounting, Revenue Accounting, and compliance with the Financial Integrity Act. The audit

TENNESSEE DEPARTMENT OF REVENUE



was conducted in accordance with government auditing standards generally accepted in the United States of America.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Department of Revenue filed its report with the Department of Audit on February 1, 2002. A follow-up of all prior audit findings was conducted as part of the current audit.

RESOLVED AUDIT FINDINGS

The current audit disclosed that the Department of Revenue has corrected previous audit findings concerning computer programs used to change data in RITS, timely deposits of special processing remittances, balancing problems in RITS, and follow-up of tax enforcement cases.

REPEATED AUDIT FINDINGS

The prior audit report also contained findings concerning inaccurate deposit dates of payments requiring special processing and proper tracking and monitoring of refund claims in order to minimize interest paid. These findings have not been resolved and are repeated in the applicable sections of this report.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

INFORMATION TECHNOLOGY RESOURCES

Our objectives in reviewing the Information Technology Resources (ITR) division were to determine whether

- relevant policies and procedures have been placed in operation;
- computer resources were planned, managed, and utilized effectively;
- an adequate disaster recovery plan had been implemented;
- adequate system information had been documented;
- user access to the Revenue Integrated Tax System (RITS) was adequately controlled;

- adequate controls were in place over RITS program changes; and
- error correction procedures were in place and were implemented.

We examined the policies and procedures manuals to determine if policies and procedures were current and reflected existing operational conditions. To determine if computer resources were managed appropriately, we reviewed the minutes and purpose of the Management Advisory Committee and reviewed the three-year plan. We also interviewed key personnel and reviewed the disaster recovery plan to determine that it had been implemented and was current. In addition, we reviewed individuals with Resource Access Control Facility (RACF) special access and verified that passwords were changed on a regular basis, and we reviewed access of terminated employees and dataset protection. We also tested a nonstatistical sample of users for proper access to RITS screens to determine if user access to RITS is adequately controlled. To determine if the system was adequately documented, we interviewed key personnel and reviewed RITS documentation. We tested nonstatistical samples of Sequential Processing User File Inputs (SPUFIs) and program changes to determine if adequate controls were in place. Finally, we examined error reports to conclude whether modifications were made as necessary to correct RITS errors.

As a result of our review, we determined that relevant policies and procedures were placed into operation; computer resources were planned, managed, and utilized effectively; and an adequate disaster recovery plan was in place. Also, RITS application documentation was complete, and user access was adequately controlled. Controls over SPUFIs and program changes were in place, and error corrections were appropriate. However, we determined that adequate controls were not in place over tax liability write-offs. In addition to the finding, a minor weakness was reported to management in a separate letter.

1. <u>The department lacks adequate control over write-offs of tax liabilities</u>

Finding

The Fiscal Administration and Taxpayer Services divisions have access capabilities within the Revenue Integrated Tax System (RITS) to write off tax liabilities. Discussions with management revealed that there are no established procedures for the write-off process. As a result, write-offs do not go through an approval process, and documentation is not being kept in either division.

In addition, an excessive number of people have write-off access in the computer system. Eleven people in the Taxpayer Services Division can write off amounts up to $5,000. Seven people in the Fiscal Administration office can write off amounts up to $100 million. These threshold amounts are set within the RITS system. Without a requirement for approval of these transactions, both the number of people who have write-off access and the amount of each write-off should be limited.

Failure to create and implement write-off policies and procedures results in a lack of control over tax liability amounts. The liberal access that has been granted could result in liabilities being inappropriately written off. Errors and irregularities would be difficult to detect due to the lack of documentation.

Recommendation

The department should create and implement policies and procedures for the tax liability write-off process that include approvals by upper management and retaining documentation for each write-off transaction. The number of employees with write-off access and the threshold amount should be limited to the minimum necessary to adequately perform the write-off duties. Computer controls should be established to prohibit write-off of high-dollar amounts without proper approval.

Management's Comment

We concur. The Department is developing new written operating policies and procedures for account balance write-offs. Also, the number of employees who have write-off access has been reduced to three in the Taxpayer Services Division and to four in the Fiscal Services Division. The threshold amount that can be written off by these employees has been reduced to $5,000 for Taxpayer Services and $50,000 for Fiscal Services. Any increase in the threshold amounts must be approved by upper management and will only be in effect for the short period required to complete the write-off process.

We have run a program that lists all manual write-offs made during the audit period and the employee who made each write-off. In the future, this report will be run on a frequent basis, and upper management will timely approve the write-off(s) on each report. In addition, the Department is currently developing an automated program to write off amounts that meet certain criteria in accordance with specific policies and procedures. This program will allow us to keep the number of employees with write-off access to a minimum and will allow us to approve and document write-offs more efficiently.

PROCESSING

Our objectives in reviewing the Processing Division were to determine whether

- policies and procedures that affect each unit of the Processing Division have been identified,
- funds received by the Processing Division are properly safeguarded and deposited in a timely manner,
- policies regarding date stamps and envelope retention are followed,

- remittances are being properly recorded by the Exceptions Processing Unit, and
- the Exceptions Processing Unit adequately safeguards funds and makes deposits in a timely manner.

We interviewed key personnel to gain an understanding of the division's policies and procedures. The process of safeguarding revenue received was observed and discussed with the appropriate personnel. Nonstatistical samples of cash receipts were tested to determine if deposits were made timely and recorded accurately by the Processing Division and the Exceptions Processing Unit. We tested a nonstatistical sample of returns for date stamps and envelope retention.

As a result of our testwork, we determined that funds were appropriately safeguarded and deposited in a timely manner, and that policies regarding date stamps and envelope retention were followed. Remittances were recorded properly; however, we found that there are problems with recording deposit dates on the Revenue Integrated Tax System (RITS). In addition to the finding, other minor weaknesses were reported to management in a separate letter.

2. **<u>Deposit dates of payments requiring special processing are not always recorded correctly</u>**

Finding

As noted in the prior audit, the Department of Revenue does not ensure that accurate and consistent deposit dates are recorded on the Revenue Integrated Tax System (RITS) and other internally created supporting documents for taxpayer payments. Sixteen of 60 exception payments tested (27%) had incorrect deposit dates recorded in RITS. Exception payments are payments that are not processible in the original form in which they are received or that have other special handling requirements. While they are investigated, the payments are deposited in the suspense account. For taxpayer payments tested that were placed in the suspense account, 9 of 60 deposit dates (15%) were not consistently recorded in RITS and on supporting documentation.

Discussions held with Department of Revenue staff revealed that updates made to the RITS system sometimes automatically alter the recorded deposit date of a payment. The inconsistent and inaccurate deposit dates make it difficult to determine if the deposit of the payments was made timely and if the payment was applied to the taxpayer account.

The prior audit report noted that 21 of 27 exception payments tested that were received on February 20, 2001, (78%) had incorrect receipt or deposit dates recorded in RITS. It also noted that for taxpayer payments that were suspended for the period September 2000 through October 2000, 63 of 71 receipt or deposit dates (89%) were not consistently recorded in RITS and on supporting documentation. Management responded, "The department will work to develop and implement a policy addressing consistency and accuracy of the RITS receipt and deposit date in the processing of documents and remittances." Corrective action appears to have been taken regarding the problems with the receipt dates. However, a reprogramming of RITS may be necessary to correct the problems with deposit dates.

Recommendation

The Department of Revenue Information Technology Resources Division should make an immediate program change to RITS that would eliminate the problem of deposit dates changing on the system automatically.

Management's Comment

We concur. Departmental personnel, including persons from the Processing Division's Exceptions Unit, create 035 documents to process a payment that has been either sent to the department without proper documentation, that has some type of special handling requirement, or that has been generated for bill payment purposes. In response to a previous audit finding, the Processing Division implemented a policy of date stamping all items upon receipt by the Exceptions Processing Unit. This policy has been consistently followed since that time. However, as noted, the current procedures did not fully address the weakness with deposit dates.

The ITR Division is currently investigating RITS to determine why the deposit date is changed in certain instances. Once ITR has identified the system/programming weakness that is causing these errors, the division will work with pertinent Revenue divisions to make an immediate update to RITS to eliminate the problem.

TAXPAYER SERVICES

Our objectives in reviewing Taxpayer Services were to determine whether

- certain rules, regulations, and laws that affect taxpayer registration have been identified;
- refunds were to valid taxpayers;
- the section's managerial controls over corrections and changes to taxpayer account balances in the Revenue Integrated Tax System (RITS) are effective;
- the procedures for adding and deleting taxpayer accounts are proper; and
- procedures for the taxpayer customer services line were established.

We interviewed key personnel to gain an understanding of the department's procedures and compliance with rules and laws. Certain rules, regulations, and laws that affect taxpayer registration were identified and reviewed. We selected a nonstatistical sample of refunds, and we verified existence of taxpayers. Employees having access to make corrections and changes to taxpayers' accounts on RITS were reviewed for proper authorization. We tested a nonstatistical sample of account balance changes to determine whether the change was properly documented and approved. We also reviewed error reports. We tested non-statistical samples of new corporations and deleted corporations from the taxpayers listed on RITS to determine if the corporations were properly recorded or properly removed. We discussed with management and verified the procedures that were established for the taxpayer services' customer service phone system.

Based on our work, we determined that refunds were made to valid taxpayers and that procedures for adding and deleting taxpayer accounts are proper. Rules, regulations, and laws were identified, and the procedures over the customer services line were established. However, we found that controls over changes to taxpayer account balances were ineffective. We also determined that the department was not following established procedures for approving bonds. In addition to the findings, a minor weakness was reported to management in a separate letter.

3. <u>Supervisors do not properly review changes to taxpayers' account balances</u>

Finding

The department's Taxpayer Services supervisors do not always review certain account balance changes made by employees. None of 25 account balance changes tested (100%) received a proper review by management, as required by the Department of Revenue's "Guidelines for Changing Account Balances and Approving Those Changes." The Supervisory Review section states,

> The Information Technology Resource (ITR) division generates an Employee Transaction Activity report that lists all account balance changes made in the RITS conversations by an employee based on their work unit. This Infopac report should be disseminated to supervisors and supervisors should be required to review adjustments made by their employees. Supervisors should review, at a minimum the following:
>
> - Multiple changes made to a taxpayer's account
> - Adjustments made by probationary employees
> - Representative sample of all other adjustments made by their employees.
>
> For audit purposes, the supervisor must initial, date, and make comments on adjustments reviewed on the RITS Report. The comments should indicate whether or not the adjustment was correct. These records should be retained for a period of three (3) years by the division.

During the testwork performed on account balance changes, 25 of 25 changes tested (100%) did not receive the initials, the date, or comments on adjustments by supervisors. The supervisors did not inspect employee changes for the three minimum requirements mentioned in their guidelines. For the Employee Transaction Activity Reports retained by Taxpayer Services, it appears the review only covered the first three pages of the report and that the review did not include multiple changes to a taxpayer's account or a representative sample of the changes made. Also, the division did not maintain the Employee Transaction Activity Reports for three years, as required by the guidelines. The division only maintained 13 nonconsecutive reports, and only 10 of the 13 months were for the year ended June 30, 2001.

When supervisors do not properly review account balance changes, the risk of detecting improper changes increases, which could compromise taxpayer accounts.

Recommendation

The Department of Revenue management should instruct their supervisors to follow the review procedures for account balance changes outlined in the department's guidelines.

Management's Comment

We concur. Supervisors in the Taxpayer Services Division will begin to review account balance changes in accordance with standards outlined in the department's "Guidelines For Changing Account Balances and Approving Those Changes." The document will be enforced for the review of all or a representative sample of the changes performed.

Operational supervisors will be required to obtain copies of their unit's current Employee Transaction Activity Reports. The reports should be reviewed for at least the minimum review requirements outlined in the "Guidelines." Certain sensitive adjustments, as defined in the guideline document, should receive special review, "prior to system changes by employees they supervise."

The supervisors should record their initials, the date of the review, and any pertinent comments on the correctness of the adjustment, for each transaction/change reviewed. The documentation containing the record "should be retained for a period of three (3) years."

4. Tax bonds held by the department lack proper signature approval

Finding

The Department of Revenue does not ensure that signature approval is present on all bonds submitted as surety by licensees or taxpayers. According to personnel, the Commissioner's signature is required on original bonds to indicate that the bond has been properly reviewed and approved. However, 59 of 60 motor fuel tax bond accounts tested (98%) did not contain the signature approval of the Commissioner of the Department of Revenue.

Sixteen of the 59 had the signature of a Department of Revenue employee without signature authority, and the other 43 had no signature approval at all. Also, 24 of 25 tobacco tax bond accounts tested (96%) did not contain the proper signature approval.

Bonds should be reviewed to ensure they are appropriate and of a sufficient amount. The bonds are necessary to ensure payment to the state of taxes, fees, penalty, and interest for which licensees or taxpayers may become liable.

Recommendation

The department should ensure that all bonds receive the signature of the Commissioner of the Department of Revenue or a designee of the Commissioner to indicate approval.

Management's Comment

We concur. All bonds are now being reviewed, approved, and signed off on by personnel authorized by the Commissioner of Revenue to perform the function. Documentation containing the names of all persons authorized to sign in lieu of the Commissioner is maintained in the Taxpayer Services Division.

TAX ENFORCEMENT

For the Tax Enforcement Division, our objectives were to determine whether

- rules and regulations of the department and the applicable *Tennessee Code Annotated* sections are complied with;
- regional Tax Enforcement offices are mailing receipts to the department's mail room timely, and the receipts are deposited by the department timely;
- cash received by Tax Enforcement officers is deposited at a local bank timely;
- the classification of delinquent Revenue Integrated Tax System (RITS) accounts as dormant, pending dormant, or unenforceable is properly supported and approved;
- bankruptcy claims are filed timely by the department, and the claims are properly computed and tracked by the department;
- the division is attempting to collect current delinquencies in a timely manner and following the appropriate collection procedures; and
- Tax Enforcement officers' receipt books and diaries are properly completed and reviewed by their supervisors.

We interviewed key personnel and reviewed Tax Enforcement's procedures manual and the applicable *Tennessee Code Annotated* sections to determine if the Tax Enforcement Division is in compliance with rules and regulations. We performed testwork on nonstatistical samples of receipts to determine if they were deposited in a timely manner. To determine if classifications are properly supported and approved, we tested a nonstatistical sample of RITS accounts classified as dormant, pending dormant, or unenforceable. We tested a nonstatistical sample of bankruptcy claims to determine if proper and timely action was taken to collect funds. We performed testwork on nonstatistical samples of receipt books and diaries for completeness and supervisor review. In addition, we tested a nonstatistical sample of delinquent cases to determine if the status was appropriately approved and follow-up was timely.

As a result of our testwork, we determined that the Tax Enforcement Division is in compliance with rules and regulations regarding cash receipts, delinquent accounts, bankruptcy claims, collections, receipt books, and diaries. We found that delinquent cases were followed up in a timely manner. Although we had no findings related to Tax Enforcement, a minor weakness was reported to management in a separate letter.

EXPENDITURES

Our objectives in reviewing Expenditures were to determine whether

- policies and procedures over travel expenditures were placed in operation,
- travel was recorded correctly as to object code and amount,
- payments were made timely, and
- payments were made in accordance with the Comprehensive Travel Regulations.

We interviewed key personnel to gain an understanding of the policies and procedures for expenditures. We selected a nonstatistical sample of travel expenditures to determine if expenditures were charged to the correct object code, payments were made timely, and the payments were in accordance with Comprehensive Travel Regulations

We determined that procedures over expenditures were effective. Travel expenditures were recorded correctly, and payments were timely and in accordance with regulations.

EQUIPMENT

Our objectives in reviewing Equipment were to determine whether

- equipment included on the Property of the State of Tennessee (POST) Exception Report was located or deleted from POST,
- equipment was correctly listed on POST,

- equipment was adequately safeguarded, and
- equipment purchases were properly supported and in compliance with relevant rules and regulations.

Key personnel were interviewed to gain an understanding of the department's procedures and controls over the inventory of equipment and safeguarding of equipment owned by the department. We selected a nonstatistical sample of equipment to determine if the items existed and were correctly listed in POST. We also selected a nonstatistical sample of equipment observed and traced relevant information back to POST. In addition, we selected a nonstatistical sample of State of Tennessee Accounting and Reporting System (STARS) equipment expenditures to review for support and compliance.

Based on our interviews, review of supporting documentation, and testwork, we determined that equipment was present, correctly listed on POST, and adequately safeguarded. Also, equipment purchases were supported and in compliance with relevant rules and regulations. Although we had no findings related to Equipment, a minor weakness was reported to management in a separate letter.

TAXPAYER ACCOUNTING

Our objectives for reviewing Taxpayer Accounting were to determine whether

- controls over the refund process for taxpayer accounting are adequate;
- refunds have been reviewed, properly approved, and recorded to the correct taxpayer account;
- transactions and conversation screens are secure from unauthorized use;
- reconciliations are performed; and
- adequate controls exist over interest calculations.

We interviewed key personnel to gain an understanding of the department's procedures. We interviewed key personnel regarding controls in the refund unit and tested nonstatistical samples of refunds for proper review, approval, posting, and timeliness. Security over access to the Revenue Integrated Tax System (RITS) was reviewed. We observed reconciliations and tested a nonstatistical sample of interest payments.

As a result of our testwork, we determined that transactions and conversation screens are secure from unauthorized use and reconciliations are performed. We found that refunds are not being processed timely and that adequate controls do not exist over penalty and interest calculations. We also determined that refunds are not approved in accordance with policies and procedures before being issued to taxpayers.

5. <u>The department lacks control over refunds and does not minimize interest paid</u>

Finding

As noted in the prior three audits, the department does not properly monitor timeliness of individual refund claims to prevent excess interest being paid. In addition, interest calculations were not properly computed or reviewed. Management concurred with the prior finding stating,

> The Refunds and Penalty Waivers Unit does have a tracking system and a procedure in place to monitor and track refunds assigned to the unit and to track the amount of interest paid on all refunds. However, we are currently revising the system and the procedure to better identify areas where processing delays are observed. As a result of these revisions, the supervisors in the unit will be better able to monitor the age of refunds and minimize any delays.

Apparently, the revisions to the tracking system are not yet complete. The current audit revealed that 9 of 18 refunds tested over $50,000 (50%) and 14 of 60 refunds tested under $50,000 (23%) were not processed within 45 days to avoid paying an interest penalty.

The Refunds and Penalty Waivers Unit is still not closely monitoring refunds to ensure that they are sent through the signature process and to ensure payment is made within 45 days of the claim date, which is the date on which the Refunds and Penalty Waivers Unit establishes a refund claim as a valid refund. Section 67-1-801(b), *Tennessee Code Annotated*, states:

> When it is determined by administrative review or court that any person is entitled to a refund or credit of any tax collected or administered by the commissioner, interest shall be added to the amount of refund or credit due, beginning forty-five (45) days from the date of filing a claim for refund.

The Attorney General's office is required to sign off on the refunds over $50,000. A sample of 60 items over $50,000 for which interest was paid was also reviewed, and 25 of the 60 claims were not sent to the Attorney General's office within 45 days, thus causing extra interest to be paid. The department appropriately will not issue a refund before it has been reviewed to avoid paying interest. Delays may sometimes occur in order to complete a refund audit and to reduce the amount of the refund. Many times the amount of the reduction compared with the amount of interest paid actually results in savings to the state; however, the rate of occurrence seems to indicate that delays occur frequently. For the year ended June 30, 2001, more than 3,000 refunds included interest.

Also, the department lacks controls to ensure that interest calculations are accurate. Interest calculations performed by RITS are not tested for accuracy. Interest amounts disbursed to the taxpayer were tested, and 13 of 60 tested (22%) were not calculated correctly in accordance with Section 67-1-801 (a)(1), *Tennessee Code Annotated,*

> When any person liable to pay any tax that is collected or administered by the commissioner of revenue fails to pay the same, or any portion thereof, on or before the date when such tax shall be required to be paid, interest shall be added to the amount of tax due, in addition to any penalty provided by law, at a rate to be determined by the commissioner in the manner hereinafter provided.

Section 67-1-801 (a)(1)(A), *Tennessee Code Annotated,* states,

> The rate of interest determined by the commissioner shall be the formula rate of interest last published in the Tennessee Administrative Register, pursuant to title 47, chapter 14.

There appears to be a problem with the automated interest calculation in RITS, and errors are sometimes created with manual interest overrides. Although the differences were all minimal, the errors indicate that the review of interest calculations should be increased. Additional liability to the state could be created if the system is not calculating interest in compliance with the law.

Recommendation

The department should implement the revisions made to the system for tracking and monitoring refund claims. These revisions should be adequate to ensure that the refund will be approved and will have all required signatures within 45 days to comply with statute. The refund tracking should be used to evaluate the process and to ensure the refund does not remain in one area for an excessive amount of time. The procedure for interest calculations should be reviewed and corrected to ensure the taxpayer receives the correct amount.

Management's Comment

We concur. Revisions to the refund-tracking database system and the procedures governing the refund process were implemented April 2002. The emphasis of these changes is to reduce interest paid by better identifying areas where the refund process sustains delays and prompt action is needed to eliminate or minimize these delays.

Enhancements made to the database now allow division management to trace the status and processing time of a refund claim at all processing stages, i.e., the Department's mailroom, audit review, audit field examination, legal office, Attorney General's office, etc. Additionally, included in this enhancement is the ability to generate reports from the database that pinpoint when and where delays are occurring. This will enable management to address and identify areas that are incurring or have the potential for incurring interest expense. These reports will be reviewed routinely so that problem areas can be identified.

In February 2002, the function of penalty waiver processing was moved from the Refund Section to the Termination and Withdrawal Section. Now, employees of the Refund Section can concentrate solely on processing refunds. Additionally, a new supervisor with strengths in system analysis and workflow functionality oversees the Refund Section. This supervisor's directions are to supervise, analyze, and make the necessary adjustments to the refund process to ensure refunds are issued properly and in accordance with the statute. A weekly inventory report has been developed to provide for improved monitoring of each employee's workload and will assist in the monitoring of claims that are in danger of reaching the 45-day limit at which interest expense begins to accrue.

As noted in the Department's previous audit response, it is our policy not to issue a refund that has not been determined valid just to avoid paying interest. Therefore, the Department will always have some claims where interest was ultimately paid. It is our goal, however, to minimize the amount of interest paid.

The Department has also increased the threshold, based on certain criteria, for automatic refunds to $50,000 for Franchise, Excise tax and $5,000 for Income tax. This change will allow more refunds to be issued within the 45-day limit.

Pursuant to a Request for Service, the Department's Information Technology Resources Division is currently working to address a minor problem with the way refund interest is automatically calculated by our RITS mainframe system. As recommended, reviews of the interest calculation will be performed to ensure that the correct amount of interest is being paid. These reviews will be performed on the manual interest calculations as well as the automated interest calculations.

6. <u>Approval of refund claims was not always documented</u>

Finding

The approval requirements over taxpayer refunds established in Section 67-1-1802, *Tennessee Code Annotated*, and/or Department of Revenue policies were not followed. Testwork revealed that 16 of 60 refunds tested over $50,000 (27%) either were not properly approved or the approval was not documented. Fourteen of the 60 refunds tested under $50,000 (23%) were not properly approved.

As mentioned in finding 5, the Attorney General's office is required to approve refunds over $50,000. The department's Franchise/Excise refund policies and procedures and income tax policies and procedures state that the supervisor is required to approve certain smaller-dollar claims. In the 30 errors noted above, 16 did not have the supervisors' initials, 8 did not have enough information on the paperwork to conclude whether or not the claim went through the Attorney General's office, and 6 original returns were not located and therefore not documented.

Lack of review could result in the payment of inappropriate or miscalculated refunds. Effort should be made to ensure that taxpayers are refunded appropriately while minimizing the cost to the state.

Recommendation

The department should follow policies and procedures in *Tennessee Code Annotated* as well as those developed for the department to ensure that the refunds are properly approved. Documentation of the review process should be maintained. In addition, original tax returns should be retained when approval information is documented on the return.

Management's Comment

We concur. In April of 2002, management of the Refund Section implemented a new procedure that more clearly defines and documents the appropriate refund approval process as statutorily authorized in T.C.A. 67-1-1802. This procedure is aimed at ensuring thorough and complete documentation of refunds and the overall flow of refund documents.

REVENUE ACCOUNTING

Our objectives in reviewing the Revenue Accounting section were to determine whether

- certain rules, regulations, and laws that affect tax revenues have been identified;
- the cashier's Daily Summary of Collections Report is being properly completed;
- deposit slips are reconcilable to the Bank Deposit Report, the Daily Summary of Collections Report, and the Daily Balancing Report;
- revenues have been properly recorded and classified by tax type in the monthly collection reports;
- reconciliations are being performed and are properly documented;
- error reports are used to ensure errors are corrected properly;
- procedures used for monthly close-outs are proper; and
- procedures used to reallocate undistributed funds for the Revenue Integrated Tax System (RITS) are proper.

We interviewed key personnel and reviewed applicable sections of *Tennessee Code Annotated* to identify laws that affect tax revenues. We reviewed the cashier's Daily Summary of Collections Report for completeness. We performed testwork to determine that deposit slips were reconcilable to the Bank Deposit Report, the Daily Summary of Collections Report, and the Daily Balancing Report. To determine revenues were properly recorded and classified by tax type in the monthly collection reports, we performed analytical procedures. We re-performed a reconciliation and reviewed reconciling items. We tested a nonstatistical sample of errors for proper corrections. We reviewed monthly closeouts and reconciled the RITS Daily Summary of Collections to the County Situs Report. We reviewed procedures for reallocating undistributed funds to determine whether those procedures were proper.

As a result of our testwork, we determined that the Daily Summary of Collections Report was properly completed, deposit slips reconciled to the applicable reports, reconciliations and error reports were utilized appropriately, and close-out procedures and reallocation procedures were proper. We determined that the State of Tennessee Accounting Reporting System and RITS refunds reconcile. We also determined that revenues have been properly recorded and classified by tax type in the monthly collection reports. Although we had no findings related to Revenue Accounting, a minor weakness was reported to management in a separate letter.

FINANCIAL INTEGRITY ACT

Section 9-18-104, *Tennessee Code Annotated*, requires the head of each executive agency to submit a letter acknowledging responsibility for maintaining the internal control system of the agency to the Commissioner of Finance and Administration and the Comptroller of the Treasury by June 30 each year.

Our objective was to determine whether the department's June 30, 2001, responsibility letter was filed in compliance with Section 9-18-104, *Tennessee Code Annotated.*

We reviewed the June 30, 2001, responsibility letter submitted to the Comptroller of the Treasury and to the Department of Finance and Administration to determine adherence to the submission deadline. We determined that the Financial Integrity Act responsibility letter was submitted on time.

OBSERVATIONS AND COMMENTS

TITLE VI OF THE CIVIL RIGHTS ACT OF 1964

Section 4-21-901, *Tennessee Code Annotated*, requires each state governmental entity subject to the requirements of Title VI of the Civil Rights Act of 1964 to submit an annual Title VI compliance report and implementation plan to the Department of Audit by June 30 each year. The Department of Revenue filed its compliance report and implementation plan on June 30, 2001.

Title VI of the Civil Rights Act of 1964 is a federal law. The act requires all state agencies receiving federal money to develop and implement plans to ensure that no person shall, on the grounds of race, color, or origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal funds. The Human Rights Commission is the coordinating state agency for the monitoring and enforcement of Title VI. A summary of the dates state agencies filed their annual Title VI compliance reports and implementation plans is presented in the special report *Submission of Title VI Implementation Plans,* issued annually by the Comptroller of the Treasury.

APPENDIX

DIVISIONS AND ALLOTMENT CODES

Department of Revenue divisions and allotment codes:

347.01	Administration
347.02	Tax Enforcement
347.11	Information Technology Resources
347.13	Taxpayer Services
347.14	Audit Division
347.16	Processing Division
347.99	Revenue Refunds