

Department of Revenue

September 2003

Arthur A. Hayes, Jr., CPA, JD, CFE
Director

Charles K. Bridges, CPA
Assistant Director

Katherine J. Anderson, CPA
Audit Manager

Treesie Farmer, CFE
In-Charge Auditor

Danisha Jones
Sophia Massey
LaShanda Mott
Valerie Petty
Jennifer Whitsel
Staff Auditors

Amy Brack
Editor

Comptroller of the Treasury, Division of State Audit
1500 James K. Polk Building, Nashville, TN 37243-0264
(615) 401-7897

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**STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY**

State Capitol
Nashville, Tennessee 37243-0260
(615) 741-2501

John G. Morgan
Comptroller

September 18, 2003

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and

The Honorable Loren L. Chumley, Commissioner
Department of Revenue
1200 Andrew Jackson Building
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Department of Revenue for the period July 1, 2001, through March 31, 2003.

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
03/023



**STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT**

**SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 401-7897
FAX (615) 532-2765**

June 2, 2003

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 period July 1, 2001, through March 31, 2003.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. 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 Period July 1, 2001, Through March 31, 2003

AUDIT SCOPE

We have audited the Department of Revenue for the period July 1, 2001, through March 31, 2003. 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, Revenue Accounting, Taxpayer Accounting, Tax Enforcement, Taxpayer Services, and the Financial Integrity Act. The audit was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

AUDIT FINDINGS

The Department Is Not Revoking RACF IDs of Terminated Employees in Accordance With Policy

The department is not revoking RACF IDs of terminated employees in a timely manner. The IDs were revoked as late as 70 days after the date of termination (page 4).

Data Security Revision Forms Could Not Be Located

The department could not locate three Data Security Revision Forms when requested for review. The Department of Revenue's Information Technology Resources (ITR) division uses Data Security Revision Forms to document a user's access to RITS and the approval for such access (page 5).

The Department Processes Tax Returns That Do Not Have a Taxpayer's Signature

Testwork performed on the Processing division revealed that several unsigned tax returns mailed in by taxpayers were processed without obtaining the taxpayers' signature. Returns that do not contain the taxpayer's signature may not be enforceable (page 7).

Interest Calculations Were Not Properly Computed, and the Approval of Refund Claims Was Not Always Documented*

Testwork revealed that management is not approving refunds properly and interest calculations were not properly computed. Also, the department lacks controls to ensure that interest calculations are accurate (page 9).

The Department Needs to Enhance and Enforce Universal Policies for Tax Enforcement Offices

Differing procedures for following current policies were being implemented at each Tax Enforcement office reviewed. Also, recent supervisory decisions made by management in Nashville were not communicated efficiently to all offices. Currently, there is no Tax Enforcement supervisor's manual in place (page 12).

In-Dates Recorded in the Tax Enforcement Officers' Diaries Do Not Always Agree With RITS or Other Supporting Documentation

The in-dates recorded in the diaries do not always agree with the in-dates recorded in RITS, with the postmark date on the envelope, or with the receipt written for the collection. The officers do not always provide sufficient information to determine if the correct in-date is recorded in the diary or in RITS (page 14).

Procedures Over Tax Enforcement Collections Need Improvement

Receipts are not immediately sent to the Nashville office from the field offices. The department's Tax Enforcement offices do not adequately safeguard monies that are not deposited or mailed the same day they are collected (page 15).

Tax Enforcement Officers Are Not Properly Maintaining Diaries and Receipt Books

The department's diaries, which are used by Tax Enforcement officers to record all collections

received, are not maintained sufficiently. Nine of 22 officers' calculations for the monthly collection totals were not mathematically accurate. Twenty-two of 22 officers reviewed (100%) had collections that were not recorded correctly. In addition, 17 of 22 officers (77%) did not correctly complete their receipt book or receipts (page 17).

Renewal of Government Petroleum Permits in Accordance With State Law Is Not Enforced

Fifty-five of 60 government petroleum exemption permits tested (92%) were not renewed every three years as required by Section 67-3-1501(b), *Tennessee Code Annotated* (page 21).

Tax Bond Reviews Are Not Completed Timely

The Taxpayer Services division is not completing bond reviews according to department policy. For 20 of 60 motor fuel bonds tested (33%), the review was not performed timely. Testwork on tobacco bonds revealed that for 2 of 25 tested (8%), the review process was not initiated at all (page 22).

Tax Bonds Lacked Proper Signature Approval by the Commissioner *

As noted in the prior audit, the department does not ensure that signature approval is present on all surety bonds submitted by taxpayers (page 23).

* This finding is repeated from the prior audit.

Audit Report
Department of Revenue
For the Period July 1, 2001, Through March 31, 2003

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Department of Revenue
For the Period July 1, 2001, Through March 31, 2003

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

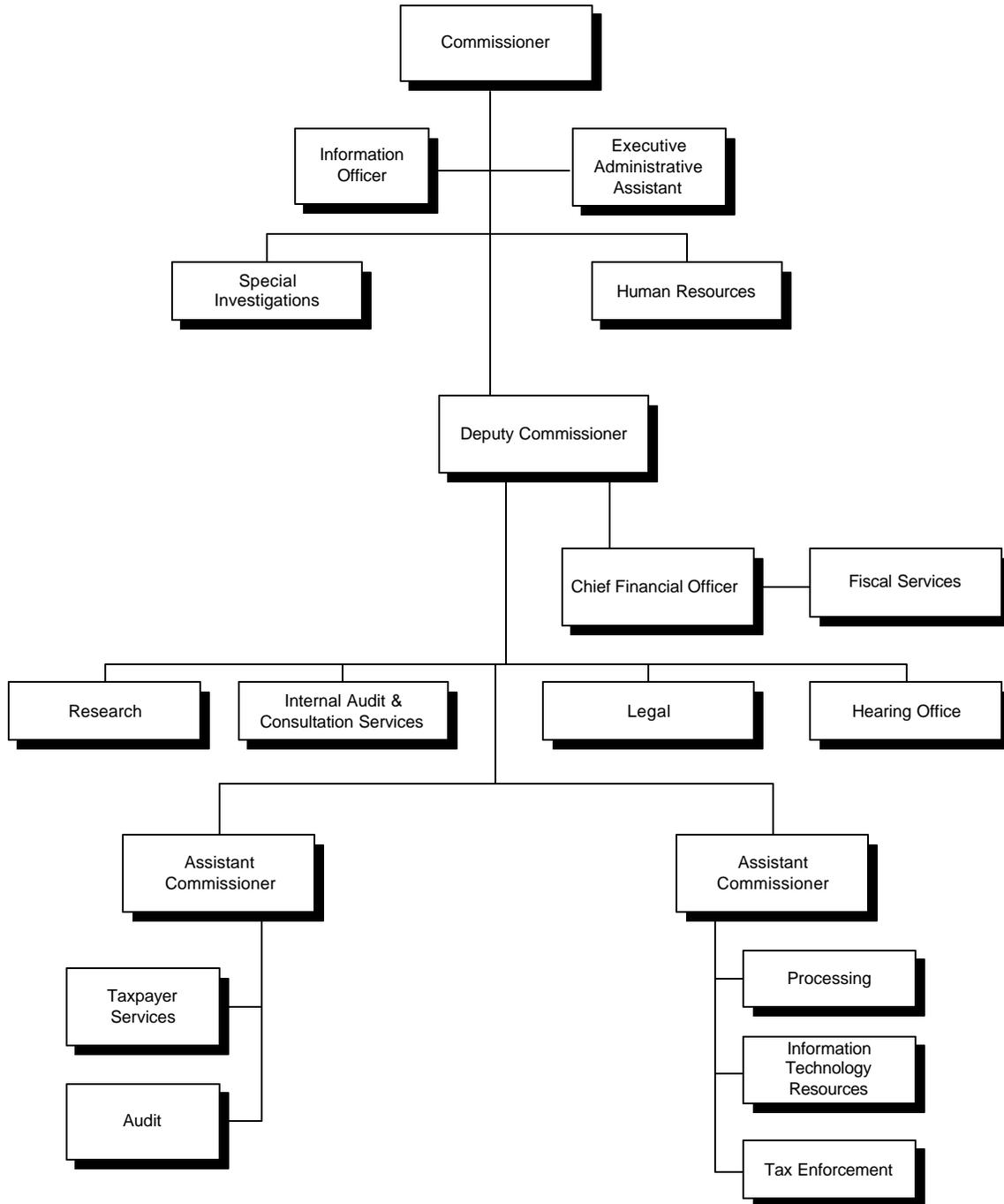
The mission of the Department of Revenue is to collect state revenue. Specifically, the department is responsible for the collection of most state taxes and fees, for enforcing the revenue statutes of the state to ensure that taxpayers are in compliance with all tax laws, and for preparing the monthly 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 of Revenue is on the following page.

AUDIT SCOPE

We have audited the Department of Revenue for the period July 1, 2001, through March 31, 2003. 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, Revenue Accounting, Taxpayer Accounting, Tax Enforcement, Taxpayer Services, and the Financial Integrity Act. The audit was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Tennessee Department of Revenue Organization Chart



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 January 13, 2003. 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 control over write-offs of tax liabilities, correct recording of deposit dates for special processed payments, minimizing interest paid, and supervisors' review of changes to taxpayers' account balances.

REPEATED AUDIT FINDINGS

The prior audit report also contained findings concerning proper signature approval for tax bonds held by the department, interest calculations, and approval documentation of refund claims. 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.

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 reviewed error report procedures, and we examined an error report 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. Controls over SPUFIs and program changes were in place, and error corrections were appropriate. Also, system documentation was adequate. However, we determined that RITS user access approval forms were not retained, and terminated employees' access was not immediately revoked. In addition to the findings, a minor weakness was reported to management in a separate letter.

1. **The department is not revoking RACF IDs of terminated employees in accordance with policy**

Finding

The Department of Revenue is not revoking Resource Application Control Facility access (RACF IDs) of terminated employees in a timely manner. The Office of Information Resources' (OIR) Security Procedures, *Granting and Revoking Access to Personnel Entering and Leaving State Government*, states, "On the last day of employment or as soon as possible thereafter, managers should revoke workstation/LAN user ID and notify the appropriate LAN Administrator to remove the user account . . . and . . . revoke State ID and submit a request to remove the user account. . . ." However, in a review of all employees that terminated during a three-month period, 7 of 18 RACF IDs tested (39%) were not revoked in accordance with OIR procedures.

The department requires that each division submit a Data Security Revision Form to the Information Technology Resources (ITR) division to request that an employee's RACF ID be revoked. Five of the seven noted above were not revoked in a timely manner because the terminated employee's division manager/director did not submit the form on or before the termination date. The RACF IDs were revoked as late as 70 days after the date of termination.

In addition, the termination dates reported by the Human Resources division, on the Separation Log and the Personnel Change forms, and the dates reported by ITR, on the Data Security Revision Forms for the same IDs mentioned, conflicted. The remaining two of the seven RACF IDs noted were submitted on time by the division manager/director but were not revoked by ITR until six days after the termination date.

Subsequent to the review mentioned above, an additional instance was noted related to a RACF ID that belonged to a division director who was terminated when the administration changed. The Data Security Revision Form was not received on the termination date for this employee; thus, the RACF ID was not revoked timely.

When terminated employees' RACF IDs are not revoked in a timely manner, the department increases the risk of inappropriate access and data manipulation by terminated employees.

Recommendation

The directors of each division should ensure that Data Security Revision Forms are submitted to ITR by the last day of employment. The Commissioner should ensure that the forms are submitted timely by having ITR report late submissions of the forms. ITR should revoke RACF IDs by the next working day to minimize the chance of unauthorized access. Every opportunity to minimize the threat to state information must be taken to protect the integrity of the information contained in the system.

Management's Comment

We concur. The department should revoke user IDs timely. We will revoke employees the afternoon of their last day of employment, but no later than the morning of the next business day. In the case of a terminated employee, we will revoke the user ID immediately. In order to expedite our revocation of user IDs, we have changed our policy that had required a data security revision form in order to revoke or delete a user ID; we now may revoke or delete a user ID on the basis of receipt of a personnel change form.

2. Data Security Revision Forms could not be located

Finding

The Department of Revenue's Information Technology Resources (ITR) division uses Data Security Revision Forms to document a user's access to the Revenue Integrated Tax System (RITS). The form is used to add, modify, or delete a user, and the forms provide access to each specific user class. According to the Department of Revenue Standard Practice Procedure, the division's security contact person completes a Data Security Revision Form and sends the

completed, signed form to ITR. The form must then be approved by the ITR Security Administrator to be entered into RITS.

Twenty-five Data Security Revision Forms were requested from ITR security personnel to verify proper authorization of RITS users. According to the Department of Revenue Standard Practice Procedure, the completed forms are to be filed in the Security Revision Request Book. Three of the 25 Data Security Revision Forms requested (12%) could not be located in their respective book. Neither the original Data Security forms nor the reauthorization forms could be located as requested.

When Data Security Revision Forms are not adequately maintained, the department cannot document authorization for established levels of access.

Recommendation

The ITR Information System Manager Security Administrator should ensure that each revision form is retained and authorization for all levels of access is documented. Additionally, RITS IDs and revision forms should be reviewed periodically, possibly during the reauthorization phases, to verify the necessity of the IDs in the department.

Management's Comment

We concur. We should have data security revision forms on file for all our user IDs. We have instituted a checklist, as a result of this review, in which we log the receipt of reauthorization forms. Also, we have conducted a review of documentation for all user IDs and obtained and filed new forms for those that were missing.

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 Exception 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 tax returns were tested to determine if deposits were made timely and properly recorded 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 adequately 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 the department processes returns that do not have a taxpayer's signature. In addition to the finding, a minor weakness was reported to management in a separate letter.

3. The department processes tax returns that do not have a taxpayer's signature

Finding

Divisions within the Department of Revenue have processed tax returns that do not have the taxpayer's signature. Testwork performed on the Processing division revealed that several unsigned tax returns mailed in by taxpayers were processed without obtaining the taxpayers' signatures. Regarding income tax returns, Section 67-2-107(b), *Tennessee Code Annotated*, states:

Any such statement or report shall be signed and verified by the oath of the president, vice president, treasurer, assistant treasurer or managing agent in this state of the association, trust or corporation making the same. Returns filed by individuals shall contain or be verified by a written declaration that the return is made under the penalties of perjury.

Regarding franchise tax returns, Section 67-4-2114, *Tennessee Code Annotated*, states:

Every taxpayer . . . shall file . . . an accurate and complete return, signed by its president or other principal officer under penalty of perjury. . . .

The department does not have a procedure in place to attempt to obtain taxpayers' signatures when taxpayers have neglected to sign the returns. Returns that do not contain the taxpayer's signature may not be enforceable under law. The department does not have a policy for pursuing the taxpayer's signature on unsigned income and franchise tax returns to ensure enforceability.

Recommendation

The Director of Processing and the Director of Tax Enforcement should establish and enforce a policy which requires a follow-up procedure to attempt to obtain the taxpayer's signature on all applicable tax returns.

Management's Comment

We concur. The department is working to minimize the number of unsigned returns submitted by taxpayers. We are installing computers connected to the Revenue Website in all of the major field offices to allow taxpayers to file their sales tax and on-line taxes electronically, to reduce the number of returns received directly in the field offices.

In addition, the department is in the process of establishing a policy which provides for follow-up procedures to obtain taxpayers' signatures when a return does make it to processing without one.

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 properly corrected;
- procedures used for monthly closeouts 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 whether revenues were properly recorded and classified by tax type in the monthly collection reports, we performed analytical procedures. We reperfomed 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 closeout procedures and reallocation procedures were proper. 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, minor weaknesses were 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, and posting. Security over access to the Revenue Integrated Tax System (RITS) was reviewed. We reviewed the reconciliation process 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 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. In addition to the findings, minor weaknesses were reported to management in a separate letter.

4. Interest calculations were not properly computed, and the approval of refund claims was not always documented

Finding

As noted in the prior audit, interest calculations were not properly computed. Management concurred with the prior findings stating,

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.

Although certain reviews are being performed, interest was not always properly computed. Based on the testwork performed, 8 of 59 refunds over \$50,000 (14%) and 4 of 58 refunds under \$50,000 (7%) included incorrect interest amounts. Also, the original refund claims could not be located for one of the 60 refunds greater than \$50,000 (2%) and 2 of the 60 under \$50,000 refund claims requested (3%).

Of the eight incorrect calculations in the over \$50,000 testwork, four taxpayers received interest and should not have, and four taxpayers did not receive interest but should have. Also, one of the four who should not have received interest was paid \$31,627.47 of interest in error. The taxpayer withdrew its certificate of authority in October 2001, but the error was not detected until January 2002. Therefore, it is unlikely that the erroneously issued refund of \$31,627.47 will be recouped. Of the four in the under \$50,000 testwork, one taxpayer received interest and should not have, and three taxpayers did not receive interest but should have.

In addition, interest calculations performed are not adequately reviewed to ensure that proper rates and accrual periods are used. Interest amounts disbursed to the taxpayer were tested, and 4 of 60 (7%) tested were not calculated correctly in accordance with Section 67-1-801, *Tennessee Code Annotated*, which specifies when interest should begin accruing and at what rate. There appears to be a problem with the automated interest calculation in RITS, and errors are created with manual interest overrides. The errors indicate that the review of interest calculations should be increased. Additional liability could be created if the system is not calculating interest in compliance with the law.

A prior audit finding also noted that the department lacks control over the refund approval process. The approval requirements established in Section 67-1-1802, *Tennessee Code Annotated*, and/or Department of Revenue policies were not followed. Management concurred stating,

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.

However, testwork revealed that management is still not approving refunds properly. Two of 60 refunds tested over \$50,000 (3%) either were not properly approved or did not have documented approval. One of the claims was issued before it was submitted to the Attorney General's office for approval. In addition, 8 of 35 refunds tested under \$50,000 (23%) were not properly

approved. Three of the original tax returns were not located, and therefore approval was not documented.

Lack of review could result in the payment of inappropriate or miscalculated refunds. Departmental approval policies should be followed to ensure that taxpayers are refunded appropriately.

Recommendation

The procedure for interest calculations should be reviewed and corrected to ensure the taxpayer receives the correct amount. Documentation of the review process should be maintained. The department should follow policies and procedures and ensure compliance with *Tennessee Code Annotated* for proper and consistent approval of the refund claims. Finally, the department should maintain the original refund claim and any supporting documentation to support the claim for refund and the related approvals.

Management's Comment

We concur. We have requested that the RITS system be changed to use 365.25 days when calculating refund interest, in order to be consistent with current deficiency interest calculations. Audit Division management has taken steps to correct the instances of refunds that are processed within 45 days, but receive interest.

In March 2003, we evaluated the length of time currently required to produce refund checks. The check process has been streamlined, and the number of days added to account for that processing has been reduced from eight to three.

We agree that refund claims should be properly approved and will reinforce procedures on manual refunds to ensure compliance with approval procedures.

TAX ENFORCEMENT

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

- the division complied with rules and regulations of the department and the applicable *Tennessee Code Annotated* sections;
- regional Tax Enforcement offices are mailing receipts to the department's mailroom 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 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 applicable rules and regulations regarding bankruptcy claims. Timely and proper action was taken on the bankruptcy claims. Dormant, pending dormant, and unenforceable classifications were supported and approved, and delinquent cases were approved and followed up. However, we found that collections that are not deposited within 24 hours are not properly safeguarded, the officers do not always mail cash receipts and non-cash collections to the department's mailroom timely, and the division is not following appropriate collection procedures. We also determined that the officers' receipt books and diaries are not always properly completed, in-dates are not recorded properly, and the division lacks detailed universal policies and procedures for Tax Enforcement supervisors. In addition to the findings, minor weaknesses were reported to management in a separate letter.

5. The department needs to enhance and enforce universal policies for Tax Enforcement offices

Finding

The department does not have detailed universal policies for the Tax Enforcement offices. Differing procedures for following current policies were being implemented at each Tax Enforcement office reviewed. Updates to policies are not always communicated globally, required reviews by supervisors are not consistent, receipts are not filled out completely, and receipt books are not always retained.

Recent decisions made by management in Nashville were not communicated efficiently to all offices. The decision made in December 2002 to record account identification numbers

rather than entity identification numbers to identify taxpayers in the entries in the officers' diaries was not communicated to two of the three offices reviewed.

There is currently no Tax Enforcement supervisor's manual. However, the Department of Revenue's *Tax Enforcement Officer's Manual*, Section 3.G, states that the supervisors are required to review the officer's receipt books once a month. One of the requirements for reviewing an officer's receipt book which is found in Section 3.G.4 is to "periodically reconcile the receipt book to the diary." This policy needs to be defined.

Some supervisors reconciled the receipt book to the diary every month. Other supervisors did not perform this step at all. Also, the new procedure, which requires the supervisor to audit a 30-day period in every officer's diary, has been interpreted differently by each supervisor. One supervisor only verifies cash collections to the Revenue Integrated Tax System (RITS), while the other supervisors in the offices reviewed verify every entry within the 30-day period. In addition, the frequency with which audits were performed and the number of officers audited varied between the two regional managers reviewed.

Policies for requirements regarding the completion of receipt forms have not been established. Some supervisors did not require the recording of assessment periods covered by the payment collected. Other supervisors only required the recording of an assessment period for payments accompanied by returns. Some supervisors also required an explanation for the collection of the receipt if no assessment period was indicated. Assessment periods assist the supervisors when attempting to locate the collection on RITS. Inconsistent interpretations of vague policies or procedures by supervisors and regional managers can lead to overlooking fraud or theft since the collections are not easy to verify on the computer system.

One of the three offices reviewed allows officers to retain all used receipt books when they retire, quit, or are terminated. The department should keep the receipt books for their records. The information that is found in the receipt books regarding collections might be needed to resolve future problems or verify collections on a taxpayer's account. Also, maintaining all receipt books in the office decreases the chances for fraud or theft.

The only policy in place regarding the retention of receipt books is Section III.F. of the Department of Revenue *Tax Enforcement Procedure Manual*, which states: "The yellow copy of the receipt should be retained by the employee for a minimum of three years and if destroyed, must be shredded or burned by an employee of the department." This policy is unclear concerning the procedure for the retention of the receipt books of officers who are no longer employees of the Department of Revenue.

Recommendation

Adequate, detailed policies should be enhanced regarding important aspects of the Tax Enforcement division. Detailed policies indicating the steps that a supervisor should take when reviewing or verifying a receipt book or diary should be established. A policy should be

established which requires supervisors to retain the receipt books of officers who have retired, quit, or been terminated. The directors should communicate all policies or changes in policies effectively to all levels of management. This will avoid any confusion about policies, create uniformity among all Tax Enforcement regional offices, and reduce the risk of fraud.

Management's Comment

We concur with the finding. The department has developed extensive written operating procedures, which are to be applied consistently throughout all regional Tax Enforcement offices. Departmental and Enforcement management will work with regional Enforcement managers and supervisors to ensure uniformity in the application of all policies and procedures. Procedures that detail the proper steps to follow in the preparation and review of receipt books and diaries will be properly updated and enforced. In addition, the Tax Enforcement and departmental receipts are being redesigned to more accurately reflect the information recorded to document a collection in the field.

6. In-dates recorded in the Tax Enforcement officers' diaries do not always agree with RITS or other supporting documentation

Finding

The dates of receipt (in-dates) recorded in the Tax Enforcement officers' diaries do not always agree with the in-dates recorded in the Revenue Integrated Tax System (RITS), with the postmark date on the envelope, or with the receipt written for the collection. The officers do not always provide sufficient information to determine if the correct in-date is recorded in the diary or in RITS. When a tax return and payment are received via mail by the Tax Enforcement division, policy requires the officer to record the postmark date, stamped on the envelope, as the in-date in the T-box. The T-box is an area of the return reserved for pertinent information to be entered by department personnel. If the officer personally collects monies via field visits or taxpayer visits to the office, the date of receipt should be recorded as the in-date.

Twenty-two of 22 diaries reviewed (100%) contained in-dates that did not agree with the in-date recorded in RITS, with the postmark date, or with the date on the receipt written for the collection. Testwork revealed that the Tax Enforcement officers do not always complete the T-box on a tax return. When a T-box is not completed, RITS automatically assigns the in-date as the original due date of the return—even if that date is years, months, weeks, or days before the actual date of collection. During testwork, instances were noted where the original due date, assigned as the in-date, was a year or more before the date the return was received.

During testwork in the Processing division, it was also determined that in-dates for returns received in the Nashville office are not always recorded correctly. For 3 of 60 suspended items tested (5%), the in-dates did not agree with the postmark date or the date received in the mailroom. The in-date was recorded as the date the tax return was originally due; thus, no

interest or penalty charges were applied to the accounts for the late payments. *Procedures for Processing Mail* states that if the return is delinquent, the mailroom personnel are to “write the postmark date in the t-box.” One of the three items noted was received in the mail by the Tax Enforcement unit. The date received was not written in the T-box by Tax Enforcement. When the return was taken to the cashier’s office to be processed, the return was recorded as a timely return.

When the original due date is recorded as the in-date, instead of the postmark date or the date received, interest and late fees that accumulated for the delinquent payment are not charged to the taxpayer’s account. In instances where the taxpayer submits payments for penalty and interest charges on delinquent returns but RITS assigned the original due date as the in-date, a credit for the amount of the payment received is applied to the taxpayer’s account. In addition, when the officers do not distinguish between collections received via visits or collections received via mail, the accuracy of the in-dates cannot be determined. Also, when the T-box is not completed, sometimes the collection cannot be located on RITS because the in-date recorded in the diary does not agree with the in-date in RITS.

Recommendation

Since penalty and interest charges are determined based on the time elapsed from the original due date to the date the tax return payment was received, the policy concerning the Tax Enforcement officers’ completion of the T-box should be enforced. The Director of Tax Enforcement should also require the officers to document how a collection was received to ensure that the correct in-date is recorded in RITS. The Director of Processing should require the Processing division to record the in-dates based on the postmark date or the date the payment was received for returns received directly from taxpayers.

Management’s Comment

We concur. Tax Enforcement management has established a procedure for officers to complete the ‘T-boxes’ on all delinquent returns received by Tax Enforcement personnel. That date will coincide with the postmark date or the date Tax Enforcement personnel receive the return from the taxpayer, and will be the date keyed into RITS by Processing Division Data Entry personnel.

7. Procedures over Tax Enforcement collections need improvement

Finding

The Department’s Tax Enforcement offices do not adequately safeguard monies that are not deposited or mailed the same day that they are collected. As Tax Enforcement officers collect money, they are responsible for depositing cash collections and mailing checks to the

Nashville office within 24 hours. The department's *Tax Enforcement Officer's Procedures Manual*, Section III.C.4-5, states, "All cash collections by field officers must be converted to a Certificate of Deposit [deposit slip] or Bank Cashier's Check on the day of the collection or by 12:00 p.m. the next workday. All collections must be mailed . . . to the mailroom in Nashville by close of the business the following workday." The officers are responsible for safeguarding their collections if they retain the collection overnight or over the weekend.

The regional offices do not use safes or limited access areas to secure collections overnight or over the weekend. During review at the Johnson City office, a cashier's check for \$873 was found lying on the desk in an officer's cube. That officer was working out of the office. Per the supervisor, a taxpayer came to make a payment to the officer, but the officer was out of the office so the Tax Information Assistant placed the check on the officer's desk so the officer could record the collection the next day.

Additionally, officers are not mailing checks, cashier's checks, or money orders to the Nashville office on the day of collection or by the end of the following workday. Twenty-two of 22 officers reviewed (100%) did not mail all checks or money orders to the Nashville office on the day of collection or by the end of the following workday. The same deposit date was recorded in RITS for collections made over a week or longer period. Eleven of 25 checks tested from mail received in the Nashville office mailroom from Tax Enforcement field offices (44%) were not mailed timely.

It appears that officers are holding checks or money orders for several days and sometimes several weeks and mailing several days' or weeks' worth of checks on one day. Holding checks sometimes causes taxpayers' checks to be returned because of insufficient funds once they are deposited in Nashville. Penalty and interest charges may accumulate on the taxpayers' account until the payment is received by the Nashville office and is processed. Also, the state loses potential interest income on the funds for the days that the checks are held by the officer instead of being held in a state account. In addition, the potential for checks to be lost or stolen increases when they are not timely deposited. During testwork performed at the Memphis office, the auditor found a check lying in the cubicle of a retired officer. The officer retired January 15, 2003. The check was dated January 7, 2003. The check was found on February 20, 2003, and had not been deposited.

Recommendation

The department's Tax Enforcement offices should maintain safes or limited access areas to adequately safeguard monies overnight or over the weekend. Regional office supervisors should ensure that revenue officers are not allowed to take home with them overnight or over the weekend monies that they have collected on behalf of the department. The Director of Tax Enforcement should develop policies to ensure that all monies collected are recorded by a person independent of the collection process and reconciled to deposit receipts and officers' diary records. The department should revise its policy on mailing deposits to Nashville and require

that the monies be deposited to a state account daily to adhere to Section 9-4-301(a), *Tennessee Code Annotated*, which states:

It is the duty of every department, institution, office and agency of the state and every officer and employee of state government, including the state treasurer, collecting and receiving state funds, to deposit them immediately into the state treasury or to the account of the state treasurer in a bank designated as a state depository or to the appropriate departmental account.

Management's Comment

We concur. All cash collections should be deposited in the bank or converted to a cashier's check on the day it is collected or no later than noon the following day. Procedures also require that all collections be mailed to Nashville by the close of business the following day. There are no circumstances where it is permissible for Tax Enforcement personnel to hold collections in the regional offices any longer than specified by procedure. We will continually monitor the handling of collections and take corrective action where warranted.

We do not concur that the department does not adequately safeguard monies not deposited or mailed the same day that they are collected. The two checks noted as mishandled should have been deposited as required, but they were located in secure areas that are not accessible to the general public. The department makes every effort to safeguard receipts and will continue to reinforce with employees the importance of not leaving checks or other receipts in the open.

Auditor's Comment

Although the areas may not have been accessible to the general public, the areas were accessible to numerous Department of Revenue employees in addition to any maintenance or housekeeping personnel. Collections are highly susceptible to theft, and any receipting location should restrict the number of individuals with access to taxpayer funds.

8. Tax Enforcement officers are not properly maintaining diaries and receipt books

Finding

The department's diaries, which are used by Tax Enforcement officers to record all collections received, are not maintained sufficiently. During testwork performed at the Memphis, Johnson City, and Knoxville Tax Enforcement offices, 9 of 22 officers' calculations for the monthly collection totals in the officers' diaries (41%) were not mathematically correct.

In addition, 22 of 22 officers reviewed (100%) had collections that were not recorded correctly. Five of 22 officers noted recorded the wrong amount for a collection in their diary. Two of 22 officers noted either issued receipts for collections but did not record the collection in the diary or recorded a collection in their diary on a different day than the date written on the receipt. Two of 22 officers noted had a collection that could not be located on the Revenue Integrated Tax System (RITS).

Testwork also revealed that 17 of 22 officers (77%) did not correctly complete their receipt book or receipts. The officers did not always record the account number as required by Tax Enforcement policy, provide the period the collection would be applied to, distinguish the type of tax payment, or provide accurate account numbers and/or Entity ID numbers. Twelve of the 17 officers did not enter complete information on the covers of their receipt books as required by the receipt book instructions. The back of the front cover of the receipt book contains directions that require the officer to fill in all information on the front cover. The assigned date, completion date, ending receipt number, region the receipt book was assigned, and signature of the officer should all be completed per the receipt book instructions.

When the officers do not provide adequate information on the receipts, the risks increase that the payment would be applied to the wrong tax type, or to the wrong period, or not applied to the account at all but held as undistributed monies. Also, inadequate recording in the officers' diaries hinders the audit trail for supervisors, managers, directors, and auditors.

Recommendation

The Director of Tax Enforcement should improve and enforce detailed policies requiring officers to record all required information on receipt book covers and receipts. Policies for recording collections in the officers' diaries should be improved and enforced. The policies should require all of the Tax Enforcement field offices to be consistent in recording collections in the officers' diaries and receipt books. Also, supervisors should be required to review officers' diaries and receipt books for mathematical accuracy, agreement between diary and receipt book, completely filled out receipt books and receipts, and agreement between diary and RITS on a monthly basis rather than a quarterly basis. More frequent verifications of diaries to RITS will result in more accurately recorded collections and a decrease in the chances for fraud or theft.

Management's Comment

We concur. Tax Enforcement management will continue to emphasize the importance of close adherence to established procedures and continue to monitor receipts for correctness and take corrective action where necessary.

Tax Enforcement management now requires Supervisors to verify the accuracy of collection entries in Revenue Officers' diaries. While mistakes do occur, Managers and Supervisors will be more vigilant when reviewing diaries to minimize these errors. The

department and Tax Enforcement Division are also currently exploring ways to improve the overall collection documentation process, and ways to improve the “diary” process as well.

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;
- bond reviews and bond approvals were timely and proper; and
- petroleum exemption permits were issued to eligible agencies and were renewed in accordance with applicable state law.

We interviewed key personnel to gain an understanding of the department’s procedures and compliance with rules and laws. 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 tested nonstatistical samples of new corporations and deleted corporations from the taxpayers listed on RITS to determine if the corporations were properly recorded or properly removed. To determine if bond reviews are conducted timely and if bonds are properly approved, we tested nonstatistical samples of bonds. We tested a nonstatistical sample of petroleum exemption permits to verify that the permits were issued to eligible agencies and that permits were issued and renewed in accordance with state law.

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 controls over changes to taxpayer account balances were effective. Procedures for adding and deleting taxpayer accounts were operating and effective. We verified that the permits were issued to eligible agencies; however, we found that petroleum permits are not renewed in accordance with state law. We also determined that the department was not following established procedures for approving bonds and bonds reviews are not completed timely. In addition to the findings, other minor weaknesses were reported to management in a separate letter.

9. **Renewal of government petroleum permits in accordance with state law is not enforced**

Finding

Fifty-five of 60 government petroleum exemption permits tested (92%) were not renewed every three years as required by Section 67-3-1501(b), *Tennessee Code Annotated*, which states,

Each governmental agency making purchases of petroleum products shall, prior to the purchase of such products, acquire a valid exemption permit issued by the commissioner. The exemption permit shall be numbered and shall entitle such governmental agency to purchase petroleum products tax exempt for a period of three (3) years from the date of issuance. The permittee shall make application for renewal prior to the expiration of the permit.

For 20 of the 55 exceptions noted, the permittee had not submitted an application for renewal to the department. For 35 of the 55 exceptions, the Taxpayer Services division sent letters to the permittee acknowledging the existence of the permit, but an application for renewal was neither requested nor received by the department.

When permits are not renewed in accordance with *Tennessee Code Annotated*, the risk increases that agencies that no longer qualify as governmental agencies can operate under the exemption and not pay applicable taxes for petroleum products.

Recommendation

The Director of Taxpayer Services should ensure that applications for renewals for all permits that have expired are obtained and should require a renewal application from the permittees every three years. When a permittee fails to submit an application for renewal, the department should ensure the permit is voided and returned.

Management's Comment

We concur. The Department had issued renewals for a four-year period, as indicated in the finding, thinking that this renewal period had been changed as part of 1999 legislation (67-3-1501[b]). However, the renewal was not passed into law until the statute was amended in 2003 to put the review of these motor fuel exemptions on a four-year cycle.

10. Tax bond reviews are not completed timely

Finding

The Taxpayer Services Division of the Department of Revenue is not completing bond reviews according to department policy. According to department procedure for bond review, personnel are to complete a bond review every six months on all petroleum accounts and notify the taxpayer of any increases or decreases necessary. For tobacco accounts, all tobacco bonds are reviewed once a year. If a bond is increased, the taxpayer has 30 days to submit a rider, an amendment to the original bond.

Twenty of 60 motor fuel bonds tested (33%) were not reviewed in a timely manner. Of the 20 bonds noted, 14 were reviewed and resulted in increases in the bond's amounts, but no riders were issued to cover these amounts. For 6 of the 20 bonds, the review forms were sent to the taxpayers, but as of the date of testwork, none of the taxpayers had submitted their forms so that the review could be completed. According to department personnel responsible for the bond reviews, second notices should have been sent but were not. After no response is received for second notices, department policy requires the cancellation of the bond and termination of the applicable license. Furthermore, testwork on tobacco bonds revealed that for 2 of 25 tested (8%), the review process was not initiated at all.

It appears that personnel are not monitoring bond activity to ensure the bonds are maintained adequately and timely. By not reviewing the bonds regularly, the bonds may not be sufficient, which can result in taxes not being paid.

Recommendation

The Director of Taxpayer Services should enforce the division's bond review policy regarding frequency of review and correspondence with the taxpayers, including subsequent cancellations when required information is not received from the taxpayer. The director should investigate the options for an automated review process for the bonds that are currently completed manually. The director should also monitor current bond reviews to ensure that they are being completed according to policy.

Management's Comment

We concur. Bond review is now being done utilizing account information generated by the RITS system. The reviews are being conducted in accordance with time frames required by the applicable statutes. The two tobacco bonds noted in the report have since been reviewed and updated. We will work to ensure the timely update of all bond riders.

11. Tax bonds lacked proper signature approval by the Commissioner

Finding

As noted in the prior audit, the Department of Revenue does not ensure that signature approval is present on all surety bonds submitted by taxpayers. According to bond procedures, the Commissioner's signature indicates that the bond has been properly reviewed for completeness and that the bond is valid and, therefore, approved. Based on the bonds tested, 32 of 60 motor fuel bonds (53%), 13 of 25 tobacco bonds (52%), and 4 of 60 liquor-by-the-drink bonds (7%) did not contain the Commissioner's signature approval or were signed by an employee who did not have the Commissioner of Revenue's written consent to sign in her place.

The prior audit noted that 59 of 60 motor fuel bonds tested (98%) and 24 of 25 tobacco bonds tested (96%) did not contain the Commissioner's signature. Management concurred with the finding by stating "all bonds are now being reviewed, approved, and signed off on by personnel authorized by the Commissioner of Revenue to perform the function." Based on the testwork performed for this audit period, the department has not acted accordingly.

The signature approval is part of the process the department has established to maintain internal control related to surety bonds. Without approval by the Commissioner, the risk that incomplete or invalid bonds would be accepted increases.

Recommendation

The Commissioner or a designee should review and approve all bonds in accordance with policy to ensure that they are complete and valid. The Director of Taxpayer Services should ensure that the signature of the Commissioner or a designee is present on all accepted bonds.

Management's Comment

We concur. Files for all taxes requiring bonds have been reviewed. Signature authority letters have been reviewed to ensure that representatives signing for the Commissioner are authorized to do so, and each file now contains either the signature of the Commissioner or the person authorized to sign for her.

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, 2002, responsibility letter was filed in compliance with Section 9-18-104, *Tennessee Code Annotated*.

We reviewed the June 30, 2002, 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 reports and implementation plans on June 26, 2002.

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