Department of Revenue

September 2004

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STATE OF TENNESSEE
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John G. Morgan
Comptroller

September 23, 2004

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 April 1, 2003, through March 31, 2004.

The review of internal control and compliance with 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/th
04/036

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

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June 10, 2004

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 April 1, 2003, through March 31, 2004.

We conducted our audit in accordance with *Government Auditing Standards,* issued by the Comptroller General of the United States. These standards require that we obtain an understanding of internal control significant to the audit objectives and that we design the audit to provide reasonable assurance of the Department of Revenue's compliance with laws, regulations, and provisions of contracts or grant agreements significant to the audit objectives. Management of the Department of Revenue is responsible for establishing and maintaining effective internal control and for complying with applicable laws, regulations, and provisions of contracts and grant agreements.

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 control and/or instances of noncompliance to the Department of Revenue's management in a separate letter.

Sincerely,

Arthur A. Hayes, Jr., CPA,
Director

AAH/th

State of Tennessee

Audit Highlights

Comptroller of the Treasury | Division of State Audit

Financial and Compliance Audit
Department of Revenue
September 2004

AUDIT SCOPE

We have audited the Department of Revenue for the period April 1, 2003, through March 31, 2004. Our audit scope included a review of internal control and compliance with laws and regulations in the areas of Information Technology Resources, Revenue Accounting, Taxpayer Accounting, Tax Enforcement, Taxpayer Services, and the Financial Integrity Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States.

AUDIT FINDINGS

In-Dates Recorded in the Tax Enforcement Officers' Daily Reports Do Not Always Agree With RITS*
As noted in the prior audit, the in-dates recorded in the daily reports do not always agree with the in-dates recorded in RITS. Ten of 16 daily reports reviewed, covering the month of January 2004, contained in-dates that did not agree with the in-date recorded in RITS (page 7).

Tax Enforcement Collections Are Not Deposited Timely*
As noted in the prior audit, the department's Tax Enforcement offices do not mail checks, cashier's checks, or money orders to the Nashville office in a timely manner. Twelve of 16 officers reviewed did not mail all January 2004 checks or money orders 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 (page 8).

Tax Enforcement Officers Are Not Properly Maintaining Daily Reports and Receipt Books, and Certain Supervisory Reviews Were Not Performed*
As noted in the prior audit, the department's daily reports, which are used by Tax Enforcement officers to record all collections received, are not maintained sufficiently. During testwork performed at the Jackson, Columbia, and Chattanooga Tax Enforcement offices, 11 of 16 officers reviewed had January 2004 collections that were not recorded

correctly. Also, 12 of 16 officers did not always correctly complete their receipt book or receipts (page 9).

Pending Amounts Were Not Researched Timely, and Reliable Information on Outstanding Pending Amounts Could Not Be Obtained

The department is reviewing the newest pending debits and credits first instead of prioritizing the older debits and credits that will not be valid after a three-year period. Seven of 60 pending amounts reviewed (12%) were not resolved timely. Computer reports showing the extent of the pending debits and credits were not reliable (page 12).

The Guidelines for Account Balance Changes in RITS Are Not Followed

Forty-four of the 60 account balance change transactions tested (73%) were not handled correctly in accordance with the guidelines set forth by management (page 14).

Regional Offices Did Not Record Issuances of Receipt Books

The Taxpayer Services regional offices did not maintain a receipt book log to indicate to whom receipt books were issued, who issued the receipt books, or when they were issued (page 16).

Internal Control Over Cash Receipts Was Not Adequate

During a review of the Taxpayer Services regional offices, it was noted that the regional offices had been collecting monies for several years without any established procedures, guidelines, or internal control. Due to the lack of control, certain problems with receipts were noted during the audit period (page 17).

* This finding is repeated from the prior audit.

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Department of Revenue

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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 requires 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

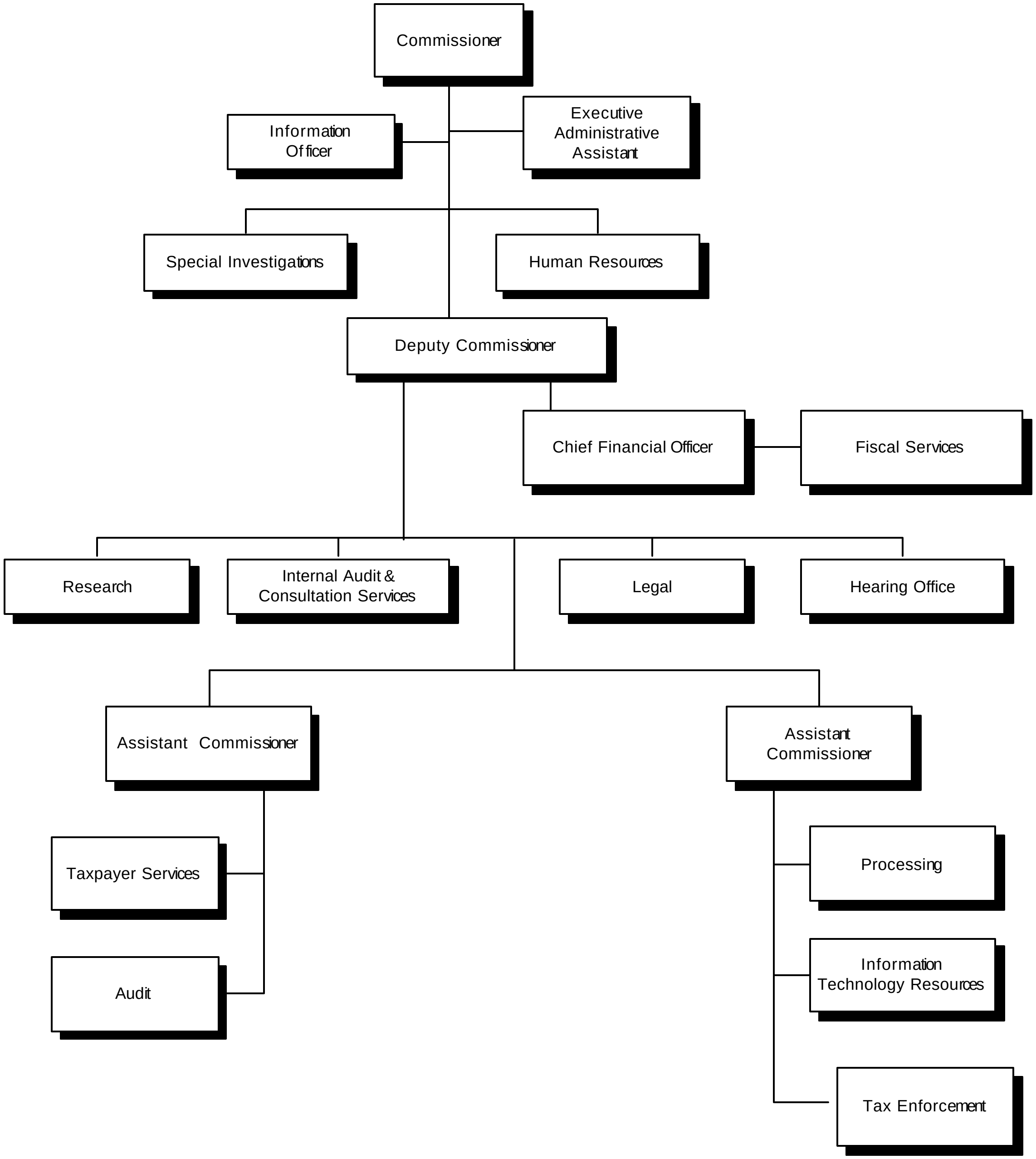
The mission of the Department of Revenue is to collect state revenue. Specifically, the department is responsible for the collection of most state taxes and fees, for enforcing the revenue statutes of the state to ensure that taxpayers are in compliance with all tax laws, and for preparing the monthly apportionment of revenue collections for distribution to various state funds and local units of government. The department also offers taxpayer assistance and taxpayer education. 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 April 1, 2003, through March 31, 2004. Our audit scope included a review of internal control and compliance with laws and regulations in the areas of Information Technology Resources, Revenue Accounting, Taxpayer

Tennessee Department of Revenue
Organization Chart



Accounting, Tax Enforcement, Taxpayer Services, and the Financial Integrity Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States.

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 2, 2004. 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 terminated employees' RACF IDs, data security revision forms, tax return signatures, refund calculations and approvals, universal policies for Tax Enforcement offices, government petroleum permit renewals, signature approval for tax bonds, and tax bond reviews.

REPEATED AUDIT FINDINGS

The prior audit report also contained findings concerning in-dates recorded in Tax Enforcement officers' daily reports, Tax Enforcement collections, and Tax Enforcement daily reports and receipt book maintenance. These findings have not been resolved and are repeated in the applicable section 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 January 2003 users for proper access to RITS screens to determine if user access to RITS was 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) as of January 23, 2004, and program changes as of December 29, 2003, 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, program changes, and RITS user access were in place, and error corrections were appropriate. Also, system documentation was adequate.

REVENUE ACCOUNTING

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

- the cashier's Daily Summary of Collections Report was being properly completed;
- deposit slips were 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 were being performed and are properly documented;
- error reports were used to ensure errors were properly corrected;

- procedures used for monthly closeouts were proper; and
- procedures used to allocate undistributed funds for the Revenue Integrated Tax System (RITS) were 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 that revenues were properly recorded and classified by tax type in the monthly collection reports, we performed analytical procedures. We reperformed a November 2003 reconciliation and reviewed reconciling items. We tested error corrections from five months for proper and timely corrections. We reviewed the November 2003 monthly closeout and reconciled the RITS Daily Summary of Collections to the County Situs Report. We reviewed procedures for reallocating undistributed funds for November 2003 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 also determined that revenues have been properly recorded and classified by tax type in the monthly collection reports.

TAXPAYER ACCOUNTING

Our objectives for reviewing Taxpayer Accounting were to determine whether

- controls over the refund process for taxpayer accounting were adequate;
- refunds have been reviewed, properly approved, and recorded to the correct taxpayer account;
- electronically filed tax returns recorded in RITS reconciled to the amounts submitted by taxpayers and recorded at the bank and were posted to the correct taxpayer account;
- reconciliations were performed;
- adequate controls existed over interest calculations; and
- petroleum exemption permits were issued to eligible agencies.

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 from April 1, 2003, through November 30, 2004, for proper review, approval, and posting. We also tested a nonstatistical sample of electronically filed claims submitted April 1, 2003, through January 29, 2004, to determine if the amounts recorded reconciled to other sources and were posted properly. We reviewed the reconciliation process. In addition, we tested a nonstatistical sample of interest payments from April 1, 2003, through November 30, 2004. To verify that petroleum exemption permits were issued to eligible agencies, we tested a nonstatistical sample of permits as of November 7, 2003.

As a result of our testwork, we determined that controls over the refund process for taxpayer accounting were adequate. Applicable reconciliations were performed. Refunds were approved in accordance with policies and procedures before being issued to taxpayers, and adequate controls existed over penalty and interest calculations. We found that electronically filed tax returns were recorded correctly and reconciled appropriately. We verified that the permits were issued to eligible agencies.

TAX ENFORCEMENT

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

- regional Tax Enforcement offices were mailing receipts to the department's mailroom timely, and the receipts were deposited by the department timely;
- cash received by Tax Enforcement officers was deposited at a local bank timely;
- the classification of delinquent Revenue Integrated Tax System (RITS) accounts as dormant, pending dormant, or unenforceable was properly supported and approved;
- bankruptcy claims were filed timely by the department, and the claims were properly handled by the department;
- the division was attempting to collect current delinquencies in a timely manner and following the appropriate collection procedures; and
- Tax Enforcement officers' receipt books and daily reports were properly completed and reviewed by their supervisors.

We interviewed key personnel to gain an understanding of the laws, rules, and departmental procedures related to tax enforcement. We performed testwork on nonstatistical samples of cash and checks received during selected days in the months of January, February, and March 2004 to determine if they were deposited in a timely manner. To determine if classifications were properly supported and approved, we tested a nonstatistical sample of RITS accounts classified as dormant, pending dormant, or unenforceable from April 1, 2003, through December 18, 2003. We tested a nonstatistical sample of bankruptcy claims as of February 19, 2004, to determine if proper and timely action was taken to collect funds. We performed testwork on nonstatistical samples of January 2004 receipt books and daily reports for completeness and review. In addition, we tested a nonstatistical sample of delinquent cases as of February 19, 2004, to determine if the status was appropriately approved and follow-up was timely.

As a result of our testwork, we determined that cash collections received by Tax Enforcement officers were deposited in the local banks timely. The classification of delinquent RITS accounts was properly supported and approved, and the division was attempting to collect the delinquencies timely and properly. Bankruptcy claims were properly handled and filed timely. However, noncash collections were not always deposited timely. In addition, problems were noted with the maintenance of daily reports and receipt books.

1. <u>In-dates recorded in the Tax Enforcement officers' daily reports do not always agree with RITS</u>

Finding

As noted in the prior audit, the dates of receipt (in-dates) recorded in the Tax Enforcement officers' daily reports do not always agree with the in-dates recorded in the Revenue Integrated Tax System (RITS). When a tax return and payment are received via mail by the Tax Enforcement division, the *Tax Enforcement Officer's Procedures Manual* 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. Management concurred with the prior finding and stated that Tax Enforcement management had established a procedure for officers to complete the T-boxes on all delinquent returns received that would coincide with the postmark date or the date received from the taxpayer. However, the officers are not following this procedure.

Ten of 16 daily reports reviewed, each covering the month of January 2004, contained in-dates on certain entries that did not agree with the in-date recorded in RITS. One reason for this problem is that the Tax Enforcement officers do not always complete the T-box on a tax return. Four of 60 returns tested that were received in the Nashville administrative office (7%) did not contain dates in the T-box. When a T-box is not completed, RITS automatically assigns the original due date of the return as the in-date—even if that date is years, months, weeks, or days before the actual date of collection. Instances were also found where the date received by Processing was recorded as the in-date. If the return is manually keyed and no date is in the T-box, the keyer will sometimes put the date received by Processing as the in-date.

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. When 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 penalty and interest charges appears on the taxpayer's account. In instances where the date received by processing is recorded as the in-date, the taxpayer could be assessed interest and fees in excess of the amount truly owed. Also, when the T-box is not completed, sometimes the collection cannot be located on RITS because the in-date recorded in the daily report 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. Tax Enforcement supervisors should periodically review returns to ensure the Tax Enforcement officers are completing the information appropriately.

Management's Comment

We concur. The Tax Information Assistant in each regional office will spot check returns, before they are mailed to Nashville, to ensure the 'T' boxes are completed as required by procedure. Tax Enforcement supervisors will continue to make periodic checks of returns prior to mailing to ensure procedures are followed.

2. Tax Enforcement collections are not deposited timely

Finding

As noted in the prior audit, not all employees of the department's Tax Enforcement offices have been mailing checks, cashier's checks, or money orders to the Nashville office in a timely manner. 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.B.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.

Management concurred with the portion of the prior audit finding regarding timely deposits and stated, "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." Although the number of officers who did not follow the procedure has decreased, problems still exist.

Officers are not consistently 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. Twelve of 16 officers reviewed did not mail all January 2004 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. Seven of 60 checks tested from mail received in the Nashville office mailroom from Tax Enforcement field offices (12%) were not mailed timely.

It appears that some officers are holding checks or money orders for several days and mailing several days' 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. To address the safeguarding of the funds before deposit, the regional offices have begun using safes to secure cash collections overnight or over the weekend. Although the safes were placed in the field offices, no internal control policies were established requiring the use of the safes.

Recommendation

The regional office supervisors should review the deposit practices in their regions and take disciplinary action as necessary against the officers who disregard the deposit policies. The Director of Tax Enforcement should ensure that the supervisors are following the established policy. For collections that must be held overnight or over the weekend, policies should be developed regarding the use of safes.

Management's Comment

We concur. Tax Enforcement supervisors are required to check Revenue Officers' work and daily reports to ensure that collections are deposited timely and mailed to Nashville in accordance with written procedures. Tax Enforcement managers make periodic unannounced checks of daily reports and work completed by the Revenue Officers to determine if supervisors are carrying out their responsibilities. When supervisors find that procedures covering the timely deposit and mailing of collections are not being followed, disciplinary action is immediately taken, and some of the auditor's findings of untimely deposit of collections had been previously documented in reports submitted to Enforcement Division management by a supervisor, and were being addressed.

3. Tax Enforcement officers are not properly maintaining daily reports and receipt books, and certain supervisory reviews were not performed

Finding

As noted in the prior audit, the department's daily reports, which are used by Tax Enforcement officers to record all collections received, are not maintained sufficiently. In addition, the officers did not correctly complete their receipt books or receipts. Management concurred with the prior finding and stated that managers and supervisors would be more vigilant when reviewing diaries to minimize these errors. However, problems still continue to occur.

During testwork performed at the Jackson, Columbia, and Chattanooga Tax Enforcement offices, 11 of 16 officers reviewed had collections that were not recorded correctly in their daily report for January 2004. Four of the 11 officers noted issued receipts for collections but did not record the collection in the daily report. Three of the 11 officers recorded a collection in their daily report on a different day than the date written on the receipt. Two of the officers recorded a collection twice, and therefore had incorrect monthly collection totals. Two of the 11 officers noted did not record that a receipt was voided in their daily report. Also, one officer recorded the incorrect amount for a collection in the daily report.

The *Tax Enforcement Officer's Procedures Manual*, Section I, requires each Tax Enforcement officer to complete the daily report for each collection with information regarding the account identification number, amount of the delinquent or current collection, taxpayer name, receipt number if applicable, and tax type or other pertinent information. Also, the department's *Tax Enforcement Officer's Procedures Manual*, Section III. F., states that the officers should "list the receipt number in the diary [daily report] on the date that it was voided."

Testwork also revealed that 12 of 16 officers did not correctly complete their receipt book or certain receipts during the month of January. Eight of the 12 officers noted did not complete the assessment period on all receipts. Six of the 12 officers noted did not maintain the white copy of the Receipt Book Transfer Form in their receipt books. One of 12 officers noted had receipts that had mistakes that were crossed out and corrected rather than being voided. Also, one officer reviewed did not sign and date the voided receipt. In addition, 3 of 12 officers did not enter complete information on the covers of their receipt books.

Section III of the *Tax Enforcement Officer's Procedures Manual* requires certain information to be completed on the receipt, including the assessment period or debit memo section of the receipt. This section also requires that receipts with errors should be voided, signed, and dated. The white copy of the transfer form is required to be maintained in the receipt book. In addition, 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.

Certain daily reports and receipt books were not reviewed by the supervisor. The *Supervisor's Procedures Manual*, Section I.A., states that "supervisors must audit two random workdays of each employee's daily reports from the preceding month." Supervisors should ascertain that all collections for the two days selected were deposited or mailed to Nashville on a timely basis and posted to the system. Supervisors are also required to compare receipt books to the daily report. The review allows the supervisor to find and correct errors made and helps to detect fraud and other problems that may arise. There was no evidence that the Chattanooga supervisor performed this review for any of the daily reports during the month selected for testwork. That supervisor has since terminated his employment.

When the officers do not provide adequate information on the receipts, the risks increase that the payment would be applied to the wrong period. Also, inadequate recording in the officers' daily reports and officers not adhering to policies on voiding receipts and accounting for receipt books hinders the audit trail for supervisors, managers, directors, and auditors. Without supervisory reviews, errors or irregularities on the daily reports and the receipts would go undetected.

Recommendation

The Director of Tax Enforcement should enforce the policies for writing receipts and recording collections in the officers' daily reports. Daily report totals should be reconciled to the receipt books. Also, the managers should ensure the supervisors review officers' daily reports and receipt books frequently enough to ensure compliance with policies. These verifications of daily reports will result in a decrease in the chances of fraud or theft.

Management's Comment

We concur. The electronic daily report used by Tax Enforcement personnel has been revised, making it more user friendly. Supervisors, in addition to the required audits of daily reports and receipt books, must also make frequent periodic checks of daily reports to ensure that they are being completed correctly and timely by the users. When conducting the monthly review of receipt books, supervisors are checking to ensure that the receipt book covers are being completed as per procedure.

TAXPAYER SERVICES

Our objectives in reviewing Taxpayer Services were to determine whether

- 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) were effective and functioning,
- bond reviews and bond approvals were timely and proper,
- current collections received at the regional offices were handled properly,
- regional offices' current collections were deposited timely to a local bank in a State of Tennessee account, and
- pending debits and credits were worked timely and efficiently.

We interviewed key personnel to gain an understanding of the laws, rules, and departmental procedures related to taxpayer services. We selected a nonstatistical sample of refunds issued issued April 1, 2003, through November 30, 2004, and we verified the existence of the taxpayers. We tested a nonstatistical sample of account balance changes from April 1, 2003, through January 30, 2004, to determine whether the change was properly documented and approved. To determine if bond reviews were conducted timely and if bonds were properly approved, we tested nonstatistical samples of bonds as of March 2004. Regional offices' current collections accepted during the audit period were tested to determine if the collections were handled properly and deposited timely. A nonstatistical sample of pending debits and credits as of January 28, 2004, was tested to determine if the cases are resolved timely and efficiently.

Based on our work, we determined that refunds were made to valid taxpayers. We determined that the department was following established procedures for approving bonds and that bonds reviews were completed timely. However, we determined that pending amounts were not resolved timely. Also, controls over changes to taxpayer account balances were adequate but were not always followed. In addition, we determined that procedures over current collections were inadequate and that receipt books were not accounted for properly.

4. <u>Pending amounts were not researched timely, and reliable information on outstanding pending amounts could not be obtained</u>

Finding

When account differences are created from a taxpayer return or payment that has calculations that differ in amount from what is calculated by RITS, the debit or credit amount is placed in a pending status when the amount of the item either exceeds a threshold level or meets other criteria defined in RITS programming. A debit or credit remains in pending status until an employee of the department reviews it and either approves or denies the debit or credit. Per Section 67-1-1501(b), *Tennessee Code Annotated*,

> the amount of any tax imposed under any title, wherein the filing of a return is required by the state, shall be assessed within three (3) years from December 31 of the year in which the return was filed, and no levy or other proceeding to enforce the collection of such tax without assessment shall be made or begun after expiration of such period.

In addition, Section 67-1-1802, *Tennessee Code Annotated,* states that the department can give refunds to taxpayers without a claim being filed if the commissioner is in possession of proper proof and facts that a refund is due within three years of December 31 of the year that the payment creating a credit was received. A debit in pending status could represent an amount owed to the state which has not been assessed because, when in pending status, the taxpayer has not been notified of the debit. A credit in pending status is a credit that has not yet been determined to be eligible for refund. Therefore, if action is not taken for these debits and credits before the three-year limitation has expired, the department no longer has the opportunity to resolve the debits or the legal responsibility to resolve the credits.

Seven of 60 pending debits and credits reviewed (12%) were not resolved timely. One of the seven items noted was a debit of $15 that was not assessed within three years of December 31 of the year in which the return was filed. Six of the seven items noted were credits totaling $653 that were not resolved or refunded within three years of December 31 of the year in which the return was filed.

According to the Director of Taxpayer Services, the department is reviewing the most recent pending debits and credits first. The department is not placing priority on the pending debits and credits created in 2001 that will not be collectible or refundable by December 31, 2004. Over $500,000 of pending debits were recently written off because they exceeded the cut-off date. To determine the extent of the pending debits and credits in existence, the auditor requested reports. These reports were later determined not to be reliable. The reports do not affect the financial reporting for the state, but the department should have accurate information available on pending debits and credits in order to evaluate the extent of reviews performed to remove the debits and credits from the pending status.

When pending debits are valid and are not assessed timely, the department loses the opportunity to collect taxes which may be owed to the state. When pending credits are valid and are not researched, the department may be keeping funds that belong to the taxpayer.

Recommendation

The Commissioner should reevaluate the system in place for reviewing pending debits and credits. Pending debits should be assessed or resolved within three years of December 31 of the year the return was filed or payment received. Pending credits should also be resolved appropriately during the three-year time period. The Commissioner should ensure adequate resources are available to appropriately research and resolve pending amounts. The Commissioner should also make sure that reliable reports are available on the amount of pending debits and credits outstanding so management can continuously assess the status of outstanding items. The cause of the unreliable information should be determined and appropriate action should be taken to correct any unreliable or inaccurate reports.

Management's Comment

We concur and agree that the system for reviewing pending debits and credits should be reviewed; however, certain pending debits and credits shown on reports have been reviewed but cannot be approved for billing or refunds. Among those pending debits and credits are cases that are in an active bankruptcy, Special Investigations, or field audit.

The department recently implemented a write-off program for debits and credits based on applicable guidelines and statutes. During the transition from the TRIMS computer system to RITS, many old debits were converted. A large percentage of the debits identified for write-off were these old debits which were from six to twelve years old. These uncollectible items continued to accrue interest over all those years.

5. The guidelines for account balance changes in RITS are not followed

Finding

The department did not always ensure that changes in taxpayer account balances were properly made. Changes to taxpayer accounts are sometimes necessary to adjust incorrect balances created by keying, scanning, and taxpayer errors. A sample of 60 of these account balance changes was reviewed. Forty-four of the 60 account balance change transactions tested (73%) were not handled correctly in accordance with the guidelines set forth by management.

Nineteen of the 44 account balance changes mentioned did not have adequate documentation or review, 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] 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 reports 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 samples 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.

Of the 19 review errors noted, 13 employee transaction activity reports did not bear the initials, date, or comments on adjustments by supervisors. The adjustment amounts ranged from $3,024 to $31,020. The supervisor of the regional offices terminated employment during the audit period, and any evidence of any possible review was not retained. The other six activity reports contained initials indicating that they had been reviewed by the supervisor; however, comments to indicate whether the adjustment was correct did not appear on the reports. One of the six was for an adjustment of $10,318 in which the supervisor did not indicate if the adjustment made was correct. In addition, several managers and supervisors within the Audit Division have not been retaining their Employee Transaction Reports for three years. When supervisors do not properly review account balance changes, the risk of improper changes increases, which could compromise taxpayer accounts.

Also, for 34 of the 44 errors noted, the notes were not entered into RITS in accordance with the Department of Revenue's "Guidelines for Changing Account Balances and Approving Those Changes." The Documentation section of the guidelines states, "Employees making adjustments to the taxpayer accounts must place a note on the taxpayer accounts in RITS. . . ." The Notes in RITS section states,

> Employees making adjustments to taxpayer accounts must place a Note on RITS, using the Notes conversation, explaining the adjustment was made as a result of a walk-in taxpayer and/or telephone conversation with a taxpayer or their representative. In addition, the name and telephone number of a caller or walk-in taxpayer should be entered, along with any other pertinent information.

Twenty-four of the account balance changes tested did not have a note in RITS to document the account balance change transaction, four of which were each over $300,000. For example, one employee made an adjustment for $914,102 to a taxpayer's account without documenting the purpose of the adjustment. For 10 of the errors, notes were created in RITS; however, the notes did not document if the taxpayer walked in or called to authorize the change. In addition, the taxpayers' names and telephone numbers were not documented.

The notes are necessary for a reviewer to determine whether the account change was valid. The required detail of the notes is necessary to document the exact details of the account change to deter questionable changes. If improper changes are made when controls are lacking, the state loses access to potential revenues.

Recommendation

The Commissioner should require supervisors and employees to follow the procedures for account balance changes outlined in the department's guidelines. Management should ascertain that supervisors are reviewing the employee transaction activity reports by regularly verifying the supervisors' reviews and take disciplinary action as necessary. Management should also ensure that the employee transaction activity reports are retained for three years. The system should be modified to require notes on the taxpayer accounts when necessary before account balance changes can be completed. During the supervisors' reviews of the reports, employee comments should be reviewed for all necessary components and for the validity of the account changes.

Management's Comment

We concur. The guidelines for account balance changes have been reviewed and updated to ensure that internal controls are in place and that accounts are reviewed and documented as reviewed after changes are made to RITS. Management is working with supervisors to ensure that the review of the employee transaction reports is properly documented, the reports are initialed, and they are retained for three years.

6. <u>Regional offices did not record issuances of receipt books</u>

Finding

The Taxpayer Services regional offices did not maintain a receipt book log to indicate to whom receipt books were issued, who issued the receipt books, or when they were issued. The regional offices have been accepting payments and writing receipts for several years without controls in place to document or log issuance of receipt books. None of the seven receipt books reviewed (0%) were accounted for by management. There were no records regarding which employee had which receipt book or the date when receipt books were issued.

Control procedures were not established until January 2004. The *Accounting for monies collected* procedure states,

> Official Revenue Department Receipt Books are issued to all Taxpayer Services Regional Employees by the supervisor or manager. The taxpayer services regional employee will verify that all 50 receipts in the book are accounted for and in numerical order when the receipt book is issued. The employee will sign and date the Receipt Book Transfer Form and retain the white copy for three years. This transfer slip will be maintained in the receipt book that was drawn.

However, these procedures were not always followed. The one receipt book that was observed by the auditor as having been issued since the policy was in place did not have a transfer slip. The copy of the transfer slip that management was to retain could not be located either.

When receipt books are issued without proper documentation being completed, the department runs the risk of employees having multiple receipt books or hidden receipt books. If an employee has a receipt book that the department does not know about, taxpayers could pay cash to an employee for their taxes and receive a receipt from that employee, but the employee could keep the payment without detection by the Department of Revenue's controls. The employee could either temporarily make use of the funds and deposit them at a later time or never deposit the funds at all. Reconciliation procedures between the receipt books and the department's deposit records are ineffective when the department does not account for all written receipts.

Recommendation

The Director of Taxpayer Services should ensure that regional supervisors and managers properly track all receipt books. Each regional office should have a log book which documents the employee who received the receipt book, when the receipt book was issued, and who issued the receipt book. This log should account for each prenumbered receipt book. Management should also enforce the policy that a copy of the receipt book transfer form is to be maintained in the receipt book, and the original should be maintained by management.

Management's Comment

We concur. The guidelines and procedures for accounting for receipt books have been reviewed and updated. Management is working with the regional offices to ensure that the receipt books are being properly accounted for, initialed by management and reconciled to RITS.

7. <u>Internal control over cash receipts was not adequate</u>

Finding

During a review of the Taxpayer Services regional offices, it was noted that the regional offices had been collecting monies for several years without any established procedures, guidelines, or internal control. Due to the lack of control, certain problems with receipts were noted. Information filled out on receipts did not always match the information recorded in the department's accounting records. In one case, a cash receipt of $16 could not be located in RITS. In the other instances, the account numbers written on the receipts did not always match the account numbers recorded in RITS. Also, for several receipts written by one Taxpayer Service representative, either the account number or the pay period was not completed. Another Taxpayer Services representative did not always submit the green copy of the receipt to the Nashville office and instead left the copy in the receipt book. That representative also did not always give the white copy of the receipt to the taxpayer and instead left the copy in the receipt book. In addition, two of seven representatives' deposit slips were not always attached to the cash receipt. These errors could have been minimized if the department had required supervisory review of the receipt books. However seven of seven taxpayer services representatives reviewed (100%) had receipt books that were not reviewed by a supervisor. None of the receipt books reviewed by auditors showed any indication that a review had been performed by a supervisor.

Taxpayer Services representatives also have not been depositing or submitting funds timely. Section 9-4-301(a), *Tennessee Code Annotated,* 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 or 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. . . .

Six of seven representatives did not always deposit cash payments timely. Some larger payments ranging from $230 to $575 were not deposited until six to eleven days after receipt. Several payments received were kept over the weekend by the taxpayer services representatives reviewed, and the Taxpayer Services regional offices do not have safes or secured areas to safeguard the cash collections. Also, seven of seven representatives did not mail the paperwork related to the payments, including the actual checks when the payment was not made with cash, to the Nashville office by the next day. Based on the review, it appears that the representatives are holding the paperwork for a period of time before mailing it in to the Nashville office. The paperwork was sometimes held over a week or even over a few weeks, and in some cases included the actual check.

Six of the seven representatives reviewed did not always follow the policy for voided receipts. One of the six representatives tore two receipts along with each applicable copy of the receipts from the receipt book. Neither the receipt nor the applicable copies could be located. The other representatives did not submit copies of the receipts to their offices. Also, mistakes on receipts were scratched out and written on instead of voiding the receipt and writing a new one. Additionally, four of seven representatives did not provide complete information on the receipt book covers. The receipt book instructions state that the cover should be completed.

Policies for the regional offices that accept payments were not established until January 2004. The new policies address supervisor review, deposit time frames for cash collections, and voided receipts. However, as mentioned previously, there was no evidence of supervisory review even though the new policy requires that the review occur monthly. Also, receipts that should have been voided were still observed after the policy became effective. The new policy does not address when the paperwork associated with payments should be mailed to the central office, and the required monthly review does not include reconciling the information on certain receipts to the information recorded in RITS.

Without proper review procedures, including a review of the accounting records, taxpayer services representatives could write receipts for funds received and not deposit the money into a state account. Recording errors and procedural errors go unnoticed. When the department does not follow the law related to cash receipts, funds that should be available for state expenditure are not realized and could conceivably contribute to cash flow problems if not better controlled. Also, the customer's account is not credited promptly and may be flagged as being late when the payment has actually been received. Allowing strike-throughs on the original receipt could provide the means for a representative to alter copies of the receipt after issuance to cover up misappropriated funds.

Recommendation

The Director of Taxpayer Services should strengthen the new policy and ensure that the regional supervisors and managers follow the policies. The policy should include time frames to submit payment paperwork to the Nashville office and specific requirements for supervisor reviews. Supervisors should review the receipt books frequently enough to prevent problems with receipts. The review should include comparing information that was recorded in RITS. Missing receipts or amounts that were not recorded in the accounting system should be investigated. Payments should be deposited according to *Tennessee Code Annotated* and the adopted policy. When information on a receipt is incorrect, the receipt should be voided, and all voided receipts should be turned in and accounted for by the supervisor. In addition, receipt book covers should be completed properly. The Director of Taxpayer Services should regularly review the activities of the regional offices, and appropriate control related to cash receipts should be established and maintained.

Management's Comment

We concur. The guidelines for accounting for and depositing cash receipts have been reviewed and updated. Management is working with the regional offices to ensure that cash receipts are being properly accounted for and deposited.

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. In addition, the head of each executive agency is required to conduct an evaluation of the agency's internal accounting and administrative control and submit a report by December 31, 1999, and December 31 of every fourth year thereafter.

Our objectives were to determine whether

- the Department of Revenue's June 30, 2003, responsibility letter and December 31, 2003, internal accounting and administrative control report were filed in compliance with Section 9-18-104, *Tennessee Code Annotated;*
- documentation to support the Department of Revenue's evaluation of its internal accounting and administrative control was properly maintained;
- procedures used in compiling information for the internal accounting and administrative control report were in accordance with the guidelines prescribed under Section 9-18-103, *Tennessee Code Annotated;* and
- corrective actions have been implemented for weaknesses identified in the report.

We interviewed key employees responsible for compiling information for the internal accounting and administrative control report to gain an understanding of the Department of Revenue's procedures. We also reviewed the June 30, 2003, responsibility letter and the December 31, 2003, internal accounting and administrative control report to determine whether they had been properly submitted to the Comptroller of the Treasury and the Department of Finance and Administration. To determine if corrective action plans had been implemented, we read the letter and report to identify weaknesses noted.

We determined that the Financial Integrity Act responsibility letter and internal accounting and administrative control report were submitted on time, support for the internal accounting and administrative control report was properly maintained, and procedures used were in compliance with *Tennessee Code Annotated.* There were no weaknesses identified in the report.

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 July 23, 2003.

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 Tennessee Title VI Compliance Commission is responsible 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

ALLOTMENT CODES

Department of Revenue 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