AUDIT REPORT

Department of Revenue

November 2005

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
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John G. Morgan
Comptroller

November 29, 2005

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, 2004, through February 28, 2005.

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

John G. Morgan
Comptroller of the Treasury

JGM/th
05/050

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May 12, 2005

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, 2004, through February 28, 2005.

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

A u d i t   H i g h l i g h t s

Comptroller of the Treasury   Division of State Audit

Financial and Compliance Audit
Department of Revenue
November 2005

AUDIT SCOPE

We have audited the Department of Revenue for the period April 1, 2004, through February 28, 2005. Our audit scope included a review of internal control and compliance with laws and regulations in the areas of Information Technology Resources, on-line filing, Revenue Accounting, Taxpayer Accounting, Tax Enforcement, Taxpayer Services, undistributed revenue, and the Financial Integrity Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include approving accounting policies of the state as prepared by the state's Department of Finance and Administration; approving certain state contracts; participating in the negotiation and procurement of services for the state; providing support staff to various legislative committees and commissions; and approving write-off amounts and assisting with revenue estimates for the Department of Revenue.

AUDIT FINDINGS

Dates of Receipt (In-Dates) Recorded in the Revenue Integrated Tax System Do Not Always Agree With Other Documentation**

The receipt dates (in-dates) documented in the Revenue Integrated Tax System (RITS) do not always agree with the actual date of receipt. Seven of 60 receipts tested (12%) had in-dates on the related tax forms that did not agree with the date recorded in RITS (page 7).

Tax Enforcement Officers Are Still Not Properly Maintaining Daily Reports and Receipt Books**

Daily reports, which are used by Tax Enforcement Officers to record all collections received, are not maintained sufficiently, and the officers did not correctly complete their receipt book covers or receipts. Receipt numbers and voided receipts were not all listed in the daily reports; receipt book transfer forms were not retained; and assessment periods were not listed on the receipts (page 8).

The Approved Guidelines for Account Balance Adjustments in the Revenue Integrated Tax System (RITS) Are Not Followed*

Fifty-one of 60 account balance change transactions tested (85%) were not handled correctly. Forty-eight did not have adequate documentation of review, and 19 did not include appropriate notes in RITS. Revised guidelines for account balance changes have been adopted but were not properly approved (page 11).

Pending Amounts Were Not Reviewed Timely*

Fifty-nine of 60 pending credits (98%) and 40 of 60 pending debits (67%) have not been reviewed and resolved timely. As a result, the department may lose the opportunity to collect certain taxes owed to the state, or the department may erroneously keep funds that belong to the taxpayer (page 14).

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

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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

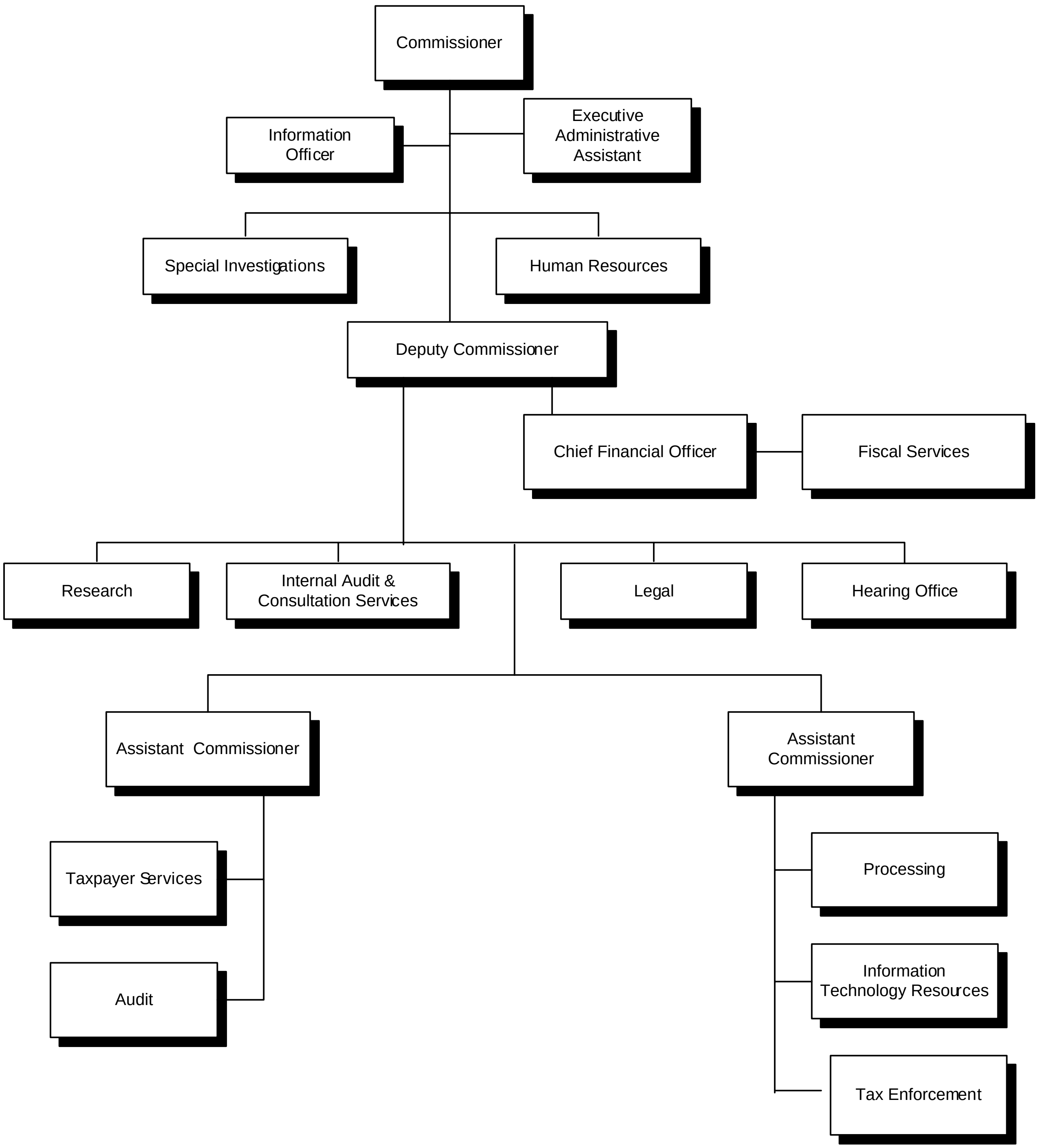
The mission of the Department of Revenue is to collect state revenue. Specifically, the department is responsible for the collection of most state taxes and fees, for enforcing the revenue statutes of the state to ensure that taxpayers are in compliance with all tax laws, and for preparing monthly apportionment 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, 2004, through February 28, 2005. Our audit scope included a review of internal control and compliance with laws and regulations in the areas of Information Technology Resources, on-line filing, Revenue Accounting, Taxpayer Accounting, Tax Enforcement, Taxpayer Services, undistributed revenue,

Tennessee Department of Revenue
Organization Chart



and the Financial Integrity Act. The audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Tennessee statutes, in addition to audit responsibilities, entrust certain other responsibilities to the Comptroller of the Treasury. Those responsibilities include approving accounting policies of the state as prepared by the state's Department of Finance and Administration; approving certain state contracts; participating in the negotiation and procurement of services for the state; providing support staff to various legislative committees and commissions; and approving write-off amounts and assisting with revenue estimates for the Department of Revenue.

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 March 10, 2005. 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 issuance of receipt books by regional offices, Tax Enforcement collections, and internal control over cash receipts.

REPEATED AUDIT FINDINGS

The prior audit report also contained findings concerning in-dates recorded in RITS, Tax Enforcement daily reports and receipts, account balance changes in RITS, and pending debits and credits. 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 division were to determine whether

- adequate system information has been documented,
- user access to the Revenue Integrated Tax System (RITS) is adequately controlled,
- adequate controls have been placed in operation over RITS, and
- valid information is recorded in RITS.

To determine if system information was adequately documented and that controls were adequate and placed into operation, we interviewed key personnel and reviewed related documentation. We tested a nonstatistical sample and reviewed the authorizations of individuals with RITS access to determine if user access to RITS was adequately controlled. We also selected a nonstatistical sample of employees that left the Department of Revenue between April 1, 2004, and January 5, 2005, to determine if RITS access was appropriately disabled. We performed data integrity tests to determine that valid information was recorded in RITS.

As a result of our review and testwork, we determined that adequate system information is documented and control over RITS is adequate. User access to RITS is adequately controlled, and valid information is recorded in RITS.

ON-LINE FILING

Our objectives in reviewing on-line filing were to determine whether

- controls over on-line filing have been placed in operation;
- error report procedures are in place, and errors are investigated and corrected;
- tax amounts submitted by the taxpayers agree to the amount on the taxpayers' returns and the amounts deposited in the bank; and
- reconciliations are performed and properly documented.

We interviewed key personnel and performed walkthrough procedures to determine if controls over on-line filing were in operation and to determine if error report procedures were in place. We reviewed a nonstatistical sample of tax return errors that occurred between April 1, 2004, and December 29, 2004, to see if the errors were investigated and corrected promptly. We tested a nonstatistical sample of electronically filed claims submitted April 1, 2004, through January 6, 2005, to determine if the tax return amount agreed to the amount paid and received by the state. Also, we reviewed the reconciliation process and selected a nonstatistical sample of reconciliations for five different tax types to determine if the reconciliations were performed, documented, and authorized.

As a result of our testwork, we determined that controls over on-line filing were placed into operation. We determined that procedures for error reports are adequate, and errors are promptly investigated and corrected. We determined that tax amounts submitted by the taxpayers agree to the amounts on the taxpayers' returns and the amounts deposited in the bank. Reconciliations are performed and are properly documented.

REVENUE ACCOUNTING

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

- relevant policies and procedures have been placed in operation,
- revenues are properly recorded and classified by tax type in the monthly collection reports,
- reconciliations are being performed and are properly documented, and
- system balancing problems are minimized.

We interviewed key personnel to determine whether relevant policies and procedures had been placed into operation. In order to determine that revenues were properly recorded and classified by tax type in the monthly collections report, we reviewed preparation procedures and performed an analytical review. We reperformed an October 2004 reconciliation and reviewed the reconciling items. We also reviewed the number of days that the Revenue Integrated Tax System was out-of-balance, the causes of the balance problems, and the action taken to correct the problems.

As a result of the testwork performed, we determined that relevant policies and procedures were placed into operation. Revenues are properly reported and classified by tax type in the monthly collection reports. We determined that reconciliations are properly documented and performed. Also, out-of-balance situations are appropriately minimized.

TAXPAYER ACCOUNTING

Our objectives in reviewing Taxpayer Accounting were to determine whether

- controls over taxpayer accounting are in place and adequate,
- taxes are reported accurately on the Revenue Integrated Tax System (RITS), and
- tax deposits are timely.

We interviewed key personnel to gain an understanding of the department's control in the area of taxpayer accounting. We selected a nonstatistical sample of tax returns from July 1, 2004, through December 31, 2004, to determine if the tax return information was added accurately into RITS and to determine if the associated deposits were made timely. We also selected a nonstatistical sample of payments recorded in RITS July 1, 2004, through December 31, 2004, to determine if the information in RITS agreed to supporting documentation.

Based on our interviews and testwork, we determined that controls are adequate and in place. We also determined that the taxes are reported accurately in RITS and the tax deposits are timely.

TAX ENFORCEMENT

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

- controls over Tax Enforcement are adequate and in place,
- regional Tax Enforcement offices mail receipts to the department's processing division timely,
- cash received by Tax Enforcement officers is deposited timely to a local bank in a State of Tennessee account,
- Tax Enforcement officers' receipt books and daily reports are properly completed and reviewed by their supervisor, and
- voided receipts from Tax Enforcement officers' receipt books are properly completed and accounted for by the officers.

We interviewed key personnel to determine whether relevant policies and procedures have been placed into operation. We performed testwork on a nonstatistical sample of tax collections received during selected days in January and February 2005 to determine whether receipts were being mailed to the processing division timely. We tested a nonstatistical sample of receipts for selected field offices issued April 1, 2004, through February 17, 2005, to determine that receipt books and daily reports were properly completed and reviewed by supervisors. We also tested a nonstatistical sample of cash collections from April 1, 2004, through February 1, 2005, to determine if cash collections were deposited timely. Finally, we tested voided receipts of selected officers to see if the voids were handled properly.

As a result of our testwork, we determined that cash collections received by Tax Enforcement officers are deposited in the local bank in a State of Tennessee bank account timely, and the collections mailed to the processing division are mailed timely. There were problems noted with maintenance of receipt books and daily reports, including the recording of voided receipts. Also, certain dates on supporting documents do not agree to the dates recorded in the Revenue Integrated Tax System.

1. <u>Dates of receipt (in-dates) recorded in the Revenue Integrated Tax System do not always agree with other documentation</u>

Finding

The receipt dates (in-dates) documented in the Revenue Integrated Tax System (RITS) do not always agree with the actual date of receipt. Seven of 60 receipts tested (12%) had in-dates on the related tax forms that did not agree with the date recorded in RITS. Management concurred with similar findings in 2003 and 2004 and stated that supervisors would periodically check the returns to ensure the appropriate dates were documented. The spot checks occurred as promised and improvements in paperwork completion occurred, but differences in the dates actually recorded in RITS were still noted. It now seems that an error is occurring within RITS that is causing the dates to differ.

When a date is recorded in RITS for a delinquent payment that was earlier than the date that revenue was actually received, interest and late fees that accumulated for the delinquent payment are not charged to the taxpayer's account. When a date is recorded in RITS that was later than the actual date that the revenue was actually received, the taxpayer could be assessed interest and fees in excess of the amount truly owed.

Recommendation

The Director of Processing should determine why the dates recorded in RITS do not always agree with the dates that revenue is actually received. The Information Technology Resources division should work with the Processing division to correct the problem with RITS. The Director of Processing should continue the process of reviewing the entries in RITS to ensure that the in-dates recorded represent the actual date that payments were received.

Management's Comment

We concur. The department has worked to ensure that return T-boxes are completed by the Revenue Officers in the field. Tax Enforcement Tax Information Assistants and Supervisors check returns for dates, prior to their being mailed to Nashville. An error in the RITS system has allowed the "process" date to be posted as the "in-date" on certain transactions involving deposit certificates which has resulted in the dates not corresponding. The system weakness has been identified and is being corrected. We will continue to monitor in-dates to ensure they are properly recorded.

2. <u>Tax Enforcement officers are still not properly maintaining daily reports and receipt books</u>

Finding

As noted in the prior two audits, the department's daily reports, which are used by Tax Enforcement Officers to record all collections received, are not maintained sufficiently. In addition, as noted in previous years, the officers did not correctly complete their receipt book covers or receipts.

Tax enforcement collections are inherently risky. It is vital that controls are in place to ensure that theft is not occurring. Accurate documentation of the tax enforcement officers' activity is essential to ensure that the recorded receipts are all-inclusive. Appropriate accountability for the receipt books and for each individual receipt is important to deter fraudulent activity. While procedures have been developed to recognize the risks of theft, the tax enforcement officers are still not following the procedures. Management at the regional offices has not performed sufficient monitoring to ensure that policies and procedures are being consistently followed.

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 Procedure Manual*, Section III. F, states that the officer is to "list the receipt number in the daily report the date it was voided."

Daily reports and receipts were reviewed at the Memphis, Knoxville, Cookeville, and Nashville Tax Enforcement offices. The daily reports reviewed did not always include required information. One of 60 collections reviewed was not recorded in the daily report. For 9 of the 59 remaining collections recorded in the daily report that were reviewed, the receipt number was not listed on the daily report. Also, 17 of 51 voided receipts tested were not listed on the officers' daily reports. The daily reports are used to document each officer's activities and serve to reconcile with receipts issued by the officer through the supervisor's review to deter misappropriation of taxpayer funds. Completed daily reports are necessary to allow this reconciliation process and to account for all receipts.

Section III of the *Tax Enforcement Officer's Procedure Manual* requires certain information to be completed on the receipt, including the assessment period. The manual also requires that receipts with errors 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.

Testwork also revealed that officers did not correctly complete their receipt book or certain receipts. Eight of 44 receipt books tested did not have the white copy of the receipt book transfer form stapled to the book. Seven of 60 receipts tested were not properly completed. Of the seven, six did not have the assessment period completed, and one included scratched-out information and should have been voided. In addition, 4 of 50 receipt book covers were not properly completed. Three of the covers did not show the appropriate ending receipt number, and one cover did not include information regarding to which officer the book was assigned. Accounting for the receipt books is necessary to ensure that the officers are not issuing unauthorized receipts. Receipt transfer forms should be retained as necessary, and the covers of the books should be completed properly to allow supervisors to account for all of the receipts. Receipts must be completed properly to ensure that payments are applied for the proper period and to ensure that changes are not made to the receipts subsequent to issuance.

Management concurred with the 2003 audit finding. In response to the finding, they stated they would continue to emphasize the importance of the established procedures and would continue monitoring receipts. Supervisors were required to verify the accuracy of the collection entries. Management subsequently improved the documentation process by introducing the daily report system. However, in spite of these efforts, errors continued to occur and the finding was repeated last year. Management also concurred with the 2004 finding and stated that the electronic daily report program had been revised to make it more user friendly and that frequent periodic checks of daily reports and receipt books were being conducted. The reporting system was improved and evidence of the periodic checks was available. However, problems still continue to occur.

Recommendation

The Director of Tax Enforcement should enforce the policies for writing receipts and recording collections in the officer's daily reports. The director should require more frequent supervisory reviews until the errors are sufficiently minimized. All receipts should be accounted for. These reviews should be documented and disciplinary action should be taken to ensure that the officers understand the importance of following departmental policies and procedures. The Commissioner should monitor the Director of Tax Enforcement's strategies for minimizing the problems with daily reports and receipts.

Management's Comment

We concur. The Department has made great strides in improving procedures followed by Revenue Officers in the field, and we will continue to work on improving collection and daily report procedures further. We have updated and implemented improvements both in written procedures and in review of officers' work by line supervisors. Many of the errors noted in this audit finding (22 of 29, or 75.6%) were committed by just four of the division's 99 Revenue Officers. Each of these officers had been written up during receipt book/daily report reviews performed by their supervisor, and their work was being monitored on an ongoing basis.

Revenue management and Tax Enforcement personnel are acutely aware of the necessity of maintaining good and accurate records. Tax Enforcement personnel are continually trained and, if necessary, disciplined appropriately for mistakes and omissions on receipt books and daily reports. Of the four employees that made the 22 errors referenced above, one has since left the department, another has been reprimanded with an oral warning, a third was a trainee at the time of the transactions audited, and the performance of the fourth is being addressed through supervisor review and intervention.

The Enforcement Division has an extensive review process and we expect there to be fewer and fewer errors of this type, as we move forward. We have sufficient controls in place to quickly detect theft or fraud and also to detect trends that may indicate the probability or possibility of theft. In addition, we have put a receipt review process in place to account for all receipts written in the field, once they are received in Nashville.

TAXPAYER SERVICES

Our objectives in reviewing Taxpayer Services were to determine whether

- controls over Taxpayer Services are adequate and in place,
- the section's managerial controls over correction and changes to taxpayer account balances in the Revenue Integrated Tax System (RITS) are effective and functioning,
- taxpayer services representatives are properly accounting for receipt books,
- collections received at regional offices are handled properly and mailed to Nashville timely,
- regional offices' current collections are deposited timely to a local bank in a State of Tennessee account, and
- pending debits and credits are reviewed timely and efficiently.

We interviewed key personnel to determine if relevant policies and procedures were placed into operation. A nonstatistical sample of account balance changes from April 1, 2004, through February 1, 2005, was tested to determine whether the change was properly documented and approved. Receipt book logs were reviewed to determine if the books were accounted for correctly. We tested a nonstatistical sample of selected receipts of certain regional offices from April 1, 2004, to February 1, 2005, to determine whether collections were receipted and recorded properly and mailed to Nashville timely. We also selected a nonstatistical sample of receipts for cash collections to determine if the receipts were recorded properly and deposited timely. Nonstatistical samples of pending debits and pending credits as of February 21, 2005, were tested to determine if the debits or credits were resolved timely and efficiently.

Based on our work, we determined that procedures are adequate. Receipt books are accounted for properly, collections are receipted and recorded appropriately, and receipts are mailed or deposited timely. However, account balance changes are not handled correctly. Also, we determined that pending amounts are not reviewed timely.

3. **<u>The approved guidelines for account balance adjustments in the Revenue Integrated Tax System (RITS) are not followed</u>**

Finding

As noted in the prior audit, the department did not always ensure that adjustments 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. These account balance changes are especially risky because the changes could be used for improper changes to the taxpayer accounts or could be used to cover the theft of incoming funds by the revenue employee or a coworker. Improper account balance changes could also be made as attempts to cover up errors or mistakes that affect taxpayer accounts. Notes are necessary to document the exact details of the account change to deter questionable changes. If improper changes are made, a fraud would not be discovered if the supervisor is not reviewing the adjusted account balances and related explanations. Without proper supervision, there is a lack of accountability, a lack of appropriate scrutiny, and an inability of upper management to control the risks associated with these account balance changes.

A sample of 60 balance changes was reviewed. Fifty-one of 60 account balance change transactions tested (85%) were not handled correctly in accordance with the guidelines set forth by management.

Forty-eight of the 51 account balance changes mentioned did not have adequate documentation of review (supervisor's initial, date, and/or comments on the propriety of the adjustment), 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 [*sic*] 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 48 reviews that did not have documentation noted, two employee transaction activity reports did not bear the initials, date, or comments on adjustments by supervisors. One of the transactions was over $13,000. The other 46 activity reports contained initials indicating that the supervisor had reviewed them; however, comments to indicate whether the adjustment was correct did not appear on the reports. Four were for adjustments of over $10,000 up to $70,000 in which the supervisor did not indicate if the adjustment made was correct. When supervisors do not properly review account balance changes, the risk of improper changes increases.

Also, for 19 of the 51 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.

However, the 19 changes did not have the required notes.

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, employees could commit frauds unnoticed and the state could lose access to potential revenues.

Management concurred with the prior-year finding and stated that the guidelines had been reviewed and updated and that management was working with the supervisors to ensure proper documentation. However, management did not adequately address the risks associated with account balance changes. The problems continued and the guideline changes were not properly approved.

As mentioned above, management stated that the guidelines for account balance changes had been reviewed and updated. However, the changes that were proposed in January 2005 had certain inconsistencies that prevented final approval. The guidelines quoted above were the guidelines that received approval in 1999. The new proposed guidelines still included requirements for account balance change notes and documentation of required supervisory reviews, but certain key control requirements were contradictory. For example, the proposed guideline stated, "The supervisor must initial, date, and make comment on adjustments reviewed on the RITS report. The comments should indicate if the adjustment was correct or incorrect." Two sentences later the proposed guideline states, "no notation is necessary if correct." As a result of the inconsistencies, the proposed guideline was not approved. However, the division stated that they were following the proposed guidelines and not the 1999 guidelines.

In March 2005, department management stated that a new set of guidelines were in the process of review and approval. They stated that the 1999 guidelines were outdated and did not accurately reflect the current business processes in place for the department. The department is letting practice drive its decisions about the control structure when really, a properly performed risk assessment and implementation of controls should drive the decisions about how the division will operate. Management also stated that the validation of new guidelines is being given high priority by the department.

Recommendation

The Commissioner should require supervisors and employees to follow the approved procedures for account balance changes outlined in the department's guidelines. The Commissioner also should determine why management failed to implement new guidelines as stated in the prior-year audit. The Commissioner should complete a risk assessment in this area to determine the controls necessary to safeguard the assets of the state. She should then ensure that management gives the high priority to validating the new guidelines, which should incorporate these controls. The controls incorporated should continue to require documentation for the reasons for account balance changes and documentation of the supervisor conclusions and approvals. The Commissioner's risk assessment should also include an evaluation of whether the guidelines are requiring supervisors to review enough of these risky transactions. These steps should be taken to minimize the risks in this area, and documentation should be retained that documents the decisions made and should be available for review by the auditors.

Regardless of the guidelines in place, management should ascertain that supervisors are reviewing the employee transaction activity reports by regularly verifying the supervisors' reviews and take disciplinary action as necessary. The recordkeeping 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. Supervisory conclusions and reviews should be documented as required in approved guidelines.

Management's Comment

We concur. The 1999 Departmental Guidelines for Making Account Balance Changes are outdated due to changes to the department's processes over the past several years. A Debit/Credit Committee was created to review and recommend revised guidelines that would establish policy and procedures to be used by any departmental personnel engaged in making account balance changes in RITS. These guidelines have been promulgated, submitted to

Revenue management, and we are awaiting their final approval. They should be approved before the end of calendar year 2005.

4. <u>Pending amounts were not reviewed timely</u>

Finding

Individual amounts on each taxpayer's tax return are entered into the department's computerized Revenue Integrated Tax System (RITS) and the system calculates the amount of tax due to the state. If the calculated tax due is different from the amount shown on the taxpayer's return, the difference, a debit or a credit, may be placed in a pending status if it meets pre-set criteria. 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. These reviews are not always being made on a timely basis.

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. 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.

Based on our review of outstanding credits, 59 in a sample of 60 pending credits tested (98%) had not been reviewed timely. Sixteen of these 59 items were not assessed within three years of December 31 of the year in which payment was made. Based on review, a total of at least $1,348,909 is past the eligible period for refund determination.

Based on our review of outstanding debits, 40 in a sample of 60 pending debits tested (67%) had not been reviewed timely. Fifteen of the 40 items were not assessed within three years of December 31 of the year in which the return was filed. Based on review, a total of at least $1,879,626 is past the deadline for assessment.

Management responded to the prior finding and stated:

> 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.

However, when the amounts associated with bankruptcy, special investigations or field audit were omitted from the totals, large pending balances still remained. Again, when the amounts associated with the older balances were omitted from the totals, large pending balances still remained. In addition, the development of a write-off program did not address the fundamental problem that these balances should be reviewed and resolved before the stage where write-off is necessary.

Since the prior audit, management has attempted to review the more current amounts to address the issue. Management did create a debit/credit review section, staffed with personnel who have an accounting background. Newly created debits and credits are listed on a daily report for review by this section. Due to the volume of pending amounts, priorities have been established regarding which balances to review first. So although this initial progress has been made, there is still significant work to be done.

When pending debits are valid and are not assessed, reviewed, and approved 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 and approved, the department may be keeping funds that belong to the taxpayer.

Recommendation

The Commissioner should monitor the system in place for reviewing pending debits and credits. Management should ensure that the review section is able to continuously resolve some of the older pending debits and credits while still reviewing all of the current pending debits and credits. The Commissioner should ensure adequate resources are available to appropriately research and resolve the pending amounts until the balance is appropriately minimized. 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.

Management's Comment

We concur. Pending debits and credits exist in RITS that have not been resolved in a timely manner and the department continues to work to decrease the number and dollar amount of outstanding pending debits and credits. Analyzing pending debits and credits can be difficult, and involves the manual research of the item that created the debit or credit to ascertain the validity of its status, before application to the period on the account.

As was mentioned in the response to Finding # 3, a Debit/Credit Committee was created to review how debits and credits are created in RITS, identify who is responsible for working those items, and to recommend changes to effectively resolve all debit and credit issues. Several recommendations have been submitted to management by the debit/credit committee.

In addition, we have developed new reports relating to pending items which we expect to provide us the information needed to complete the review of pending debits and credits in a more timely manner. These new reports will not include debits or credits involved in an active Legal, Bankruptcy, Special Investigation or Audit case, nor will they include any items that are barred by statute.

UNDISTRIBUTED REVENUE

Our objectives in reviewing undistributed revenue were to determine whether

- process and controls over the undistributed Revenue Integrated Tax System (RITS) account are adequate;
- procedures used to reallocate undistributed funds in RITS are proper; and
- the unknown classification in the undistributed RITS account is being investigated and distributed timely, when appropriate.

We interviewed key personnel regarding the procedures and controls over the undistributed revenue account. In addition, we interviewed key personnel to determine the reallocation process of undistributed funds in RITS. We tested a nonstatistical sample of deposits from the unknown classification in the undistributed RITS account as of January 6, 2005, to determine if the amounts were being investigated and distributed timely.

Based on our work, we determined that the procedures and controls over the undistributed revenue are adequate. Also, the reallocation process of the undistributed revenue is adequate. We also determined that amounts classified as unknown are being investigated and distributed timely, when appropriate.

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 objective was to determine whether the department's June 30, 2004, responsibility letter was filed in compliance with Section 9-18-104, *Tennessee Code Annotated.*

We reviewed the June 30, 2004, responsibility letter to determine whether the letter had been properly submitted to the Comptroller of the Treasury and the Department of Finance and Administration. We determined that the Financial Integrity Act responsibility letter was submitted on time.

OBSERVATIONS AND COMMENTS

MANAGEMENT'S RESPONSIBILITY FOR RISK ASSESSMENT

Auditors and management are required to assess the risk of fraud in the operations of the department. The risk assessment is based on a critical review of operations considering what frauds could be perpetrated in the absence of adequate controls. The auditors' risk assessment is limited to the period during which the audit is conducted and is limited to the transactions that the auditors are able to test during that period. The risk assessment by management is the primary method by which the department is protected from fraud, waste and abuse. Since new programs may be established at any time by management or older programs may be discontinued, that assessment is on-going as part of the daily operations of the department.

Risks of fraud, waste and abuse are mitigated by effective internal controls. It is management's responsibility to design, implement and monitor effective controls in the department. Although internal and external auditors may include testing of controls as part of their audit procedures, these procedures are not a substitute for the on-going monitoring required of management. After all, the auditor testing is limited and is usually targeted to test the effectiveness of particular controls. Even if controls appear to be operating effectively during the time of the auditor testing, they may be rendered ineffective the next day by management override or by other circumventions that, if left up to the auditor to detect, will not be noted until the next audit engagement and then only if the auditor tests the same transactions and controls. Furthermore, since staff may be seeking to avoid auditor criticisms, they may comply with the controls during the period that the auditors are on site and revert to ignoring or disregarding the control after the auditors have left the field.

The risk assessments and the actions of management in designing, implementing, and monitoring the controls should be adequately documented to provide an audit trail both for auditors and for management, in the event that there is a change in management or staff and to maintain a record of areas that are particularly problematic.

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99 promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates the obvious premise that management, and not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

During our audit, we discussed these responsibilities with management and how management might approach meeting them. We also increased the breadth and depth of our inquiries of management and others in the entity as we deemed appropriate. We obtained formal assurances from top management that management had reviewed the entity's policies and procedures to ensure that they are properly designed to prevent and detect fraud and that management had made changes to the policies and procedures where appropriate. Top management further assured us that all staff had been advised to promptly alert management of all allegations of fraud, suspected fraud, or detected fraud and to be totally candid in all communications with the auditors. All levels of management assured us there were no known instances or allegations of fraud that were not disclosed to us.

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 1, 2004.

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 monitoring and enforcement of Title VI.

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