AUDIT REPORT

Department of Revenue

July 2006

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

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

July 31, 2006

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 March 1, 2005, through March 31, 2006.

The review of internal control and compliance with laws and regulations resulted in no audit findings.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/th
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April 28, 2006

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 March 1, 2005, through March 31, 2006.

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 resulted in no audit findings. We have reported other less significant matters involving the department's internal control to the Department of Revenue's management in a separate letter.

Sincerely,

Arthur A. Hayes, Jr.

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
July 2006

AUDIT SCOPE

We have audited the Department of Revenue for the period March 1, 2005, through March 31, 2006. 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, procurement cards, 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; approving write-off amounts; and approving compromises of tax liabilities.

AUDIT FINDINGS

The audit report contains no findings.

Financial and Compliance Audit
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

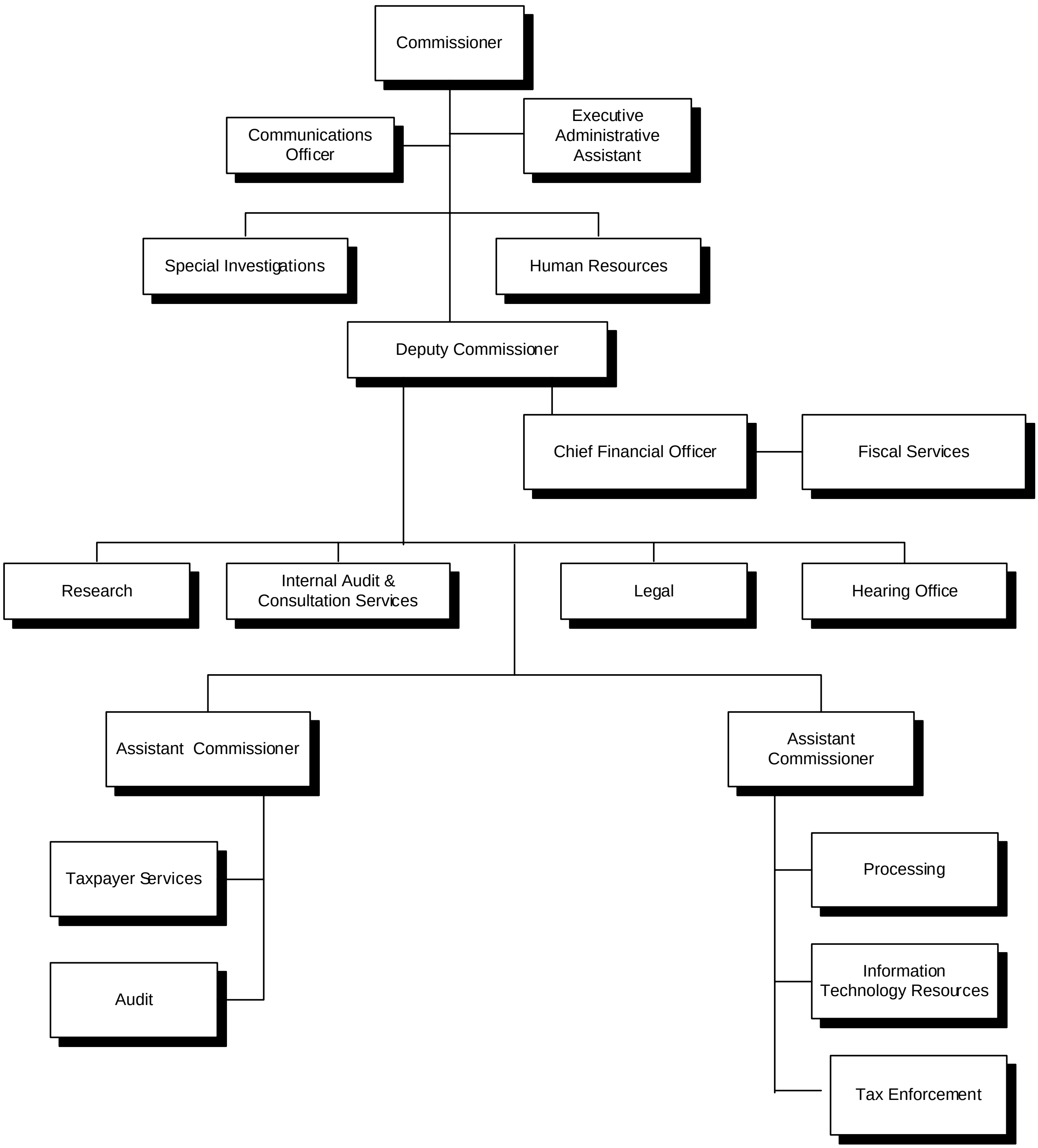
The mission of the Department of Revenue is to collect state revenue. Specifically, the department is responsible for the collection of most state taxes and fees, for enforcing the revenue statutes of the state to ensure that taxpayers are in compliance with all tax laws, and for preparing monthly apportionment 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 March 1, 2005, through March 31, 2006. 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, procurement cards, and the Financial Integrity Act.

Tennessee Department of Revenue
Organization Chart



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; approving write-off amounts; and approving compromises of tax liabilities.

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 31, 2006. 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 in-dates recorded in the Revenue Integrated Tax System (RITS), Tax Enforcement daily reports and receipts, account balance changes in RITS, and pending debits and credits.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

INFORMATION TECHNOLOGY RESOURCES

Our objectives in reviewing the Information Technology Resources Division were to determine whether

- adequate system information had been documented,
- user access to the Revenue Integrated Tax System (RITS) was adequately controlled,
- adequate controls were placed in operation over RITS, and
- valid information was 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 March 1, 2005, and February 24, 2006, 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 was documented and control over RITS was adequate. User access to RITS was adequately controlled, and valid information was recorded in RITS.

REVENUE ACCOUNTING

Our objectives in reviewing revenue accounting were to determine whether

- relevant policies and procedures had been placed in operation,
- revenues were properly recorded and classified by tax type in the monthly collection reports,
- reconciliations were being performed and were properly documented, and
- system balancing problems were 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 a September 2005 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 were properly reported and classified by tax type in the monthly collection reports. We determined that reconciliations were properly documented and performed. Also, out-of-balance situations were appropriately minimized.

TAXPAYER ACCOUNTING

Our objectives in reviewing taxpayer accounting were to determine whether

- controls over taxpayer accounting were in place and adequate,

- policies and procedures of the Processing Division that affect taxpayer accounting were adequate,
- taxpayer accounting collections received by the Processing Division were adequately safeguarded,
- taxes were reported accurately on the Revenue Integrated Tax System (RITS),
- amounts in RITS were adequately supported, and
- taxes collected were deposited.

We interviewed key personnel to gain an understanding of the department's control in the area of taxpayer accounting. We reviewed policies and procedures, interviewed key personnel, and conducted observations to gain an understanding of the effect of the Processing Division's controls on taxpayer accounting and to determine if collections received by the Processing Division were adequately safeguarded. We selected a nonstatistical sample of tax returns from July 1, 2005, through February 28, 2006, to determine if the tax return information was added accurately into RITS and to determine if the associated amounts were deposited. We also selected a nonstatistical sample of tax collections recorded in RITS from July 1, 2005, through February 28, 2006, to determine if the information in RITS agreed to supporting documentation and to determine if the associated amounts were deposited.

Based on our interviews, observations, and review, we determined that controls over taxpayer accounting were adequate and in place, and that the policies and procedures of the Processing Division that affect taxpayer accounting were adequate. We also determined that collections received by the Processing Division were adequately safeguarded. Based on our testwork, we determined that taxes were reported accurately in RITS, amounts in RITS were adequately supported, and taxes collected were deposited.

TAX ENFORCEMENT

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

- controls over tax enforcement were adequate and in place,
- policies and procedures of the Processing Division that affect the Tax Enforcement Division were adequate,
- Tax Enforcement collections received by the Processing Division were adequately safeguarded,
- regional Tax Enforcement offices mailed receipts to the department's Processing Division timely,
- cash received by Tax Enforcement officers was properly recorded and deposited timely,

- Tax Enforcement officers' receipt books and daily reports were properly completed and reviewed by their supervisors, and
- voided receipts from Tax Enforcement officers' receipt books were properly completed and accounted for by the officers.

We interviewed key personnel to determine whether relevant policies and procedures had been placed into operation. We reviewed policies and procedures, interviewed key personnel, and conducted observations to gain an understanding of the effect of the Processing Division's controls on the Tax Enforcement Division and to determine if collections received were adequately safeguarded. We performed testwork on a nonstatistical sample of tax collections received during selected days in February and March 2006 to determine whether receipts were being mailed to the Processing Division timely. We performed an analytical review on certain regional offices to determine that cash receipts were properly recorded. We tested a nonstatistical sample of receipts for selected field offices issued March 1, 2005, through March 2, 2006, to determine that receipt books and daily reports were properly completed and reviewed by supervisors and to determine that cash collections were deposited timely. Finally, we tested voided receipts of selected officers to see if the voids were handled properly.

Based on our interviews, observations, and review, we determined that controls over tax enforcement were adequate and in place, and policies and procedures of the Processing Division that affect the Tax Enforcement Division were adequate. We also determined that collections received by the Processing Division were adequately safeguarded. Based on our testwork, we determined that cash collections received by Tax Enforcement officers were properly recorded and deposited timely, and the collections mailed to the Processing Division were mailed timely. Receipt books and daily reports were properly completed and reviewed by the supervisor. Voided receipts were properly completed and accounted for by the officers.

TAXPAYER SERVICES

Our objectives in reviewing the Taxpayer Services Division were to determine whether

- controls over taxpayer services were adequate and in place,
- the division's corrections and changes to taxpayer account balances in the Revenue Integrated Tax System (RITS) were proper and adequately supported and that managerial controls over these corrections and changes were effective and functioning,
- significant deposits from regional offices were properly receipted and deposited, and
- pending debits and credits were 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 January 1, 2006, through March 3, 2006, was tested to determine whether the changes were proper, adequately supported, and reviewed. We tested a significant collection deposited by one of the regional offices to determine whether it was properly receipted and deposited. In addition, a population of pending debits as of March 27, 2006, and pending credits as of March 23, 2006, were obtained to determine the age and extent of debits and credits that had not been reviewed.

Based on our work, we determined that procedures were adequate and in place. Account balance changes were proper, adequately supported, and reviewed. The significant tax collection tested was properly receipted and deposited, and pending debits and credits were reviewed timely and efficiently.

PROCUREMENT CARDS

Our objectives in reviewing procurement cards were to determine whether

- relevant policies and procedures had been placed in operation and users were properly approved;
- purchases were supported by receipts, approved, and reconciled to the monthly bank statement;
- purchases were adequately supported, necessary for conducting state business, and they complied with Department of General Services purchasing policies and procedures; and
- procurement card transactions considered unusual were proper.

We interviewed key personnel and performed testwork to determine whether relevant policies and procedures had been placed into operation and users were properly approved. In order to determine that purchases were supported by receipts, approved, and reconciled to the monthly bank statements, we tested all transaction logs for November 2005. We tested a nonstatistical sample of procurement card transactions made from March 1, 2005, through February 28, 2006, to determine if purchases were adequately supported, necessary for conducting state business, and that they complied with the Department of General Services purchasing policies and procedures. We obtained the population of procurement card transactions made from March 1, 2005, through February 28, 2006, and reviewed transactions deemed unusual for propriety. For example, we extracted and reviewed all purchases made on weekends and holidays, and all purchases amounting to greater than $400 from the same vendor during two consecutive days.

As a result of the interviews and testwork performed, we determined that relevant policies and procedures were placed into operation and users were properly approved. We also determined that purchases were supported by receipts, approved, and reconciled to monthly bank statements. Procurement card transactions were adequately supported, necessary for conducting state business, and complied with the Department of General Services purchasing policies and procedures. Transactions considered unusual were 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, 2005, responsibility letter was filed in compliance with Section 9-18-104, *Tennessee Code Annotated.*

We reviewed the June 30, 2005, 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 entity. 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 entity 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 ongoing as part of the daily operations of the entity.

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 entity. Although internal and external auditors may include testing of controls as part of their audit procedures, these procedures are not a substitute for the ongoing 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. The assessment and the controls should be reviewed and approved by the head of the entity.

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, 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 June 28, 2005.

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