B42133

STATE BOARD OF ACCOUNTS
302 West Washington Street
Room E418
INDIANAPOLIS, INDIANA 46204-2769

REVIEW REPORT

OF

DEPARTMENT OF REVENUE

STATE OF INDIANA

July 1, 2007 to June 30, 2012

FILED
04/22/2013

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AGENCY OFFICIALS

Office	Official	Term
Commissioner	John Eckart	02-22-05 to 05-06-12
	Michael J. Alley	05-07-12 to 01-08-17

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AN EQUAL OPPORTUNITY EMPLOYER

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INDEPENDENT ACCOUNTANT'S REPORT

TO: THE OFFICIALS OF THE DEPARTMENT OF REVENUE

We have reviewed the activities related to the receipts, disbursements, and assets of the Department of Revenue for the period of July 1, 2007 to June 30, 2012. The Department of Revenue's management is responsible for the receipts, disbursements, and assets.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the receipts, disbursements, and assets. Accordingly, we do not express such an opinion.

Financial transactions of this office are included in the scope of our audits of the State of Indiana as reflected in the Indiana Comprehensive Annual Financial Reports. Federal programs are included in the scope of our statewide single audits as reflected in the Statewide Single Audit Reports.

Based on our review, nothing came to our attention that caused us to believe that the activities related to the receipts, disbursements, and assets of the Department of Revenue are not in all material respects in conformity with the criteria set forth in the Accounting and Uniform Compliance Guidelines Manual for State Agencies, and applicable laws and regulations, except as stated in the review comments.

The Department of Revenue's response to the Review Comments identified in our review is described in the accompanying section of the report entitled Official Response. We did not review the Department of Revenue's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Department of Revenue's management and others within the entity, and is not intended to be and should not be used by anyone other than these specified parties. In accordance with Indiana Code 5-11-5-1, this report is a part of the public records of the State Board of Accounts and of the office reviewed.

STATE BOARD OF ACCOUNTS

February 26, 2013

INTERNAL CONTROLS OVER LOCAL OPTION INCOME TAXES

The Indiana General assembly enacted legislation that provides each county the option of adopting a County Adjusting Gross Income Tax (CAGIT) in 1973, County Option Income Tax in 1984 and a third option that can stand alone or may be supplementary to the first two, County Economic Development Income Tax (CEDIT) in 1987. Collectively, these local option income taxes are commonly referred to as "LOITs". LOITs are collected by the State and distributed back to the counties from which the collections were derived for allocation to governmental entities within the counties. The collections for any particular county that has adopted a LOIT are derived from residents of the county and individuals who work in the county but reside in a county that has not adopted a LOIT. For LOIT purposes, an individual's county of residence or an individual's county of principal work activity is determined as of January 1 of each year.

The LOIT amounts to be distributed in a calendar year are determined and certified by the State Budget Agency (SBA) by August 2 of the preceding year. In April 2012, a programing error was discovered affecting the County Statistics Detail Report that the Department of Revenue (DOR) provides SBA to determine the LOIT certified amounts counties receive each year, causing a portion of the LOITs collected to be kept in the State's General Fund, instead of being remitted to the counties. The programming error was a result of DOR not having proper internal controls in place for reviewing coding changes made to reports provided by DOR to ensure the reports are providing accurate information. The programming error affected LOIT distributions made in State Fiscal Year (SFY) 2011 through March 2012, totaling $207,047,684.

Adequate procedures should be in place to ensure accruals and other adjustments needed to fairly state tax revenue activity and balances for external financial reporting are made in accordance with standards issued by the Governmental Accounting Standards Board.

Changes to the accounting system's computer programs must be adequately controlled including the following requirements:

- Computer source (human readable) and load (machine readable) modules must be protected from unauthorized modification.

- Modifications to computer source code must occur in a test environment and not affect production source code.

- All modifications to computer source code must be adequately tested. Modifications must be approved by management.

- Individuals responsible for modifying computer source code in a test environment must be prevented from updating computer code in the production environment. Movement of computer source and load modules from the test to production environments must be completed by authorized employees not responsible for modification of computer source or load modules.

Various other system components such as configuration parameters and control tables can also have a significant impact on the way the system operates and processes information without changing actual program code. Changes to these system components should also be controlled by similar mechanisms. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, 14.3.11)

Written procedures must be available for all computerized accounting systems which provide instructions on the requirements for the approval of information prior to entry into the computer, as well as the accurate entry, processing, and reporting of information from the accounting system. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, 14.3.14)

Controls over the receipting, recording, and accounting for the financial activities are necessary to avoid substantial risk of invalid transactions, inaccurate records and financial statements, and incorrect decision making. An Agency's control environment consists of the overall attitude, awareness and actions of management and the governing board or commission. This would include establishing and monitoring policies for developing and modifying accounting systems and control procedures. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, Organizational Overview Chapter)

INTERNAL CONTROLS OVER TAX RECEIPTS

The Department of Revenue (DOR) was created by an Act of the Indiana General Assembly on Feb. 18, 1947. DOR is responsible for providing service to Indiana citizens regarding state tax matters. Additionally, DOR administers state tax laws, develops regulations and makes decisions about tax policy. As part of DOR's duties they administer and collect tax revenues for the State.

DOR has a number of standalone custom taxpayer account systems, spreadsheets and databases that were developed over time to support the core tax processes at DOR. DOR's Returns Processing System (RPS), implemented in the mid-1990s, processes a majority of the funds collected by DOR but only for a limited number of tax types. As a result of not all of the taxes being maintained in a central taxpayer account system and since RPS was not designed as an integrated tax system (ITS), this has created daily challenges for DOR's technical staff in maintaining aging and incompatible technologies, while at the same time being responsible for updating RPS and the other taxpayer account systems to accommodate annual tax form and policy changes. By having multiple taxpayer account systems, this has created difficulty or inability for DOR to trace all tax revenues maintained and collected by the agency throughout the entire depositing/reporting process to ensure tax revenues are being properly reported in the Encompass financial accounting system for the State's financial statements. Since DOR's taxpayer account systems are not interfaced with the Encompass financial accounting system, DOR is unable to reconcile the taxpayer account systems to the Encompass financial accounting system to ensure that DOR's internal records agree with the State's financial statements. DOR's finance staff must manually create all tax revenue accounting entries based on reports and supporting documentation they receive from various sources and then manually enter those entries into the Encompass financial accounting system. By having functions being manually performed there is a greater potential risk of errors occurring that could affect the State's financial statements.

DOR has several clearing funds that are used to deposit tax revenues. They are later distributed to the proper location in the general ledger. A number of these clearing funds within the general ledger have reported balances at State Fiscal Year (SFY)-end when balances should net to zero. It was determined that these accounts have not been properly reconciled. Adjusting journal entries will need to be prepared to correct the general ledger. It was also discovered that DOR does not have procedures in place to perform a trend analysis of all tax revenues maintained and collected to ensure: tax revenues are being properly reported, operational results are monitored and reported, high risk areas are identified, strategic and operational performance measures are developed, and revenues trends are identified for specific tax types.

Currently DOR has only one internal auditor to monitor the entire agency. A good internal audit function is necessary to insure that: internal controls are operating as intended, objectives for effectiveness and efficiency of operations are being achieved, financial reporting is reliable, laws and regulations are complied with and assets are properly safeguarded.

During our audit of tax revenues at DOR, we discovered several recording errors totaling $13,528,291 affecting net assets in the financial statements. These errors were a result of DOR lacking proper internal controls in place to monitor and approve the manual entries performed in the Finance section to ensure that tax revenue activities were being properly recorded and reported in the State's financial statements. Other factors that contributed to DOR not detecting these errors were a result of there being multiple taxpayer account systems which are not interfaced, or reconciled to the Encompass financial accounting system.

Each agency, department, quasi, institution or office has the following accounting responsibilities:

- Operate within the confines of the established budget.

- Maintain an adequate internal control environment.

- Maintain adequate internal control procedures.

- Properly utilize the state accounting system as prescribed by the ENCOMPASS team.

- Maintain an effective and accurate accounting system for necessary subsidiary and supplementary records.

- Maintain, and make available for audit, documentation supporting the validity and accountability of monies received or disbursed.

- Perform duties in accordance with statute, regulations, state policy, contract provisions, and federal requirements as applicable. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, Organizational Overview Chapter)

System controls are in effect on the ENCOMPASS financial accounting system, which is the official book of record for the State; however, each agency is responsible for controls in any subsidiary systems used or other records maintained. At all times, the agency's manual and subsidiary ledgers should reconcile with ENCOMPASS. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, Organizational Overview Chapter)

Each agency, department, quasi, institution or office should have internal controls in effect to provide reasonable assurance regarding the reliability of financial information and records, effectiveness and efficiency of operations, proper execution of managements' objectives, and compliance with laws and regulations. Among other things, segregation of duties, safeguarding controls over cash and all other assets, and forms of information processing are part of an internal control system. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, Organizational Overview Chapter)

Controls over the receipting, recording, and accounting for the financial activities are necessary to avoid substantial risk of invalid transactions, inaccurate records and financial statements, and incorrect decision making. An Agency's control environment consists of the overall attitude, awareness and actions of management and the governing board or commission. This would include establishing and monitoring policies for developing and modifying accounting systems and control procedures. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, Organizational Overview Chapter)

The computerized accounting system must maintain electronic audit trails sufficient to trace all transactions from the original source of entry into the system, through all system processing, though various levels of summarizations, and to the results produced by the system. The audit trails must also maintain sufficient information to trace all transactions from the final results produced by the system, through all system processing and summarizations, and to the original source of entry into the system. Audit trails must also identify the user that processed the transaction or updated the information. These audit trails must be protected from modification and deletion. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, 14.3.5)

Automated processes that support the unit's business processes should operate accurately, efficiently and completely. The system should accurately calculate, summarize, categorize and update accounting information. The system should allow for effective and efficient reconciliation of subsidiary ledgers to control ledgers, and detail transactions to summary totals. The system should automatically identify erroneous input, prevent concurrent file updates, and generate control totals to ensure completeness of processing. The system should also include standard controls such as tables which ensure only valid values can be posted, suspense files to identify transactions that fail system edits, effective error messages, appropriate restore points, and methods to prevent or detect out-of-balance conditions. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, 14.3.9)

INTERNAL CONTROLS OVER CORPORATE TAX

The Department of Revenue (DOR) administers and collects tax revenues for the State. Beginning in 2007, DOR provided taxpayers the option to pay their estimated corporate income tax through an electronic payment method known as eCheck. In November 2011, an error was discovered in DOR's post-remittance transfer process in which estimated corporate income tax payments made since the inception of the electronic filing were not transferred out of DOR's Collection Fund and credited to the State's General Fund. The error occurred from January 2007 through November 2011, totaling $320,193,219. Of this amount, $148,850,227 occurred prior to State Fiscal Year (SFY) 2011, $139,194,583 occurred during SFY 2011, and $32,148,409 occurred in SFY 2012. These errors resulted in a prior period adjustment in the SFY 2011 financial statements of $148,850,227 to increase the beginning net assets of the General Fund and reduce the net assets of the Collection Fund, as well as adjusting entries to properly reflect corporate income tax revenues during SFY's 2011 and 2012.

The post-remittance transfer error was a result of a programming error in DOR's Voucher Commit Report that is used to transfer revenues out of the Collection Fund. The lack of internal controls in place over the Collection Fund by not having proper reconciliation procedures in place allowed the accumulation of corporate tax revenues in the Fund to go undetected.

During our audit of DOR's adjusting entries to correct the General Fund understatement of $320,193,219, we discovered DOR had duplicated $993,174 of the estimated corporate income tax eCheck November 2011 activity, thereby causing the Collection Fund to be understated and the General Fund overstated by that amount after the adjusting entries were posted to the State's accounting system in November 2011. An adjusting entry was made to correct for the duplication error in December 2011. A balance of $46,404,517 remained in the Collection Fund after the November 2011 adjusting entries for corporate income tax revenues were made. This balance increased to $47,397,691 after the December adjusting entry was posted.

Upon discovery of the issues surrounding the Collection Fund during the SFY 2011 audit, DOR performed an internal review of their procedures and policies in place to determine how to the correct the Collection Fund imbalance as well as correct any other issues with their tax revenue processes. DOR made five adjusting entries totaling $91,671,748, to reconcile and correct the material portion of the Collection Fund imbalance as well as corrected other errors that were discovered for DOR tax revenue activities up through December 2012. As of January 2013, DOR is in the process of correcting the $7,587,549 unreconciled balance remaining in the Collection Fund.

Adequate procedures should be in place to ensure accruals and other adjustments needed to fairly state tax revenue activity and balances for external financial reporting are made in accordance with standards issued by the Governmental Accounting Standards Board.

System controls are in effect on the ENCOMPASS financial accounting system, which is the official book of record for the State; however, each agency is responsible for controls in any subsidiary systems used or other records maintained. At all times, the agency's manual and subsidiary ledgers should reconcile with ENCOMPASS. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, Organizational Overview Chapter)

Controls over the receipting, recording, and accounting for the financial activities are necessary to avoid substantial risk of invalid transactions, inaccurate records and financial statements, and incorrect decision making. An Agency's control environment consists of the overall attitude, awareness and actions of management and the governing board or commission. This would include establishing and monitoring policies for developing and modifying accounting systems and control procedures. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, Organizational Overview Chapter)

LATE PAYMENT PENALTY

Auditor of State accounting records reflect late payment penalties paid to vendors and charged to accounts of the Department of Revenue as a result of untimely payment of claims. Total penalties for fiscal years 2011 and 2012 were $540.05 and $276.06, respectively. These penalties are an unnecessary use of public funds.

Indiana Code 5-17-5 requires a state agency to: ". . . pay a late payment penalty at a rate of one percent (1%) per month on amounts due on written contracts for public works, personal services, goods and services, equipment, and travel whenever the state agency . . . fails to make timely payment."

Payment of penalties and interest due to late payments to vendors may be the obligation of the responsible official or employee. (Accounting and Uniform Compliance Guidelines for State and Quasi Agencies, 6.4.7.4)

Each agency, department, quasi, institution, or office is responsible for compliance with applicable statutes, regulations, contract provisions, state policies, and federal requirements. (Accounting and Uniform Compliance Guidelines for State and Quasi Agencies, Organizational Overview - General Guidelines and Policy, IV. Summary of Agency Accounting Responsibilities)

CAPITAL ASSET INVENTORY

The Department of Revenue's capital asset listing in Encompass has not been properly updated. During our current review, we found that the agency performed an annual physical inventory of assets owned, but the agency's asset listing was not updated in Encompass based on those physical inventories performed.

Agency personnel are responsible for accountability for all assets under their control, including capital assets. Adequate asset management staff should be assigned to recording and maintaining, on the ENCOMPASS financial system, all capital assets with a cost greater than $500. Assets are automatically capitalized upon approval by either the BU approver or AOS approver. Controls should be in effect to assure that additions, disposals, and transfers to other departments or agencies are recorded timely. Inventories of these assets should be performed each year in each department and compared to the ENCOMPASS listing. Results of inventories should be retained for audit purposes. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, 8.3)

INTERNAL CONTROLS OVER IFTA FEES

As stated in our prior Report B31671, the International Fuel Tax Agreement (IFTA) is an agreement between various taxing jurisdictions for intrastate and interstate commercial vehicles traveling within and across state lines. IFTA fees are based on the number of miles traveled in each state as well as the amount of fuel purchased and consumed. Monthly, each state distributes to the other states the amount of the fees they collected on behalf of the other states. The Department of Revenue receives IFTA fees from other states for commercial vehicles registered in other states that traveled through Indiana and sometimes for commercial vehicles registered in Indiana that traveled through other states. These fees are deposited into an IFTA holding fund and later transferred to a number of the Department of Transportation funds used to finance various state and local road improvement and maintenance projects.

During the prior review period, the Department of Revenue discovered they had overdrawn the IFTA Holding Fund by making duplicate transfers from the holding fund into the Department of Transportation's funds. Duplicate transfers were made from January 1, 2004 through June 28, 2006, for fees received from other states for vehicles registered in other states as well as vehicles registered in Indiana. To correct the shortage in the IFTA Holding Fund, on May 29, 2007, the Department of Revenue made two adjustments to the Department of Transportation's funds totaling $17,028,140.32 to restore the correct balance in the IFTA holding fund. During the current review period, it was determined that the IFTA holding fund still has a reported balance at State Fiscal Year-end when balances should be transferred out timely. It was determined that this fund still has not been properly reconciled.

A lack of adequate internal controls over receipt of IFTA fees received from other states could impact the state's ability to fund various highway projects.

Controls over the receipting, recording, and accounting for the financial activities are necessary to avoid substantial risk of invalid transactions, inaccurate records and financial statements, and incorrect decision making. An Agency's control environment consists of the overall attitude, awareness and actions of management and the governing board or commission. This would include establishing and monitoring policies for developing and modifying accounting systems and control procedures. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, Organizational Overview Chapter)

Each agency, department, quasi, institution or office should have internal controls in effect to provide reasonable assurance regarding the reliability of financial information and records, effectiveness and efficiency of operations, proper execution of managements' objectives, and compliance with laws and regulations. Among other things, segregation of duties, safeguarding controls over cash and all other assets, and forms of information processing are part of an internal control system. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, Organizational Overview Chapter)

WITHHOLDING RECONCILIATION

As stated in the prior reports (B31671 and B26849), the Department of Revenue's internal controls over the reconciliation of income tax withholding did not guarantee that adequate compliance was being maintained. Controls are still not adequate and may allow discrepancies to go undetected.

Controls over the receipting, recording, and accounting for the financial activities are necessary to avoid substantial risk of invalid transactions, inaccurate records and financial statements, and incorrect decision making. An Agency's control environment consists of the overall attitude, awareness and actions of management and the governing board or commission. This would include establishing and monitoring policies for developing and modifying accounting systems and control procedures. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, Organizational Overview Chapter)

DEPARTMENT OF REVENUE
EXIT CONFERENCE

The contents of this report were discussed on February 27, 2013, with Michael J. Alley, Commissioner; Michael Ashley, Chief Financial Officer; Valerie Hunt, Deputy Controller; Laurie Mendez, Deputy Controller; and Paul Siegfried, Internal Audit. The Official Response has been made a part of this report and may be found on pages 11 through 13.

A copy of the review comments were sent by email on February 27, 2013, to John Eckart, former Commissioner.

STATE OF INDIANA

DEPARTMENT OF REVENUE
OFFICE OF THE COMMISSIONER

Indiana Government Center North
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March 8, 2013

Mr. Bruce Hartman
State Examiner
Indiana State Board of Accounts
302 W. Washington Street, Room E418
Indianapolis, IN 46204

Indiana Department of Revenue Official Response
To 2012 Indiana State Board of Accounts Compliance Audit Findings

Dear Mr. Hartman:

The Department of Revenue (DOR) recognizes the Compliance findings denoted by the State Board of Accounts (SBOA) contained in the audit covering fiscal years 2008 -- 2012. All material adjusting entries have been made to the state's General Ledger in accordance to protocols prescribed by the Auditor-of-State's office. The SBOA's concerns expressed within this audit regarding our internal controls, processes, systems, and resources are similar to those issues brought forth in an audit conducted by Deloitte & Touche during 3rd/4th quarter of 2012. The DOR has incorporated these findings and recommendations into a formal, comprehensive project plan and has begun to implement this plan to improve our capability and accuracy in properly accounting for receipt and disbursement of revenues. Specific comments by the DOR are noted under each SBOA audit section as presented below.

Internal Controls Over Local Option Income Taxes

The DOR completed all LOIT adjustments including adjusting entries to the General Ledger and disbursement corrections to the Counties in Fiscal year 2012. The application code that produced these errors has also been corrected, and corresponding review and system testing methods were enhanced in concert with the State Budget Agency to prevent re-emergence of this issue.

Internal Controls Over Tax Receipts

The DOR has a project underway to improve its traceability and recording of transactions from point of origin to the state's General Ledger. The 1st phase of this project includes systematic transfer of payment data between our Returns Processing System and the General Ledger in an effort to reduce the risk of error due to multiple manual transfers of data that currently takes place. Reconciliation controls are also being enhanced and incorporated into an agency Compliance program that will monitor the operating effectiveness of related processes and controls on a scheduled basis. Expansion of system and staffing resources, and the use of subject-matter-expert (SME)-based Product Councils by major tax type are additional initiatives that are underway to improve our capabilities, process integrities, and accuracies in accounting and disbursing revenues in accordance to state statute.

The DOR is also conducting a review of its standalone applications used to administer a number of ancillary fees and revenues in an effort to identify opportunities for consolidation into one system as a longer-term solution.

Internal Controls Over Corporate Tax

The DOR has made all correcting entries to the General Ledger; corrected all material, underlying problems associated with the Collection Fund; and implemented monthly review and reconciliation controls that should prevent re-emergence of this issue in the future. The DOR is also in the process of evaluating all revenues processed through this holding account for opportunities to reduce the use of this account and directly post to the appropriate revenue account in the General Ledger.

Late Payment Penalty

During fiscal years 2011 and 2012, DOR's Finance Dept. experienced significant personnel changes that included its Accounts Payable function. While penalty amounts of $540.05 and $276.06 paid during 2011 and 2012 respectively are small in comparison to total vendor dollar and invoice volume processed during this two-year period, the DOR recognizes this deficiency and will strive to process vendor payments in accordance to state policy.

Capital Asset Inventory

In 2012, the DOR added staff to its Finance Dept. that will facilitate timely completion and recording of capital asset inventory to the State's Encompass records. The DOR expects to have all updates from our last inventory conducted in 2012 entered into Encompass by June 30, 2013.

Internal Controls Over IFTA Fees

The DOR recently hired an accountant in its Motor Carrier Services unit in order to enhance our internal control and reconciliation capabilities within the division to include completion of scheduled reconciliations of the IFTA Holding account.

Withholding Reconciliation

The DOR has a taskforce in place that is currently reviewing its Withholding reconciliation strategies as part of our focus for continual improvement.

The DOR values the SBOA's opinion as a part of our remediation and improvement programs, and wishes to convey our appreciation for the insights gained through this audit.

Sincerely,

Michael J. Alley
Commissioner

Michael Ashley
Michael Ashley
Chief Financial Officer