

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, 2012 to June 30, 2013



FILED
06/16/2014

TABLE OF CONTENTS

<u>Description</u>	<u>Page</u>
Agency Official	2
Independent Accountant's Report.....	3
Review Comments:	
Internal Controls Over Changes to Taxpayer Account Systems.....	4
SDO Advance	4
Endorsement of Checks	4
Internal Controls Over Tax Receipts	5-6
Internal Controls Over IFTA Fees.....	7
Withholding Reconciliation	7-8
Exit Conference.....	9
Official Response	10-11

AGENCY OFFICIAL

Office

Official

Term

Commissioner

Michael J. Alley

05-07-12 to 01-08-17



STATE OF INDIANA
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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, 2012 to June 30, 2013. 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 and Quasi 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 Indiana State Board of Accounts and of the office reviewed.

STATE BOARD OF ACCOUNTS

April 16, 2014

DEPARTMENT OF REVENUE
REVIEW COMMENTS
June 30, 2013

INTERNAL CONTROLS OVER CHANGES TO TAXPAYER ACCOUNT SYSTEMS

The Department of Revenue's internal controls over changes to the taxpayer account systems were not adequate to ensure compliance was being maintained. Deficiencies in internal controls increase the risk that discrepancies or fraud could be undetected.

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)

SDO ADVANCE

The Special Disbursing Officer Fund (SDO) advance (Local Purchase Number 4687) for the Department of Revenue was not fully utilized during the current review period.

Whenever a SDO fund is established, money is removed from a Treasurer of State bank account, thus, not being invested. Therefore, consideration should be given to the size of the SDO fund. If an agency is not using the total SDO advance within one or two months, the SDO advance is too large and should be reduced. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, 6.4.10.6)

ENDORSEMENT OF CHECKS

During our review of revenues, it was determined that checks processed through the IBML machine to electronically deposit the revenues received are not being restrictively endorsed.

Checks should be restrictively endorsed with an endorsement stamp immediately upon receipt. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, 4.3.2)

Each agency, department, quasi, institution or office also has the responsibility to comply with its own internal policies and guidelines. These internal policies and guidelines cannot conflict with state or federal laws, state policies or procedures (including those in the various chapters of this manual) or other policies established by the Department of Administration, State Personnel, or through the Financial Management Circulars. (Accounting and Uniform Compliance Guidelines Manual for State and Quasi Agencies, Organizational Overview Chapter)

DEPARTMENT OF REVENUE
REVIEW COMMENTS
June 30, 2013
(Continued)

INTERNAL CONTROLS OVER TAX RECEIPTS

As stated in the prior Report B42133, the Department of Revenue (DOR) administers and collects tax revenues for the State of Indiana. 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 tax revenues collected by DOR but other standalone taxpayer account systems and databases are used by DOR to support the other tax types not maintained in RPS. 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), there have been 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. Multiple taxpayer account systems have created difficulty or inability for DOR to trace all tax revenues maintained and collected by the agency throughout the entire depositing/reporting process. The taxpayer account system's inability to provide an audit trail for all revenues processed at DOR has created additional risk of DOR being able to ensure tax revenues are being properly reported in the ENCOMPASS financial accounting system for the State's financial statements. Also, DOR's taxpayer account systems are not interfaced with the ENCOMPASS financial accounting system, which has contributed to DOR being unable to reconcile some of 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 section must manually create many of their tax revenue accounting entries based on reports and supporting documentation they receive from various sources. By having functions being manually performed there is a greater risk of errors occurring that could affect the State's financial statements. During the 2013 audit period and subsequent to it, DOR has implemented procedures to reduce and eliminate some of the manual processes performed by the finance staff, so once the entries are created they can be electronically uploaded to ENCOMPASS.

DOR utilizes a number of clearing (holding) funds to deposit tax revenues until the monies are later distributed to the proper fund(s)/account(s) in the general ledger. During the 2013 audit, it was determined that DOR has three clearing funds at the Motor Carrier Division that have a significant unaccounted for balance that have accumulated over a number of years and have not been properly reconciled. The International Registration Plan (IRP) Holding Account and the International Fuel Tax Agreement (IFTA) Holding Account both have accumulated balances while the Motor Carrier Fuel Tax (MCFT) Holding Account has a negative balance and may have been over distributed. DOR is currently analyzing the activity in these accounts to determine where the revenues should have been properly posted in the general ledger. Adjusting journal entries will need to be prepared to correct the general ledger once the analysis has been completed. In order to reduce the risk of tax revenues not being posted properly in the general ledger, DOR should implement procedures to monitor and reconcile the holding accounts. A review of the usage of holding accounts should be made to determine if there are tax revenues that can be directly deposited and posted in the proper fund(s)/account(s) in the general ledger without the use of clearing funds.

During the 2013 audit, several recording errors totaling \$8.5 million were detected affecting revenues. Motor Carrier Surtax revenues were affected when it was determined that the taxpayer account system was not detecting taxpayers reporting the wrong unit of measurement resulting in a system conversion issue that affected distributions. Motor Carrier Surtax revenues were also affected when penalties and interest on late payments were not being distributed out of the IFTA Holding Account and the MCFT Holding Account because the Transmittal report that is used to make distributions to the proper fund(s)/account(s) in the general ledger and to the other Foreign Jurisdictions (FJ) did not capture this activity. IRP revenue and

DEPARTMENT OF REVENUE
REVIEW COMMENTS
June 30, 2013
(Continued)

Commercial Vehicle Excise Tax (CVET) revenue were affected when DOR made an adjusting entry to correct a prior fiscal year accounting error, but DOR did not post the entry as a prior period adjustment. IRP and CVET revenues were also affected when DOR used the wrong CVET rate causing CVET revenues to not be properly distributed into the IRP Fund/Account. Special Fuel Tax revenues were affected as a result of DOR not having proper controls in place to monitor revenue activity to ensure that when a tax type has met its maximum statute distribution threshold that the future distributions are properly updated to reflect what is stipulated in the Indiana Code.

During fiscal year 2013 and subsequent to it, DOR has implemented additional procedures 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. DOR has implemented procedures to review and produce a monthly report of revenues processed beginning with activity for the month ending November 2012, so that it can monitor revenue processed on a monthly basis. The Finance section and Motor Carrier Division staff have implemented procedures to monitor all revenue account activity on a monthly basis for large variances to ensure that revenues processed under DOR's business unit were being properly recorded in the State's financials starting with activity for the month ending May 2013. Beginning with the month ending July 2013 activity, DOR began trending revenue using historical activity in order to project how much revenue DOR will receive on a monthly basis. DOR has also made management and organizational changes in order to address the internal control issues within the agency to ensure tax revenues are properly deposited and posted to the general ledger.

In May 2013, DOR created and filled a second internal audit position. A good internal audit function is necessary to ensure 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.

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)

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, through 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)

DEPARTMENT OF REVENUE
REVIEW COMMENTS
June 30, 2013
(Continued)

INTERNAL CONTROLS OVER IFTA FEES

As stated in the prior Reports B42133 and 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 state compliance review for the period ending June 30, 2007, the Department of Revenue discovered it 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 the 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)

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WITHHOLDING RECONCILIATION

As similarly stated in the prior reports (most recently B42133 and B31671), 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.

DEPARTMENT OF REVENUE
REVIEW COMMENTS
June 30, 2013
(Continued)

During the review period DOR completed a sample cross-check of WH3 documentation/Employer provided W-2 detail/W-2 Individual filings; however, the cross-check had to be manually completed against a limited population.

Subsequent to the review period, DOR's management has appointed a team that is currently examining system-supported options and enhancements that would draw upon DOR's technology and data warehouse capabilities to deliver a better long-term solution.

Indiana Code 6-3-4-16 states: "For individual income tax returns filed after December 31, 2010, the department shall develop procedures to implement a system of crosschecks between: (1) employer WH-3 forms (annual withholding tax reports) with accompanying W-2 forms; and (2) individual taxpayer W-2 forms."

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 April 16, 2014, with Michael J. Alley, Commissioner; Valerie Hunt, Chief Financial Officer; Paul Siegfried, Deputy Director of Finance, Internal Controls & Payroll; and Michelle Drake, Assurance Auditor 1. The Official Response has been made a part of this report and may be found on pages 10 and 11.



STATE OF INDIANA

DEPARTMENT OF REVENUE
OFFICE OF THE COMMISSIONER

Indiana Government Center North
100 North Senate Avenue, Room N248
Indianapolis, Indiana 46204-2253

April 24, 2014

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

Indiana Department of Revenue Official Response To 2013 Indiana State Board of Accounts Compliance Audit Findings

Dear Mr. Joyce:

The Department of Revenue (DOR) recognizes the Compliance findings denoted by the State Board of Accounts (SBOA) in their audit of our internal controls for fiscal year 2013. We also welcome SBOA's input throughout the year in our design and implementation of solutions that increase the integrity of our Financial Reporting processes, systems, and controls while adding value to the State and its taxpayers. 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 & Touché during late 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. As of March 2014, the DOR has completed projects to address 42% of the Deloitte & Touché audit findings and have additional projects underway that will address an additional 42% of the issues by December 2014. The remaining findings and recommendations will be addressed over a longer period as we migrate to a new integrated tax system.

As noted in our CAFR response for Fiscal Year 2013, all material adjusting entries apart from the Motor Carrier Holding Accounts (IRP, IFTA, MCFT) have been made to the State's General Ledger in accordance to protocols prescribed by the Auditor of State's office. Since FY 2013, the DOR has made significant strides in addressing material findings brought forth by this audit. In accordance with our promise to the Auditor-of-State's Office and the SBOA, we are on track to have reconciliation procedures in place, and balances accounted for and tried up, and any funds owed to program funds distributed by May 31, 2014 related to these holding accounts.

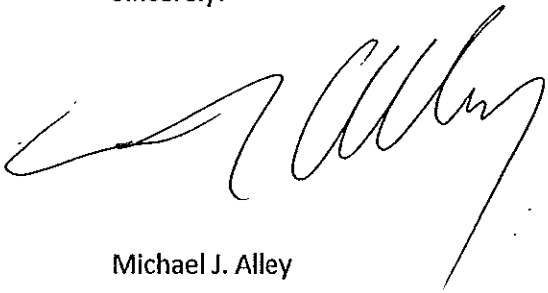
The Department of Revenue (DOR) has conducted a review of its standalone applications used to administer a number of ancillary fees and revenues in an effort to identify opportunities for consolidation into one system as a longer-term solution. As of March, 2014 the DOR has reduced the

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number of standalone systems by 37%. Additionally, the DOR is currently retiring three standalone outdated legacy systems supporting three significant special tax types (Cigarette Tax, Other Tobacco Products, and Alcohol Beverage Control Tax) and converting them to one modern integrated tax system.

The DOR has also improved its control of internal changes to Taxpayer accounts in our Returns Processing System, and has established a taskforce that is in the process of developing an automated procedure to systematically cross-check Employer WH3 information against Employer-provided W2 detail and individual tax return data. Finally, the DOR has a Fraud Investigation Team in place that performs many of the same WH3/W2 cross-check procedures mentioned above to uncover and remediate Taxpayer Fraud.

Sincerely:

A handwritten signature in black ink, appearing to read "Michael J. Alley". The signature is fluid and cursive, with a long, sweeping underline that extends to the right.

Michael J. Alley
Commissioner

A handwritten signature in black ink, appearing to read "Valerie Hunt". The signature is cursive and somewhat stylized, with a prominent initial "V".

Valerie Hunt
Chief Financial Officer