



**STATE OF MISSISSIPPI
OFFICE OF THE STATE AUDITOR
STACEY E. PICKERING
STATE AUDITOR**

February 16, 2012

Financial Audit Management Report

J. Ed Morgan
Commissioner of Revenue
Mississippi Department of Revenue
1577 Springridge Road
Raymond, Mississippi 39154

Dear Commissioner Morgan:

Enclosed for your review are the financial audit findings for the Mississippi Department of Revenue for the Fiscal Year 2011. In these findings, the Auditor's Office recommends the Mississippi Department of Revenue:

1. Strengthen controls over checks received;
2. Ensure audit trails exist for all STARS work-list activities;
3. Strengthen controls for processing and reporting individual income tax returns;
4. Strengthen controls over reconciliation of deposits for the Legacy system;
5. Strengthen controls over sales tax journal entries;
6. Strengthen controls over withholding tax adjustments;
7. Strengthen controls over preparation of GAAP package schedules and note disclosures;
8. Strengthen controls over delinquent taxpayer accounts;
9. Strengthen controls over abatement of sales tax penalties; and
10. Strengthen controls over the withholding reconciliation process.

Please review the recommendations and submit a plan to implement them by March 12, 2012. The enclosed findings contain more information about our recommendations.

During future engagements, we may review the findings in this management report to ensure procedures have been initiated to address these findings.

This report is intended solely for the information and use of management, individuals charged with governance, and Members of the Legislature and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited. The Office of the State Auditor has also issued an Information Systems Management Report on the Mississippi Department of Revenue, Alcohol Beverage Control Division, dated October 20, 2011. That report should be read in conjunction with this report.

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I hope you find our recommendations enable the Mississippi Department of Revenue to carry out its mission more efficiently. I appreciate the cooperation and courtesy extended by the officials and employees of the Mississippi Department of Revenue throughout the audit. If you have any questions or need more information, please contact me.

Sincerely,

A handwritten signature in cursive script, appearing to read "Stacey E. Pickering".

Stacey E. Pickering
State Auditor

Enclosures

FINANCIAL AUDIT MANAGEMENT REPORT

The Office of the State Auditor has completed its audit of selected accounts included on the financial statements of the Mississippi Department of Revenue for the year ended June 30, 2011. These financial statements are consolidated into the State of Mississippi's Comprehensive Annual Financial Report. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. The Office of the State Auditor's staff members participating in this engagement included Karlanne Coates, CPA, Kayla McKnight, Adam Haywood, Chelsea Caul, Jeanne Julious, and Tammy Sterling

Our procedures and tests cannot and do not provide absolute assurance that all state legal requirements have been met. In accordance with Section 7-7-211, Miss. Code Ann. (1972), the Office of the State Auditor, when deemed necessary, may conduct additional procedures and tests of transactions for this or other fiscal years to ensure compliance with legal requirements.

Internal Control over Financial Reporting

In planning and performing our audit of selected accounts included on the financial statements, we considered the Mississippi Department of Revenue's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on these accounts, but not for the purpose of expressing an opinion on the effectiveness of internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies in internal control over financial reporting. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. Significant deficiencies identified are numbered as findings 2011-06, 2011-07, 2011-08, 2011-09, 2011-10, 2011-11, 2011-12 and 2011-13 and are noted under the heading **SIGNIFICANT DEFICIENCIES**. In addition, we noted certain control deficiencies involving the internal control over financial reporting that require the attention of management. Control deficiencies identified are numbered as findings 2011-14 and 2011-15 and are noted under the heading **CONTROL DEFICIENCIES**.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether selected accounts included on the financial statements of the Mississippi Department of Revenue are free of material misstatement, we performed tests of compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

SIGNIFICANT DEFICIENCIES

<u>Finding Number</u>	<u>Finding and Recommendation</u>
2011-06	<p><u>Controls over Checks Received Should Be Strengthened</u></p> <p><i>Finding:</i></p> <p>The Mississippi Department of Revenue processing division receives numerous trays of mail each day which consists of tax returns, checks and correspondence. For all mail containing checks, the clerks verify the checks and the return agree and there is an account number on the return. If there is a problem with the return or check, such as a missing account number or instances in which the check and return don't agree, then the return and check are forwarded to the Data Assembly/Pre-Edit section of the processing division for resolution of the problem, if possible. If the Data Assembly/Pre-Edit section cannot correct the problem, the return and check are forwarded to the appropriate tax divisions for research/correction. In some instances, the mail will be sent directly to the tax divisions prior to being processed. Some of the major reasons checks and returns are sent directly to a tax division is the return is an initial, amended or final corporate return; the return is a composite corporate return (a parent company with subsidiaries); a city schedule or master file schedule is not attached to a sales tax return; the return and check are out of balance more than \$500 before being processed; the return is for tobacco, oil and gas severance taxes within the miscellaneous tax division; or the mail is addressed to a specific employee within the tax division.</p> <p>Procedures performed during the audit for fiscal year 2011 revealed that checks which were sent to the divisions by the Data Assembly/Pre-Edit section were not adequately controlled by the processing division. The log maintained by the Data Assembly/Pre-Edit section only included three large dollar checks sent to the tax divisions during the fiscal year. Management indicated the log had only been reviewed once in approximately the last seven years when a check was missing. The checks sent to the divisions were not logged (except for the three mentioned above) or restrictively endorsed by the processing division.</p> <p>We also noted the corporate, income, withholding, sales and miscellaneous tax divisions had not implemented adequate controls or procedures to ensure that checks received in their divisions were properly safeguarded while being processed in these divisions. Check logs were not maintained by any of these divisions. It should be noted that personnel in the tax divisions are authorized to make adjustments to taxpayer's accounts which could result in the circumvention of controls established within the delinquency system. Good internal controls require that receipts which bypass the normal processing stream should be controlled to expedite the deposit of checks into the bank and reduce the potential for errors or fraud to occur without being detected in a timely manner.</p>

Recommendation:

We recommend the Mississippi Department of Revenue strengthen controls over checks received by the various tax divisions. For checks that are routed to the tax divisions, the agency should develop a check receipts log in each division and restrictive endorsements should be placed on checks at the earliest possible moment. Due to the volume of checks received by the divisions, management should consider a reasonable dollar threshold for checks which need to be logged. The threshold should not be so large that significant errors or fraud could occur without being promptly detected. We further recommend the logs in each tax division and in the processing division be reviewed by management to ensure the proper disposition of the checks recorded on the logs.

2011-07

Audit Trails Should Exist for all STARS Work-list Activities

Finding:

During audit procedures performed on withholding tax at the Mississippi Department of Revenue, we followed up on a prior year finding relating to the procedures over processing tax returns included on the work-list from the submissions process of the STARS application. STARS is an application system of the agency which processes withholding taxes and tax information from employers. STARS has application segments in several places beginning with the workstation that captures the work. During the input or submissions process to STARS, certain errors may cause the system to suspend the submission of the transaction until it is corrected by agency personnel. Until the actual transaction posts to the STARS' taxpayers' accounts, the record of the submission is held in the work-list queue. Once resolved, the transactions post into the STARS taxpayers' account. We noted the work-list is a real-time process and the work-list record disappears once the error is resolved.

Since this process is real-time, the work-list is ever changing, with new items being added and old items being resolved during the course of the business day. Therefore only the current contents of the work-list may be captured via running a real-time snapshot report. This creates a problem with auditing the work-list activities, and reviewing the effectiveness of the system edits, in that evidence of the error and correction of the error is not maintained.

STARS should have been designed to journal any actions taken to correct submission deficiencies and correct work-list actions. An audit trail of adjustments to a system's data, including input corrections, should always be created and maintained. Best practices in accounting as exemplified in Section 404 of Sarbanes-Oxley suggest that organizations adhere to the principle that all changes to financial data be recorded and monitored.

Recommendation:

We recommend the Mississippi Department of Revenue, in reviewing for any renovations or replacement system for STARS, include system specification criteria to require the application to maintain full audit trails of any changes/corrections to financial system data, including work-list activities.

2011-08

Controls Should Be Strengthened for the Processing and Reporting of Individual Income Tax Returns

Finding:

Follow-up procedures performed on a prior year finding relating to the Phoenix individual income tax system at the Mississippi Department of Revenue indicated the system was not producing sufficient audit trails of exceptions noted in taxpayer account records. The following weaknesses were noted.

- The Phoenix system shows processing in real time in its ongoing work-list (exceptions list) which can contain any issues that are of an exceptions nature identified by the Phoenix system. But the work-list is of a transitory nature, in constant flux, due to additions and resolutions caused by the normal process flow during a given work day. We noted the agency now captures items on the work-list at a certain time each morning during the work week and saves the work-list using the agency's Crystal Management System. However, we also noted there is no audit trail for activity occurring after the daily report is produced if the exception is resolved before the next day's report is run. For this reason, there are exceptions which are never documented on the report.
- There are Phoenix system rule sets that require certain authority levels to process abatement of penalties and interest over a certain threshold limit; however, there are no approval levels or threshold limits for monetary adjustments to taxpayer's account by agency personnel. Also, there are reporting capabilities to produce reports which would show such monetary changes applied to the system as well as abatements made by employees but the agency is currently not utilizing or reviewing the report.
- There are edits built into the system to aid in detecting and correcting errors on returns. However, returns can be processed by overriding these edits. No report is generated documenting transactions which were processed in an override mode for management's review.

Good internal controls require adequate information be available to manage an entity, and provide a basis for investigating any errors and unusual situations that arise. Reporting capabilities should exist that provide an audit trail for all changes at every stage of the information processing cycle.

Failure to have sufficient management information available could cause problems in determining the root of problems that may arise in taxpayers' accounts as well as provide an incomplete history of changes made to correct taxpayers' accounts by agency personnel.

Recommendation:

We recommend the Mississippi Department of Revenue strengthen controls over the processing and reporting of individual income taxes. All monetary changes to taxpayer's accounts over certain threshold limits should be approved by management and a separate report of the monetary adjustments, including abatements, should be reviewed by management. In addition, any transactions which are applied to the Phoenix individual tax system which are made in an override mode should be separately reported and reviewed by management. All reviews performed by management should be documented by initial and date, and reports should be maintained and available for the auditor's review. In addition, when implementing the replacement system for the Phoenix individual income tax system, reporting capabilities should be included to enable it to provide daily reporting of all accounts added and deleted to the work-list and an on-going picture of the work-list.

2011-09

Controls over Reconciliation of Deposits for the Legacy System Should Be Strengthened

Finding:

Mississippi Department of Revenue procedures include weekly reconciliations between the amount of all tax types processed in the Legacy system (i.e., sales, use, corporate, petroleum, etc.) and the amount of funds deposited for all tax types. However, this weekly reconciliation does not reconcile amounts deposited and processed to amounts posted to individual taxpayers' accounts. Good internal controls require reconciliations include additional procedures to ensure all transactions are correctly posted to the taxpayers' accounts in a timely manner. Failure to do so could result in errors occurring without being detected in a timely manner and could adversely affect the integrity of taxpayers' accounts. Also, because overpayments and tax due notices are processed using the individual taxpayer account information, misleading or erroneous results could be generated.

Recommendation:

We recommend the Mississippi Department of Revenue strengthen internal controls to ensure Legacy deposit reconciliations include additional procedures to ensure all transactions are properly posted to the taxpayers' accounts in a timely manner.

2011-10

Controls over Sales Tax Journal Entries Should Be Strengthened

Finding:

During sales tax journal entry testwork at the Mississippi Department of Revenue, we selected 25 journal entries exceeding \$100,000 totaling \$9,621,231 to test. Our testwork revealed the following problems.

- Three instances were noted in which journal entries were either posted incorrectly or were not prepared, resulting in errors in taxpayer account information.

- Seven instances, totaling \$2,748,497, were noted in which journal entries were not properly authorized by supervisory personnel.

Good internal controls should ensure the proper preparation and input of journal entries to a taxpayer's account. Good internal controls also require journal entries be reviewed and approved by a responsible official not involved with the origination of the entry. Agency policy requires all journal entries over \$5,000 to be reviewed by supervisory personnel. Failure to ensure journal entries are correctly prepared and input to the computer system could adversely affect the integrity of the taxpayer's account information and could cause errors in the amounts diverted to the municipalities. Also, because overpayments and tax due notices are processed using the individual taxpayer account information, misleading or erroneous results could be generated. Lack of a supervisory review could allow errors or irregularities to occur without being detected in a timely manner.

Recommendation:

We recommend the Mississippi Department of Revenue strengthen controls over sales tax journal entries to ensure the taxpayer's account information is correct. A detailed supervisory review should be performed to ensure sales tax journal entries are prepared and input correctly. This review should be documented by the initials and date of the reviewer.

2011-11

Controls over Withholding Tax Adjustments Should Be Strengthened

Finding:

Audit procedures performed on adjustments made in the withholding tax division and in the accounting division at the Mississippi Department of Revenue revealed the following weaknesses.

- Adjustments made to withholding tax returns can be made without approval authorization. These adjustments include adjusting the amount of the return, moving the return between withholding tax periods or accounts, and changing the return type between original, amended or additional.
- Adjustments made to the application of withholding tax payment amounts over \$1,000 have to be approved by authorized personnel. However, there are numerous supervisory personnel throughout the agency that can make these adjustments without approval authorization. These adjustments include changing the application of the payment either by posting the payment to a different withholding tax period or account, or through reallocation in which one payment is received and the payment has to be split between other withholding tax accounts established by the taxpayer, but not changing the amount remitted.
- Adjustments made by accounting division personnel can be made without approval authorization. These adjustments include changing payment amounts between tax types.

Good internal controls require a supervisory review and approval of adjustments be made to accounting records and to taxpayer's account information. The review should be documented in the tax system or documented by initial and date in the accounting records. Failure to perform a supervisory review of withholding tax adjustments could result in errors to the taxpayer's account information and possible misstatement of the accounting records occurring and not being detected in a timely manner. Also, because overpayments and tax due notices are processed using individual taxpayer account information, misleading or erroneous results could be generated.

Recommendation:

We recommend the Mississippi Department of Revenue strengthen internal controls to ensure withholding tax adjustments are properly authorized to ensure taxpayers' account information and the accounting records are correct. The review and approval should either be documented within the withholding tax system or documented by initial and date in the accounting records.

2011-12

Controls over the Preparation of GAAP Package Schedules and Note Disclosure Information Should Be Strengthened

Finding:

Audit procedures performed on the GAAP reporting package for state treasury fund 9171 and its supporting schedules prepared by the Mississippi Department of Revenue revealed the following problems.

- The receivable for gaming tax revenues per the Untransferred Taxes Receivable schedule was overstated by \$3,539,106. The overstatement was due to returns, as of June 30, 2011, reporting revenue which was never received due to the casinos reporting a loss for the remainder of the week. These losses reduced the payments actually received by the agency. Therefore, the financial statements included amounts that were never received. An adjustment was proposed by the auditors and made by management to correctly state the account. Under the modified accrual basis of accounting, revenue should be not only measurable but available to liquidate the liabilities of the agency. Therefore, amounts that will not be received by the agency should not be reported as a receivable.
- The amounts reported for the allowance for uncollectible accounts receivable, both current and noncurrent, and the allowance for uncollectible tax liens, both current and noncurrent, related to the sales tax receivable on the Taxes Receivable Schedule were transposed. This error was detected by the auditors. Agency personnel revised the schedule and submitted it to the Department of Finance and Administration.

Good internal controls require supporting schedules used in the preparation of GAAP reporting packages and note disclosures be reviewed for propriety. This review should be performed by someone other than the preparer of the schedules. Failure to follow proper GAAP reporting guidelines and to perform a review of supporting schedules used in the preparation of GAAP reporting packages and note disclosures could result in errors occurring and not being detected timely.

Recommendation:

We recommend the Mississippi Department of Revenue strengthen internal controls over the preparation of supporting schedules used in the preparation of the GAAP reporting package and note disclosures for state treasury fund 9171. An independent review should be performed to ensure amounts reported are accurate. This review should be documented by initial and date of the reviewer.

2011-13

Controls over Delinquent Taxpayer Accounts Should Be Strengthened

Finding:

Audit procedures performed at the Mississippi Department of Revenue on 40 sales tax delinquent accounts and 40 withholding tax delinquent accounts revealed several instances in which agency personnel did not perform timely follow up on delinquent taxpayer accounts. These errors appeared to have been caused by the agency personnel posting return information incorrectly, not closing taxpayers' account when requested, and failing to change taxpayers' filing status (from monthly to annually).

Assessment letters are required by law to be issued on delinquent accounts; however, tax liens may be filed at the agency's discretion for sales tax but are required to be filed for withholding tax. Sections 27-7-53 and 27-65-35, Miss. Code Ann. (1972), state that taxpayers shall be given a period of 60 days from the date of notice in which to pay withholding and sales tax due, including penalties and interest. Several instances were noted in our testwork in which assessment letters and/or liens were issued untimely and numerous instances in which liens were not issued at all. In addition, numerous assessment letters were issued to taxpayers indicating 30 days instead of 60 days from date of notification to submit payments.

In addition, testwork performed on 9 large dollar assessment amounts reported for corporate tax in the delinquent taxes receivable schedule indicated one instance in which a delinquent corporate tax account was reported for an incorrect amount. This error was due to the tax assessment amount erroneously including penalty and interest, which resulted in receivables being overstated by \$4,327,841. An adjustment was proposed by the auditors and made by management to correct this error.

Good internal controls require the agency to perform proper and timely follow up procedures on all delinquent taxpayer accounts to ensure timely issuance of assessment letters, liens and warrants and to ensure the delinquent accounts are valid receivables. Failure to conduct proper and timely follow-up procedures on delinquent accounts may result in the under collection of revenue by the agency and noncompliance with state laws. It can also cause financial statements to be misstated if amounts recorded for taxes receivable are determined to not be due to the state.

Recommendation:

We recommend the Mississippi Department of Revenue strengthen controls over delinquent taxpayer accounts. Proper follow-up procedures on delinquent taxpayer accounts should be performed in a timely manner to help ensure all revenues owed the state are collected and that accounts reported as delinquent are valid receivables. In addition, the agency should ensure all assessment notices allow the taxpayer the 60 day time period to pay taxes due in accordance with the state law.

CONTROL DEFICIENCIES

**Finding
Number**

Finding and Recommendation

2011-14

Controls over Abatement of Sales Tax Penalties Should Be Strengthened

Finding:

Audit procedures performed over the abatement of sales tax penalties at the Mississippi Department of Revenue revealed the following weaknesses.

- A personal computer system (Foxpro) was used to manually enter information and generate tax due letters. We noted that when a penalty was abated, there was no documentation in the system of the reason for the abatement or the identity of agency personnel who made the decision. The system maintained a "letter history for account" which indicates an abatement was made but did not provide the amount or the identity of the employee who worked on the account. It should be noted the agency's policy is that supervisory approval should be obtained for abatements over \$5,000 made within the sales tax division, and should be scanned into the MDA (MDOR Document Archives) system.
- There was no listing of abatements generated for management review. We noted the withholding tax division utilizes such a printout which provides a tool for management's use in tracking the occurrence of penalty abatements.

Good internal controls require accounting records be maintained for abatements of penalty and interest and that abatements be monitored by supervisory personnel to ensure their propriety. Failure to maintain adequate internal controls could allow errors or fraud to occur without being promptly detected.

Recommendation:

We recommend the Mississippi Department of Revenue strengthen internal controls over abatements of sales tax penalties by recording the reason for the abatement as well as documenting the identity of agency personnel authorizing the abatement. We further recommend the agency determine if a tracking mechanism can be placed in operation within the sales tax system to aid management in reviewing and documenting the occurrence of abatements such as is in place in the withholding tax division. Management should review the tracking mechanism for unusual transactions, and should document the review with their initials and the date.

2011-15

Controls over the Withholding Reconciliation Process Should Be Strengthened

Finding:

The Mississippi Department of Revenue prepares a monthly reconciliation which is designed to identify discrepancies between the various deposit reports run by data processing and the information systems divisions, the amount of withholding tax actually deposited by accounting personnel and the amount of withholding tax posted into the taxpayer's accounts in the STARS system. Audit procedures performed on all 12 monthly withholding reconciliations revealed there was no indication of when the reconciliations were prepared and no documentation of a supervisory review. Good internal controls require the reconciliations be prepared timely after month-end and that a review be performed to ensure accuracy. This review should be documented with the initials and date of authorized accounting personnel performing the review. Failure to prepare and review reconciliations could result in errors or fraud occurring without being detected in a timely manner.

Recommendation:

We recommend the Mississippi Department of Revenue strengthen controls over the withholding reconciliation process. The date the reconciliation was prepared should be documented. In addition, the review of these reconciliations should be documented with the initials and date of the reviewer.