



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

April 9, 2015

Financial Audit Management Report

J. Ed Morgan
Commissioner of Revenue
Mississippi Department of Revenue
500 Clinton Center Drive
Clinton, MS 39056

Dear Commissioner Morgan:

Enclosed for your review are the financial audit findings for the Mississippi Department of Revenue for the Fiscal Year 2014. In these findings, the Auditor's Office recommends the Mississippi Department of Revenue:

1. Strengthen controls to ensure proper computation of the estimate for income tax refunds payable by tax type at fiscal year-end;
2. Strengthen controls over the diversion of tax collections;
3. Strengthen controls over adjustments and abatements to taxpayer accounts;
4. Strengthen controls over the process of applying cease dates on taxpayer accounts; and,
5. Strengthen controls over the review of stop indicators with indefinite cease dates on taxpayer accounts.

Please review the recommendations and submit a plan to implement them by April 30, 2015. 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.

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the Mississippi Department of Revenue's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Mississippi Department of Revenue's internal control and compliance. Accordingly, this communication is not suitable for any other purpose. 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 dated December 18, 2014. That report should be read in conjunction with this report.

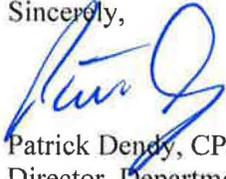
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I hope you find our recommendations enable the Mississippi Department of Revenue to carry out its mission more efficiently. I appreciate the cooperation and courtesy extended by the officials and employees of the Mississippi Department of Revenue throughout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

Sincerely,

A handwritten signature in blue ink, appearing to read "Patrick Dendy".

Patrick Dendy, CPA
Director, Department of Audit
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, 2014. 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 Yolanda Campbell, CPA; Sallie Dier, CPA; Thomas Wirt, CPA; Kayla McKnight; Lee Alford; Kelly Holtsinger; Jeremy Miller, CPA; David Stewart; Elevia Tate and Leigh Taylor, CPA.

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 (internal control) to determine the audit procedures that are appropriate in the circumstances 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. Accordingly, we do not express an opinion on the effectiveness of the Mississippi Department of Revenue's internal control.

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. 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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control, identified in this letter as items 14-01, 14-02, 14-03 and 14-04, that we consider to be significant deficiencies.

In addition, we noted a control deficiency involving internal controls that requires the attention of management. This matter is listed under the heading **OTHER CONTROL DEFICIENCY** as item 14-05.

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 its 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*.

<u>Finding Number</u>	<u>Finding and Recommendation</u>
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SIGNIFICANT DEFICIENCIES

14-01	<u>Controls Should Be Strengthened to Ensure Proper Computation of the Estimate for Income Tax Refunds Payable by Tax Type at Fiscal Year-End</u>
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Finding:

Section 27.104.4(1), Miss. Code Ann. (1972) requires each state agency to prepare annual financial statements for the State Fiscal Officer in accordance with generally accepted accounting principles. The *Mississippi Agency Accounting Policies and Procedures* (MAAPP) manual Section 27 prescribes the rules and regulations over the preparation of agency financial statements referred to as GAAP Reporting Packets.

In preparing the GAAP Reporting Packet for Fund 3851, the Mississippi Department of Revenue (DOR) calculated and recorded an accrual entry for the estimated Income Tax Refunds Payable at fiscal year-end. For fiscal year 2014, we noted that, when recording the estimated income tax refunds payable by crediting liability, the agency recorded the offsetting debit to individual income; however, individual income taxes and corporate income and franchise taxes (corporate income) are both refunded from Fund 3851. Because individual income and corporate income are recorded separately in the *Comprehensive Annual Financial Report* (CAFR), the entry to revenue should have been calculated separating the amount between the two tax types. An audit adjustment for \$31,463,745 was proposed and made by agency management to properly state the revenue accounts by tax type.

In addition, an audit adjustment was proposed and made by agency management to decrease the total estimated income tax refunds payable for refunds processed during fiscal year 2014 but which were accrued in the prior fiscal year 2013 due to a delay in the processing of refunds after the implementation of the Mississippi Automated Revenue System. This entry reduced the total payable by \$14,000,000, with \$13,000,000 credited to individual income tax and \$1,000,000 credited to corporate income tax.

The effect of the errors noted was an overstatement to estimated income tax refunds payable of \$14,000,000, a net overstatement of corporate income tax of \$30,463,745 and a net understatement of individual income tax of \$44,463,745.

Recommendation:

We recommend the Mississippi Department of Revenue (DOR) strengthen controls to ensure the estimated income tax refunds payable recorded at fiscal year-end in the GAAP Reporting Packet is properly calculated between individual income tax and corporate income and franchise tax. Furthermore, we recommend DOR ensure the computation of the estimated payable only considers underlying transactions relevant to the appropriate fiscal period.

14-02

Controls Should Be Strengthened over the Diversion of Tax Collections

Finding:

The Mississippi Automated Revenue System (MARS) is an integrated tax management system being implemented in a series of annual rollouts at the Mississippi Department of Revenue (DOR) over a five year period beginning in October of 2011 and continuing through October of 2015. Over this time period, MARS is replacing the former method of diverting tax collections out of the State Treasury Clearing Fund 9171 to various other Treasury Funds from a manual method to a computer automated process. Through observation and discussions with management, it appears that MARS has been tested by DOR and the MARS developer to ensure the system is properly programmed to automate tax diversions based on specific tax laws as included in the Miss. Code Ann. (1972).

During this implementation period, DOR has not performed a routine reconciliation of the month ending un-transferred collection balances of tax types managed in MARS as compared to the amounts reported in the agency's monthly accounting records. No audit trail was provided to the auditor to support the un-transferred tax collections in Fund 9171 at month-end. The month-ending balances can be affected by various system activities, such as credit balances on taxpayer accounts, the number of returns and payments held as work items for manual intervention, whether an account diverts in the month of collection or the month following collection, etc. Any errors made while the agency manually records collections by tax type from data in the MARS revenue cube are absorbed in the MARS non-cash sheet line item in DOR's accounting records, which will result in a misstated un-transferred collections balance for the tax type, but total deposits will be correctly stated by the amount deposited into Fund 9171 at the State Treasury from DOR's instructions.

Based on testwork performed, we noted the following problems.

- Due to the manner in which MARS processes reserves from withholding income tax collections, a system error occurred in June of 2014 which caused an untimely transfer of withholding collections held for refunds in the

Treasury Clearing Fund 9171 to the State General Fund 2999 totaling \$10,492,257. This appeared to be an isolated system error specific only to the way in which reserves for income tax refunds are processed. We noted that DOR does make reasonable estimates of income tax collections to maintain as reserves for refunds based on historical data.

- Due to the manner in which MARS was programmed to generate estimated tax assessments for delinquent Insurance Premium (ISP) taxpayers, collections were over-diverted by the system to the State General Fund 2999 when ISP taxpayers remitted payment against the assessments without filing returns. The amount owed to the State General Fund 2999 was double calculated, resulting in an over-diversion totaling \$310,286.

The potential effect of not reconciling the month-ending un-transferred collection balances in Fund 9171 to MARS system documentation could result in potential errors in the automated processing of the various tax diversions to go uncorrected, and therefore misstate the state's financial statements as well as impact other agencies, cities, or counties within the state.

Recommendation:

We recommend the Mississippi Department of Revenue (DOR) strengthen controls over the diversion of tax collections. During the compilation of monthly accounting records, including the General Ledger and Trial Balance Coversheet, the un-transferred collections' balances of tax types processed in the Mississippi Automated Revenue System (MARS) should be reconciled to MARS system documentation to ensure the balances are accurate. An audit trail should be maintained to provide support and to substantiate the month ending balances of tax types in the State Clearing Fund 9171.

14-03

Controls Should Be Strengthened over Adjustments and Abatements to Taxpayer Accounts

Finding:

The Mississippi Automated Revenue System (MARS) has security function levels that allow users to perform certain types of activity within the system. Of the 529 users with access to MARS, 446 users with security function level 2702, or 84% of users with MARS access, have the capability to change, transfer and reverse returns in the MARS system without another user interacting with the transaction. This includes Mississippi Department of Revenue (DOR) employees across the different tax divisions as well as employees in administrative divisions that can enter changes, transfer or reverse returns for any tax type managed in MARS. This function relates to manually clearing computer edit exceptions during the submission of tax returns in order to initially post the returns in the system, which is a fundamental job duty of many DOR employees who work return exceptions from work list queues tailored specifically for the employee. However, the function also allows return changes to be created after the initial posting of a return, which results in a new version of the return being created.

In addition, 118 users with security function level 2904, or 22% of users with MARS access, have the capability to request and approve adjustments and abatements in the MARS system without any type of approval from other personnel.

DOR implemented a system mechanism at the end of February 2014 to send an Electronic Notification in MARS to tax managers when DOR staff, in the respective bureaus/divisions, request an adjustment/abatement over \$5,000. However, DOR managers are not required to follow up after receiving the Electronic Notifications. Managers do not have to log their approval via notes on taxpayer accounts or enter the actual system approval if the person requesting has security function level 2904. Also, the notifications are only generated for adjustments/abatements entered via the adjustment tab on a filing period. The notifications are not sent for any return change adjustments when a new version of a return is created, including return changes after the initial posting.

Good internal controls require a supervisory review and approval of significant and unusual adjustments and abatements made to taxpayer trial balances. The review and approval should be performed in a timely manner and adequately documented to identify the date of the review and the person approving. Failure to require a supervisory review and approval of significant and unusual adjustments to taxpayers' account balances could result in errors occurring and not being timely detected, which could result in misstatements to the agency's financial statements.

Recommendation:

We recommend the Mississippi Department of Revenue strengthen controls by ensuring significant and unusual adjustments and abatements to taxpayer account trial balances in Mississippi Automated Revenue System are reviewed and approved by appropriate management personnel.

14-04

Controls Should Be Strengthened over the Process of Applying Cease Dates on Taxpayer Accounts

Finding:

The Mississippi Automated Revenue System (MARS) is designed with an automated delinquency function that assesses an estimated tax liability if a tax return is not filed by the billing date of the month following the month of the filing period due date. During testwork over the Sales Tax Receivables Account# 12200 accrued at fiscal year-end, an invalid receivable was identified on a sales taxpayer's account. The taxpayer intended to have security access information changed on their sales account; however, a new sales tax account was created for the taxpayer in error by the Department of Revenue (DOR). The taxpayer continued to file sales returns for their original account; however, when no return posted to the account opened in error, an estimated liability was computed and a tax assessment notice was generated by MARS. The taxpayer contacted DOR and a cease date was applied to the account effective April 24,

2014; however, DOR did not remove the estimated tax assessments posted to the taxpayer's account on filing periods dated prior to the cease date and therefore a receivable balance still existed in the system. The error noted in the sample tested was for the December 31, 2013 filing period. The account was opened in error and therefore no tax assessments should have been on the account, prior to or subsequent to the cease date applied. DOR did not timely remove the liability from the taxpayer's account until October 27, 2014, after the Sales Tax Receivable Account #12200 was computed for fiscal year 2014 using MARS system data. The error of the tested sample item resulted in a known overstatement of \$17,564 to the sales tax receivable and a projected overstatement of \$5,825,604.

Failure to adequately apply cease dates and any related indicators may result in incorrect tax assessments being generating by MARS and ultimately affect the taxpayer's account and financial statements of the Mississippi Department of Revenue.

Recommendation:

We recommend the Mississippi Department of Revenue strengthen controls over the process of applying cease dates on taxpayer accounts in the Mississippi Automated Revenue System to ensure accuracy of taxpayer information.

OTHER CONTROL DEFICIENCY

14-05

Controls Should Be Strengthened over the Review of Stop Indicators with Indefinite Cease Dates on Taxpayer Accounts

Finding:

The Mississippi Department of Revenue's (DOR) Mississippi Automated Revenue System (MARS) CRM Indicators – Stop Mail, Stop Statements and Stop Billing policy states that indicators without a specific end date will be routinely reviewed to ensure the indicator is valid and that managers document their review at least once each quarter.

During our review of security features in MARS over stop indicator/suspended activity process, we noted DOR MARS users have access to apply indicators to the filing period, tax account and taxpayer levels of MARS taxpayer's financial information. Indicators can be applied without adding a time limit, or cease date, after which the impacts of the indicator would be released. Of the three indicators below, we noted the following instances of usage during fiscal year 2014.

- For the Stop Billing Processing indicator, we noted 2,946 instances of usage, of which 2,849 had no cease date applied. This stops assessments and liens from being created on delinquent filing periods and tax accounts.

- For the Stop Statement indicator, we noted 13,629 instances of usage, of which 13,627 had no cease date applied. This prevents billing statements from being created to be mailed to delinquent taxpayers.
- For the Stop Mail indicator, we noted 23,633 instances of usage, of which 23,632 had no cease date applied. This stops correspondence from being printed and mailed to taxpayers, other than billing statements.

The majority of the indicators did have a reason selected or an indicator note posted, including all the Stop Billing indicators which had an indicator note posted. The majority were for returned mail, in which a DOR billing statement was returned to DOR due to an invalid mailing address. Multiple stop indicators can be applied to a single taxpayer account. The total number of unique taxpayer accounts that had one or more of the three above stop indicators applied with no cease date is 23,445, which represents less than one percent of total tax accounts managed in MARS.

Based on inquiry with management, and, even though required by policy, no review was performed over stop indicators applied with indefinite cease dates in fiscal year 2014. Potential errors in the application of stop indicators could result in errors to taxpayer account information not being timely detected and the possible under-collection of taxes, thus resulting in potential misstatements to the agency's financial statements.

Recommendation:

We recommend the Mississippi Department of Revenue strengthen controls to ensure stop indicators placed on the filing period, tax account and/or taxpayer levels in the Mississippi Automated Revenue System (MARS) with indefinite cease dates are reviewed and approved by management personnel for validity. The review and approval should be documented with the initial and date of reviewer.

End of Report