WEST VIRGINIA LEGISLATURE
Joint Committee on Government and Finance

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Memorandum

To: **Thedford L. Shanklin, Director**

From: **Michael E. Sizemore, Audit Manager** MES
Stanley D. Lynch, Legislative Auditor III

Date: **November 15, 2006**

Subject: **FOLLOW-UP REVIEW OF THE SPECIAL REPORT ON THE INTERNAL CONTROLS FOR REVENUE OPERATIONS AND TAX COLLECTIONS OF THE WEST VIRGINIA STATE TAX DEPARTMENT FOR THE PERIOD 7/1/2002 - 6/30/2004**

In accordance with your instructions, we conducted a follow-up review to examine the implementation of recommendations contained within the special report on the internal controls over revenues and tax collections of the West Virginia State Tax Department (the Department) for the period July 1, 2002 - June 30, 2004. In conducting this follow-up, we met with Mr. Virgil Helton, State Tax Commissioner and Mr. Christopher Morris, Deputy Tax Commissioner, on October 27, 2006, to discuss the implementation of procedures to satisfy the recommendations made in our report and the logistical requirements necessary on the part of the Department in order for us to conduct our follow-up review in an efficient and effective manner.

As part of the follow-up process, we conducted interviews with State Tax Department personnel, reviewed Department procedures and examined documents to determine what procedural changes were made. We then evaluated these procedures and ascertained if such procedural changes would resolve the internal control weaknesses noted in the aforementioned report. Our review determined that actions taken by the Department have addressed almost all of the internal control weaknesses noted in our report. However, the Department did not agree with one finding in our report and, as a result, took no action on our recommendation.

In the following pages of this review, each finding included in the special report on the internal controls over revenues and tax collections are set out individually with a short synopsis of the State Tax Department's actions taken thus far to remedy the finding. Attention should be paid to Finding #6 where no action was taken because the West Virginia State Tax Department did not agree with the audit finding.

FINDING #1

During our review of the internal controls over the collection and deposit of tax revenues, we were told two former employees of the Department's Compliance Division were found to have embezzled tax payments prior to our audit period. The former employees were able to exploit system weaknesses because they had the simultaneous ability to receive a payment from a taxpayer, convert the tax payment to their own personal use, and conceal the theft by deleting all or part of the corresponding receivable in the accounts receivable system and/or suspend the billing process with respect to the receivable. According to information provided by the Department, the accounts receivable balances totaled $91,363,722.12 as of June 30, 2004, and consisted of $59,637,765.46 in the Business Tax Accounts Receivable (AREC) System and $31,725,956.66 in the Personal Income Tax (PITS) System. Our report noted that114 employees for AREC and 93 employees for PITS had the abilities to delete or suspend billings and post payments to accounts. No automated approval process was utilized within the accounting systems which required supervisory approval for employee system entries, no reconciliations were performed between the receipts posted in AREC and PITS and the amounts deposited in State accounts, and no supervision was exercised over deleted accounts receivable or suspended billings.

We recommended:

The Department comply with Chapter 11, Article 1, Section 2 of the West Virginia State Code and strengthen internal controls related to collecting, recording and depositing revenues.

Spending Unit Action:

1. **As of September 1, 2005, Compliance Division Revenue Agents, who are charged with the collection of delinquent taxes, were no longer able to delete or suspend billings (accounts) in AREC.**

2. **In the AREC system the ability to delete and suspend billings was reduced from 121 employees to 81 employees. The ability to post payments to accounts was reduced from 114 employees to 110 employees. During our review, 93 Department employees had the ability to delete and suspend billings, as well as, post payments to accounts in the PITS system. After our report was released, the Department segregated the delete and suspend functions from the payment posting function. Currently, 42 employees have the ability to delete and suspend billings and 66 employees have the ability to post payments in the PITS system.**

3. **The Department instituted a new procedure where management reports are provided to the Compliance Division Director and the Accounts Monitoring Unit Supervisor.**

These reports list all deletions, suspensions and postings from the PITS and AREC systems. Management reviews these reports for unusual entries and, if an entry appears suspect, the source documents supporting the entry can be retrieved and reviewed.

4. **According to Tax Department Management, beginning with Tax Year 2007, the new integrated tax system will have automated edit functions that will match deposits processed in the Receipts Processing Unit to those payments posted to taxpayer accounts. Reports can be generated that list deviations. These deviations can be investigated by either management or the Compliance Division.**

FINDING #2

During our review of the Department's audit procedures of West Virginia personal income tax returns, we learned the Department did not use random sampling techniques to achieve sufficient audit coverage of tax submitted to the Department. According to information provided by the Department, the Department processed $103,870,867.00 and $99,914,249.00 in personal income tax refunds for Tax Years 2003 and 2002, respectively, with the average tax refunds being $223.00 and $224.00 in those years, respectively. Based on conversations with personnel from the Department's Internal Auditing Division, we found that returns related to those refunds were generally not "audited" by Department staff unless the return was "flagged" due to some special circumstance, such as claiming some specific tax credits, or the taxpayer claimed withholdings exceeding some preset ceiling programed in the PITS system. Nevertheless, these audit parameters failed to prevent substantial erroneous overpayments for personal income tax refunds.

We recommended:

The Department comply with Chapter 11, Article 10, Section 11 of the West Virginia Code, as amended, and establish a random sampling audit plan for use on the general population of personal income tax returns, as well as, review and improve the Department's audit procedures for those returns selected for audit.

Spending Unit Action:

1. **Beginning with Tax Year 2004, the Department audits a representative sample of remittance returns (tax returns that have payments enclosed) which are filed on or before April 15th of each tax year, an additional representative sample of returns filed after August 15th of each tax year, and another representative sample of returns filed after October 15th of each tax year.**

2. **Also, beginning with Tax Year 2004, the Department selects a representative sample of personal income tax returns for audit purposes where the West Virginia withholding amount exceeds a certain threshold of the reported Federal Adjusted Gross Income.**

FINDING #3

Companies conducting business in West Virginia are required by the Department to complete a business registration application. Answers provided to questions on the application indicate the types of tax returns the company will be expected to file. Information contained on the business application is entered into the Business Master File / Detail Payments database in the form of an "active" business account. The information in these active accounts is later processed by the Department to determine those tax returns and related forms that are to be filed by the business. If an account is "inactivated" in the Business Master File when the business is still actively engaged in business, the Department would be unaware if the company failed to file the applicable tax returns. During our review, we learned the Department's Business Systems Entry Unit placed businesses in "inactive status" if an employee of the unit noticed the company had not renewed its business registration certificate. Inactivated businesses were not subject to delinquency runs and corresponding audits for delinquent tax filings if the inactivation date was prior to the beginning date for the delinquency run period. Plus, the Department's Auditing Division random sampling techniques were used only for active businesses in the Business Master File. Since only active businesses were included in the audit population, there was no possibility of an inactive business being selected for audit. Therefore, an indeterminable number of businesses may have been conducting business in West Virginia after being inactivated in the Business Master File, since businesses that failed to renew their business license and ignored the Department's follow-up inquiries were not subjected to the Department's oversight functions.

We recommended:

The Department comply with Chapter 11, Article 1, Section 2 of the West Virginia Code, as amended, and establish procedures to ensure that businesses are no longer engaged in business activities prior to rendering them inactive.

Spending Unit Action:

1. **Companies are no longer removed from the Business Master File unless they remit some form of written documentation indicating they are no longer conducting business in the State.**

2. **A monthly report provided by the Department's Information Technology Division (IT Division) lists all companies that remit business tax payments that are not active in the Business Master File. All companies listed on the report are immediately reactivated.**

3. **After the conclusion of each month, the IT Division provides the Department's Compliance Division with a report listing a sample of 25 inactivated companies from a population of approximately 800 companies that are inactivated from the Business Master File during each preceding month. Compliance Division auditors verify if supporting documentation from each of the 25 businesses is on file and that the documentation clearly indicates the business is dissolving. A second report, which is just an expanded version of the first report, lists 10% of the inactivated accounts from the previous month. This report is only worked if it was determined from**

auditing the first report that some businesses were incorrectly rendered inactive. Finally a third report is provided to the Compliance Division that lists all accounts that have been inactivated in the previous month. The Compliance Division has the option to investigate any of the businesses from the list if they detect a pattern of erroneous or improper inactivation of businesses from the Master File.

FINDING #4

According to a spreadsheet dated March 22, 2005, provided to us by the Compliance Division, a health care provider owed $1,012,120.97 in Health Care Broad Based and Health Care Severance taxes, penalties and interest for the period of March 1, 2002, through January 31, 2005. We learned the provider contacted the Tax Department during October or November 2004, and requested amnesty for unpaid taxes. Prior to this contact, Tax Department personnel were unaware that the company had failed to file numerous estimated tax returns and only filed one of six required annual returns since July 1, 2001. We were told that the Tax Department's Compliance Division is responsible for running Healthcare "Delinquency Runs," which will alert the Department if a taxpayer failed to file. According to a memorandum provided by the Director of the Compliance Division, the last Healthcare Delinquency Run was performed on January 6, 2003, for calendar years 2000 and 2001. The Department obviously did not have internal controls in place to ensure that Health Care Providers were filing Broad Based and Healthcare Severance tax returns on a timely basis and paying taxes due the State. Therefore, we concluded there was a significant possibility that other health care providers also failed to file Broad Based and Healthcare Severance tax returns and pay the taxes due the State.

We recommended:

The Department comply with Chapter 11, Article 10, Section 5 of the West Virginia Code, as amended. We further recommended the Department establish internal controls that would ensure Health Care Providers were filing Broad Based and Healthcare Severance tax returns on a timely basis and paying taxes due the State.

Spending Unit Action:

1. The Department's Compliance Division currently performs health care delinquency runs annually. The last health care delinquency run for Tax Year 2005 was run on April 2006. Each account included on the run is assigned to a revenue agent and the agent investigates the account to ensure it is, in fact, delinquent. If the agent determines the health care provider is delinquent, an estimated tax is assessed and the provider is billed. The assessment is purposely estimated higher than the provider's previous healthcare tax payments for similar periods. This is done in order to persuade the provider to file the appropriate healthcare tax returns and remit the proper amount of tax due.

FINDING #5

Other Tobacco Products (OTPs) is the classification given by the Tax Department for all tobacco products other than cigarettes that are subject to the Tobacco Products Excise Tax. The Department permits OTP taxpayers to apply a discount of four percent to the gross tax due. This discount is incorporated into the monthly OTP tax form used by taxpayers to calculate the net tax due to the Tax Department. Unlike the tobacco taxes on cigarettes, OTP taxes are not paid through stamp purchases and, therefore, the taxes are required to be remitted to the Department in conjunction with the OTP tax return. According to State Statute, the four percent discount is granted "for persons affixing stamps, collecting and paying of tax." Since OTP taxpayers do not affix stamps to OTPs, our position was OTP taxpayers were not entitled to the four percent discount authorized by the Statute. Due to the application of this discount, we estimated the Department failed to collect tobacco products excise taxes of approximately $197,000.00 and $193,000.00 for fiscal years 2004 and 2003, respectively.

We recommended:

The Department comply with Chapter 11, Article 17, Section 9 of the West Virginia Code, as amended.

Spending Unit Action:

The State Tax Department disagreed with the audit finding and, therefore, took no action.

FINDING #6

During our review of the Department's accounting procedures, we found the Department did not have adequate segregation of duties related to the inventory controls over Cigarette and Soft Drink stamps. One Department employee maintained the inventory records for the Cigarette and Soft Drinks Tax stamps, had regular access to the stamps located in the Department vault, and conducted the monthly inventory count of the stamps. A large vault is used to store the majority of stamps kept on hand by the Tax Department; however, a small quantity is kept in a safe for convenient retrieval by employees processing stamp orders from distributors. According to documents and interviews conducted with Department staff, eighteen Department employees had access to the vault and five employees to the small safe.

We recommended:

The Department comply with Chapter 11, Article 17, Section 7 and Chapter 11, Article 19, Section 5 of the West Virginia Code, as amended, and the Department establish inventory procedures for cigarette and soft drink stamps that incorporate segregated duties for custody of the assets, record keeping and inventory verification counts.

Spending Unit Action:

1. **Access to the vault combination is restricted to six Department employees. Specifically, two Internal Auditing Division (IAD) employees, the Director of the Revenue Division, the Secretary to the Revenue Division Director, an Information Technology Division employee and a Criminal Investigations Unit employee have access to the vault combination. All other employees must be escorted to the vault by one of the aforementioned six employees. In accordance with Department procedure, all employees who visit the vault must sign a log sheet which documents the time each employee enters and leaves the vault.**

2. **Inventory counts of cigarette and soft drink stamps are conducted after the conclusion of each month by two Office of Business Registration employees. These employees must be escorted to the vault since neither of them have the vault combination. The results of the inventory counts are entered in an inventory spreadsheet by one of the employees. The other employee reconciles the previous business months ending balance less documented removals from the vault to the physical count. All discrepancies are reported to management, investigated and resolved.**

3. **The two employees that conduct the stamp inventory counts in the vault are responsible for the day to day issuance of stamps which are retrieved from the small safe . At the conclusion of each day one of the employees performs a count of the stamp inventory in the safe. The results of the counts are entered into an inventory control spreadsheet by the other employee. This employee performs a reconciliation to the previous business days ending balance less documented sales.**

4. **Once a month, the Acting Director of the Revenue Division of the State Tax Department reviews the vault log book. She determines if those employees recorded on the log book had legitimate reasons for being inside the vault and if the employees correctly documented the required information in the vault log book. If deemed necessary, the Revenue Division Director will question employees about their need to be inside of the vault.**

FINDING #7

The Tax Department did not maintain accounts receivable ledgers for Beer Barrel and Wine Liter Taxes. Therefore, in order to provide us with a total accounts receivable balance, it was necessary for the Department's Excise Tax Unit to construct an accounts receivable total by obtaining individual assessments from electronic copies of lien and assessment letters mailed to delinquent taxpayers. Once this process was complete, we were told the total outstanding receivable balance for Beer Barrel and Wine Liter Taxes as of June 9, 2005, was $214,528.64. Another $232,460.23 in tax, interest and penalties for Wine Liter Taxes had been assigned to the Compliance Division for collection. The method used by the Department to monitor accounts receivable balances for Beer Barrel and Wine Liter Taxes was confusing, inefficient and prone to error. As a result, we believed there was a significant risk of accounts receivable recording errors and possible employee misappropriation of accounts receivable payments.

We recommended:

We recommend the Department comply with Chapter 11, Article 10, Section 5 of the West Virginia Code, as amended. We further recommend the Department establish an accounts receivable system for Beer Barrel and Wine Liter Tax that is logical and readily accessible.

Spending Unit Action:

1. **The Department established a computerized Beer Barrel and Wine Liter Tax accounts receivable ledger. In addition to the taxpayer name and the billing date, the current amounts of tax, interest, penalties and grand total due are recorded in the ledger.**

FINDING #8

While documenting the controls over the health care provider tax revenues, we learned the Department did not monitor health care provider estimated tax returns for underpayment of estimated taxes and, therefore, did not impose interest on provider underpayments or late payments of estimated taxes. According to State statute, health care providers must either remit at least eleven-twelfths of the total health care provider taxes due for the tax year with their estimated monthly tax returns when tax liabilities are reasonably expected to exceed $50.00 per month, or pay interest on the underpayment. We were unable to determine the number of estimated healthcare tax remittances with underpayments, if any, or the amount of foregone interest charges.

We recommended:

The Department comply with Chapter 11, Article 10, Section 11 of the West Virginia Code, as amended, and establish a procedure whereby health care provider estimated tax returns are monitored for underpayments of estimated taxes and the providers are assessed penalties for late payments and underpayments in accordance with State statute.

Spending Unit Action:

1. **The Department sent all Health Care Providers a letter informing them that eleven-twelfths of the estimated tax liability for the year must be remitted in monthly installments if the liability can be reasonably expected to exceed $50 per month. The Tax Department will begin imposing the penalty for tax years ending December 31, 2006 and later. The Department's IT Division has been working on programing an "underpayment penalty function" in the Health Care System in order to calculate and capture those providers that fail to remit required amounts throughout the tax year. As of the date of this memorandum, the Healthcare Programming changes are in the testing phase.**
2. **According to a Tax Department supervisor, the Tax Department requested on three separate occasions that the Department of Health of Human Resources (DHHR) provide the Tax Department with an annual report documenting the Medicaid**

Reimbursements made to the healthcare providers during each calendar year. With such a report, the Tax Department could independently verify the amount of taxes calculated and paid by health care providers. However, as of the date of this memorandum, the DHHR has yet to provide such a report to the Tax Department.

FINDING #9

While documenting the Department's procedure for receipts processing, we discovered the Department did not deposit all revenues within 24 hours of receipt, as required by State statute. Although the Department did deposit the majority of revenues promptly, the Department's Receipts Processing Supervisor told us "miscellaneous split" receipts were deposited, on average, twice per week. A "miscellaneous split" receipt is when multiple types of taxes are paid with one check, one money order or one credit card receipt. According to documents we reviewed, the Tax Department deposited $105,457,012.54 and $134,634,089.67 in Fiscal Years 2004 and 2003, respectively, in "miscellaneous split" receipts. The average time elapse between each deposit for the two-year period was 3.4 days. Additionally, the Department occasionally received payments by check or money order with no accompanying tax forms or remittance coupons. As a result, the Receipts Processing Section was unable to determine how to record the payment in the receipts processing system. When this occurred, the Receipts Processing Section personnel attached the payment to a cork board located in the Tax Department's Receipts Processing Section until the corresponding tax form or coupon was located or received. According to Receipts Processing personnel, one or two checks or money orders per day were received without tax forms or coupons. If a corresponding tax form or coupon was not located or received within approximately one week of the Department's receipt of a payment, the Receipts Processing personnel forwarded the check or money order to the Tax Department's Personal Income Tax Prep Unit for investigation.

We recommended:

The Department comply with Chapter 12, Article 2, Section 2 of the West Virginia Code, as amended, and deposit tax payments within 24 hours of receipt.

Spending Unit Action:

1. **Miscellaneous splits are now deposited every business day.**

2. **Payments without accompanying tax forms or remittance coupons are immediately forwarded to Tax Department's Personal Income Tax Prep Unit for investigation to ensure their timely deposit.**