State of Mississippi
OFFICE OF THE STATE AUDITOR
PHIL BRYANT
Auditor

December 2, 2004

Financial Audit Management Report

Joseph L. Blount, Chairman
Mississippi State Tax Commission
1577 Springridge Road
Raymond, Mississippi 39154

Dear Mr. Blount:

Enclosed for your review are the financial audit findings for the Mississippi State Tax Commission for the Fiscal Year 2004. In these findings, the Auditor's Office recommends the Mississippi State Tax Commission:

1. Strengthen controls over keypunch of journal entries;
2. Strengthen controls over individual income tax refunds;
3. Strengthen controls over data processing security; and
4. Follow procedures concerning delinquent sales tax payments.

Please review the recommendations and submit a plan to implement them by January 5, 2005. 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 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.

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

Sincerely,

Phil Bryant
State Auditor

Enclosures

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FINANCIAL AUDIT FINDINGS

The Office of the State Auditor has completed its audit of selected accounts included on the financial statements of the Mississippi State Tax Commission for the year ended June 30, 2004. These financial statements will be consolidated into the State of Mississippi's Comprehensive Annual Financial Report. The Office of the State Auditor's staff members participating in this engagement included Rob Robertson, Laura Griffin, Judy Bounds, Mike McCollough, Andy Salin, Jessica Short, Rebecca Wilson, and Amy Ellis, CPA.

The fieldwork for audit procedures and tests was completed on October 29, 2004. These 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 State Tax Commission's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on these accounts and not to provide assurance on the internal control over financial reporting.

However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgement, could adversely affect the department's ability to record, process, summarize and report financial data consistent with assertions of management in the financial statements. These matters are noted under the heading **REPORTABLE CONDITIONS**.

A material weakness is a condition in which the design or operation of one or more of the internal components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are considered to be material weaknesses. However, we believe none of the reportable conditions described above is a material weakness.

In addition, we noted a matter involving the internal control over financial reporting that requires the attention of management. This matter is noted under the heading **IMMATERIAL WEAKNESS IN INTERNAL CONTROL**.

Compliance

As part of obtaining reasonable assurance about whether selected accounts included on the financial statements of the Mississippi State Tax Commission are free of material misstatement, we performed tests of compliance with certain provisions of laws, regulations, contracts and grants, 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. We are pleased to report the results of out tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

REPORTABLE CONDITIONS

Controls over Keypunch of Journal Entries Should Be Strengthened

Finding:

During testwork on sales tax journal entries performed at the State Tax Commission, we selected all journal entries which exceeded $100,000 to test. We noted four instances out of 25 items tested, or 16 percent, in which errors were made in the keypunch of journal entries. In each of the instances noted, the original sales tax return information was keypunched to the wrong tax period causing a journal entry to be necessary to record the tax information in the correct tax period. Testwork performed on the journal entries revealed the following errors:

- One entry which should have been keypunched as $765.31 gross tax with a discount of $15.31 was input as $7,653,115.31. It appears the keypunch operator input both the gross tax and the discount amounts in the gross tax field. At the time of audit testwork, agency personnel had made a correcting entry to record the correct amounts in the correct tax period, but had not reversed the incorrect entry.

- One entry which should have been keypunched as $2,151.02 gross tax was input as gross tax of $2,151,021.02. It appears the keypunch operator input the last three digits of the amount twice.

- One entry which should have been keypunched as $10,857 gross tax was input as $210,857.

- One entry which should have been keypunched as $25,719 was input as $225,719.

Because of the high error rate and the large dollar amounts noted in the errors, we extended our testwork by selecting a random sample of 25 additional journal entries for testing. Three instances, or 12 percent, were noted with errors caused by keypunch and/or calculation errors. Testwork revealed the following errors:

- One entry which was calculated incorrectly by sales tax personnel with a $60 error was also keypunched incorrectly by data processing with an additional $60 error. We also noted that this journal entry to correct the tax period of the return was unnecessary because a correcting journal entry had already been processed the previous week.

- One entry which should have been keypunched as $7,845 was input as $78,450.

- One entry totaling $93,224 which was completed incorrectly by sales tax personnel. This entry was to correct the tax period of the return but the debit and credit of the entry was to the same tax period, therefore no correction was accomplished. We also noted that the entry was keypunched incorrectly with a $20 error.

Discussions with agency personnel revealed that there are no computer checks to ensure that errors of the type noted are caught in post audit. While journal entries which exceed a certain dollar amount are reviewed by supervisory personnel in the sales tax division, there does not appear to be review procedures in place in data processing to ensure that journal entries are input to the system correctly. Because we tested all journal entries which were keypunched with amounts greater than $100,000, we do not think that the problems noted would materially affect the State Tax Commission's ability to process and record tax returns. Also, the errors in calculation of journal entries that we noted were immaterial in amount. It should be noted that the state's revenues are recorded from the initial collection of tax receipts and should not be affected by the journal entries made to a taxpayer's individual accounts. However, errors of the type noted could affect the integrity of the information available.

Recommendation:

We recommend the State Tax Commission immediately implement controls over data processing of journal entries to ensure that sales tax journal entries are correctly input. We further recommend that the journal entries noted in this finding be researched and corrected so that taxpayer accounts correctly reflect tax return information submitted to the agency.

<u>Controls over Individual Income Tax Refunds Should Be Strengthened</u>

Finding:

Testwork performed at the State Tax Commission on individual income tax refunds issued revealed the following:

- Five instances in which a tax refund check was issued twice to the taxpayer. The amounts noted ranged from $111 to $22,000. In four of five instances noted, both the original refund check and the duplicate check were cashed by the taxpayer. In the one instance in which the duplicate check had not been cashed, the taxpayer had not returned the check or notified the agency.

- Two instances in which refunds were issued even though the income reported on the return was less than income reported on the W-2s. In these two instances, when audit procedures were applied, we noted that gross income was under-reported on the two returns by $112,000 and $3,100, respectively. After these returns were brought to the attention of agency personnel the agency issued a notice requesting repayment of $18,000 in one instance, and in the other instance, the agency has requested additional documentation before determining the amount of repayment needed. It should be noted that both of these returns where reviewed by agency personnel prior to approving the refunds. It appears the information on the return was not vouched to the attached W-2s which is required by agency policy.

- Five instances in which refunds were issued to taxpayers who had failed to submit W-2s with the tax returns. Therefore, it appears the income was not verified prior to issuing the refunds. In the instances noted, the required documentation was not requested until the refunds were reviewed during the audit. The agency subsequently requested the documentation and the refunds appear to be valid. However, it is agency policy that returns received without W-2s are to be returned to the taxpayer for proper documentation at the time the return is opened in the mail room.

- One instance in which numerous errors were noted on a tax return and agency personnel reviewed the return prior to issuing a refund. We noted that when agency personnel reviewed the return and made corrections, they did not compare the amount withheld to the amount reported on the attached W-2 causing the refund to be understated. The agency owes an additional $490 to the taxpayer.

- One instance in which a taxpayer claimed a credit of $5,047 of tax paid to another state. The taxpayer did not submit documentation for the credit as required. This return was reviewed by agency personnel and a refund was issued without obtaining required documentation supporting the credit claimed as is agency policy. After bringing this to the attention of agency personnel, documentation was requested and received from the taxpayer which substantiated the refund. However, agency policy requiring documentation be received prior to authorizing the refund should have been followed.

- One instance noted in which the return was not input correctly which resulted in an over-stated refund. When agency personnel reviewed the return they did not note the error and approved the refund which was over-stated by $900. When we brought this to the attention of agency personnel, a letter was sent to require repayment of $900. This has subsequently been received.

It should be noted that of the returns selected for audit which are identified in this finding, nine of 15 returns, or 60 percent, had previously been selected and reviewed by agency personnel prior to issuing the refund. However, we noted the refunds were either in error or lacked proper verification or documentation.

Good internal controls require proper procedures be followed in processing tax refunds to ensure accuracy. We noted the agency has policies and procedures for reviewing a return and supporting documentation/verification of amounts reported on the return. However, it appears these procedures are not being consistently applied. Failure to properly process refunds and follow agency policies and procedures for reviewing tax returns and supporting documentation could result in loss of tax revenue to the state as well as errors or fraud to occur without being detected in a timely manner.

Recommendation:

We recommend the Mississippi State Tax Commission strengthen existing controls and implement additional controls over individual income tax refunds to ensure accuracy. Agency personnel should follow proper policies and procedures when reviewing and approving a refund based on receipt of a tax return. Returns received in the mail without appropriate documentation, such as W-2s, should be returned to the taxpayer prior to processing. When returns are reviewed during the process of approving refunds or as a result of computer flags, agency personnel should vouch return information to supporting documentation to ensure that all required documentation has been submitted and amounts reported on the tax return are properly supported. Any missing documentation should be requested prior to approving the tax refund. We also recommend that appropriate action be taken by the agency for the errors noted in this finding to recover funds erroneously paid to taxpayers, and in one instance, remit the amount owed to the taxpayer.

Data Processing Security Controls Should Be Strengthened

Finding:

During our review of the physical security controls over electronic data processing at the Mississippi State Tax Commission - Alcoholic Beverage Division, we noted the access door to the computer room was not locked and no other method of access tracking was utilized. We also noted materials used in the room such as furniture and blinds were not fire resistant.

The *Control Objectives for Information and Related Technology* (CobiT) guidelines, a generally accepted standard for good information technology security and control practices, require information technology facilities have appropriate physical security and access control measures. Without these controls, unauthorized access, theft and/or damage could occur. The lack of controlled access to the computer room, as well as failure to use fire resistant materials could result in corruption, loss and/or theft of data.

Recommendation:

We recommend the Mississippi State Tax Commission - Alcoholic Beverage Division improve physical security over the computer room by ensuring the door is secure at all times, therefore allowing only authorized personnel access to the room. This can be accomplished effectively through the use of keypad entry, swipe card entry or a locked door with assigned keys. We also recommend the use of fire resistant and/or retardant materials throughout the computer room to minimize damage in the event of a fire or disaster.

IMMATERIAL WEAKNESS IN INTERNAL CONTROL

Policies and Procedures Concerning Delinquent Accounts Should Be Followed

Finding:

During testwork at the Mississippi State Tax Commission on sales tax delinquencies, we noted three instances out of 25 tested, or 12 percent, in which agency personnel did not perform appropriate follow-up procedures for sales tax delinquencies. The three instances noted were out-of-state accounts for which a lien/warrant was not recorded. According to agency delinquency policies and procedures, assessment letters must be sent out within 30 days of the return date plus a 10 day grace period and liens/warrants must be recorded by the time the delinquency is 60 days past due. Failure to follow delinquency policies and procedures could result in delay or failure to collect delinquent taxes.

Recommendation:

We recommend the Mississippi State Tax Commission follow delinquency policies and procedures to collect taxes from delinquent sales tax accounts. Agency personnel should ensure that liens/warrants are recorded for delinquent accounts 60 days past due.

End of Report