



A REPORT
TO THE
ARIZONA LEGISLATURE

Financial Audit Division

Management Letter

Department of Revenue

Year Ended June 30, 2006



Debra K. Davenport
Auditor General

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**STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL**

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

September 18, 2007

Gale Garriott, Director
Arizona Department of Revenue
1600 West Monroe Street
Phoenix, AZ 85007-2650

Dear Mr. Garriott:

In planning and conducting our audit of the State of Arizona for the year ended June 30, 2006, we considered the Department of Revenue's internal controls over financial reporting and tested its compliance with laws and regulations that could have a direct and material effect on the State's financial statements as required by *Government Auditing Standards*.

Specifically, we performed tests of cash receipts and distributions of individual, withholding, corporate, transaction privilege, use, excise, tobacco, and liquor taxes; unclaimed property; taxes receivable; tax refunds; tax refunds payable; due to local governments; payroll; transfers; and capital assets.

All audit findings that are required to be reported in the *Government Auditing Standards* Report on Internal Control over Financial Reporting and on Compliance and Other Matters have been included in the State of Arizona's Single Audit Reporting Package for the year ended June 30, 2006, and have been communicated to your staff. In addition, our audit disclosed internal control weaknesses that do not meet the reporting criteria. Management should correct these deficiencies to ensure that it fulfills its responsibility to establish and maintain adequate internal controls. Our recommendations are described in the accompanying summary.

Also, certain information came to our attention that has not been included in this report because of its sensitive nature. This information has already been provided to you.

This letter is intended solely for the information of the Department of Revenue and is not intended to be and should not be used by anyone other than the specified party. However, this letter is a matter of public record, and its distribution is not limited.

Should you have any questions concerning its contents, please let us know.

Sincerely,

Dennis L. Mattheisen, CPA
Financial Audit Director

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The Department should accurately maintain adjusted taxpayer accounts

The Department uses a computerized information system, Business Reengineering Integrated Tax System (BRITS), to process tax collections and to store critical taxpayer information. As such, it is vital that the Department ensures that BRITS accurately maintains taxpayer accounts. However, adjusted taxpayer accounts were not always recorded accurately in BRITS as a result of system limitations. For example, one adjusted return and payment transfer had inconsistent effective dates assigned by BRITS, resulting in the appearance of a taxpayer overpayment. In addition, several transactions were adjusted to accurately reflect taxpayer liabilities; however, the balances presented by BRITS were still incorrect.

To help ensure the Department accurately maintains taxpayer accounts in BRITS, the Department should:

- Require employees to verify that each adjustment to taxpayer accounts results in the correct balance reported in BRITS. Employees should investigate and correct all differences.
- Identify all transactions that have been previously adjusted, but are still inaccurately reported in BRITS. These transactions should be reviewed and corrected.
- Investigate and implement system corrections that will allow adjustments to be accurately reported in BRITS.

The Department should adequately plan to administer its new tax system

In 2002, the Department contracted with an outside vendor to develop an integrated tax system—BRITS. Throughout implementation, the vendor also provided system support and maintenance. Since the Department's information technology staff will be responsible for administering the system when the contract ends, department management should ensure that they have adequately planned for the management, support, and maintenance of its new system. Although some divisions within the

Department had implemented transition plans, management did not complete a thorough analysis of the requirements, including technologies needed to support the system, nor did they determine if necessary resources were available. In addition, the Department had not examined the potential need for continuing vendor support. Continued reliance on the vendor to run and monitor its own system could result in increased costs.

In order to ensure that the Department has adequately planned to administer its new tax system, department management should conduct a thorough analysis to identify the requirements, including technologies and resources needed to support the system. In addition, any external support determined necessary by the Department should be obtained in accordance with the State's procurement policies.

The Department should establish policies and procedures to ensure the completeness of e-file data transfers

Taxpayers have the option of filing their annual individual income tax returns and payments electronically. This process is known as e-file. The Department receives the e-file transactions and stores them on a server prior to being recorded onto the Department's system. However, the Department did not have adequate internal controls in place to ensure the completeness of e-file transactions recorded on the Department's system. Failure to reconcile the total number of transactions recorded on the Department's system could result in missing e-file transactions and inaccurate taxpayer accounts.

To ensure that e-file data transfers are complete, the Department should develop and implement policies and procedures to ensure that all transactions received and stored on the server are reconciled to the transactions recorded on the Department's system. The reconciliation should be reviewed and approved by a supervisor, and all differences should be investigated and resolved.

The Department should ensure data entry vendors have appropriate security measures to secure sensitive taxpayer information

The Department is responsible for receiving and recording tax returns from Arizona taxpayers. To meet the demands of inputting tax returns, the Department utilizes vendors to perform data entry services. Tax returns input by vendors are transmitted and retrieved electronically by the Department using a secure file transfer protocol

process. As tax returns contain confidential data, it is critical that sensitive transaction data is securely maintained at all times. However, the Department did not have policies and procedures in place to ensure the data entry vendors used the appropriate security measures to secure sensitive taxpayer data.

To help ensure that all confidential taxpayer information maintained by the data entry vendors is secure and to help prevent sensitive taxpayer data from being compromised, the Department should establish and follow policies and procedures to verify that the data entry vendors have effective internal controls in place to securely process and protect sensitive taxpayer data. To determine whether controls have been placed in operation and are operating effectively, the Department should have information technology employees ensure that the data entry vendors have appropriate security measures in place and are in compliance with the data protection contract provisions, and that all vendor security updates are kept current.

The Department should improve controls over retention of tax returns

Throughout the year, taxpayers submit tax returns and payments to the Department for various taxes, including sales, income, and luxury taxes. These returns are entered onto the Department's tax systems as they are received and the original returns are filed. It is vital that the Department maintain the original tax returns to support the accuracy of amounts collected as well as amounts due from taxpayers. However, the Department could not always locate original tax returns.

To help ensure that adequate supporting documentation is maintained, the Department should:

- Physically limit access to areas where original tax documents are stored to a minimum number of employees who are responsible for the custody of such documents.
- Enforce policies and procedures that require employees to check out and check in all original tax documents necessary to perform their duties. Review, at least monthly, all tax documents that are checked out. Any documents that have been checked out for an extended period of time should be investigated to determine if the document is still being reviewed.

The Department should consistently control change management policies and procedures

Effective change management policies and procedures are designed to ensure that required changes to an information technology environment are implemented with minimal disruptions to operations. To help ensure that an information system functions as designed, it is essential that modifications to the system are properly logged, authorized, tested, reviewed, and approved prior to being implemented. The Department used system investigation requests to track their changes and implemented policies and procedures requiring that all changes be authorized, tested, reviewed, and approved. However, the Department did not consistently monitor and enforce its policies and procedures over change management. Specifically, auditors noted several system investigation requests were listed as completed before proper resolution or left open after resolution.

To help ensure policies and procedures over change management are consistently followed, the Department should monitor all system investigation requests, ensuring all requests are consistently logged, authorized, tested, reviewed, and approved before implementation.

A similar recommendation was previously provided in our Management Letter to the Department dated September 6, 2005.

The Department should reconcile income tax receipts to income tax revenues recorded on the Arizona Financial Information System (AFIS)

The Department's management and state officials depend on accurate financial information so they can fulfill their oversight responsibility, report accurate information to the public, and ensure that accurate information is reported in the State's annual financial report. Reconciling revenues to AFIS allows the Department to resolve any timing differences and detect errors in a timely manner. However, the Department did not prepare reconciliations for individual, corporate, and withholding income tax revenues recorded on its system. As a result, auditors noted that income tax collections recorded on the Department's income tax processing system differed from amounts recorded as income tax revenues on AFIS by approximately \$6.3 million.

To help ensure that accurate and complete information is recorded on AFIS, the Department should reconcile total income tax collections recorded on its system to the amount of income tax revenues recorded on AFIS at least quarterly. The Department should promptly investigate and resolve differences noted.

A similar recommendation was previously provided in our Management Letter to the Department dated September 6, 2005.

STATE OF ARIZONA

Department of Revenue
Office of the Director
(602) 716-6090



Janet Napolitano
Governor

Gale Garriott
Director

August 10, 2007

Ms. Debra K. Davenport, Auditor General
Office of the Auditor General
2910 N. 44th Street, Suite 410
Phoenix, AZ 85018

Ms. Davenport:

The following is the Department of Revenue's response to the financial audit for fiscal year 2006. We have appreciated your staff's professionalism throughout the audit and we look forward to completing the fiscal year 2007 audit.

Recommendation 1: The Department should accurately maintain adjusted taxpayer accounts.

Department's Response: Agree

The Department is taking the following steps to ensure that adjusted taxpayer account balances are accurate.

- *Require employees to verify adjustments made to taxpayer accounts.*
The current BRITS system design allows an employee to review taxpayer account adjustments before committing the updated information into the system. To help ensure that employees verify adjustments made to taxpayers' accounts, all staff will receive training on the procedure and the impacts of not adhering to the procedure. The training will be incorporated into the BRITS individual income tax training, scheduled to be provided in the fall.
- *Review previously adjusted transactions to ensure that they are correct.*
The Department reviewed the three errors identified by auditors where the BRITS system processed a taxpayer account adjustment that resulted in an incorrect account balance. It was determined that two BRITS system issues were responsible for the three errors. The Department is currently identifying all transactions that may have been impacted by these two system issues and will review and make any necessary corrections to those transactions by the end of September 2007.

- *Investigate and implement necessary system corrections to ensure that taxpayer account adjustments are processed correctly.*

It was determined that two BRITS system issues were responsible for the errors identified by the Auditor General. A system investigation request (SIR) was completed (#9647) identifying the system fixes needed. The SIR will be prioritized and implemented through the Department's demand management process. Because the Department is preparing for the upcoming individual income tax release, however, all system changes have been put on hold until January 2008. Assuming the individual income tax release goes without incident, it is estimated that the SIR would be completed by June 2008. In the meantime to ensure the accuracy of adjustments made to taxpayers' accounts, employees will be provided additional training beginning in the fall and a process will be developed and implemented to crosscheck the accuracy of adjustments.

Recommendation 2: The Department should adequately plan to administer its new tax system.

Department's Response: Agree

Following the transaction privilege tax release of BRITS in January 2004, the Department was consumed with addressing all of the problems associated with the release. It wasn't until August 2004 that the Department could even begin to think about turning its attention to the future administration of BRITS.

Nevertheless, the Department had begun planning for the administration of BRITS in FY2006 but not as comprehensively as was needed to provide for the on-going support of the system. Between the months of May 2005 (FY2005) and September 2005 (FY2006) the Department was identifying the resources needed to support BRITS, and on September 1st, 2005 a budget request was submitted identifying the need for \$1,038,100 to fund the necessary technical skills. However, the funding was not appropriated, and the Department remained reliant on Accenture's support of BRITS.

In July 2006 (FY2007), the Department began a more comprehensive planning effort to identify what portion of BRITS support should be handled by internal DOR staff and what portion of system support would be more appropriately provided by a vendor. To determine the most appropriate mix of internal/external support a thorough analysis was completed to identify 1) all systems that need to be supported, 2) current staffing levels available to support the systems, and 3) technical skills required to support the system. In addition, the Department used an outside vendor to conduct a formal independent technical skills assessment of DOR IT staff followed by formal training in those skill-sets requiring attention.

The outcome of the analysis was the development of a FY2008/FY2009 biennial budget request and a comprehensive IT Staffing Plan. The budget request was submitted on October 29, 2006 for funding in the amount of \$1,863,800; however, only \$1,378,300 of the

request was funded. The IT Staffing Plan was presented to and approved by the Information Technology Authorization Committee in January 2007. Both the IT Staffing Plan and the budget were based on the Department transitioning, through training and hiring, to support 70% of BRITS with internal staff and support 30% with vendor staff by the end of FY2009. Please note, however, the Department's success at achieving 70% support of BRITS is dependent on being able to secure very high-cost IT skill-sets in a very competitive labor market with significant funding constraints.

Recommendation 3: The Department should establish policies and procedures to ensure the completeness of e-file data transfers.

Department's Response: Agree

To ensure that e-file data transfers are complete, the Department has developed and implemented a mainframe file reconciliation procedure, which has been in effect since April 14, 2007. The current procedure reconciles the total number of records on the server to those extracted to the mainframe. In addition, an administrator or manager reviews a reconciliation report weekly to determine if there have been any variances noted. If a variance is noted, the cause is investigated and, if necessary, the issue is escalated until the variance has been corrected.

Recommendation 4: The Department should ensure data entry vendors have appropriate security measures to secure sensitive taxpayer information.

Department's Response: Agree

As noted in the finding, the Department utilizes vendors to perform data entry services. The Department's ability to utilize those vendors is authorized by a state-wide contract between the Department of Administration (DOA), State Procurement Office (SPO) and the vendors. The Department of Revenue, however, is not a party to the data entry contract.

The Department will schedule a meeting with SPO within the next 3 weeks to examine the existing contract and determine if the contract provides the authority needed to audit the data entry vendors' security measures. If the contract does not provide the needed audit authority then the Department will request that SPO amend or re-bid the data entry contract. It should be noted, however, that the Department's ability to audit vendors is guided by a contract that is not in the Department's control.

While simultaneously working with SPO, the Department will develop standards for how vendors should appropriately secure sensitive taxpayer information. In addition when the contractual authority exists, the Department will validate the vendors' security measures to ensure that they are following the established standards.

Recommendation 5: The Department should improve controls over retention of tax returns.

Department's Response: Agree

The Department will improve the controls over retention of tax returns by taking the following actions:

- *Physically limit access to tax documents.*

Currently, the Department retains original tax documents in the Phoenix main office until the documents have been processed. Once processed, the documents are transported to the warehouse and later to the State's Records Management Center. While at the Phoenix office tax documents are accessible by a greater number of employees than at any other location. To address the finding, the Department is exploring options to limit the physical access to the documents by other DOR employees. Some of the options being considered include completing tenant improvements on the facility to limit access to documents and moving documents to a more secure area or facility. The Department will examine the options and develop a plan by September 2007.

- *Enforce policies and procedures regarding document control.*

The Department currently requires employees to check original tax documents in and out by using card-tracking system. Beginning in August 2007, the Department will better enforce this procedure by having the document control unit review the card-tracking system monthly to ensure documents have been appropriately returned or, if not, investigate and document the reason that the return is still outstanding.

Recommendation 6: The Department should consistently control change management policies and procedures.

Department's Response: Agree

As noted in the finding the Department tracks proposed system changes through SIR process. SIRs are logged into the tracking tool and then prioritized to be fixed through a subsequent software release. Once the software release containing all the requested and prioritized changes has been put into production, the SIRs fixed in that software release are to be closed. In addition to closing SIRs following a software release the Department, on an informal basis, periodically reviews the inventory of SIRs to monitor that all the SIRs open are appropriate and that no SIRs previously fixed remain open. To address the finding, beginning in October, the Department will formalize the reviews of the SIR inventory and conduct those reviews on a quarterly basis. In addition, the Department will examine software tools that would further automate the process and permit better monitoring and aging of SIRs.

Recommendation 7: The Department should reconcile income tax receipts to income tax revenues recorded on the Arizona Financial Information System (AFIS).

Department's Response: Agree

As previously stated in the response to the September 6, 2005 Management Letter, the Department's legacy tax system does not have the functionality necessary to complete the reconciliation of tax receipts. As also previously explained, the Department had been awaiting the development of the reconciliation functionality within BRITS. However, because the BRITS system development is a 5-year phased implementation, the reconciliation functionality was not yet available at the time of the September 6, 2005 Management Letter.

On September 5, 2006 the corporate income tax release of BRITS went into production and provided the Department the capability to conduct monthly reconciliations of withholding and corporate income tax revenues to AFIS. The Department has completed the reconciliation process for the months of September 2006 through June 2007. While the timing of the reconciliation process has not yet been finalized, the Department has for the first time in 20 years reconciled withholding and corporate tax receipts with the State's accounting system and will have the ability to reconcile individual income tax receipts with the third BRITS release scheduled for December 2007.

Thank you for the opportunity to provide this response. If you have any questions, please call Joanne Prakapas, Chief Internal Auditor at (602) 716-6265.

Sincerely,

Gale Garriott,
Director