

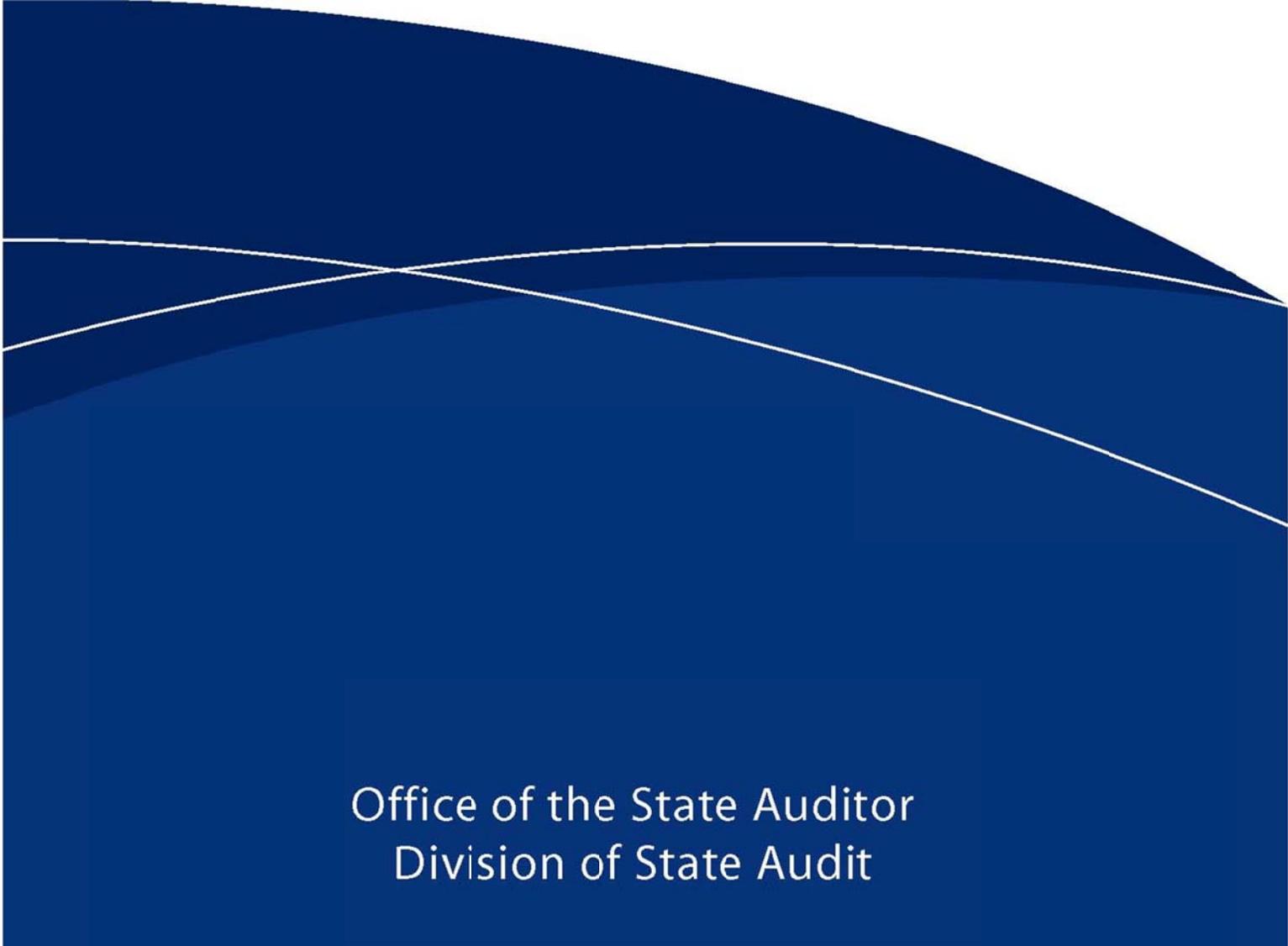


Office of the State Tax
Commissioner
BISMARCK, NORTH DAKOTA

Audit Report

For the Biennium Ended
June 30, 2009

ROBERT R. PETERSON
STATE AUDITOR



Office of the State Auditor
Division of State Audit

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STATE CAPITOL
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BISMARCK, NORTH DAKOTA 58505

Transmittal Letter

February 10, 2010

The Honorable John Hoeven, Governor
Members of the North Dakota Legislative Assembly
The Honorable Cory Fong, Tax Commissioner

We are pleased to submit this audit of the Office of the State Tax Commissioner for the biennium ended June 30, 2009. This audit resulted from the statutory responsibility of the State Auditor to audit or review each state agency once every two years. The same statute gives the State Auditor the responsibility to determine the contents of these audits.

In determining the contents of the audits of state agencies, the primary consideration was to determine how we could best serve the citizens of the state of North Dakota. Naturally we determined financial accountability should play an important part of these audits. Additionally, operational accountability is addressed whenever possible to increase efficiency and effectiveness of state government.

The in-charge auditor for this audit was Allison Bader. Kristi Morlock and Angela Klubberud were the staff auditors; Cindi Pedersen, CPA, was the audit supervisor; and Paul Welk, CPA, was the audit manager. Inquiries or comments relating to this audit may be directed to the audit manager by calling (701) 328-2241. We wish to express our appreciation to Commissioner Fong and his staff for the courtesy, cooperation, and assistance they provided to us during this audit.

Respectfully submitted,

A handwritten signature in cursive script that reads "Bob Peterson".

Robert R. Peterson
State Auditor

Executive Summary

Introduction

The North Dakota Office of the State Tax Commissioner is responsible for collecting tax revenue required to be paid by law and necessary to fund the operation of state and local government.

More information can be obtained from the Office of the State Tax Commissioner's website at <http://www.nd.gov/tax/>.

The Legislative Audit and Fiscal Review Committee (LAFRC) requests that certain items be addressed by auditors performing audits of state agencies. Those items and the Office of the State Auditor's response are noted below.

Responses to LAFRC Audit Questions

1. What type of opinion was issued on the financial statements?

Financial statements were not prepared by the Office of the State Tax Commissioner in accordance with generally accepted accounting principles so an opinion is not applicable. The agency's transactions were tested and included in the state's basic financial statements on which an unqualified opinion was issued.

2. Was there compliance with statutes, laws, rules, and regulations under which the agency was created and is functioning?

Yes.

3. Was internal control adequate and functioning effectively?

Yes.

4. Were there any indications of lack of efficiency in financial operations and management of the agency?

No.

5. Has action been taken on findings and recommendations included in prior audit reports?

The Office of the State Tax Commissioner has implemented the recommendation included in the prior audit report.

6. Was a management letter issued? If so, provide a summary below, including any recommendations and the management responses.

Yes, a management letter was issued and is included on page 14 of this report, along with management's response.

LAFRC Audit Communications

7. *Identify any significant changes in accounting policies, any management conflicts of interest, any contingent liabilities, or any significant unusual transactions.*

There were no significant changes in accounting policies, no management conflicts of interest were noted, no contingent liabilities were identified or significant unusual transactions.

8. *Identify any significant accounting estimates, the process used by management to formulate the accounting estimates, and the basis for the auditor's conclusions regarding the reasonableness of those estimates.*

The Office of the State Tax Commissioner's financial statements do not include any significant accounting estimates.

9. *Identify any significant audit adjustments.*

Significant audit adjustments were not necessary.

10. *Identify any disagreements with management, whether or not resolved to the auditor's satisfaction relating to a financial accounting, reporting, or auditing matter that could be significant to the financial statements.*

None.

11. *Identify any serious difficulties encountered in performing the audit.*

None.

12. *Identify any major issues discussed with management prior to retention.*

This is not applicable for audits conducted by the Office of the State Auditor.

13. *Identify any management consultations with other accountants about auditing and accounting matters.*

None.

14. *Identify any high-risk information technology systems critical to operations based on the auditor's overall assessment of the importance of the system to the agency and its mission, or whether any exceptions identified in the six audit report questions to be addressed by the auditors are directly related to the operations of an information technology system.*

ConnectND Finance, GenTax, Financial Institutions Tax, and Oil and Gas Tax Information Systems are high-risk information technology systems critical to the Office of the State Tax Commissioner.

Audit Objectives, Scope, and Methodology

Audit Objectives

The objectives of this audit of the Office of the State Tax Commissioner for the biennium ended June 30, 2009 were to provide reliable, audited financial statements and to answer the following questions:

1. What are the highest risk areas of the Office of the State Tax Commissioner's operations and is internal control adequate in these areas?
2. What are the significant and high-risk areas of legislative intent applicable to the Office of the State Tax Commissioner and are they in compliance with these laws?
3. Are there areas of the Office of the State Tax Commissioner's operations where we can help to improve efficiency or effectiveness?

Audit Scope

This audit of the Office of the State Tax Commissioner is for the biennium ended June 30, 2009. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The Office of the State Tax Commissioner's sole location is its Bismarck office, which was included in the audit scope.

Audit Methodology

To meet the objectives outlined above, we:

- Prepared financial statements from the legal balances on the state's accounting system tested as part of this audit and the audit of the state's Comprehensive Annual Financial Report, and developed a discussion and analysis of the financial statements.
- Performed detailed analytical procedures including computer assisted auditing techniques. These procedures were used to identify high risk transactions and potential problem areas for additional testing.
- Tested internal control and compliance with laws and regulations which included selecting representative samples to determine if controls were operating effectively and to determine if laws were being followed consistently. Non-statistical sampling was used and the results were projected to the population, as applicable.
- Interviewed appropriate agency personnel.
- Queried the ConnectND (PeopleSoft) system. Significant evidence was obtained from ConnectND.
- Observed Office of the State Tax Commissioner's processes and procedures.

In aggregate there were no significant limitations or uncertainties related to our overall assessment of the sufficiency and appropriateness of audit evidence.

Discussion and Analysis

The accompanying financial statements have been prepared to present the Office of the State Tax Commissioner's revenues and expenditures on the legal (budget) basis. The accompanying financial statements are not intended to be presented in accordance with generally accepted accounting principles (GAAP).

For the biennium ended June 30, 2009, operations of the Office of the State Tax Commissioner were primarily supported by appropriations from the state's general fund. This is supplemented by special funding appropriated for the purchase of an integrated tax system.

Financial Summary

Pursuant to authorization of the 59th Legislative Assembly House Bill 1006, Section 6, the Office of the State Tax Commissioner entered into a financing agreement of \$14 million with the Bank of America for the development and implementation of an Integrated Tax System. During the 2007-2009 biennium, the Office of the State Tax Commissioner commenced payment on the loan principle and interest in the amount of \$5,356,702. The Office of the State Tax Commission received an appropriation during the 2009-2011 biennium of approximately \$12.9 million to repay the remaining balance of the loan and accrued interest.

Revenues consisted primarily of sales and use, income, natural resources, and business taxes. Other revenues during the audit period included various other taxes: telecommunications, provider assessment, airline, electrical franchise, performing rights, and estate taxes.

Significant increases in sales and use, individual income, and natural resources taxes were the result of a strong economy in North Dakota, increased oil production, and higher oil prices during the biennium. Income tax revenue from financial institutions tax decreased during the biennium due to turmoil in the U.S. banking industry and related regulations affecting profitability. In addition, corporation income tax revenue also decreased due to multi-state/multi-national corporations being negatively impacted by the national recession. Total revenues were \$1,747,217,194 for the year ended June 30, 2009 as compared to \$1,633,568,754 for the year ended June 30, 2008.

Total expenditures for the Office of the State Tax Commissioner were \$16,132,214 for the year ended June 30, 2009 as compared to \$15,564,337 for the prior year. Expenditures remained fairly constant during the biennium.

Analysis of Significant Variances Between Final Budgeted and Actual Expenditures

The 60th Legislative Assembly authorized increased appropriation for the 2007-2009 biennium due to expanded eligibility for homeowners to apply for the homestead tax credit. The excess appropriation remaining was due to less than anticipated applications received for the homestead tax credit.

Taxes Collected by the State in a Trustee Capacity

The Office of the State Tax Commissioner collects sales, use, or gross receipts taxes in accordance with NDCC 57-01-02.1 for any incorporated city or county that has adopted the home rule provisions of NDCC 40-05.1 or NDCC 11-09.1. These monies are remitted pursuant to the applicable contract with the city or county. City lodging, lodging and restaurant, and motor vehicle rental taxes are collected by the state pursuant to NDCC 40-57.3. The distribution of tax collections are certified by the Office of the State Tax Commissioner to the Office of the State Treasurer for monthly distribution in accordance with NDCC 57-39.2. Sales, lodging, lodging and restaurant, and motor vehicle rental taxes collected pursuant to these sections were \$114,192,435 for the year ended June 30, 2009 as compared to \$101,796,214 for the prior year.

Financial Statements

Statement of Revenues and Expenditures

	<u>June 30, 2009</u>	<u>June 30, 2008</u>
<u>Revenues and Other Sources:</u>		
Sales and Use Taxes (Net of Refunds)	\$ 768,402,161	\$ 699,162,538
Income Taxes (Net of Refunds)	499,706,977	479,174,097
Natural Resource Taxes	462,947,833	436,516,081
Business Taxes	15,409,753	15,055,612
Integrated Tax System Loan Proceeds		2,852,146
Other Taxes	637,028	637,028
Alcohol License Fees	47,600	43,590
Estate Taxes	41,562	87,805
Miscellaneous Revenue	24,280	39,857
Total Revenues and Other Sources	<u>\$1,747,217,194</u>	<u>\$1,633,568,754</u>
<u>Expenditures and Other Uses:</u>		
Salaries and Benefits	\$ 7,354,028	\$ 6,941,724
Loan Principal and Interest Repayment	2,678,351	2,678,351
Homestead Tax Credit	2,715,750	2,606,619
Major Operating Expenditures:		
Professional Services	1,064,049	996,530
Integrated Tax System Maintenance	550,000	550,000
Data Processing	478,982	575,585
Postage	464,448	408,232
Supplies	148,845	110,888
Travel	126,046	148,387
IT Communications	111,173	90,061
Printing	95,389	120,855
Equipment Under \$5,000	94,824	57,063
Operating Fees and Services	59,803	70,500
Professional Development	55,218	70,257
Equipment Over \$5,000	15,637	
Other Operating Expenditures	114,114	133,928
Transfers Out	5,556	5,357
Total Expenditures and Other Uses	<u>\$ 16,132,214</u>	<u>\$ 15,564,337</u>

Statement of Appropriations

For The Biennium Ended June 30, 2009

Expenditures by Line Item:	<u>Original Appropriation</u>	<u>Adjustments</u>	<u>Final Appropriation</u>	<u>Expenditures</u>	<u>Unexpended Appropriation</u>
Salaries and Benefits	\$ 14,728,637	\$ 178,657	\$ 14,907,294	\$ 14,117,377	\$ 789,917
Operating Expenses	6,030,814	52,146	6,082,960	5,934,120	148,840
Capital Assets	18,000		18,000	15,637	2,363
Property Tax Rebate Admin	1,100,000		1,100,000	939,434	160,566
Homestead Tax Credit	8,104,000		8,104,000	5,333,282	2,770,718
Integrated Tax System	5,356,702		5,356,702	5,356,701	1
Totals	<u>\$ 35,338,153</u>	<u>\$ 230,803</u>	<u>\$ 35,568,956</u>	<u>\$ 31,696,551</u>	<u>\$ 3,872,405</u>
Expenditures by Source:					
General Fund	\$ 32,538,153	\$ 178,657	\$ 32,716,810	\$ 29,054,979	\$ 3,661,831
Other Funds	2,800,000	52,146	2,852,146	2,641,572	210,574
Totals	<u>\$ 35,338,153</u>	<u>\$ 230,803</u>	<u>\$ 35,568,956</u>	<u>\$ 31,696,551</u>	<u>\$ 3,872,405</u>

Appropriation Adjustments:

The \$178,657 increase in the Salaries and Benefits line item was for market equity increases for classified state employees. The appropriated funds were approved by the 60th legislative assembly within Senate Bill 2189.

The \$52,146 increase in the Operating Expenses line were remaining available funds appropriated per section 6 of House Bill 1006 of the 2005 Session Laws. Pursuant to Senate Bill 2006, section 5 of the 2007 Session Laws, these funds were not subject to the provisions of NDCC 54-44.1-11 and were available for continued work on the integrated tax system during the 2007-2009 biennium.

Internal Control

In our audit for the biennium ended June 30, 2009, we identified the following areas of the Office of the State Tax Commissioner's internal control as being the highest risk:

Internal Controls Subjected to Testing:

- Controls surrounding the processing of revenues.
- Controls surrounding the processing of expenditures.
- Controls effecting the safeguarding of assets.
- Controls relating to compliance with legislative intent.
- Controls surrounding the ConnectND (PeopleSoft) system.
- Controls surrounding the Oil and Gas Tax system.
- Controls surrounding the Financial Institutions Tax system.

The criteria used to evaluate internal control is published in the publication *Internal Control – Integrated Framework* from the Committee of Sponsoring Organizations (COSO) of the Treadway Commission.

We gained an understanding of internal control surrounding these areas and concluded as to the adequacy of their design. We also tested the operating effectiveness of those controls we considered necessary based on our assessment of audit risk. We concluded internal control was adequate.

Auditors are required to report deficiencies in internal control that are significant within the context of the objectives of the audit. 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 (1) misstatements in financial or performance information, (2) violations of laws and regulations, or (3) impairments of effectiveness or efficiency of operations, on a timely basis. Considering both qualitative and quantitative factors, we did not identify any significant deficiencies in internal control. However, we noted other matters involving internal control that we have reported to management of Office of the State Tax Commissioner in a management letter dated February 10, 2010.

Compliance With Legislative Intent

In our audit for the biennium ended June 30, 2009, we identified and tested the Office of the State Tax Commissioner's compliance with legislative intent for the following areas that we determined to be significant and of higher risk of noncompliance:

- Deposit of taxes to proper funds, including:
 - Motor Vehicle Excise Tax (NDCC 57-40.3)
 - Motor Vehicle Fuel Tax (NDCC 57-43.1, 57-27)
 - Special Fuels Tax (NDCC 57-43.2, 57-27)
 - Aircraft Excise Tax (NDCC 57-40.5)
 - Aviation Fuel Tax (NDCC 57-43.3)
 - Provider Assessment Tax (NDCC 57-63)
 - Sales and Use Tax (NDCC 57-39.2, 57-40.2)
 - Individual/Corporation Income Tax (NDCC 57-38, 57-39)
 - Financial Institutions Tax (NDCC 57-35.3)
 - Coal Severance Tax (NDCC 57-61)
 - Coal Conversion Tax (NDCC 57-60)
 - Cigarette/Tobacco Tax (NDCC 57-36)
 - Telecommunications Tax (NDCC 57-34)
 - Oil and Gas Production Tax (NDCC 57-51)
 - Oil Extraction Tax (NDCC 57-51.1)
 - Transmission Line Tax (NDCC 57-33.1)
 - Estate Tax (NDCC 57-35.1)
 - Air Transportation Company Tax (NDCC 57-32)
 - City Lodging Tax (NDCC 57-01)
 - City Sales Tax (NDCC 57-01)
 - City Motor Vehicle Rental Tax (NDCC 40-57.3)
 - City Restaurant and Lodging Tax (NDCC 57-01)
- Proper use of legally restricted funds, including:
 - Integrated Tax System Fund (2005 Session Laws, House Bill 1006)
 - Sales and Use Tax Deposit Fund (NDCC 57-39.2-12(3))
 - Motor Fuel Cash Bond Deposit Fund (NDCC 57-43.3-14(5))
 - Provider Assessment Bond Fund (NDCC 57-63-11)
 - Cigarette Tax Distribution Fund (NDCC 57-36-31(2))
 - Gas Tax Collection and Refund Fund (NDCC 57-43.1)
 - Aviation Tax Collection and Refund Fund (NDCC 57-43.3-03)
 - Corporate Income Refund Reserve Fund (NDCC 57-38-40.1)
 - Individual Income Refund Reserve Fund (NDCC 57-38-40.1)
 - Special Fuels Tax Collection and Refund Fund (NDCC 57-43.2-20)
 - Oil and Gas Production Tax Distribution Fund (NDCC 57-51-15)
 - City Lodging Tax Suspense Fund (NDCC 57-01-02.1)
 - City Sales Tax Suspense Fund (NDCC 57-01-02.1)
 - City Motor Vehicle Rental Tax Fund (NDCC 40-57.3-02)
 - City Restaurant and Lodging Tax Suspense Fund (NDCC 57-01-02.1)
 - Contribution Refund Reserve Fund (NDCC 57-38-34)
 - Oil Extraction Tax Development Trust Fund (NDCC 57-51.1-07)
- Proper use of the State Treasurer (State Constitution, article X, section 12).
- Compliance with appropriations and related transfers (2007 North Dakota Session Laws chapter 33).

- Adequate blanket bond coverage of employees (NDCC section 26.1-21-08).
- Compliance with fixed asset requirements including lease and financing arrangements in budget requests and lease analysis requirements.

The criteria used to evaluate legislative intent are the laws as published in the *North Dakota Century Code* and the *North Dakota Session Laws*.

Government Auditing Standards requires auditors to report all instances of fraud and illegal acts unless they are inconsequential within the context of the audit objectives. Further, auditors are required to report significant violations of provisions of contracts or grant agreements, and significant abuse that has occurred or is likely to have occurred.

The results of our tests disclosed one instance of noncompliance that is required to be reported under *Government Auditing Standards*. This finding is described below. Other than this finding, we concluded there was compliance with the legislative intent identified above.

Noncompliance With Tax Revenue Deposit Requirements (Finding 09-1)

In fiscal year 2008, the Office of the State Tax Commissioner exceeded the amount authorized to be deposited to the telecommunications carriers fund by approximately \$1.1 million. Pursuant to North Dakota Century Code (NDCC) 57-34-05, up to \$8.4 million of telecommunications tax revenue is to be deposited to the telecommunications carriers fund. Telecommunications tax revenue exceeding \$8.4 million is to be deposited to the general fund. During fiscal year 2009, the Office of the State Tax Commissioner corrected the error by properly transferring the excess balance in the telecommunications carriers fund to the general fund and properly complied with NDCC for the deposit of telecommunications tax revenue. Since the Office of the State Tax Commissioner corrected the error and properly complied with NDCC during fiscal year 2009, no recommendation will be made.

Operations

This audit did not identify areas of Office of the State Tax Commissioner's operations where we determined it was practical at this time to help to improve efficiency or effectiveness.



STATE OF NORTH DAKOTA
OFFICE OF THE STATE AUDITOR
STATE CAPITOL
600 E. BOULEVARD AVENUE - DEPT. 117
BISMARCK, NORTH DAKOTA 58505

Management Letter (Informal Recommendations)

February 10, 2010

The Honorable Cory Fong
Tax Commissioner
Office of the State Tax Commissioner
600 E. Boulevard Avenue
Bismarck, ND 58505

Dear Mr. Fong:

We have performed an audit of the Office of the State Tax Commissioner for the biennium ended June 30, 2009, and have issued a report thereon. As part of our audit, we gained an understanding of the Office of the State Tax Commissioner's internal control structure to the extent we considered necessary to achieve our audit objectives. We also performed tests of compliance as described in the same report.

Our audit procedures are designed primarily to enable us to report on our objectives including those related to internal control and compliance with laws and regulations and may not bring to light all weaknesses in systems and procedures or noncompliance with laws and regulations which may exist. We aim, however, to use our knowledge of your organization gained during our work to make comments and suggestions which we hope will be useful to you.

In connection with the audit, gaining an understanding of the internal control structure, and tests of compliance with laws and regulations referred to above, we noted certain conditions we did not consider reportable within the context of your audit report. These conditions relate to areas of general business practice or control issues that have no significant bearing on the administration of federal funds. We do, however, want to present our recommendations to you for your consideration and whatever follow-up action you consider appropriate. During the next audit we will determine if these recommendations have been implemented, and if not, we will reconsider their status.

The following present our informal recommendations.

GENERAL

Informal Recommendation 09-1: We recommend the Office of the State Tax Commissioner:

- Establish and perform a fraud risk assessment on a recurring basis.
- Design and document the necessary control activities to ensure that each significant fraud exposure identified during the risk assessment process has been adequately mitigated.

Tax Department Response: *The Office of State Tax Commissioner agrees with this recommendation. Establishing proper internal controls is important and is always considered when implementing new programs or changing the process for existing programs. However, the controls have not been documented to the extent that a fraud risk assessment would. The Department is in the process of formalizing the fraud risk policy and establishing written procedures for conducting recurring fraud risk assessments on significant exposures identified.*

Informal Recommendation 09-2: We recommend the Office of the State Tax Commissioner require employees to acknowledge the Code of Business Conduct policy on an annual basis and include standards to the policy to promote:

- Full, fair, accurate, timely, and understandable disclosure in reports and documents; and,
- Compliance with applicable governmental laws, rules, and regulations.

Tax Department Response: *The Office of State Tax Commissioner agrees with this recommendation. The Department has established the procedure to have the Code of Business Conduct policy acknowledged yearly during the employee's annual performance reviews. The Human Resource Officer will maintain all acknowledgements.*

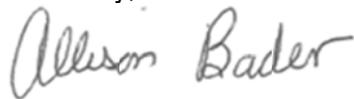
GENERAL LEDGER

Informal Recommendation 09-3: We recommend the Office of the State Tax Commissioner review and approve transactions processed by the Office of Management and Budget and Office of the State Treasurer to ensure all transactions processed to the Office of the State Tax Commissioner's accounting records are proper.

Tax Department response: *The Office of State Tax Commissioner agrees with this recommendation. The Department routinely reviews all transactions processed by OMB and the State Treasurer's office as part of its monthly verification and reconciliation of system printouts. The Department will add to its procedures to have available documentation to support the review and approval of these types of transactions.*

I encourage you to call myself or an audit manager at 328-2241 if you have any questions about the implementation of recommendations included in your audit report or this letter.

Sincerely,



Allison Bader
Auditor in-charge

You may obtain audit reports on the internet at:

www.nd.gov/auditor/

or by contacting the
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