

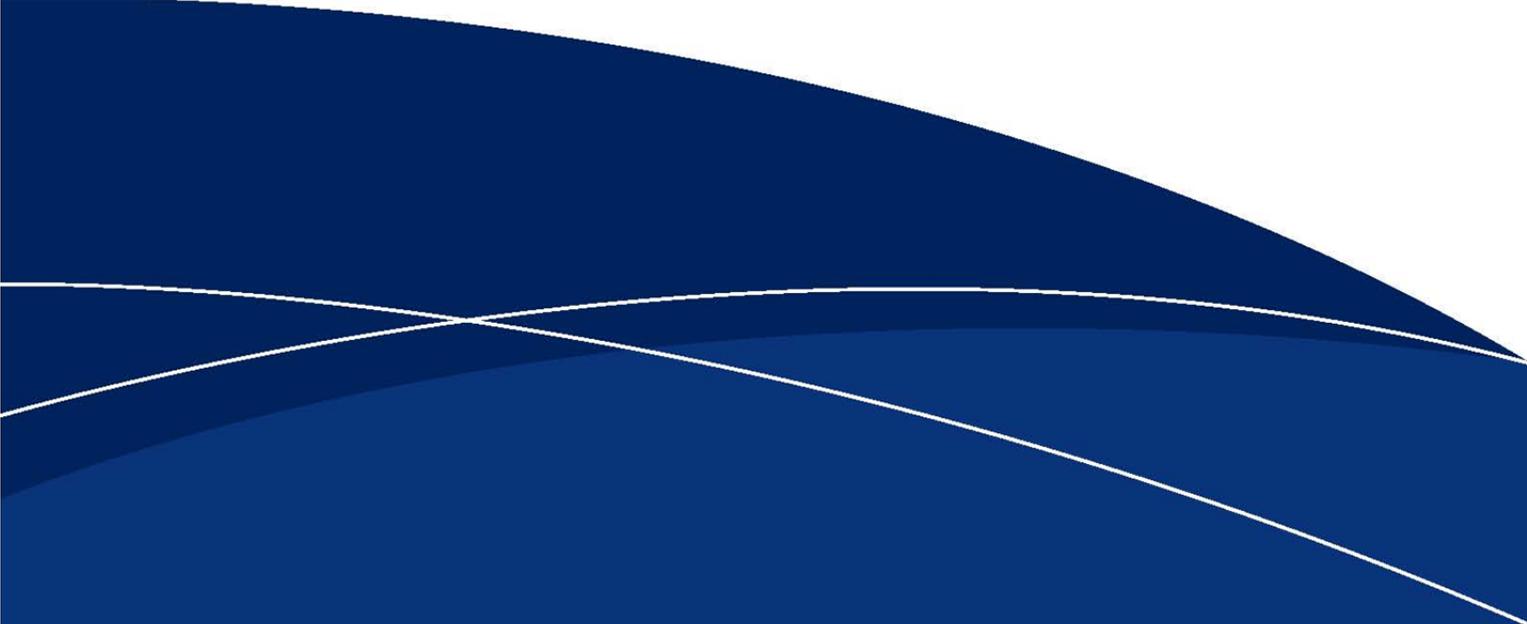
Office of the State Tax
Commissioner

BISMARCK, NORTH DAKOTA

Audit Report

For the Biennium Ended
June 30, 2011

ROBERT R. PETERSON
STATE AUDITOR



Office of the State Auditor
Division of State Audit

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STATE AUDITOR
ROBERT R. PETERSON



PHONE
(701) 328 - 2241
FAX
(701) 328 - 1406

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

Transmittal Letter

March 23, 2012

The Honorable Jack Dalrymple, 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, 2011. 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 Angela Klubberud. Fred Ehrhardt, CPA, was the audit supervisor; and Cindi Pedersen, 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 the 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?

There were no recommendations 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, Gen Tax, and Financial Institutions Tax 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, 2011 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, 2011. 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 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. Where applicable, populations were stratified to ensure that particular groups within a population were adequately represented in the sample, and to improve efficiency by gaining greater control on the composition of the sample.
- Interviewed appropriate agency personnel.

- Queried the ConnectND (PeopleSoft) system. Significant evidence was obtained from ConnectND.
- Observed the Office of 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, 2011, operations of the Office of the State Tax Commissioner were primarily supported by appropriations from the state's general fund.

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. The Office of the State Tax Commissioner received an appropriation during the 2009-2011 biennium of approximately \$10.2 million to repay the remaining balance of the loan and accrued interest.

Revenues consisted primarily of natural resource, sales and use, income, and business taxes. Other revenues during the audit period include alcohol license fees and estate gift taxes.

Significant increases in natural resource, sales and use, income, and business taxes were the result of a strong economy in North Dakota, increased oil production, and higher oil prices during the biennium. Total revenues were \$2,611,087,704 for the year ended June 30, 2011, as compared to \$1,815,474,888 for the year ended June 30, 2010.

Total expenditures for the Office of the State Tax Commissioner (less the loan principal and interest repayment for the development and implementation of an Integrated Tax System) were \$18,509,412 for the year ended June 30, 2011 as compared to \$16,947,322 for fiscal year 2010. Expenditures remained fairly constant during the biennium with the exception of Equipment Under \$5,000 and Other Operating Expenditures which was due to the Office of the State Tax Commissioner remodeling office space.

Taxes Collected by the State in a Trustee Capacity

The Office of the State Tax Commissioner collects sales, use, and 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 and restaurant, and motor vehicle rental taxes collected pursuant to these sections, net of refunds, were \$151,982,846 for the year ended June 30, 2011 as compared to \$125,733,184 for the prior year.

Financial Statements

Statement of Revenues and Expenditures

	<u>June 30, 2011</u>	<u>June 30, 2010</u>
<u>Revenues and Other Sources:</u>		
Natural Resource Taxes	\$1,021,054,047	\$ 628,698,648
Sales and Use Taxes (Net of Refunds)	972,298,618	778,428,006
Income Taxes (Net of Refunds)	593,756,707	392,110,633
Business Taxes	23,888,342	16,147,439
Alcohol License Fees	48,634	43,550
Miscellaneous Revenue	41,356	37,438
Estate Gift Taxes		9,174
Total Revenues and Other Sources	<u>\$2,611,087,704</u>	<u>\$1,815,474,888</u>
<u>Expenditures and Other Uses:</u>		
Salaries and Benefits	\$ 8,426,200	\$ 8,157,884
Homestead Tax Credit	3,958,289	3,447,830
Disabled Veterans Tax Credit	1,965,165	1,627,763
Loan Principal and Interest Repayments		10,230,247
Major Operating Expenditures:		
Professional Services	1,449,334	1,546,469
IT Software	635,446	608,280
IT Data Processing	545,000	513,933
Postage	389,565	408,243
Equipment Under \$5,000	292,692	30,115
Travel	133,121	131,600
Printing	101,928	91,698
IT Communications	97,292	88,076
Professional Development	81,714	62,762
Supplies	64,654	52,788
Operating Fees and Services	62,902	50,363
IT Equipment Over \$5,000	15,433	15,453
Other Operating Expenditures	275,514	101,307
Transfers Out	15,166	12,758
Total Expenditures and Other Uses	<u>\$ 18,509,415</u>	<u>\$ 27,177,567</u>

Statement of Appropriations

For The Biennium Ended June 30, 2011

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	\$ 16,910,525	\$ 173,520	\$ 17,084,045	\$ 16,584,084	\$ 499,961
Operating Expenses	8,079,814	24,574	8,104,388	7,814,796	289,592
Capital Assets	58,000		58,000	30,886	27,114
Integrated Tax System	10,230,247		10,230,247	10,230,247	
Homestead Tax Credit	5,964,000	1,499,000	7,463,000	7,423,660	39,340
Disabled Veteran Tax Credit	3,000,000	611,000	3,611,000	3,603,311	7,689
Totals	<u>\$ 44,242,586</u>	<u>\$ 2,308,094</u>	<u>\$ 46,550,680</u>	<u>\$ 45,686,984</u>	<u>\$ 863,696</u>
Expenditures by Source:					
General Fund	\$ 44,046,586	\$ 2,283,520	\$ 46,330,106	\$ 45,272,048	\$ 858,058
Other Funds	196,000	24,574	220,574	214,936	5,639
Totals	<u>\$ 44,242,586</u>	<u>\$ 2,308,094</u>	<u>\$ 46,550,680</u>	<u>\$ 45,686,984</u>	<u>\$ 863,697</u>

Appropriation Adjustments:

The \$173,520 increase in the Salaries and Benefits line item was for market equity increases for classified state employees and for the Government Internship Stipend Program. The appropriated funds for market equity increases were approved by the 60th Legislative Assembly within Senate Bill 2189 and amounted to \$470,000. Salaries and Benefits were decreased by \$300,000 as described below. \$3,520 of the adjustment is for the Government Internship Stipend Program by Office of Management and Budget Human Resource Management Services.

The \$24,574 increase in the Operating Expenses line was remaining available funds appropriated. Pursuant to House Bill 1006, section 5 of the 2009 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 2009-2011 biennium.

The \$1,499,000 increase in the Homestead Tax Credit is due to \$1,349,000 additional appropriation per Senate Bill 2023 of the 2011 Session Laws enacted as an emergency measure. An additional \$150,000 was transferred from the Salaries and Benefits line as approved by the Emergency Commission to fund additional Homestead Tax Credit claimed.

The \$611,000 increase in the Disabled Veteran Tax Credit is due to \$461,000 additional appropriation per Senate Bill 2023 of the 2011 Session Laws enacted as an emergency measure. An additional \$150,000 was transferred from the Salaries and Benefits line as approved by the Emergency Commission to fund additional Disabled Veteran Tax Credit claimed.

Internal Control

In our audit for the biennium ended June 30, 2011, 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 GenTax 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 the Office of the State Tax Commissioner in a management letter dated March 23, 2012.

Compliance With Legislative Intent

In our audit for the biennium June 30, 2011, we identified and tested the Office of the State Tax Commissioner's compliance with legislative intent for the following areas we determined to be significant and of higher risk of noncompliance:

- Deposit of taxes to proper funds, including:
 - Motor Fuel Tax (NDCC 57-43.1-28)
 - Special Fuels Tax (NDCC 57-43.2-19)
 - Sales and Use Tax (NDCC 57-39.2-20)
 - Income Tax (NDCC 57-38-55)
 - Motor Vehicle Excise Tax (NDCC 57-40.3-10)
 - Aviation Fuel Tax (NDCC 57-43.3-06,07)
 - Coal Severance Tax (NDCC 57-61-10)
 - Oil Extraction Tax (NDCC 57-51.1-06)
 - Cigarette/Tobacco Tax (NDCC 57-36-31,32)
 - Telecommunications Tax (NDCC 57-34-05)
 - Sales and Use Tax Deposit Fund (NDCC 57-39.2-12(3))
 - Motor Fuel Cash Bond Deposit Fund (NDCC 57-43.1-14(5))
- 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))
 - Corporate Income Refund Reserve Fund (NDCC 57-38-40.1)
 - Individual Income Refund Reserve Fund (NDCC 57-38-40.1)
 - Oil Extraction Tax Development Trust Fund (NDCC 57-51.1-07)
- Proper certifications to the State Treasurer's Office, including:
 - City Sales Taxes (NDCC 57-01-02.1)
 - Homestead Tax Credit (NDCC 57-02-08.2)
 - Disabled Veterans Tax Credit (NDCC 57-02-08.8)
 - Taxation of Express and Air Transportation Companies (NDCC 57-32-04)
 - Electric Generation, Distribution, and Transmission Tax (NDCC 57-33.2-18)
 - Financial Institutions Tax (NDCC 57-35.3-09)
 - Oil and Gas Gross Production Tax (NDCC 57-51-15)
 - Oil Extraction Tax (NDCC 57-51.1-06)
 - Coal Conversion Tax (NDCC 57-60-13)
 - Coal Severance Tax (NDCC 57-61-01.5)
- Proper use of the State Treasurer (State Constitution, article X, section 12).
- Compliance with appropriations and related transfers (2009 North Dakota Session Laws chapter 6).
- Compliance with OMB's Purchasing Procedures Manual.
- Travel-related expenditures are made in accordance with OMB policy and state statute.
- Adequate blanket bond coverage of employees (NDCC section 26.1-21-08).
- Compliance with fixed asset requirements including record keeping, surplus property, lease and financing arrangements in budget requests, and lease analysis requirements.
- Compliance with payroll-related laws including statutory salaries for applicable elected and appointed positions, and certification of payroll.

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 require 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 no instances of noncompliance that are required to be reported under *Government Auditing Standards*. Thus, we concluded there was compliance with the legislative intent identified above.

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.

Management Letter (Informal Recommendations)

March 23, 2012

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, 2011, 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.

INFORMATION SYSTEMS

Informal Recommendation 11-1: We recommend the Office of the Tax Commissioner review and document access rights in GenTax on a regular basis.

GENERAL

Informal Recommendation 11-2: We recommend the Office of the Tax Commissioner require employees to acknowledge the Fraud Policy on an annual basis and to include standards in their Code of Business Conduct Policy to promote:

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

Management of the Office of the State Tax Commissioner agreed with these recommendations.

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,

A handwritten signature in cursive script, appearing to read "Angela Klubberud". The signature is written in dark ink and is positioned above the printed name.

Angela Klubberud
Auditor in-charge

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Division of State Audit

Office of the State Auditor
600 East Boulevard Avenue – Department 117
Bismarck, ND 58505-0060

(701) 328-2241