

Office of the State
Tax Commissioner
BISMARCK, NORTH DAKOTA

Audit Report

For the Biennium Ended
June 30, 2013

ROBERT R. PETERSON
STATE AUDITOR



Office of the State Auditor
Division of State Audit

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Contents

<i>Transmittal Letter</i>	<i>1</i>
<i>Executive Summary</i>	<i>2</i>
<i>Introduction</i>	<i>2</i>
<i>Responses to LAFRC Audit Questions</i>	<i>2</i>
<i>LAFRC Audit Communications</i>	<i>3</i>
<i>Audit Objectives, Scope, and Methodology</i>	<i>4</i>
<i>Discussion and Analysis</i>	<i>6</i>
<i>Financial Summary</i>	<i>6</i>
<i>Taxes Collected by the State in a Trustee Capacity</i>	<i>6</i>
<i>Financial Statements</i>	<i>7</i>
<i>Statement of Revenues and Expenditures</i>	<i>7</i>
<i>Statement of Appropriations</i>	<i>8</i>
<i>Internal Control</i>	<i>9</i>
<i>Lack of Background Checks for Temporary Employees (Finding 13-1)</i>	<i>9</i>
<i>Compliance With Legislative Intent</i>	<i>11</i>
<i>Adjustments of Assessed Tax (Finding 13-2)</i>	<i>13</i>
<i>Operations</i>	<i>14</i>
<i>Management Letter (Informal Recommendations)</i>	<i>15</i>

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Transmittal Letter

May 6, 2014

The Honorable Jack Dalrymple, Governor
Members of the North Dakota Legislative Assembly
The Honorable Ryan Rauschenberger, Tax Commissioner

We are pleased to submit this audit of the Office of the State Tax Commissioner for the biennium ended June 30, 2013. 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 Delan Hellman. 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 Rauschenberger 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 certain items be addressed by auditors performing audits of state agencies. Those items and the Office of the State Auditor's responses 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 unmodified opinion was issued.

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

Other than our finding addressing "Adjustments of Assessed Tax" (page 13), the Office of the State Tax Commissioner was in compliance with significant statutes, laws, rules, and regulations under which it was created and is functioning.

3. Was internal control adequate and functioning effectively?

Other than our finding addressing the "Lack of Background Checks for Temporary Employees" (page 9), we determined internal control was adequate.

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 15 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, Human Resource Management System (HRMS), Financial Institutions Tax System, and GenTax System 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, 2013 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, 2013. 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 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 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, 2013, operations of the Office of the State Tax Commissioner were primarily supported by appropriations from the state's general fund.

Financial Summary

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, and income taxes were the result of a strong economy in North Dakota, increased oil production, and higher oil prices during the biennium. Total revenues were \$4,856,088,055 for the year ended June 30, 2013 as compared to \$3,735,080,710 for the year ended June 30, 2012.

Total expenditures for the Office of the State Tax Commissioner were \$19,325,267 for the year ended June 30, 2013 as compared to \$18,243,598 for the prior year. Expenditures remained fairly constant during the biennium.

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, lodging and restaurant, and motor vehicle rental taxes collected pursuant to these sections, net of refunds, were \$216,446,962 for the year ended June 30, 2013 as compared to \$201,720,504 for the prior year.

Financial Statements

Statement of Revenues and Expenditures

	<u>June 30, 2013</u>	<u>June 30, 2012</u>
<u>Revenues and Other Sources:</u>		
Natural Resource Taxes	\$2,456,781,758	\$1,712,472,666
Sales and Use Taxes (Net of Refunds)	1,506,135,626	1,349,407,063
Income Taxes (Net of Refunds)	867,485,598	648,149,151
Business Taxes	25,545,005	24,920,679
Alcohol License Fees	67,931	59,950
Estate Gift Tax	27,500	1,112
Miscellaneous Revenue	44,637	70,089
Total Revenues and Other Sources	<u>\$4,856,088,055</u>	<u>\$3,735,080,710</u>
<u>Expenditures and Other Uses:</u>		
Salaries and Benefits	\$8,971,901	\$8,638,788
Homestead Tax Credit	3,925,817	3,887,250
Disabled Veterans Tax Credit	2,604,221	2,299,511
Major Operating Expenditures:		
Professional Services	1,847,930	1,805,617
Postage	437,570	396,573
IT Data Processing	388,635	474,377
Equipment Under \$5,000	274,035	48,291
Travel	160,050	152,555
IT Communications	97,266	92,614
Printing	89,194	62,376
Professional Development	86,321	70,593
Supplies	81,755	76,280
Operating Fees and Services	64,577	46,357
IT Software	51,941	34,362
Other Operating Expenditures	226,389	141,840
Transfers Out	17,665	16,214
Total Expenditures and Other Uses	<u>\$19,325,267</u>	<u>\$18,243,598</u>

Statement of Appropriations

For The Biennium Ended June 30, 2013

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	\$ 18,797,710	\$	\$ 18,797,710	\$ 17,610,689	\$ 1,187,021
Operating Expenses	7,398,031	115,000	7,513,031	7,200,333	312,698
Capital Assets	16,000	50,000	66,000	7,164	58,836
Homestead Tax Credit	8,792,788		8,792,788	7,832,393	960,395
Disabled Veteran Tax Credit	4,243,920	981,855	5,225,775	4,918,284	307,491
Totals	<u>\$ 39,248,449</u>	<u>\$ 1,146,855</u>	<u>\$ 40,395,304</u>	<u>\$ 37,568,863</u>	<u>\$ 2,826,441</u>
Expenditures by Source:					
General Fund	\$ 39,238,449	\$ 1,031,855	\$ 40,270,304	\$ 37,552,023	\$ 2,718,281
Other Funds	10,000	115,000	125,000	16,840	108,160
Totals	<u>\$ 39,248,449</u>	<u>\$ 1,146,855</u>	<u>\$ 40,395,304</u>	<u>\$ 37,568,863</u>	<u>\$ 2,826,441</u>

Appropriation Adjustments:

A \$65,000 increase to the Operating Expenses line and the \$50,000 increase to the Capital Assets line were properly approved by the Emergency Commission for additional spending authority to accept federal funds from the Federal Highway Administration for the Office of the State Tax Commissioner's Motor Fuel Tax enforcement program.

The remaining \$50,000 increase to the Operating Expenses line was authorized by Senate Bill 2006 of the 2011 Session Laws, Section 5, to allow \$50,000 of carryover authority from the 2009 Legislative Session to be used for a grant to NDSU for the preparation of agricultural land valuations.

The \$981,855 increase to the Disabled Veteran Tax Credit line is due to an additional appropriation per House Bill 1023 of the 2013 Session Laws, enacted as an emergency measure.

Internal Control

In our audit for the biennium ended June 30, 2013, 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

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 that internal control was not adequate, noting a certain matter involving internal control and its operation that we consider to be a significant deficiency.

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 identified the following significant deficiency in internal control. We also noted one other matter involving internal control that we have reported to management of the Office of the State Tax Commissioner in a management letter dated May 6, 2014.

Lack of Background Checks for Temporary Employees (Finding 13-1)

Condition:

The Office of the State Tax Commissioner hires up to 40 temporary employees during the income tax season each year. These temporary employees have access to tax records and are not subject to any criminal history background checks.

Criteria:

North Dakota Century Code section 57-38-57 states the Tax Commissioner, the Tax Commissioner's deputies, agents, clerks, and other officers and employees may not divulge nor make known, in any manner, whether or not any report or return has been filed, the amount of income, or any particulars set forth or disclosed in any report or return. In order to ensure the secrecy of this information, an important component would be to perform background checks on all employees who have access to these tax records.

Cause:

The Office of the State Tax Commissioner does not feel the cost/benefit for the background checks is sufficient to make it a requirement for temporary employees.

Effect or Potential Effect:

The Office of the State Tax Commissioner could potentially hire someone with a criminal background and give them access to individual's financial records and social security numbers.

Recommendation:

We recommend the Office of the State Tax Commissioner ensure all employees with access to tax records be subjected to a criminal history background check.

Office of the State Tax Commissioner Response:

The Office of State Tax Commissioner agrees with this recommendation.

Compliance With Legislative Intent

In our audit for the biennium ended June 30, 2013, 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:

- The transfer from the Motor Vehicle Fuel Tax Fund to the General Fund was completed properly (Senate Bill 2006, section 3 of the 2011 Legislative Session).
- The proper alcohol direct shipping permit fee is being collected (NDCC 5-01-16 (5)).
- The proper domestic wine or distillery license fee is being collected (NDCC 5-01-17 (1) and NDCC 5-01-19 (1)).
- Revenue from generation taxes was properly allocated (NDCC 7-33.2-19).
- Proper individual and corporate income levels and tax rates are being used (NDCC 57-38-30.3 and NDCC 57-38-30).
- The maximum administrative expenses amount withheld by retailers for sales and use tax is not exceeded (NDCC 57-40.2-07.1).
- The proper amount was withheld from the State Aid Distribution Fund and deposited in the Agricultural Land Valuation Fund (NDCC 57-02-27.2 (10)).
- The annual and lifetime limits were followed when taxpayers applied for the Angel Fund Investment Credit (NDCC 57-38-01.26).
- Assessments made for non-filers are not reviewable (NDCC 57-38-39).
- The machinery or equipment sales tax exemption limit for each new mine was not exceeded (NDCC 57-39.2-04.8).
- Retailer compensation is granted only when sales tax returns are filed timely (NDCC 57-39.2-12.1).
- The certification given to the Office of Management and Budget and the Office of the State Treasurer on oil and gas tax revenue collections was proper (Senate Bill 2371, section 23 and section 27 of the 2011 Special Legislative Session).
- Deposit of taxes to the proper funds, including:
 - Telecommunications Tax (NDCC 57-34-05).
 - Cigarette Tax (NDCC 57-36-32).
 - Income Tax (NDCC 57-38-55).
 - Sales and Use Tax (NDCC 57-39.2-20, 57-39.2-26).
 - Motor Vehicle Excise Tax (NDCC 57-40.3-10).
 - Motor Fuels Cash Bond Deposit Fund (NDCC 57-43.1-14, 57-43.2-07, 57-43.3-09).
 - Motor Fuel Tax (NDCC 57-43.1-28).
 - Special Fuels Tax (NDCC 57-43.2-19).
 - Aviation Fuels Tax (NDCC 57-43.3-02, 57-43.3-04, 57-43.3-06, 57-43.3-07).
 - Oil Extraction Tax (NDCC 57-51.1-06).
 - Coal Severance Tax (NDCC 57-61-10).
- Proper use of legally restricted funds, including:
 - Sales and Use Tax Deposit Fund (NDCC 57-39.2-12(3)).
 - Motor Fuel Cash Bond Deposit Fund (NDCC 57-43.3-14(5)).
 - 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).
- City Lodging Tax Suspense Fund (NDCC 57-01-02.1).
- Oil Extraction Tax Development Trust Fund (NDCC 57-51.1-07).
- Proper certifications to the State Treasurer's Office, including:
 - Jobs Training Fund (52-02.1-03).
 - 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).
 - Agricultural Land Valuation (NDCC 57-02-50).
 - Taxation of Express and Air Transportation Companies (NDCC 57-32-04).
 - Electric Generation, Distribution, and Transmission Tax (NDCC 57-33.2-18).
 - Telecommunications Carriers Tax (NDCC 57-34-05).
 - Financial Institutions Tax (NDCC 57-35.3-09).
 - Estate Tax (NDCC 57-37.1-08).
 - Oil and Gas 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 authorization of the Office of State Tax Commissioner's funds.
- Proper use of the State Treasurer (State Constitution, article X, section 12).
- Compliance with appropriations and related transfers (2011 North Dakota Session Laws chapter 32).
- 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 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 an 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. We also noted a certain inconsequential instance of noncompliance that we have reported to management of the Office of the State Tax Commissioner in a management letter dated May 6, 2014.

Adjustments of Assessed Tax (Finding 13-2)

Condition:

The Office of the State Tax Commissioner was not in compliance with North Dakota Century Code section 57-38-39(7) which states if a taxpayer fails to file a return and the Tax Commissioner assesses the tax, it is not reviewable. We noted two instances where the Tax Commissioner assessed the income tax owed for non-filing taxpayers based on the best information available, then, after the account became delinquent, adjusted the tax down to the amount owed through a negotiated legal settlement.

Criteria:

North Dakota Century Code section 57-38-39(7) states if the Tax Commissioner determines the North Dakota taxable income of a taxpayer according to the best information available and assesses any tax due, the amount so assessed is not reviewable.

Cause:

The Office of the State Tax Commissioner feels they have the authority to adjust an assessed tax if better information becomes available at a later date.

Effect or Potential Effect:

Noncompliance with state law.

Recommendation:

- We recommend the Office of the State Tax Commissioner comply with North Dakota Century Code section 57-38-39(7) and consider any assessed tax final and not reviewable; or
- Introduce legislation to allow the Office of the State Tax Commissioner to accept, for legal settlement purposes, an amount that differs from the final and nonreviewable assessment amount.

Office of the State Tax Commissioner Response:

The North Dakota Supreme Court has established that state agencies have implied powers in addition to powers specifically granted in statute. The Tax Commissioner has implied power to negotiate and settle unpaid tax debt through a legal settlement process when in the best interests of the state. This authority is used to avoid litigation, encourage a taxpayer to comply with the tax laws, and to collect only those tax dollars which are, in fact, due the State of North Dakota.

Although we believe the Tax Commissioner has implied power to negotiate a legal settlement of a fixed assessment, the Department will pursue a statutory change to clarify the authority of the Tax Commissioner. The Department has prepared a bill draft to amend NDCC Section 57-01-11 to provide statutory authority for the Commissioner to accept, for legal settlement purposes, an amount that differs from the fixed assessment amount when a taxpayer fails or is unable to pay the tax and the account is in a collection status.

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)

May 6, 2014

The Honorable Ryan Rauschenberger
ND Tax Commissioner
Office of the State Tax Commissioner
600 E Boulevard Avenue
Bismarck, ND 58505

Dear Mr. Rauschenberger:

We have performed an audit of the Office of the State Tax Commissioner for the biennium ended June 30, 2013, 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.

ACCOUNTS PAYABLE/EXPENDITURES

Informal Recommendation 13-1: We recommend the Office of the State Commissioner ensure the Homestead Tax Credit application is properly approved.

LEGISLATIVE INTENT

Informal Recommendation 13-2: We recommend the Office of the State Commissioner comply with NDCC 57-39.2-12.1 and only allow compensation adjustments to be claimed if the tax due is paid within the time limitations.

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 that reads "Delan Hellman".

Delan Hellman
Auditor in-charge

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