

Office of the State
Tax Commissioner
BISMARCK, NORTH DAKOTA

Audit Report

For the Biennium Ended
June 30, 2015

ROBERT R. PETERSON
STATE AUDITOR



Office of the State Auditor
Division of State Audit

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

Transmittal Letter

May 23, 2016

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, 2015. 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 that 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?

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 all 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 13 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, 2015 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, 2015. 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 has operations in the following locations. Each location was included in the audit scope:

- The central office in the State Capitol.
- Remote offices in Dickinson, Fargo, Grand Forks, Minot, and Williston.

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 Office of the State Tax Commissioner's processes and procedures.
- Performed a detailed review of the Motor Fuels Program including:
 - Established policies and procedures;
 - Qualifications of staff;
 - Application review;
 - Inspections;
 - Enforcement processes; and
 - Management analysis processes.
- Performed a detailed review of the Alcohol Tax License Program including:
 - Established policies and procedures;
 - Qualifications of staff;
 - Application review;
 - Inspections;
 - Complaint handling;
 - Enforcement processes; and
 - Management analysis processes.

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, 2015, 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, business, and telecommunication taxes. Other revenues during the audit period include pre-paid wireless emergency 911 fees, alcohol license fees, and miscellaneous revenue.

Natural Resource Taxes decreased in the second half of the biennium due to a drop in the price of oil which caused a downturn in oil production in the western part of the state. Sales and Use Tax for the same period increased due to a strong population and robust (but slowing) oil industry. Total revenues were \$5,256,366,206 for the year ended June 30, 2015 as compared to \$5,649,481,322 for the year ended June 30, 2014.

Total expenditures and other uses for the Office of State Tax Commissioner were \$24,863,247 for the year ended June 30, 2015 as compared to \$21,743,574 for the prior year. The increase in total expenditures for the audited period reflects primarily an increase in homestead tax credits due to legislative expansion of the program to allow more homeowners to qualify for the credit. Increases were also noted in professional services along with salaries and benefits. All other expenditures remained fairly constant.

Analysis of Significant Variances - Budgeted and Actual Expenditures

The excess of the Homestead Tax Credit appropriation line and the Disabled Veteran Tax Credit appropriation line over actual expenditures were both due to the Office of State Tax Commissioner receiving less applications for each program than anticipated.

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 North Dakota Century Code (NDCC) section 57-01-02.1 for any incorporated city or county that has adopted the home rule provisions of NDCC chapters 40-05.1 or 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 chapter 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 chapter 57-39.2. Sales, lodging, lodging and restaurant, and motor vehicle rental taxes collected pursuant to these sections and chapters, net of refunds, were \$270,755,912 for the year ended June 30, 2015 as compared to \$240,052,871 for the prior year.

Financial Statements

Statement of Revenues and Expenditures

	<u>June 30, 2015</u>	<u>June 30, 2014</u>
<u>Revenues and Other Sources:</u>		
Natural Resource Taxes	\$2,848,430,539	\$3,292,158,985
Sales and Use Tax (Net of Refunds)	1,655,861,883	1,581,716,636
Income Taxes (Net of Refunds)	722,169,271	748,965,512
Business Taxes	16,250,875	14,652,145
Telecommunication Taxes (Net of Refunds)	12,601,228	11,631,089
Pre-Paid Wireless Emergency 911 Fees (Net of Refunds)	925,710	135,643
Alcohol License Fees	82,861	77,100
Miscellaneous Revenue	43,839	144,212
Total Revenues and Other Sources	<u>\$5,256,366,206</u>	<u>\$5,649,481,322</u>
<u>Expenditures and Other Uses:</u>		
Salaries and Benefits	\$10,370,524	\$9,687,925
Homestead Tax Credit	7,236,269	5,625,448
Disabled Veterans Tax Credit	2,640,811	2,754,964
Major Operating Expenditures:		
Professional Services	2,673,922	1,926,373
Postage	481,639	452,111
IT Data Processing	424,404	414,865
Equipment Under \$5,000	224,657	63,743
Supplies	175,740	168,722
Travel	126,599	144,912
Professional Development	87,746	77,357
IT Communications	82,067	92,904
Printing	81,625	88,712
Other Operating Expenditures	225,369	218,770
Transfers Out	31,875	26,768
Total Expenditures and Other Uses	<u>\$24,863,247</u>	<u>\$21,743,574</u>

Statement of Appropriations

For The Biennium Ended June 30, 2015

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	\$ 20,138,488	\$ 81,000	\$ 20,219,488	\$ 19,883,005	\$ 336,483
Accrued Leave Payments	624,818		624,818	175,443	449,375
Operating Expenses	8,721,834	22,609	8,744,443	8,232,238	512,205
Capital Assets	16,000		16,000		16,000
Homestead Tax Credit	20,000,000		20,000,000	12,901,093	7,098,907
Disabled Veteran Tax Credit	7,678,000		7,678,000	5,415,042	2,262,958
Totals	<u>\$ 57,179,140</u>	<u>\$ 103,609</u>	<u>\$ 57,282,749</u>	<u>\$ 46,606,821</u>	<u>\$ 10,675,928</u>
Expenditures by Source:					
General Fund	\$ 57,054,140	\$ 103,609	\$ 57,157,749	\$ 46,587,141	\$ 10,570,608
Other Funds	125,000		125,000	19,680	105,320
Totals	<u>\$ 57,179,140</u>	<u>\$ 103,609</u>	<u>\$ 57,282,749</u>	<u>\$ 46,606,821</u>	<u>\$ 10,675,928</u>

Appropriation Adjustments:

The \$81,000 increase to the Salaries and Benefits line item was a supplemental appropriation made by the 2013 Legislative Assembly under section 6 of House Bill 1015. These adjustments were approved by the Emergency Commission. The funds are for temporary salary increases for employees in areas affected by energy development.

The \$22,609 increase to the Operating Expenses line item was authorized by House Bill 1006, section 3, of the 2013 Session Laws to be paid to North Dakota State University and used for the preparation of agricultural land valuations.

Internal Control

In our audit for the biennium ended June 30, 2015, we identified the following areas of the Office of 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 *Standards for Internal Control in the Federal Government* issued by the Comptroller General of the United States (Green Book, GAO-14-704G). Agency management must establish and maintain effective internal control in accordance with policy of the Office of Management and Budget (OMB Policy 216).

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.

Compliance With Legislative Intent

In our audit for the biennium ended June 30, 2015, 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:

- A grant was properly issued to North Dakota State University (House Bill 1006 of the 2013 Legislative Session).
- The proper brewer taproom license fee is being collected (NDCC 5-01-21).
- The proper alcohol tax rates are charged and are deposited in the proper fund (NDCC 5-03-07 and NDCC 5-03-08).
- Compliance with retention bonus laws (NDCC 54-06-31).
- A \$5,000 penalty is being charged when applicable for failure to furnish a public utility report for three consecutive years (NDCC 57-06-09.1).
- The proper individual income tax rates are being used (NDCC 57-38-30.3).
- The proper electric distribution tax rate is being used (NDCC 57-33.2-03).
- The annual and lifetime limits were followed when taxpayers applied for the Angel Fund Investment Credit (NDCC 57-38-01.26).
- North Dakota Century Code was updated to allow for the ability of the Tax Commissioner to update the assessed tax amount for legal settlement purposes (NDCC 57-38-39(7)).
- Administrative expenses are being allowed properly for filing sales tax returns (NDCC 57-39.2-12.1).
- The proper amount was deposited into the State Aid Distribution Fund (NDCC 57-39.2-26.1).
- The maximum amount being withheld by retailers for administrative expenses does not exceed \$110 per return (NDCC 57-40.2-07.1).
- The proper prepaid wireless fee amounts are being collected and deposited into the Prepaid Wireless 911 Fee Fund (NDCC 57-40.6-15).
- The proper amount withheld from fuel tax refunds is being deposited into the Agricultural Research Fund (NDCC 57-43.1-03.1).
- The proper fee amounts are being collected and deposited into the State Highway Fund related to penalties for using dyed special fuel improperly (NDCC 57-43.2-41).
- 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)).
 - Prepaid Wireless Emergency 911 Fee Fund (NDCC 57-40.6-15).
 - 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:
 - City Sales Tax (NDCC 57-01-02.1).
 - Property Tax (NDCC 57-20-07.2).
 - Senior Citizens (NDCC 57-39.2-26.2).
 - 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).
- Application of proper statutory rates relating to revenue.
- 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 (2013 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, annual inventory, 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.

While we did not find any items that were required to be reported in accordance with *Government Auditing Standards*, we noted certain inconsequential or insignificant instances of non-compliance that we have reported to management of the Office of the State Tax Commissioner in a management letter dated May 23, 2016.

Operations

This audit did not identify areas of the Office of State Tax Commissioner's operations where we determined it was practical at this time to help to improve efficiency or effectiveness. However, we did note certain matters involving operations that we have reported to management of the Office of the State Tax Commissioner in a management letter dated May 23, 2016.

Management Letter (Informal Recommendations)

May 23, 2016

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, 2015, 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.

OPERATIONAL IMPROVEMENTS

Informal Recommendation 15-1: We recommend the Office of the State Tax Commissioner ensure all employees sign acknowledgement of receipt and compliance with the code of ethics policy.

Informal Recommendation 15-2: We recommend the Office of the State Tax Commissioner's Alcohol Beverage Section develop an initial training schedule for new employees.

Informal Recommendation 15-3: We recommend the Office of the State Tax Commissioner's Motor Fuel Section develop policies and procedures for staff that addresses:

- Guidance on waiving penalty and interest;
- Inspection process of the submitted fuel tax schedules and reports; and
- Licensing process.

Informal Recommendation 15-4: We recommend the Office of the State Tax Commissioner's Alcohol Beverage Section develop a policy to ensure regulatory quality exists, such as periodic reviews of program regulations and processes.

Informal Recommendation 15-5: We recommend the Office of the State Tax Commissioner's Alcohol Beverage Section develop policies and procedures surrounding their enforcement process to ensure a systematic and fair process. These policies and procedures should include guidelines and documentation required for waiving/reducing penalty amounts.

Informal Recommendation 15-6: We recommend the Office of the State Tax Commissioner's Motor Fuel Section supervisor document their review of all motor fuel section audits.

GENERAL

Informal Recommendation 15-7: We recommend the Office of the State Tax Commissioner ensure all employees receive annual performance evaluations in accordance with North Dakota Administrative Code section 4-07-10-04.

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

I encourage you to call me 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,



Delan Hellman
Auditor in-charge

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