PERFORMANCE AUDIT
OF THE

# SINGLE BUSINESS TAX PROGRAM WITHIN THE RETURN PROCESSING AND CUSTOMER CONTACT DIVISIONS

DEPARTMENT OF TREASURY

April 2004

27-240-02

"...The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof."

– Article IV, Section 53 of the Michigan Constitution

Audit report information may be accessed at:
*http://www.state.mi.us/audgen/*

Michigan

*Office of the Auditor General*

# REPORT SUMMARY

*Performance Audit*

*Single Business Tax Program Within the Return Processing and Customer Contact Divisions*

*Department of Treasury*

**Report Number:**
**27-240-02**

**Released:**
**April 2004**

*All persons and entities engaged in business activity within Michigan may be subject to the single business tax (SBT) in accordance with the SBT Act of 1975. All SBT collected is credited to the State's General Fund. The Return Processing Division (RPD) administers the SBT Act for consistent and uniform compliance by the persons subject to SBT. The Customer Contact Division (CCD) provides resolution of customers' SBT inquiries and registers and licenses new businesses.*

***Audit Objectives:***

1. To assess the effectiveness and efficiency of RPD's management controls over the administration of the SBT Program.

2. To assess the effectiveness and efficiency of CCD's management controls over the resolution of taxpayer and practitioner inquiries and the performance of its business registration functions pertaining to the SBT Program.

3. To assess RPD's and CCD's compliance with applicable statutes, rules and regulations, and Department policies and procedures pertaining to the SBT Program.

~ ~ ~ ~ ~ ~ ~ ~ ~ ~

***Audit Conclusions:***

1. RPD's management controls over the administration of the SBT Program were marginally effective and efficient.

2. CCD's management controls were generally effective and efficient in resolving taxpayer and practitioner inquiries and performing its business registration functions pertaining to the SBT Program.

3. RPD and CCD generally complied with applicable statutes, rules and regulations, and Department policies and procedures pertaining to the SBT Program.

~ ~ ~ ~ ~ ~ ~ ~ ~ ~

***Material Conditions:***

RPD had not established effective management controls to minimize the risk of unauthorized access to and use of the SBT System (Finding 1). In addition, CCD had not established effective management controls related to Michigan Taxpayer Database (MTDB) system access and security (Finding 8). By establishing effective management controls over user access to its systems, RPD and CCD could minimize the risk that such users

inappropriately use their access to modify critical system information or obtain personal taxpayer information and use it to commit financial crimes, such as identity fraud or fraudulent refunds.

~ ~ ~ ~ ~ ~ ~ ~ ~ ~

***Reportable Conditions:***
In addition to the 2 material conditions, our audit disclosed 7 reportable conditions, including:

RPD needs to improve its process for ensuring that taxpayers file annual tax returns and remit the appropriate SBT as required by the SBT Act. Also, RPD needs to notify taxpayers of its intent to assess SBT when the taxpayers have not responded to delinquency notices within the required 30 days. (Finding 2)

RPD needs to improve its procedures to reduce the payment of interest on refunds. Also, RPD needs to change its policy and eliminate its practice of paying interest on undeliverable refund warrants. (Finding 3)

RPD needs to improve its management controls over the refund approval process to ensure the propriety and validity of SBT refunds (Finding 4).

~ ~ ~ ~ ~ ~ ~ ~ ~ ~

***Noteworthy Accomplishments:***
RPD established Internet filing for some of its SBT annual returns. RPD expects the Internet filing to increase SBT return accuracy and completeness and to reduce the need for data entry resources.

CCD had taken steps to resolve correspondence ineffectiveness and inefficiencies by implementing a detailed strategy and technology improvement plan to improve the call center and ensure timely response to customer inquiries.

~ ~ ~ ~ ~ ~ ~ ~ ~ ~

***Agency Responses:***
Our audit report contains 9 findings and 11 corresponding recommendations. The Department of Treasury's preliminary response indicated that it agrees with the 11 recommendations.

~ ~ ~ ~ ~ ~ ~ ~ ~ ~

A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: http://audgen.michigan.gov

Michigan Office of the Auditor General
201 N. Washington Square
Lansing, Michigan 48913

**Thomas H. McTavish, C.P.A.**
Auditor General

**Scott M. Strong, C.P.A., C.I.A.**
Deputy Auditor General

STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

April 22, 2004

Mr. Jay B. Rising
State Treasurer
Treasury Building
Lansing, Michigan

Dear Mr. Rising:

This is our report on the performance audit of the Single Business Tax Program Within the Return Processing and Customer Contact Divisions, Department of Treasury.

This report contains our report summary; description of program and agencies; audit objectives, scope, and methodology and agency responses and prior audit follow-up; comments, findings, recommendations, and agency preliminary responses; and a glossary of acronyms and terms.

Our comments, findings, and recommendations are organized by audit objective. The agency preliminary responses were taken from the agency's responses subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General

This page left intentionally blank.

## TABLE OF CONTENTS

## SINGLE BUSINESS TAX PROGRAM WITHIN THE RETURN PROCESSING AND CUSTOMER CONTACT DIVISIONS


| | Page |
|---|---|
| INTRODUCTION | |
| Report Summary | 1 |
| Report Letter | 3 |
| Description of Program and Agencies | 7 |
| Audit Objectives, Scope, and Methodology and Agency Responses and Prior Audit Follow-Up | 9 |
| COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES | |
| Effectiveness and Efficiency of the Return Processing Division's Management Controls | 12 |
| 1. SBT System Access Controls | 12 |
| 2. Delinquent Taxpayers | 15 |
| 3. Refund Interest | 17 |
| 4. Refund Approvals | 20 |
| 5. Continuous Quality Improvement (CQI) Process | 22 |
| 6. Critical Activities | 26 |
| 7. Management Information Reports | 28 |
| Effectiveness and Efficiency of the Customer Contact Division's Management Controls | 29 |
| 8. MTDB Access Controls | 29 |
| Compliance With Applicable Statutes, Rules and Regulations, and Department Policies and Procedures | 32 |
| 9. Records Retention and Disposal Schedule | 32 |

GLOSSARY

Glossary of Acronyms and Terms 35

## Description of Program and Agencies

Single Business Tax (SBT) Program

In 1975, the Michigan Legislature approved Act 228, P.A. 1975, the SBT Act (Sections 208.1 - 208.145 of the *Michigan Compiled Laws*), which prescribed a tax for the privilege of doing business in Michigan. SBT was enacted to replace profit-based taxation with value-added taxation*. As a result, SBT replaced six business taxes (including corporate income tax) and one local property tax into a single tax, hence the name "single" business tax. Act 115, P.A. 1999, implemented a phase out of SBT over 22 subsequent years through an annual SBT rate reduction. However, Act 531, P.A. 2002, repealed SBT entirely for tax years beginning after December 31, 2009.

All persons and entities engaged in business activity within Michigan and persons and entities engaged in business activity both within and outside Michigan may be subject to SBT. All persons meeting SBT qualifications and whose adjusted gross receipts were $250,000 or more in a tax year are required to file an annual SBT return. In January 2003, the gross receipts filing threshold increased to $350,000. Persons must file quarterly estimates with payment if their estimated liability for the tax year is over $600.

All SBT collected is credited to the State's General Fund. In fiscal year 2001-02, SBT accounted for 10% of total taxes and fees and 24% of General Fund taxes collected by the Department of Treasury during the fiscal year. The SBT amounts collected from and refunded to taxpayers during October 1, 1999 through August 31, 2002 were as follows:

| Fiscal Year | Gross SBT Collections | SBT Refunds |
|---|---|---|
| 1999-2000 | $ 2,581,531,000 | $ 217,096,000 |
| 2000-01 | $ 2,428,120,000 | $ 263,972,000 |
| 2001-02 | $ 2,348,843,000 | $ 296,604,000 |

Return Processing Division (RPD)

RPD administers the SBT Act for consistent and uniform compliance by the persons subject to SBT. RPD's objectives* for the SBT Program included collecting, processing, and reviewing SBT returns; correcting or disallowing questionable or erroneous SBT returns; certifying the propriety of SBT transactions; initiating and evaluating SBT

** See glossary at end of report for definition.*

adjustments and assessments for SBT deficiencies, penalty, and interest; and initiating refunds for SBT overpayments. Also, RPD collects SBT annual and estimated payments and maintains SBT taxpayer accounts.

RPD's SBT Section had 19 employees as of August 31, 2002 and expended $1,145,188 from October 1, 2001 through August 31, 2002.

Customer Contact Division (CCD)

CCD's mission* for the SBT Program is to provide timely first-stop resolution of customers' SBT inquiries and to promptly register and license new businesses. CCD also issues SBT return forms and maintains the Michigan Taxpayer Database.

CCD's Business Taxes Section had 11 employees as of August 31, 2002 and expended $616,705 from October 1, 2001 through August 31, 2002.

* *See glossary at end of report for definition.*

## Audit Objectives, Scope, and Methodology and Agency Responses and Prior Audit Follow-Up

Audit Objectives

Our performance audit* of the Single Business Tax (SBT) Program Within the Return Processing and Customer Contact Divisions, Department of Treasury, had the following objectives:

1. To assess the effectiveness* and efficiency* of the Return Processing Division's (RPD's) management controls* over the administration of the SBT Program.

2. To assess the effectiveness and efficiency of the Customer Contact Division's (CCD's) management controls over the resolution of taxpayer and practitioner inquiries and the performance of its business registration functions pertaining to the SBT Program.

3. To assess RPD's and CCD's compliance with applicable statutes, rules and regulations, and Department policies and procedures pertaining to the SBT Program.

Audit Scope

Our audit scope was to examine the program and other records of the Return Processing and Customer Contact Divisions. Our audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Audit Methodology

Our audit procedures, performed from April through September 2002, included examination of program records and activities for the period October 1, 1999 through August 31, 2002.

Our methodology included conducting a preliminary review of the Department of Treasury's operations of the SBT Program. This included interviewing Department personnel and reviewing applicable statutes, policies and procedures, reports,

* *See glossary at end of report for definition.*

management plans, and other reference material. Also, we analyzed SBT collections and refunds for significant and unexpected changes.

To accomplish our first audit objective, we interviewed RPD personnel and evaluated RPD's practices and procedures for collecting SBT, processing SBT returns, adjusting and resolving erroneous tax returns, assessing penalties and interest, and issuing refunds. Also, we examined the functions of the SBT System, an automated processing system and database, and evaluated the System's general and application controls.

To accomplish our second audit objective, we interviewed CCD personnel and evaluated CCD's practices and procedures for registering new businesses, corresponding with SBT taxpayers and practitioners, adjusting and resolving erroneous tax returns, and issuing refunds. Also, we examined the functions of the Michigan Taxpayer Database and evaluated controls over user access.

To accomplish our third audit objective, we evaluated RPD's and CCD's practices for compliance with the statutes, rules and regulations, and Department policies and procedures pertaining to the SBT Program.

Agency Responses and Prior Audit Follow-Up

Our audit report contains 9 findings and 11 corresponding recommendations. The Department of Treasury's preliminary response indicated that it agrees with the 11 recommendations.

The agency preliminary response that follows each recommendation in our report was taken from the agency's written comments and oral discussion subsequent to our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and Department of Management and Budget Administrative Guide procedure 1280.02 require the Department of Treasury to develop a formal response to our audit findings and recommendations within 60 days after release of the audit report.

We released our prior performance audit of the Single Business Tax Division, Department of Treasury (#2724096), in April 1997. Within the scope of this audit, we followed up 4 of the 8 prior audit recommendations. The Department did not comply with the 4 prior audit recommendations. Consequently, we repeated 2 prior audit recommendations and the other 2 prior audit recommendations were rewritten for inclusion in this audit report.

# COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

# EFFECTIVENESS AND EFFICIENCY OF THE RETURN PROCESSING DIVISION'S MANAGEMENT CONTROLS

## COMMENT

**Audit Objective:** To assess the effectiveness and efficiency of the Return Processing Division's (RPD's) management controls over the administration of the Single Business Tax (SBT) Program.

**Conclusion: We concluded that RPD's management controls over the administration of the SBT Program were marginally effective and efficient.** Our assessment disclosed one material condition*. RPD had not established effective management controls to minimize the risk of unauthorized access to and use of the SBT System (Finding 1).

Our assessment also disclosed reportable conditions* related to delinquent taxpayers*, refund interest, refund approvals, continuous quality improvement* (CQI) process, critical activities, and management information reports (Findings 2 through 7).

**Noteworthy Accomplishments:** In January 2002, RPD established Internet filing for the C-8030 (Notice of No SBT Return Required). In January 2003, RPD established Internet filing for the C-8000 (SBT Annual Return) and C-8044 (SBT Simplified Return). In the first year of Internet filing, several hundred taxpayers took advantage of the option. RPD expects Internet filing to increase SBT return accuracy and completeness and to reduce the need for data entry resources.

## FINDING

1. **SBT System Access Controls**

   RPD had not established effective management controls to minimize the risk of unauthorized access to and use of the SBT System.

   Effective access controls protect automated system information and resources from unauthorized modification, fraud, loss, or disclosure by restricting inappropriate access. Creating formalized procedures for granting user access to the SBT System would reduce the risk that unauthorized users and users with

* *See glossary at end of report for definition.*

excessive access rights could gain access where they may intentionally or inadvertently add, alter, or delete sensitive data or computer programs. Such users could also obtain personal taxpayer information and use it to commit financial crimes, such as identity fraud or fraudulent refunds. Periodic monitoring of SBT System user access could help to assure RPD and taxpayers that tax information will remain confidential and secure.

RPD uses the SBT System to record, process, and maintain SBT return information and related transactions, such as refunds and assessments. Confidential personal and financial taxpayer information, including taxpayer identification, address, and business income and loss amounts, is maintained in the SBT System. As of July 23, 2002, 883 persons had access to the SBT System.

*Michigan Administrative Code* R 205.1003 states that access to confidential information shall be restricted to employees who have a need to access the information to perform their duties. In addition, Department of Management and Budget Administrative Guide procedure 1310.02 states that security requirements and procedures must be documented and approved by management for each application system and that passwords must be assigned in a secure manner and promptly deleted for terminated employees.

Our review of RPD's controls over SBT System user access disclosed that RPD did not have formal procedures describing the process and criteria for granting user access to the SBT System. The RPD administrator granted users access to the SBT System by authorizing security applications, based on the users' job duties and need for access. Users were assigned their access capabilities through various transaction codes.

Our tests of SBT System users with access during our audit period disclosed:

a. RPD could not provide applications for 3 (10%) of 29 users we sampled. Also, the RPD administrator did not approve the applications for 8 (28%) of 29 users. The users' supervisors or other Department of Treasury administrators approved the applications. For all of these users, we determined that access was appropriate for the users to perform their duties.

b. RPD did not appropriately restrict SBT System access rights. RPD granted privileged access rights to 14 users through transaction code combinations

that extensively and inappropriately provided these users with SBT System access to add, modify, and delete critical information relating to refund approval levels, System tolerances, and System overrides. For example, each of the 14 individuals had the ability to process refunds and increase the refund approval dollar threshold. Also, if the users were not authorized to approve refunds, they had the ability to create the approval authority for themselves at any dollar amount. This type of access should be highly controlled and restricted to a select few users. Inappropriate access granted to SBT users occurred in part because of the lack of RPD's sufficient understanding of the transaction codes and their risk capabilities, especially in combination with other transaction codes. A thorough understanding is critical to ensure that privileged access rights are assigned to only a select few users with a specific need to have a high-risk type of access.

c. Of 5 users we reviewed who could administer access rights, 3 possessed incompatible user access to the SBT System. The 3 users were afforded the capability to administer and change access rights to the SBT System and also function as system analysts for the SBT System. We consider these two functions to be incompatible because these users possess a comprehensive understanding of the SBT System, as well as the management controls over the SBT System. Granting these users the ability to administer and change access rights to the application system creates a high risk that a user could commit a fraudulent or unauthorized transaction and conceal it from management.

d. RPD did not periodically monitor user access to ensure that access was promptly deleted for users who left State employment or no longer had a need for access to the SBT System to perform their job responsibilities. We identified 3 (10%) of 29 users sampled who were not current State employees or contractors of the State. In addition, 3 (10%) of the 29 users no longer had a business need for SBT System access. Further, of 5 users we reviewed who had the ability to administer access rights, 1 user had left State employment but access was not removed until 12 days after the user's departure date.

## RECOMMENDATION

We recommend that RPD establish effective management controls to minimize the risk of unauthorized access to and use of the SBT System.

## AGENCY PRELIMINARY RESPONSE

The Department agrees with this recommendation. The Department reported that the human resources office now coordinates a procedure for employees separating from service that includes a checkoff form directing supervisors to remove employees' access to Department systems. The Department's Office of Security reviews this process and also conducts an annual review to purge and update this system to ensure that only essential employees have access to data. The Department reported that there are several hundred employees who need this access to perform their jobs. The Department informed us that it will be reviewing all employee access rights before June 30, 2004.

## FINDING

### 2. Delinquent Taxpayers

RPD needs to improve its process for ensuring that taxpayers file annual tax returns and remit the appropriate SBT as required by the SBT Act. Also, RPD needs to notify taxpayers of its intent to assess SBT when the taxpayers have not responded to delinquency notices within the required 30 days.

These improvements are needed to help RPD ensure that the Department receives all SBT that is due and payable to the State. An effective process for identifying, notifying, and assessing delinquent taxpayers on a timely basis would help RPD to ensure consistent and uniform compliance by all persons subject to SBT.

RPD's primary objective for administering the SBT Act is to ensure that taxpayers consistently and uniformly comply with the Act. Section 205.24 of the *Michigan Compiled Laws* requires that if a taxpayer fails or refuses to file a return or pay a tax within the time specified, the Department, as soon as possible, shall assess the tax against the taxpayer and notify the taxpayer of the amount of the tax. There are legitimate reasons why a taxpayer would be exempt from the annual filing requirement, such as a taxpayer's annual gross receipts being under the limits set forth in the SBT filing requirements. In these cases, taxpayers are encouraged to file a Notice of No SBT Return Required.

Also, Section 205.21 of the *Michigan Compiled Laws* states that the Department shall send to the taxpayer a letter of inquiry stating the Department's opinion that the taxpayer needs to furnish further information or owes taxes to the State and the reason for that opinion. If the dispute is not resolved within 30 days after the Department sends the taxpayer a letter of inquiry, the Department, after determining the amount of tax due from a taxpayer, shall give notice to the taxpayer of its intent to assess the tax.

RPD's SBT Section routinely identified delinquent taxpayers when manually processing the SBT returns that did not clear the SBT System automated processing for reasons such as inaccurate computations or missing information. RPD informed us that when SBT clerks manually processed the tax returns, they were expected to examine the taxpayer's account, identify any delinquent tax returns and tax, send a delinquency notice to the taxpayer, and follow up on the status of the taxpayer's response within approximately 90 days. However, Section 205.21 of the *Michigan Compiled Laws* requires RPD to follow up and notify a taxpayer of its intent to assess tax within 30 days, not 90 days, when not responding to a delinquency notice. Further, this process did not include an analysis of all taxpayers' accounts to provide for the timely identification of all potential delinquent taxpayers.

RPD informed us that it had not implemented a process to analyze all SBT taxpayers because the results from this type of process would not be cost beneficial. RPD based this conclusion on a previous delinquent match process conducted for sales, use, and withholding taxes, in which it concluded that 65% of the taxpayers identified did not have a tax liability due the State. However, RPD did not provide any documentation that this delinquent match was completed or explain why the results of a sales, use, and withholding tax match would correlate to a match associated with SBT. Also, even though 65% of the matches did not have a tax liability due to the State, the remaining 35% had possible revenues due to the State.

## RECOMMENDATIONS

We recommend that RPD improve its process for ensuring that taxpayers file annual tax returns and remit the appropriate SBT as required by the SBT Act.

We also recommend that RPD notify taxpayers of its intent to assess SBT when the taxpayers have not responded to delinquency notices within the required 30 days.

## AGENCY PRELIMINARY RESPONSE

The Department agrees that RPD should improve its processes to ensure consistent and uniform compliance with the SBT Act. The Department currently reported that it employs a variety of audit techniques to ensure that taxpayers file and pay the appropriate amount of SBT. The Department believes that additional resources are necessary to significantly increase such activities.

The Department agrees that Section 205.21 of the *Michigan Compiled Laws* requires RPD to notify taxpayers of its intent to assess SBT when the taxpayers have not responded within 30 days. However, due to large volumes and availability of resources, some of the correspondence cannot possibly be worked within 30 days. The Department's experience is that many taxpayers respond much later than 30 days. If RPD issued assessments after 30 days, RPD would multiply the volume of correspondence and be faced with correcting assessments, which is a costly and time-consuming activity. The Department plans to evaluate the need for a change to this legislation to extend the time period for taxpayers to respond to a delinquency notice.

## FINDING

### 3. Refund Interest

RPD needs to improve its procedures to reduce the payment of interest on refunds. Also, RPD needs to change its policy and eliminate its practice of paying interest on undeliverable refund warrants.

RPD issued 11,615 refunds including interest of approximately $21.7 million during our audit period. We estimated that the interest paid on these refunds cost the State approximately $15.0 million in General Fund revenue after subtracting the interest earned during the period RPD was holding the SBT overpayments.

Section 205.30 of the *Michigan Compiled Laws* requires RPD to credit or refund an overpayment of taxes to a taxpayer that has filed a claim for refund. Also, RPD must add interest to the refund if the refund is not issued to the taxpayer within 45

days after the claim is filed or 45 days from the date established by law for filing the tax return, whichever is later. Section 205.23 of the *Michigan Compiled Laws* requires RPD to pay interest to the taxpayer at an annual rate of one percentage point above the adjusted prime rate.

An RPD analysis of 396 refunds disclosed that a significant number of refunds (totaling $328,539) were the result of errors, untimely refund approvals, and processing inefficiencies.

Also, $72,109 in interest was unnecessarily paid on undeliverable refund warrants. RPD's policy was to pay interest on undeliverable refund warrants. *Michigan Compiled Laws* do not require RPD to pay the interest.

RPD procedures that were intended to reduce the payment of interest on refunds included prioritizing the processing of SBT returns to first process the returns on which a taxpayer has claimed a refund. Also, RPD informed us that it used a daily report of SBT refunds issued to monitor and research the amount of refund interest paid when refund interest was greater than $1,000 and return processing delays were greater than 45 days.

To assess the effectiveness of these procedures, we analyzed 76 SBT refunds issued with interest during our audit period and determined that RPD took an average of 308 days to process the associated returns. When we inquired about the cause of the processing delays, RPD informed us that the delays and payments of interest were the result of court cases, audits, and undeliverable refunds, not the result of a lack of resources or return processing inefficiency. However, RPD could not provide us with documentation to support these reasons or support that it used its monitoring and research results to make modifications to improve the timely processing of SBT returns.

Our examination of 24 of the 76 refunds disclosed:

| Reason for Refund Interest | Number | Percent |
|---|---|---|
| Processing inefficiency | 15 | 63% |
| Processing error | 4 | 17% |
| Audit | 2 | 8% |
| Additional information needed | 2 | 8% |
| Court case | 1 | 4% |

Subsequent to our audit fieldwork and our recommendation that it implement procedures to periodically conduct a thorough analysis of refund interest, RPD conducted its own analysis of 396 refund payments totaling $8.2 million dollars. RPD informed us that the majority of the amount of interest paid, approximately $6.2 million, was the result of court cases and audits. However, 227 refund interest payments totaling $328,539 were the result of errors, untimely refund approvals, processing inefficiencies, and interest unnecessarily paid on undeliverable refund warrants totaling $72,109.

RPD informed us that as a result of its analysis, it would consider modifying its policy of paying interest on undeliverable refund warrants and investigate the causes of the RPD errors and inefficiencies.

## RECOMMENDATIONS

We recommend that RPD improve its procedures to reduce the payment of interest on refunds.

We also recommend that RPD change its policy and eliminate its practice of paying interest on undeliverable refund warrants.

## AGENCY PRELIMINARY RESPONSE

The Department agrees with these recommendations. The Department points out that the majority of interest paid (75%) was directly related to pending court cases or audits. Cases in the court system or under audit tend to involve larger refund issues. The Department is obligated by law to pay interest beginning 45 days after a return is received or after the due date of the return, whichever is later. The Department has no control over the amount of interest paid on refund returns in court or in audit.

Interest paid on other refund returns is directly related to how quickly RPD can process returns filed with the Department. As the Department proceeds in the electronic filing environment, errors and processing time will be dramatically reduced. The Department fully expects to see a reduction in payment of interest this year.

Finally, the Department will immediately revise its procedure to discontinue paying interest on undeliverable warrants.

## FINDING

### 4. Refund Approvals

RPD needs to improve its management controls over the refund approval process to ensure the propriety and validity of SBT refunds.

Effective management controls are critical to help management prevent and detect, on a timely basis, the processing of erroneous and unauthorized refunds. Maintaining audit trails for refund approvals and requiring independent review and approval of refunds of $5,000 or less would help reduce the risk of erroneous and unauthorized SBT refunds.

RPD uses a transaction approval process within the SBT System to provide security over the creation and issuance of SBT refunds. RPD relies on refund approval audit trails and independent review and approval to ensure that SBT refunds issued are proper and valid. RPD employees electronically review and approve refunds using automated approval queues in the SBT System. The refund transaction progresses through a ladder of approval levels until the highest level of approval needed is attained for issuance.

Our examination of the transaction approval process disclosed the following management control deficiencies:

a. RPD did not maintain an audit trail of refund approvals.

We reviewed a random sample of 14 SBT refund transactions to assess the reliability and validity of refund approval controls within the SBT System. RPD was unable to provide us with documentation showing which employee(s)

approved and ultimately released the 14 SBT refunds. The SBT System created an approval log for each refund issued; however, the SBT System did not retain a history of the employee who approved the SBT refund. Upon investigation, RPD discovered that the refund approval audit trail was deleted once the return was cleared in the SBT System and the SBT refund was issued.

Maintaining an audit trail of SBT refund approvals, helps RPD to determine whether SBT refunds are being approved for propriety and validity.

b. RPD did not require independent review and approval for SBT refunds of $2,500 or less and for most refunds of $5,000 or less. Also, RPD had not established compensating controls to periodically test the propriety and validity of these refunds.

RPD established the following approval levels for SBT refunds:

| Refund Amount | Highest Level of Approval Needed |
|---|---|
| $1 - $2,500 | Clerical 5/6/7 |
| $2,501 - $5,000 | Lead Worker |
| $5,001 - $10,000 | Supervisor |
| $10,001 - $25,000 | Division Manager |
| $25,001 - $100,000 | Division Administrator |
| $100,001 or more | Tax Processing Director |

Of 23 employees who processed SBT tax returns and refunds, 18 (78%) were lead workers. Therefore, the 18 employees were able to process SBT refunds of $5,000 or less without further review or approval by an independent person. Also, clerical staff were able to process SBT refunds issued for $2,500 or less without further review or approval by an independent person. The RPD administrator reviewed and approved a daily report of refunds issued. However, the report did not identify the employee who approved the refunds.

RPD issued 75,476 SBT refunds totaling approximately $688.0 million during the period October 1, 1999 through June 30, 2002. Of the 75,476 SBT refunds, 56,421 (75%) totaling approximately $76.9 million (11%) were $5,000 or less and may not have received an independent review and approval.

## RECOMMENDATION

We recommend that RPD improve its management controls over the refund approval process to ensure the propriety and validity of SBT refunds.

## AGENCY PRELIMINARY RESPONSE

The Department agrees with the recommendation to develop an audit history of the SBT return. The Department plans to have a procedure implemented no later than December 31, 2004.

## FINDING

**5. Continuous Quality Improvement (CQI) Process**

RPD had not developed and implemented a comprehensive CQI process to evaluate and improve the effectiveness and efficiency of SBT Program operations.

RPD can best ensure the quality, service, and use of resources of its SBT Program operations by using a comprehensive CQI process. Complete consideration of RPD's operations is essential to the development and implementation of a comprehensive CQI process to provide RPD with the ability to evaluate the overall effectiveness and efficiency of its SBT Program operations.

A comprehensive CQI process defines the mission, goals*, and objectives of an organization and focuses on the needs and expectations of internal and external customers. It normally includes: performance indicators* for measuring outputs* and outcomes*, the use of a management information system to collect data to measure performance in relation to the standards, a comparison of actual data with desired outputs and outcomes to make modifications to improve program effectiveness and efficiency, and a reporting of comparison results to management. A comprehensive CQI process has an underlying philosophy that is team oriented and open to making changes on a continuous basis to improve organization processes.

The Legislature and the Governor have required in various appropriations acts and in Executive Directive No. 1996-1 that State programs use CQI processes to manage the use of limited State resources. Also, in Executive Directive No.

* *See glossary at end of report for definition.*

2001-3, which rescinded Executive Directive No. 1996-1, effective June 8, 2001, the Governor stated that it was the goal to increase efforts toward continuous improvement and directed department and agency heads to actively support the State's Quality Recognition System and ensure the implementation of quality and customer service management techniques.

RPD's stated purpose included an intention to maintain an environment conducive to CQI and encourage employee ideas, input, and teamwork. RPD informed us that because of the reorganization of the Bureau of Revenue in October 2000, it was in the process of developing a comprehensive CQI process during our audit period, but had not implemented such a process. We reviewed RPD's CQI developing efforts both during our audit period and subsequent to our audit fieldwork. We found that RPD was developing only limited parts of a comprehensive CQI process:

a. RPD had not developed a mission statement. Instead, RPD had a purpose statement comprised of tasks related to its administration of the SBT Program. For example: to administer the day-to-day operations to ensure the timely and accurate processing of all tax returns required to be filed with the Department and assign staff to various methods of data capture, as dictated by processing needs and/or backlogs.

   A mission statement should succinctly describe the overall role of RPD as it relates to the Department and State as a whole, describing what it does, for whom, how, and why.

b. RPD had not developed complete goals that could help assess the performance of the entire SBT Program.

   Although RPD developed goals for the SBT Internet portal project to provide for the capability of taxpayers to file returns via the Internet, it had not developed or established goals for other significant areas of the SBT Program, such as improving SBT System security (Finding 1), reducing the number of delinquent taxpayers (Finding 2), reducing the amount of refund interest paid (Finding 3), and improving the timeliness of SBT return processing.

Goals guide an organization's efforts in meeting its stated mission. Goals should be qualitative and quantifiable, be ranked in priority, and address the internal and external issues facing the organization.

c. RPD had not developed quantifiable outcome-based objectives.

RPD's primary objective for the SBT Program was the administration of the SBT Act for consistent and uniform compliance by the persons subject to SBT. RPD's other objectives included the processing and review of returns; the correction or disallowance of questionable or erroneous returns; the certification of the propriety of transactions; the initiation and evaluation of adjustments and assessments for tax, penalty, and interest; and the initiation of refunds. The objectives do not provide specific measures for a specific time period and are not outcome-based. Also, the objectives do not provide the means for RPD to meet its stated goals.

Objectives are targets for specific action that are needed for RPD to achieve its goals within a given time period. The objectives should be achievable and measurable and relate to results or outcomes desired by RPD.

d. RPD had not established outcome-related performance indicators and standards by which management could assess the overall effectiveness and efficiency of the SBT Program.

Although RPD developed employee performance standards and performance indicators for the SBT Program employees and it developed limited output measurements of return processing activity, RPD did not have the performance standards and indicators needed to measure its achievement in ensuring consistent and uniform compliance with the SBT Act and other related matters. Performance standards establish the general guidelines against which an organization's performance can be compared. RPD performance standards might include:

(1) Specific acceptable levels of security over SBT System access (Finding 1).

(2) An expectation for the percentage of applicable taxpayers who file annual tax returns and remit SBT in accordance with the SBT Act (Finding 2).

(3) The desired amount of refund interest or percentage of returns with or without interest (Finding 3).

Performance indicators are the specific outcomes that are compared to performance standards to understand the extent to which RPD is achieving its objectives. They are essential to assessing the actual impact of RPD's SBT Program operations on its internal and external customers. RPD performance indicators might include the identification of the types of on-line corrections made by SBT return processing staff (Finding 7).

RPD emphasized that, beginning in June 2002, it had taken a comprehensive look at its operations through the Department's "balanced scorecard" and "strategy map." A December 2002 memorandum from the State Treasurer stated that the balanced scorecard and strategy maps are concepts that lay out a plan for the future of the Department and provide the Department with the ability to measure accomplishments and failures. The balanced scorecard for the quarter ended September 30, 2002 contained some CQI attributes, but it did not include specific objectives to achieve the Department's desired goals. More importantly, it did not focus on RPD's needs and expectations of internal and external customers and did not provide RPD with a comprehensive evaluation tool to assess and to facilitate modifications for improving the effectiveness and efficiency of SBT Program operations.

## RECOMMENDATION

We recommend that RPD develop and implement a comprehensive CQI process to evaluate and improve the effectiveness and efficiency of SBT Program operations.

## AGENCY PRELIMINARY RESPONSE

The Department agrees with the recommendation to continue to develop and implement a comprehensive process to evaluate and improve the effectiveness and efficiency of SBT Program operations. It currently uses elements of CQI principles on a Departmentwide basis. The Department began a full-scale initiative two years ago that incorporates a balanced scorecard system of defining priorities and measuring progress. The Department informed us that it is committed to this project and regularly measures its output data and refines its goals and objectives.

## FINDING

**6. Critical Activities**

RPD needs to strengthen management controls by establishing formal procedures for its critical SBT Program activities.

RPD had not formalized procedures for routine activities that were critical to SBT Program operations. Because only one RPD employee performs these activities there exists a significant risk to the effectiveness and continuity of SBT Program operations if the procedures are not formalized and the employee separates from employment with RPD.

Formal procedures provide consistency in handling various business operations and activities and help ensure that they are carried out accurately and in an effective and efficient manner. Formal procedures also provide for continuity when employees leave, are useful in training new employees, assign activities to specific individuals, and prevent duplication of duties.

Our review disclosed:

a. RPD had not established a formal procedure for the verification of SBT payments received, including the posting of the SBT payments into taxpayer accounts.

   RPD received over $7 billion in SBT payments during our audit period. The RPD employee performed daily reconciliations of SBT payments received and recorded in the State's accounting system to the amounts posted to taxpayer accounts. The reconciliation helps to ensure the accuracy, completeness, and proper distribution of the payments.

b. RPD had not established a formal procedure for the scheduling of SBT returns into the SBT System for automated processing.

   The Data Entry Section inputted SBT return information into an external system. On a weekly basis, the RPD employee scheduled the transfer of information from the external system into the SBT System in order for the information to advance through the system audit process. The employee performed reconciliations of the information accepted by the SBT System to

ensure completeness of the transfer. If there was a discrepancy, the employee was expected to investigate and resolve the discrepancy.

c. RPD had not established a formal procedure for the verification of the transfer of SBT taxpayer assessments into the State Treasurer's Accounts Receivable (STAR) System.

   If a taxpayer owed additional tax, the SBT System generated a notification letter that tax was due. If the tax was not paid within 60 days of the notification letter date, the taxpayer was assessed for the outstanding tax; the SBT System automatically issued an assessment notice to the taxpayer; and, through a data transfer, a receivable was recorded on the STAR System to ensure collection of the outstanding tax by the Collection Division. The RPD employee performed reconciliations of the assessment data accepted by the STAR System to ensure that the transfer was complete and accurate.

d. RPD had not established a formal procedure for monthly reporting to management.

   RPD management received monthly reports of SBT processing backlogs, employee output, and suspended taxpayer account transactions. These reports were useful to management as a method to monitor SBT return processing productivity. The RPD employee was responsible for preparing and distributing these reports.

We noted similar circumstances with RPD's incompleteness of formal policies and procedures documented in its policies and procedures manual in the prior audit. RPD responded that it would update its policies and procedures manual to reflect current operations.

## RECOMMENDATION

We recommend that RPD strengthen management controls by establishing formal procedures for its critical SBT Program activities.

## AGENCY PRELIMINARY RESPONSE

The Department agrees with this recommendation and plans to be in compliance by June 30, 2005.

## FINDING

**7. Management Information Reports**

RPD did not generate management information reports to identify the types of on-line corrections made by SBT return processing staff.

RPD's SBT return processing activities allow certain staff to make on-line computer changes to taxpayer records. These changes are generally made to correct SBT returns rejected and suspended by the SBT System edit program because of taxpayer or keypunch errors. Management information reports would help management monitor the types of on-line corrections made to tax returns by SBT return processing staff. Such reports would allow management to verify that procedures are being followed and that corrections to tax return information are proper. This level of monitoring would reduce the risk that inappropriate changes to returns or other undesirable activity could occur and not be detected in a timely manner.

We reported this same condition in our prior audit. RPD informed us that it relied on the compensating controls of SBT return processing staff seniority, the refund approval process, and other reports indicating unpostable and refund transactions to minimize the risk of inappropriate processing activity. However, the unpostable and refund transaction reports do not provide information by staff person, and we found management control weaknesses in the refund approval process (Finding 4).

## RECOMMENDATION

WE AGAIN RECOMMEND THAT RPD GENERATE MANAGEMENT INFORMATION REPORTS TO IDENTIFY THE TYPES OF ON-LINE CORRECTIONS MADE BY SBT RETURN PROCESSING STAFF.

## AGENCY PRELIMINARY RESPONSE

The Department agrees with this recommendation. The Department reported that its current system allows supervisors to review a significant number of transactions performed at various staffing levels. The Department will address any risks identified by this supervisory review and develop procedures for documenting the resulting actions.

# EFFECTIVENESS AND EFFICIENCY OF THE CUSTOMER CONTACT DIVISION'S MANAGEMENT CONTROLS

## COMMENT

**Audit Objective:** To assess the effectiveness and efficiency of the Customer Contact Division's (CCD's) management controls over the resolution of taxpayer and practitioner inquiries and the performance its business registration functions pertaining to the SBT Program.

**Conclusion: We concluded that CCD's management controls were generally effective and efficient in resolving taxpayer and practitioner inquiries and performing its business registration functions pertaining to the SBT Program.** Our assessment disclosed one material condition. CCD had not established effective management controls related to Michigan Taxpayer Database (MTDB) system access and security (Finding 8).

**Noteworthy Accomplishments:** CCD had taken steps to resolve correspondence ineffectiveness and inefficiencies resulting from a large volume of telephone calls and correspondence received from taxpayers and practitioners. CCD implemented a detailed strategy and technology improvement plan to improve the call center and to ensure timely response to customer inquiries. The plan sought to maximize the use of Web-based and integrated voice technology to improve response time and customer services through the implementation of three phases. In addition, the plan included a comprehensive CQI process. CCD implemented the final phase of the plan in December 2002.

## FINDING

### 8. MTDB Access Controls

CCD had not established effective management controls related to MTDB system access and security. As a result, selected users had the capability to change SBT return calculations and overpayment amounts, create refunds, and change taxpayer information in MTDB.

Effective controls related to system access and security protect automated system information and resources from unauthorized modification, fraud, loss, or disclosure by restricting or detecting inappropriate access. For controls to be

effective, access to data, program, and system files should be granted only to the extent necessary for individuals to perform their assigned duties. Section 205.28(1)(f) of the *Michigan Compiled Laws* and *Michigan Administrative Code* R 205.1003 require that access to confidential information shall be restricted to employees who have a need to access the information to perform their duties. Also, the Department of Management and Budget Administrative Guide procedure 1310.02 states that security requirements and procedures must be documented and approved by management for each information system.

CCD is responsible for the administration of business registration for all Michigan business taxes and the administration of MTDB in which the business registration information is maintained. Various Department of Treasury personnel and other State departments' personnel use MTDB as a resource for business information. MTDB contains information about each business operating in Michigan, including highly confidential information such as the business owner's name, address, social security number, date of birth, and driver license identification and the business federal employer identification number.

CCD did not have formal procedures describing the process and criteria for granting user access to MTDB. Granting of user access was controlled by a security application authorized by a CCD administrator. Users were granted access to MTDB based on transaction codes defined in the security application that are appropriate for the users' job duties and legitimate need for MTDB access. Transaction codes control the type of access the users have in MTDB, such as whether the users have read-only access or the ability to add, modify, or delete MTDB information. Neither CCD nor the Department's security administrator monitored MTDB user access to minimize the risk of unauthorized access and use of MTDB.

Our review of MTDB users with access on July 23, 2002 disclosed 46 users who were granted high-risk incompatible access capabilities within MTDB and the SBT System. These users had transaction code capabilities to add, modify, or delete information and transactions in both systems without detection. As a control mechanism, MTDB links to the SBT System to help ensure that SBT returns and payments are recorded to the proper taxpayer account registered in MTDB and that refunds are issued to only the taxpayer's address registered in MTDB. In addition, CCD could not provide us with the capabilities of 348 (34%) MTDB users.

CCD could not define a transaction code and the code's access capability for these users.

The lack of formalized procedures for granting user access to MTDB increases the risk that users could be granted access to the system without a legitimate need. Unauthorized users could intentionally or inadvertently add, alter, or delete sensitive data and obtain personal taxpayer information and use it to commit financial crimes, such as identity fraud or fraudulent refunds. Periodic monitoring of MTDB user access could help to assure CCD and business taxpayers that tax information and transactions will remain confidential and secure.

## RECOMMENDATION

We recommend that CCD establish effective management controls related to MTDB system access and security.

## AGENCY PRELIMINARY RESPONSE

The Department agrees with this recommendation and plans to be in compliance by November 1, 2004. CCD will work in conjunction with the Department's Office of Security and the Department of Information Technology to improve controls over MTDB system access and security especially as it relates to multisystem access risk.

After completion of the audit, CCD informed us that it determined that the 348 MTDB users identified in the audit finding were primarily employees of CCD's Motor Fuel Section, the Collection Division, and the Tax Compliance Bureau's Audit and Discovery and Tax Enforcement Divisions, who used MTDB in conjunction with the Department's temporary Motor Fuel System. CCD reported that system access granted is both temporary and appropriate for the performance of revenue generating activities and development of a new automated system.

# COMPLIANCE WITH APPLICABLE STATUTES, RULES AND REGULATIONS, AND DEPARTMENT POLICIES AND PROCEDURES

## COMMENT

**Audit Objective:** To assess RPD's and CCD's compliance with applicable statutes, rules and regulations, and Department policies and procedures pertaining to the SBT Program.

**Conclusion: We concluded that RPD and CCD generally complied with applicable statutes, rules and regulations, and Department policies and procedures pertaining to the SBT Program.** However, our assessment disclosed a reportable condition related to RPD's records retention and disposal schedule (Finding 9).

## FINDING

**9. Records Retention and Disposal Schedule**

RPD had not updated its records retention and disposal schedule to address all documents used in its operations.

Section 18.1285(2) of the *Michigan Compiled Laws* states that the head of a State agency maintaining any record shall cause the records to be listed on a retention and disposal schedule.

RPD's records retention and disposal schedule asserted that the records listed are necessary for the continued effective operation of the agency and constitute an adequate and proper recording of its activities.

Our review of 13 documents listed on RPD's records retention and disposal schedule, in effect during our audit period, disclosed that RPD had not updated 3 (23%) of 13 documents to reflect changes in document numbers and no longer used 2 (15%) of the 13 documents.

Properly maintained records retention and disposal schedules are necessary for effective management of documents pertinent to the operation of RPD.

We noted similar circumstances in our prior audit and RPD responded that it had updated its records retention and disposal schedule.

## RECOMMENDATION

WE AGAIN RECOMMEND THAT RPD UPDATE ITS RETENTION AND DISPOSAL SCHEDULE TO ADDRESS ALL DOCUMENTS USED IN ITS OPERATIONS.

## AGENCY PRELIMINARY RESPONSE

The Department agrees with this recommendation and will work toward updating the retention and disposal schedule by December 31, 2004.

# GLOSSARY

## Glossary of Acronyms and Terms

| | |
|---|---|
| **CCD** | Customer Contact Division. |
| **continuous quality improvement (CQI)** | A process that aligns the vision and mission of an organization with the needs and expectations of internal and external customers. It normally includes a process to improve program effectiveness and efficiency by assessing performance indicators that measure outputs and outcomes related to the program vision, mission, goals, and objectives. |
| **delinquent taxpayer** | A taxpayer that did not file an annual tax return and/or remit the appropriate single business tax as required by the Single Business Tax Act. |
| **effectiveness** | Program success in achieving mission and goals. |
| **efficiency** | Achieving the most outputs and outcomes practical with the minimum amount of resources. |
| **goals** | The agency's intended outcomes or impacts for a program to accomplish its mission. |
| **management controls** | The plan of organization, methods, and procedures adopted by management to provide reasonable assurance that goals are met; resources are used in compliance with laws and regulations; valid and reliable data is obtained and reported; and resources are safeguarded against waste, loss, and misuse. |
| **material condition** | A reportable condition that could impair the ability of management to operate a program in an effective and efficient manner and/or could adversely affect the judgment of an interested person concerning the effectiveness and efficiency of the program. |

| | |
|---|---|
| **mission** | The agency's main purpose or the reason that the agency was established. |
| **MTDB** | Michigan Taxpayer Database. |
| **objectives** | Specific outcomes that a program seeks to achieve its goals. |
| **outcomes** | The actual impacts of the program. |
| **outputs** | The products or services produced by the program. |
| **performance audit** | An economy and efficiency audit or a program audit that is designed to provide an independent assessment of the performance of a governmental entity, program, activity, or function to improve public accountability and to facilitate decision making by parties responsible for overseeing or initiating corrective action. |
| **performance indicators** | Information of a quantitative or qualitative nature used to assess achievement of goals and/or objectives. |
| **reportable condition** | A matter that, in the auditor's judgment, represents either an opportunity for improvement or a significant deficiency in management's ability to operate a program in an effective and efficient manner. |
| **RPD** | Return Processing Division. |
| **SBT** | single business tax. |
| **STAR** | State Treasurer's Accounts Receivable. |
| **value-added taxation** | Taxation that uses the value that firms add to products as the tax base, which is different than raising tax revenue from taxes levied on profits. |