MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT

PERFORMANCE AUDIT
OF THE

RECEIPTS PROCESSING DIVISION

DEPARTMENT OF TREASURY

March 2006

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

27-147-05

"...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

Michigan

Office of the Auditor General

REPORT SUMMARY

Performance Audit

Receipts Processing Division

Department of Treasury

Report Number:
27-147-05

Released:
March 2006

The Receipts Processing Division provides financial services related to the depositing of State revenues, recording of revenues to the State's accounting system, disbursement of State funds, and administration of all State banking relationships.

Audit Objectives:

1. To assess the effectiveness of the Division's efforts to ensure that receipts are properly safeguarded.

2. To assess the effectiveness of the Division's efforts to ensure that receipts are recorded in a proper and timely manner.

3. To assess the effectiveness of the Division's efforts to ensure that compensating balances are reasonable.

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Audit Conclusions:

1. We concluded that the Division was moderately effective in its efforts to ensure that receipts are properly safeguarded. However, our audit disclosed reportable conditions related to service organization controls and banking service agreements (Findings 1 and 2).

2. We concluded that the Division was effective in its efforts to ensure that receipts are recorded in a proper and timely manner.

3. We concluded that the Division was effective in its efforts to ensure that compensating balances are reasonable. However, we noted reportable conditions related to verification of banking service charges and recognition of earnings credit and banking service charges (Findings 3 and 4).

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Reportable Conditions:

The Division did not obtain sufficient assurances regarding the internal control of the service organization used to collect, process, and deposit State tax revenue (Finding 1).

The Division did not obtain signed contracts or agreements for all significant processing services. In addition, the Division did not utilize Acquisition Services, Department of Management and Budget (DMB), to procure processing services, as required by DMB Administrative Guide procedure 510.01. (Finding 2)

The Division did not verify the accuracy or validity of banking service charges for State Treasurer bank accounts with significant compensating balances (Finding 3).

The Division did not record the earnings credit or the bank service charges for State Treasurer bank accounts as revenues and expenditures in the Michigan Administrative Information Network (Finding 4).

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Agency Response:
Our audit report contains 4 findings and 6 recommendations. The Department's preliminary response indicated that it agrees with 5 of the recommendations and disagrees with 1 of the 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

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March 21, 2006

Ms. Julie Croll
Chief Deputy Treasurer
Treasury Building
Lansing, Michigan

Dear Ms. Croll:

This is our report on the performance audit of the Receipts Processing Division, Department of Treasury.

This report contains our report summary; description of agency; 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 response 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.

AUDITOR GENERAL

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DEPARTMENT OF TREASURY

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Description of Agency

The Receipts Processing Division, Department of Treasury, provides financial services related to the depositing of State revenues, recording of revenues to the State's accounting system, disbursement of State funds, and administration of all State banking relationships. These services are provided through two sections:

1. <u>Transaction Control Section</u>
   The Transaction Control Section comprises the Lockbox* and Support Unit and the Remittances and Deposits Unit. The Lockbox and Support Unit's responsibilities include reconciliation of various lockboxes; maintenance of wire, Electronic Federal Tax Payment System* (EFTPS), and Automatic Clearing House* (ACH) transfer databases; and nonlockbox collections. The Remittances and Deposits Unit is responsible for all noncollection remittances; balance and deposits preparation for all remittances; production report preparation; walk-in payments; preparation of State agency deposits; and security liaison activities for the Division.

2. <u>Banking Services Section</u>
   The Banking Services Section comprises the Banking and Disbursements Unit and the Revenue Accounting Unit. The Banking and Disbursements Unit's responsibilities include bank relationship management, bank contracts management, credit card and electronic funds transfer* (EFT) contract administration, bank account analysis, bank profile maintenance, design and implementation of revenue ACH processes, outgoing EFT and warrant issuance, State Treasurer warrant oversight, undeliverable warrants, forgery reporting, and EFT tracking and reporting. The Revenue Accounting Unit's responsibilities include central agency Statewide accounting in the Michigan Administrative Information Network* (MAIN), Department of Treasury revenue accounting, EFT downloads, and daily reconciliation of bank statements of the State Treasurer's concentration account.

The Division had 40 employees as of August 1, 2005 and expended appropriations of approximately $2.18 million in fiscal year 2003-04. In addition, the Division contracted with a service organization* for the initial receipt, distribution, and deposit of approximately $18.9 billion of the State's tax revenue.

** 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 Receipts Processing Division, Department of Treasury, had the following objectives:

1. To assess the effectiveness* of the Division's efforts to ensure that receipts are properly safeguarded.

2. To assess the effectiveness of the Division's efforts to ensure that receipts are recorded in a proper and timely manner.

3. To assess the effectiveness of the Division's efforts to ensure that compensating balances* are reasonable.

Audit Scope

Our audit scope was to examine the program and other records of the Receipts Processing Division. 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 methodology included examination of the Division's operations and records primarily for the period October 2002 through May 2005. Our fieldwork was performed primarily from April through August 2005.

We conducted a preliminary review of the Division's operations to gain an understanding of its activities and to form a basis for selecting certain operations for audit. Our review included interviewing Division personnel and reviewing applicable laws, policies, and procedures to gain an understanding of management control* related to pertinent Division functions.

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

To assess the effectiveness of the Division's efforts to ensure that receipts are properly safeguarded, we interviewed personnel from the Departments of Treasury, Management and Budget and Information Technology; reviewed and tested the Division's controls over cash receipts; and tested the Division's lockbox reconciliations. We visited the State's primary banking partner's lockbox processing site, interviewed personnel, reviewed and tested controls, and reviewed network diagrams relating to transmissions. Finally, we reviewed contracts and agreements with the State's primary banking partner.

To assess the effectiveness of the Division's efforts to ensure that receipts are recorded in a proper and timely manner, we interviewed Division personnel, reviewed the processes in place for check tracing, and reviewed a sample of receipts recorded by the Division.

To assess the effectiveness of Division's efforts to ensure that compensating balances are reasonable, we interviewed Division personnel, reviewed appropriations and various documentation, and performed analyses related to earnings credits*, compensating balances, and banking service charges.

Agency Responses and Prior Audit Follow-Up

Our audit report contains 4 findings and 6 recommendations. The Department's preliminary response indicated that it agrees with 5 of the recommendations and disagrees with 1 of the 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.

Within the scope of this audit, we followed up 2 of the 4 audit recommendations reported in our June 2002 financial audit including the provisions of the Single Audit Act, of the Department of Treasury (#2710002). We also followed up 2 of the 4 audit recommendations reported in our July 1995 performance audit of the Bureau of Investments, Department of Treasury (#2725093). The Department complied with 2 of the 4 prior audit recommendations included within the scope of our current audit. The other 2 recommendations were rewritten for inclusion in this report.

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

COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

SAFEGUARDING OF RECEIPTS

COMMENT

Audit Objective: To assess the effectiveness of the Receipts Processing Division's efforts to ensure that receipts are properly safeguarded.

Conclusion: We concluded that the Division was moderately effective in its efforts to ensure that receipts are properly safeguarded. However, our audit disclosed reportable conditions* related to service organization controls and banking service agreements (Findings 1 and 2).

FINDING

1. Service Organization Controls

The Division did not obtain sufficient assurances regarding the internal control* of the service organization used to collect, process, and deposit State tax revenue. As a result, the Division could not ensure that State receipts were properly safeguarded and completely processed.

Section 18.1485 of the *Michigan Compiled Laws* requires that each department establish and maintain an internal accounting and administrative control system for the management of its financial affairs, including internal control techniques that are effective and efficient. Inherent in this requirement is the responsibility to ensure that its service organization has proper, effective, and operational controls over the processes performed for the Division.

The Division informed us that, to ensure that its service organization had proper, effective, and operational controls, it relied on periodic site visits to the service organization to observe and review its data entry and batch processing, biweekly test samples to verify the accuracy of returns processed by the service organization, and reconciliations of cash receipt batch totals to ensure that collections were properly processed. While these processes would generally be effective in ensuring that the revenue deposited was accurately recorded, they would provide limited assurance that all revenue received at the service organization was being credited to the State of Michigan's accounts.

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

The Division also informed us that it relied on the service organization's internal controls. However, in order to rely on the service organization's internal controls, the Division needs to (1) evaluate the organization's written policies and procedures to ensure that they documented proper and effective internal control and (2) test the controls to ensure that they were operational.

RECOMMENDATION

We recommend that the Division obtain sufficient assurances regarding the internal control of the service organization used to collect, process, and deposit State tax revenue.

AGENCY PRELIMINARY RESPONSE

The Department agrees and will periodically review the sufficiency of the service organization's existing controls and develop management mechanisms to better document and obtain additional assurances as to the adequacy of such controls.

Also, the Department informed us that, while it believes that there are sufficient compensating controls in place to ensure that revenue received by the service organization is credited to the State of Michigan's accounts, the Division will improve its documentation of the Department of Treasury's existing compensating controls.

FINDING

2. Banking Service Agreements

The Division did not obtain signed contracts or agreements for all significant processing services. In addition, the Division did not always utilize Acquisition Services, Department of Management and Budget (DMB), to procure processing services, as required by DMB Administrative Guide procedure 510.01. The lack of a signed contract or agreement exposes both parties to disputes over payments and expected services and makes the State vulnerable to the risk of loss. In addition, utilizing DMB Acquisition Services helps to ensure that the State obtains the best services at the most favorable prices.

DMB Administrative Guide procedure 510.01 requires that signed contracts be used for all professional services. In addition, the procedure limits a department's ability to issue purchase orders and multi-year contracts for services to those costing less than $25,000. Purchases of $25,000 or greater are required to be processed through DMB Acquisition Services.

The State's primary banking partner assessed bank service charges for processing services totaling $6.0 million and $4.1 million for fiscal years 2003-04 and 2002-03, respectively. The Division did not obtain signed contracts or agreements for approximately $2.0 million of these services for each of fiscal years 2003-04 and 2002-03. In addition, the Division did not utilize DMB Acquisition Services to procure processing services costing approximately $1.5 million for each of fiscal years 2003-04 and 2002-03.

The Division indicated that a master agreement for all banking services is part of its strategic plan; however, its development is on hold because of other priorities.

RECOMMENDATIONS

We recommend that the Division obtain signed contracts or agreements for all significant processing services.

We also recommend that the Division always utilize DMB Acquisition Services to procure processing services, as required by DMB Administrative Guide procedure 510.01.

AGENCY PRELIMINARY RESPONSE

The Department agrees and will work with DMB Acquisition Services to determine the appropriate procurement guidelines to follow for the Department's primary banking service providers for additional significant processing services.

PROPER AND TIMELY RECORDING OF RECEIPTS

COMMENT

Audit Objective: To assess the effectiveness of the Division's efforts to ensure that receipts are recorded in a proper and timely manner.

Conclusion: We concluded that the Division was effective in its efforts to ensure that receipts are recorded in a proper and timely manner. Our report does not include any reportable conditions related to this audit objective.

REASONABLENESS OF COMPENSATING BALANCES

COMMENT

Audit Objective: To assess the effectiveness of the Division's efforts to ensure that compensating balances are reasonable.

Conclusion: We concluded that the Division was effective in its efforts to ensure that compensating balances are reasonable. However, we noted reportable conditions related to verification of banking service charges and recognition of earnings credit and banking service charges (Findings 3 and 4).

FINDING

3. Verification of Banking Service Charges

The Division did not verify the accuracy or validity of all banking service charges for State Treasurer bank accounts with significant compensating balances. As a result, the Division may be paying for services not rendered and may be losing interest on compensating balance amounts not available for investment in higher yield securities.

Verifying and maintaining documentation to support banking service charges helps to ensure the propriety of the charges.

The State uses the compensating balance method* to cover banking service charges related to its 64 bank accounts. We reviewed banking service charges for the bank accounts with compensating balances greater than $500,000 as of September 2004. We determined that banking service charges for these 14 bank accounts totaled approximately $6.8 million and $4.7 million for fiscal years 2003-04 and 2002-03, respectively.

The Division had not verified the banking service charges for 12 of the 14 bank accounts. The unverified banking service charges totaled $4.0 million (58.8% and 85.1% of the total banking service charges) for each of fiscal years 2003-04 and 2002-03, respectively. For one of the 12 accounts, the Division began a banking service charge validation process but had not completed it.

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

RECOMMENDATION

We recommend that the Division verify the accuracy and validity of all banking service charges for State Treasurer bank accounts with significant compensating balances.

AGENCY PRELIMINARY RESPONSE

The Department disagrees and informed us that the Division regularly reviews the banking service charges associated with the State's primary banking partner and that these reviews do result in clarifications of the charges and, occasionally, billing adjustments. However, the Department indicated that, in most instances, the results of these reviews are not formally documented. The Department does agree to initiate procedures to better document its reviews of banking service charges associated with accounts maintained with the State's primary banking partner.

In addition, the Division is implementing a procedure to validate selected charges each month from the Department's nonprimary financial institutions.

FINDING

4. Recognition of Earnings Credit and Banking Service Charges

The Division did not record the earnings credit or the bank service charges for State Treasurer bank accounts as revenues and expenditures in the Michigan Administrative Information Network (MAIN). In addition, the Division had not requested an appropriation for banking service charges, including income tax processing expenditures. As a result, at least $7.3 million and $4.6 million of the State's revenues and $6.8 million and $4.7 million of the State's expenditures were not recognized in the State's financial statements or appropriated for in the State's budget in fiscal years 2003-04 and 2002-03, respectively.

Sections 1600.106 and 1600.116 of the *Codification of Governmental Accounting and Financial Reporting Standards*, published by the Governmental Accounting Standards Board, require that revenues should be recognized in the accounting period in which they become susceptible to accrual, i.e., when they become both measurable and available to finance expenditures of the fiscal period, and that expenditures should be reported when the related liability is incurred. In addition, Article IX, Section 17 of the State Constitution states: "No money shall be paid out of the state treasury except in pursuance of appropriations made by law." Furthermore, Section 18.1112 of the *Michigan Compiled Laws* defines "appropriation" to mean "the legislative authorization for expenditure or obligation of money from a state operating fund."

The State uses the compensating balance method to cover all of its banking service charges. Under this method, the State maintains a minimum compensating balance in the account and the bank allows the State an earnings credit based on an earnings credit rate* and the average investable balance*. The compensating balance amount is established and monitored to ensure that the earnings credit amount is sufficient to cover the banking service charges. The State Treasurer maintained compensating balances in 64 bank accounts around the State of Michigan as of September 2004, including one bank account used exclusively for the processing of State income tax returns. The costs relating to these bank accounts, including the income tax processing contract, were netted against the earnings credit.

We reviewed the earnings credits and banking service charges for the State's 14 bank accounts, including the income tax processing account, which had compensating balances over $500,000. We identified earnings credits totaling $7.3 million and $4.6 million and banking service charges totaling $6.8 million and $4.7 million for fiscal years 2003-04 and 2002-03, respectively. We determined that these amounts were not recorded as revenues and expenditures in MAIN or appropriated for in the State's budgets for those respective fiscal years.

RECOMMENDATIONS

We recommend that the Division record the earnings credit and the banking service charges for State Treasurer bank accounts as revenues and expenditures in MAIN.

We also recommend that the Division request an appropriation for banking service charges, including income tax processing expenditures.

AGENCY PRELIMINARY RESPONSE

The Department agrees that the banking service charges should be appropriated. The Department has initiated action for a legislative solution in compliance with the recommendation. The Department will reflect the revenue and expenditures in MAIN.

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

GLOSSARY

Glossary of Acronyms and Terms

Automatic Clearing House (ACH)	A nationwide EFT network that enables participating financial institutions to distribute electronic credit and debit entries to bank accounts and to settle such entries.
average investable balance	The funds that a customer has been able to use over a period of time. This is determined by deducting the reserve requirement and the Federal Deposit Insurance Corporation (FDIC) insurance assessment, if applicable, and the float from the average daily ledger balance.
compensating balance	The amount of money a bank requires a customer to maintain in a non-interest bearing account, in exchange for which the bank provides otherwise free services.
compensating balance method	A method in which the interest earned on the compensating balance through the earnings credit rate is used to offset the banking service charges.
DMB	Department of Management and Budget.
earnings credit	The earnings on collected balances in a commercial account. The earnings credit rate is typically tied to government issued securities. The earnings credit is not deposited to the account as interest earned. It is solely used to offset account analysis fees.
earnings credit rate	The rate used by banks to determine the allowable credit they will provide for the use of a customer's balances on deposit with them.
effectiveness	Program success in achieving mission and goals.

Electronic Federal Tax Payment System (EFTPS)	A tax payment system provided free of charge to taxpayers by the U.S. Department of Treasury.
electronic funds transfer (EFT)	Any transfer of funds that is initiated by electronic means.
internal control	A process, effected by management, designed to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.
lockbox	A post office box that is established by a bank to receive checks for another organization. Lockboxes are utilized to accelerate deposits into the bank by eliminating internal processing by an organization.
management control	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.
Michigan Administrative Information Network (MAIN)	The State's fully integrated automated administrative management system that supports the accounting, payroll, purchasing, contracting, budgeting, personnel, and revenue management activities and requirements. MAIN consists of four major components: MAIN Enterprise Information System (EIS); MAIN Financial Administration and Control System (FACS); MAIN Human Resource System (HRS); and MAIN Management Information Database (MIDB).
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.

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.
service organization	The entity (or segment of an entity) that provides services to a user organization that are part of the user organization's information system.

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STATE OF MICHIGAN

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