



NEBRASKA AUDITOR OF PUBLIC ACCOUNTS

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February 28, 2008

Mr. Douglas Ewald, Tax Commissioner
Nebraska Department of Revenue
301 Centennial Mall South, 2nd Floor
Lincoln, Nebraska 68509-4818

Dear Mr. Ewald:

We have audited the basic financial statements of the State of Nebraska (the State) for the year ended June 30, 2007, and have issued our report thereon dated December 28, 2007. We have also audited the State's compliance with requirements applicable to major federal award programs and have issued our report thereon dated February 13, 2008. In planning and performing our audit, we considered the State's internal controls in order to determine our auditing procedures for the purpose of expressing our opinions on the basic financial statements of the State and on the State's compliance with requirements applicable to major programs, and to report on internal control in accordance with the federal Office of Management and Budget (OMB) Circular A-133 (the Single Audit) and not to provide assurance on internal control. We have not considered internal control since the date of our report.

In connection with our audit described above, we noted certain internal control or compliance matters related to the activities of the Nebraska Department of Revenue (the Agency) or other operational matters that are presented below for your consideration. These comments and recommendations, which have been discussed with the appropriate members of the Agency's management, are intended to improve internal control or result in other operating efficiencies.

Our consideration of internal control included a review of the prior year comments and recommendations. To the extent the situations that prompted the recommendations in the prior year still exist, they have been incorporated in the comments presented for the current year. All other prior year comments and recommendations (if applicable) have been satisfactorily resolved.

Comment Number 1 (Accrual Procedures) and Comment Number 2 (Segregation of Duties Over GPS, Homestead, and Motor Fuels Applications) are considered significant deficiencies. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Agency's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more

than a remote likelihood that a misstatement of the financial statements that is more than inconsequential will not be prevented or detected by the Agency's internal control. These comments will also be reported in the State of Nebraska's Statewide Single Audit Report Schedule of Findings and Questioned Costs.

A separate evaluation of the State's significant Information Technology (IT) systems was completed. Some findings, as noted below, were reported as a part of the audit of the Comprehensive Annual Financial Report (CAFR). Additional findings and recommendations were reported to management in a separately issued confidential summary of findings and recommendations.

Draft copies of this letter were furnished to the Agency to provide them an opportunity to review the letter and to respond to the comments and recommendations included in this letter. All formal responses received have been incorporated into this letter. Where no response has been included, the Agency declined to respond. Responses have been objectively evaluated and recognized, as appropriate, in the letter. Responses that indicate corrective action has been taken were not verified at this time, but will be verified in the next audit.

The following are our comments and recommendations for the year ended June 30, 2007.

COMMENTS RELATED TO THE AUDIT OF THE BASIC FINANCIAL STATEMENTS

1. Accrual Procedures

Good internal control requires procedures to ensure receivables and payables reported to Administrative Services State Accounting Division (State Accounting) for the CAFR be accurate. Sound accounting practices require estimates be reasonable and adequately documented.

Accrual procedures for the Agency could be improved. The following are specific items related to accrual procedures noted while performing testing for the CAFR:

- The Agency reported accounts receivable of \$18,455,098 for Sales and Use, Withholding, Individual Income, and Corporate Income delinquent taxes. The estimation was generally based on prior collection experience of delinquent accounts. For delinquent Sales taxes, the Agency did not have prior collection information available and used actual collections for all taxes in the estimation. The Agency had no documentation to support a relationship between the percentage of collections for all delinquent taxes and the percentage of collection for delinquent Sales taxes. In addition, the Agency did not have receivable aging information available to aid in calculating the receivable amount for delinquent taxes. While there was a concern whether the delinquent receivable amounts were reasonably stated, the receivable amount reported was less than the fiscal year 2007 actual collections amount for active cases of \$21,363,826.

- The Agency had no documentation to support the percentages used to estimate tax year 2007 and 2006 collections of delinquent Withholding and Corporate Income taxes.
- The Agency reported accounts receivable of \$18,455,098 for Sales and Use, Withholding, Individual Income, and Corporate Income delinquent taxes. The amount reported is after reductions for protested audits and an estimate of the amount that will not be collected. The Agency's actual recorded receivables were \$120,036,266 which included \$40,813,360 of protested audit amounts. The Agency reported this information to State Accounting, but initially State Accounting did not record an allowance for doubtful accounts. After discussion with the auditor, an allowance for doubtful accounts of \$62,400,000 was booked. The allowance did not include the protested audits amount. In addition, the formula used to calculate Long-term Delinquent Accounts Receivable was incorrect, which resulted in the under-reporting of estimated long-term receivables by \$272,089.
- The Agency did not originally report fiscal year 2007 accrual information for lodging taxes received in July, August, and September 2007 for May and June 2007 lodging taxes. Receivables were understated by \$1,933,452.
- The Agency used two different sources of information to estimate Corporate Tax Refunds related to fiscal year 2007. The Agency revised the amount originally reported to State Accounting by \$2,349,846 by using only the forecasted amount of refunds from the Agency's Research Division.
- There was no documentation to support the Agency's adjustment to the calculation of the five year average collection percentage for individual income tax refunds. The adjustment made resulted in estimated refunds being decreased by \$1,058,504.
- The Agency did not review actual collections of Individual Income Tax, Estate Tax, and Sales and Use Tax after August and report significant collections to State Accounting prior to the CAFR being issued in December to provide a more accurate receivable at June 30. September 2007 collections were \$748,789, \$939,387, and \$524,459 respectively.

When accrual amounts reported by the Agency are not accurate there is a risk the CAFR financial statements will not be correctly stated.

We recommend the Agency with the assistance of Administrative Services State Accounting Division, review the accrual estimation procedures. This review should include the estimate of delinquent receivables, procedures for delinquent accounts and allowance for doubtful accounts, lodging tax, corporate tax refunds, and the use of September collections as they relate to regular tax receivables.

Agency's Response: The accrual amounts reported by our Agency include large dollar estimates which can be influenced not just by rate changes and the economy, but by factors such as: non-filers, late or delinquent returns, amended returns, refund claims, non or partial remittances, late remittances, audit assessments, and protested audits. Slight variances in the method of calculating various receivables or payables can substantially impact the result. For example, the \$1,058,504 mentioned in bullet point six resulted from just a 0.14% variance from the five year average favored by your auditor and our adjustment to that average to reflect the percentage of change between those five years. Our Agency does intend to comply with your recommendation to work with Administrative Services State Accounting Division in the review of our accrual estimation procedures. Toward that goal, our Agency has had discussions with State Accounting on whether to project September receivables or wait and report actual collections. Also, our Agency will report a receivable on protested audits even though, legally, protested audits remain proposed assessments and are not considered final due and owing until resolved.

2. Segregation of Duties Over GPS, Homestead, and Motor Fuels Applications

Good internal control requires procedures to ensure no one individual has the authority to administer servers and also approve changes and promote those changes to production. If security is not implemented and configured according to business risk, access to critical system settings and data can be modified inappropriately, disclosed without authorization, and/or unavailable when necessary.

One individual had the ability to administer the Windows servers supporting the General Processing System (GPS), Homestead, and Motor Fuels applications as well as the ability to approve application changes and promote them to production processing, creating a segregation of duties issue.

Should a programmer choose to do so, they have the capability to create and approve an unauthorized change for movement to production processing.

We recommend access be segregated so a single user does not have the ability to approve changes, implement changes, and change system security configurations.

Agency's Response: Our Agency is initiating a formal approval process which will segregate the authority to approve changes from the user that implements the changes.

Our audit procedures are designed primarily on a test basis and, therefore, may not bring to light all weaknesses in policies or procedures that may exist. Our objective is, however, to use our knowledge of the Agency and its interaction with other State agencies and administrative departments gained during our work to make comments and suggestions that we hope will be useful to you.

This letter is intended solely for the information and use of the Agency, the Governor and State Legislature, others within the Agency, Federal awarding agencies, pass-through entities, and management of the State of Nebraska. However, this letter is a matter of public record and its distribution is not limited.

We appreciate and thank all of the Agency employees for the courtesy and cooperation extended to us during our audit.



Pat Reding
Assistant Deputy Auditor



Don Dunlap
Assistant Deputy Auditor