

NEBRASKA DEPARTMENT OF REVENUE

**SERVICE ORGANIZATION CONTROLS (SOC) 1
TYPE 1 EXAMINATION**

**REPORT ON THE DESCRIPTION OF COLLECTION AND
DISTRIBUTION OF THE LOCAL OPTION SALES AND
USE TAX SYSTEM AND THE SUITABILITY OF
THE DESIGN OF CONTROLS**

AS OF MARCH 31, 2012

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Issued on September 5, 2012

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Section I
Independent Service Auditor's Report



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Independent Service Auditor's Report

Douglas Ewald, Tax Commissioner
Nebraska Department of Revenue
Lincoln, NE 68509-4818

We have examined the Nebraska Department of Revenue's (Department) description of its Collection and Distribution of the Local Option Sales and Use Tax System as of March 31, 2012, and the suitability of the design of controls to achieve the related control objectives stated in the description. The description indicates that certain complementary user entity controls must be suitably designed and implemented at user entities for related controls at the service organization to be considered suitably designed to achieve the related control objectives. We have not evaluated the suitability of the design or operating effectiveness of such complementary user entity controls.

On Section II, starting on page 4, the Department has provided an assertion about the fairness of the presentation of the description and suitability of the design of the controls to achieve the related controls objectives stated in the description. The Department is responsible for preparing the description and for its assertion, including the completeness, accuracy, and method of presentation of the description and the assertion, providing the services covered by the description, specifying the control objectives and stating them in the description, identifying the risks that threaten the achievement of the control objectives, selecting the criteria, and designing, implementing, and documenting controls to achieve the related control objectives stated in the description.

Our responsibility is to express an opinion on the fairness of the presentation of the description and on the suitability of the design of the controls to achieve the related control objectives stated in the description, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance, in all material respects, about whether the description is fairly presented and the controls were suitably designed to achieve the related control objectives stated in the description as of March 31, 2012.

An examination of a description of a service organization's system and the suitability of the design of the service organization's controls to achieve the related control objectives stated in the description involves performing procedures to obtain evidence about the fairness of the

presentation of the description of the system and the suitability of the design of the controls to achieve the related control objectives stated in the description. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed to achieve the related control objectives stated in the description. An examination engagement of this type also includes evaluating the overall presentation of the description and the suitability of the control objectives stated therein, and the suitability of the criteria specified by the service organization and described in Section III, starting on page 7.

We did not perform any procedures regarding the operating effectiveness of the controls stated in the description and, accordingly, do not express an opinion thereon.

We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

Because of their nature, controls at a service organization may not prevent, or detect and correct, all errors or omissions in the collection and distribution of sales tax. The projection to the future of any evaluation of the fairness of the presentation of the description, or any conclusions about the suitability of the design of the controls to achieve the related control objectives is subject to the risk that controls at a service organization may become ineffective or fail.

In our opinion, in all material respects, based on the criteria described in the Department's assertion,

- a. the description fairly presents the Collection and Distribution of the Local Option Sales and Use Tax System that was designed and implemented as of March 31, 2012, and
- b. the controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively as of March 31, 2012, and user entities applied the complementary user entity controls contemplated in the design of the Department controls as of March 31, 2012.

This report is intended solely for the information and use of the Department, user entities of the Department's Collection and Distribution of the Local Option Sales and Use Tax System as of March 31, 2012, and the independent auditors of such user entities, who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when obtaining an understanding of user entities information and communication systems relevant to financial reporting. This report is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Signed Original on File

Don Dunlap, CPA
Assistant Deputy Auditor

August 31, 2012

Lincoln, Nebraska

Section II

**Management's Assertion Provided by the Nebraska Department of Revenue
on the Description of Collection and Distribution of the Local Option Sales
and Use Tax System and the Suitability of the Design of Controls
as of March 31, 2012**



Dave Heineman
Governor

STATE OF NEBRASKA

DEPARTMENT OF REVENUE

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Nebraska Department of Revenue (Department) Assertions

We have prepared the description of the Department's Collection and Distribution of the Local Option Sales and Use Tax System and Related General IT Controls for user entities of the system as of March 31, 2012, and their user auditors who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when obtaining an understanding of user entities' information and communication systems relevant to financial reporting.

We confirm, to the best of our knowledge and belief, that

- a. the description fairly presents the Collection and Distribution of the Local Option Sales and Use Tax System and Related General IT Controls made available to user entities of the system as of March 31, 2012, for the collection and distribution of local option sales and use tax. The criteria we used in making this assertion were that the description
 - i. presents how the system made available to user entities of the system was designed and implemented to process relevant transactions, including:
 - the classes of transactions processed;
 - the procedures, within both automated and manual systems, by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, and transferred to the reports presented to user entities of the system;
 - the related accounting records, supporting information, and specific accounts that are used to initiate, authorize, record, process, and report transactions; this includes the correction of information and how information is transferred to the reports provided to user entities of the system;
 - how the computer system captures and addresses significant events and conditions, other than transactions;
 - the process used to prepare reports or other information provided to user entities of the system;
 - specified control objectives and controls designed to achieve those objectives; and

- other aspects of our control environment, risk assessment process, information and communication systems (including the related business processes), control activities, and monitoring controls that are relevant to processing and reporting transactions of user entities of the system.
 - ii. does not omit or distort information relevant to the scope of the Collection and Distribution of the Local Option Sales and Use Tax System and Related General IT Controls, while acknowledging that the description is prepared to meet the common needs of a broad range of user entities of the system and the independent auditors of those user entities, and may not, therefore, include every aspect of the Collection and Distribution of the Local Option Sales and Use Tax System and Related General IT Controls that each individual user entity of the system and its auditor may consider important in its own particular environment.
- b. the controls related to the control objectives stated in the description were suitably designed as of March 31, 2012, to achieve those control objectives. The criteria we used in making this assertion were that:
 - i. the risks that threaten the achievement of the control objectives stated in the description have been identified by the Department; and
 - ii. the controls identified in the description would, if operating as described, provide reasonable assurance that those risks would not prevent the control objectives stated in the description from being achieved.

Section III

Description of Controls Provided by the Nebraska Department of Revenue for the Collection and Distribution of the Local Option Sales and Use Tax System as of March 31, 2012

I. Overview of the Nebraska Department of Revenue's Collection and Distribution of the Local Option Sales and Use Tax System

Nebraska law allows local municipalities to levy a local option sales and use tax. State law also provides that the Tax Commissioner is responsible for collecting the local option sales and use tax in the same manner as the State sales and use tax. The Tax Commissioner is required to remit the local option sales and use tax collected, less refunds and the 3% administrative fees, to the appropriate local municipalities on a monthly basis.

II. Control Environment Over the Nebraska Department of Revenue's Collection and Distribution of the Local Option Sales and Use Tax System

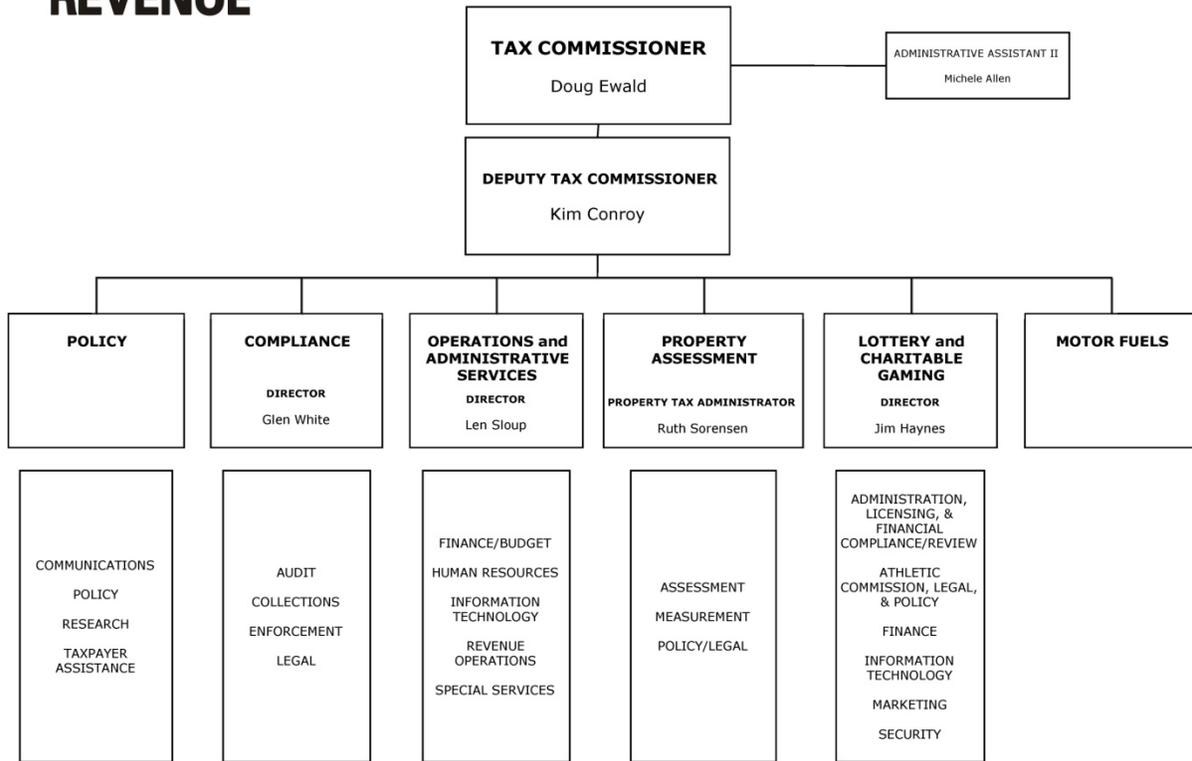
The control environment can be defined as the collective effect of various factors on establishing and enhancing the effectiveness of specific internal controls. Pertinent control information is critical to maintain an effective internal control system. Information is identified, captured, and communicated in a form and timetable that enables the Department personnel to carry out their responsibilities in an efficient and effective manner as it relates to the Department's Collection and Distribution of the Local Option Sales and Use Tax System. The Department's Collection and Distribution of the Local Option Sales and Use Tax System produces reports containing operational, financial, and compliance-related information that make it possible to monitor and control the collection and distribution of local option sales and use tax. Effective communication regarding the importance of internal controls to Department employees also occurs in a broader sense throughout the Department through management oversight and the Department's Revenue Policy entitled Internal Control Plan, as well as the Department of Revenue Goals and Values and the Taxpayer Bill of Rights.

A. Organizational Structure

The Nebraska Department of Revenue primarily uses a functional organizational structure in the administration of State tax programs. The functional organization used in the Department has each division performing their respective tax administration functions for the state and local option sales and use tax program as well as other tax programs. An example of a function is mail handling and processing which is performed in the Revenue Operations area for all tax programs, which includes all sales and use tax returns and documents. Each division has clearly identified responsibilities for the sales and use tax program and management reporting lines that relate to those responsibilities.



NEBRASKA DEPARTMENT OF REVENUE
April 2012



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B. Control Activities

The Department’s control activities integrate the methods, plans, attitudes, policies, procedures, and efforts of the staff to provide reasonable assurance that the Department will achieve its mission and objectives. The Department’s mission is to serve the public by administering the State revenue laws, which the local option sales and use tax program is a part of, with integrity, efficiency, and consistency. Control activities occur throughout the Department and include, but are not limited to, a wide and comprehensive range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties. Key Department control activities as they relate to the purpose of this report are included in Section IV of this report.

C. Risk Assessment

The Department has developed procedures and processes to monitor, address, and mitigate risk to ensure that state and local option sales and use taxes are being properly reported, collected, and distributed to the extent possible with the resources available. The Department also provides a program called [Sales Tax Rate Finder](#) on our [website](#) that allows retailers and taxpayers to determine local option sales and use tax rates based on the address they provide. Education and easy access to information is also a key component in keeping taxpayers aware of their responsibilities.

Potential risks that our processes are designed to mitigate are: improper collection of the tax, calculation errors made by taxpayers in computing the tax, improper reporting of the tax, failure to collect and report the tax, taxpayers being unaware of local option sales and use tax changes and obligations, and errors in distribution of the local option sales and use tax to localities.

There are computer system procedures in place that are performed on a monthly basis to review anomalies in state and local option sales and use tax return reporting that allow for staff to review and correct data if necessary. These review categories include: reporting to the proper municipality, proper amount of tax reported, comparisons of state and local option sales and use taxes, review of common error situations, etc. These processes are performed on data reported to the Department on the state and local sales and use tax returns. The Department also performs audits and other reviews of retailers and taxpayers to ensure that state and local option sales and use tax is being properly reported and paid.

D. Monitoring

Monitoring of the internal control system is a constant process that assesses the quality of the ongoing operational performance of the Department. This is accomplished primarily by constant monitoring of activities conducted by the Department's management and staff. Management's control methods for monitoring key Department activities as they relate to the administration of the local option sales and use tax program are described in Section IV of this report.

III. General Computer Controls Over the Nebraska Department of Revenue's Collection and Distribution of the Local Option Sales and Use Tax System

All data processing for the Collection and Distribution of Local Option Sales and Use Tax System is located in a secure facility operated by the Office of the Chief Information Officer (OCIO). Data processing controls refer to controls surrounding the development, implementation, maintenance, and operation of application systems, and the environment in which these applications operate, including:

- A. Operating Systems and Application Change Controls**
- B. Physical Access**
- C. Logical Access-Security Administration**
- D. Operations**

A. Operating Systems and Application Change Controls

All system changes are authorized and tracked through the Department's work order system. When a system change request is received from a manager in the Department by IT Services, the requirement is researched and a work order prepared. The work order is reviewed by the Director of Operations and Administrative Services or the IT manager, and is signed by that person if approved. The approved work order is presented to the OCIO for programming. Department IT Services monitor the programming by OCIO and test the changed program. Upon verification of the accuracy of the changes and the integrity of the processing of the test data, Department IT Services authorizes the changed program to be put into production. Monitoring continues in production.

B. Physical Access

The Department's computer systems, which are maintained on a mainframe computer, are located in a secure facility operated by the OCIO. Access to that building, as well as the Department's offices located in the Nebraska State Office Building, is limited to authorized personnel and is monitored by security officers of the Nebraska State Patrol and computerized access control systems. Authorization is based on job roles. There is no public access to the OCIO facility.

C. Logical Access-Security Administration

Access to software and data is controlled by security software which meets Nebraska Information Technology Commission (NITC) and Internal Revenue Service (IRS) standards. Access may be at varying levels and is granted dependent upon job roles. The software prevents access to data at any level for which the user is not authorized.

D. Operations

Processing of sales and use tax data takes place on a mainframe computer operated by the OCIO. That office is responsible for computer operations, including application and systems programming. The mainframe is located in a secure facility with a backup power supply. Additional backups and disaster recovery for the system are also the responsibility of the OCIO.

IV. Process Description, Control Objectives, and Related Controls Over the Nebraska Department of Revenue's Collection and Distribution of the Local Option Sales and Use Tax System

The Department has implemented controls, found on subsequent pages under the heading Department Controls, to ensure the following control objectives for the collection and distribution of local option sales and use taxes are met:

Control Objectives:

- 1 Based on the tax returns filed, the amount of tax collected on behalf of each locality is correct;
- 2 An adequate segregation of duties exists within the Department to ensure all amounts received are deposited; and
- 3 Sales and use tax is correctly allocated and distributed to each locality.

Tax Policy Division

- 1 & 3 The Tax Policy Division coordinates the implementation of new revenue laws and monitors the resulting implementation to ensure that these laws are efficiently administered and fit within the framework of the goals and functions of the administration. It is responsible for originating and coordinating all necessary forms, instructions, information guides, regulations, and revenue rulings. It also monitors, implements, and provides notice to permit holders on all relevant tax changes through [GovDelivery®](#) (the Department's web-based free email information subscription service), as well as information on the [Department's website](#) and [educational training sessions](#) conducted by the Communications Section.

Revenue Operations-Initial Operations

- 1 & 2 Mail enters the Department in Initial Operations. The envelope is attached documenting the postmark date for the calculation of penalty and interest. Returns that are late are noted as such. Returns are also filed electronically via [NebFile for Business](#) or on the phone. NebFile for Business is the Department's web application for online filing of sales and use tax returns.

- 1 & 2 All tax receipts are entered and validated on the Nebraska Online Validation System (NOV) on the date they are received in the Department, which provides immediate document and receipt control. This is an online real-time system. Electronic funds transfers (EFT) also bring payments of tax liability into the sales and use tax system. While electronic payments do not go through the Initial Operations Section of the Revenue Operations Division, they enter the NOV system from the Electronic Tax Receipt (ETR) system.

- 2 Paper receipts are written for any cash received. Receipts and checks are validated, then added together and compared to the validation total for reconciliation purposes. The receipts and checks are scanned, and then cash and checks are sent to the Finance Section. The EFT payments received through the Automated Clearing House (ACH) is downloaded each day by staff in IT Services. An accounting clerk prepares the deposit documents for both cash and checks. A revenue agent prepares the deposit documents for EFT payments. The deposit documents are reviewed and approved in the Finance Section by a revenue agent, accountant III, or controller. The deposit documents, cash, and checks are sent to the State Treasurer for posting/processing. An accounting clerk II reconciles the deposit document on a daily basis to the NOV validation totals. This daily reconciliation is reviewed by the revenue agent and by the accountant III, who document their review and approval by initialing.

Data Entry

- 1 & 2 The information reported by the taxpayer from each individual return is entered into the sales tax system. The return is identified by the same batch number and report number as the batch number and report number assigned in the validation (NOV) process.

Electronic Filing

- 1 & 2 TeleFile and e-filing allow taxpayers to enter data into the reporting system. Substantially the same validity and mathematical checks apply to electronically filed returns as paper filed returns. The SCT055 (journal routine), which is worked by the Processing Resolution Section in Revenue Operations, checks these returns just as it does paper ones for data and calculation correctness.

Business Processing Resolution

- 1 & 2 The data from paper returns then goes to Business Processing Resolution where the edit/match function is performed to ensure the data entered in the NOV system agrees with data entered on the sales tax system. Items that pass the control test go to the journal for calculation verification and items that do not pass are sent to an error listing for correction of NOV control information.

- 1
- After the data from the individual returns is merged, the records are tested for mathematical accuracy in the journal stage. Items that pass all tests are considered accepted. Report SCT055 is generated, which details daily accepted items, dollar amounts in total, and records in error. Records not in error are passed into the Month-to-Date (MTD) accepted data file. Posting of the data into computer history transaction files occur at the SCT545 step each month. Posted returns can be accessed online.

The balance forward file contains credit balances that have not been refunded or used and sales or use tax owed in excess of remittance from prior periods. Additional sources of balance forwards are penalty and interest assessments. The penalty is either \$25 or 10% of the tax liability; whichever is greater. Any interest calculated is based upon the balance outstanding at an interest rate specified by State law. Report SCT536 is generated, which details machine-assessed penalty and interest.

The program ledger then combines the MTD information, penalty and interest, and balance forward records. Report SCT545 is generated, which details the number and type of records processed for the current period, in addition to those brought forward from prior periods. The new balance forward or credit balance represents the liability for which no remittance has been received or the remittance was in excess of the calculated liability, respectively.

- 1, 2 & 3
- There are computer system procedures in place that are performed on a monthly basis to review anomalies in state and local option sales and use tax return reporting that allow for staff to review and correct data if necessary. These review categories include: reporting to the proper locality, was the proper amount of tax reported, comparisons of state and local option sales and use taxes, review of common error situations, comparisons of actual totals to forecasted totals, etc. These processes are performed on data reported to the Department on the sales and use tax returns and are not audited amounts. The Department also performs audits and reviews of taxpayers where state and local option sales and use tax reporting is reviewed to ensure these taxes are being reported and paid properly.

Business Processing Resolution-Licensing

- 1
- The Department carefully reviews and processes the applications for new sales and use tax permits that are filed by taxpayers to register for the collection of state and local option sales and use taxes so that the data in our records can be used to help make sure that the proper taxes are collected, reported, and distributed. It is critical that the proper names, addresses, location of county and city, social security numbers, and other detail information of the business be correct in our records so that tax return reporting be accurate for balance and distribution purposes.
- 2
- The allocation summary relates the amounts remitted for the period to the associated current and prior-period tax liability. The Department allocates to the oldest liability first. This amount is allocated by the system on a taxpayer-by-taxpayer basis as follows:
- Current Month Tax Processing
 - Current Penalty Assessment
 - Current Interest Assessment
 - Balance Forward Tax Processing
 - Balance Forward Penalty
 - Balance Forward Interest

Information Systems

- 3
- The allocation summary is created for remitted amounts for the period less collection fees. An allocation listing is produced (SCT712), which details amounts to be remitted by tax category to each applicable locality and to the State. The listing is entirely system-generated, based upon the detail information entered at the data entry stage.

An IT applications developer lead receives reports generated from the sales tax system on a daily basis. He/she balances all reports daily to ensure completeness by comparing the number of records and the dollar amounts, and investigates any possible anomalies indicated by the totals.

- 3 A local option sales and use tax listing (SCT815) is generated subsequent to the monthly allocation process which contains all taxpayers with situations where the system allocated local option sales and use tax to a locality other than the business location but not to the locality of the business location. This listing is reviewed by Business Processing Resolution to check for any possible reporting or input problems. If any errors are noted, the error is netted against the next month's distribution.

Finance Section

- 3 The accountant III in the Finance Section accumulates information on any required sales or use tax refunds to taxpayers. The accountant III totals the amounts for entry into the allocation spreadsheet. Any refund related to a locality will be deducted when calculating the monthly remittance.
- 3 A monthly allocation listing (SCT712) is generated from the SCT mainframe system after all timely filed returns have been processed. This listing allocates the sales tax, use tax, and sales tax on motor vehicles amounts by each locality. In addition, local sales tax on motorboats reported and remitted by the county treasurers are obtained on a monthly basis from the General Processing System (GPS). The GPS is not a mainframe program, but is used for processing miscellaneous tax returns. The accountant III imports the SCT712 listing information and manually enters the GPS information, along with taxpayer refund returns (adjustments) into the allocation spreadsheet. The allocation spreadsheet sums the amounts by locality, less adjustments, to arrive at the gross remittance. From this gross remittance amount, State statutes provide for a 3% administration fee to be deducted to arrive at the net remittance per locality.
- 1 & 3 The net remittance to each locality is tested for reasonableness by the accountant III via a historical range spreadsheet. Amounts considered reasonable are passed through to the final allocation spreadsheet. Amounts not deemed reasonable are investigated.
- 3 The accountant III contacts the IT applications development lead concerning remittance amounts that do not appear reasonable. Data is extracted and investigated as needed to explain unusual fluctuations. Once amounts are investigated and resolved, they are returned to the final allocation spreadsheet.
- 3 The controller or revenue agent provides approval and the accountant III posts a multiple vendor payment document in the EnterpriseOne accounting system to issue EFT payments to each locality based upon the final allocation spreadsheet. Details that make up the remittance and information on the settlement date are posted on the Department's website for viewing by the locality.

Compliance Division-Audit Section

1, 2 & 3

The Audit Section within the Compliance Division conducts audits on the books and records of larger taxpayers to ensure they are in compliance with the tax laws and also participates in informational exchanges with other tax authorities. These audits include state and local option sales and use taxes. Audits are generally conducted where the taxpayer's records are located, including locations outside of Nebraska.

The Audit Section also administers the [economic incentive programs](#) and provides education to taxpayers on benefits available; answer technical questions from taxpayers; prepare agreements with taxpayers allowing for the use of the incentives; review refund claims; and audit the records of the taxpayer to ensure compliance with the relevant incentive program. Review of refund claims includes a review of whether it is appropriate to refund state and local option sales and use taxes. In addition, an [annual report](#) to the Nebraska Legislature on the economic incentive programs is prepared.

Compliance Division-Collection Section

1, 2 & 3

The Collection Section within the Compliance Division is responsible for the collection of delinquent state and local option sales and use taxes. Those delinquencies may be in the form of non-filed returns or unpaid balances which includes both state and local option sales and use taxes that have not been paid. In the case of non-filed returns, the agent makes every effort to obtain the tax returns and payment. If a permit holder fails to file the returns, the agent will make an assessment of state and local option sales and use taxes based on prior reporting history, and begin collection processes. As a last resort, the agent may pursue revocation of the permit-holder's sales tax permit.

The Tax Discovery Section in the Compliance Division reviews businesses which meet certain review criteria. The focus is on state and local sales and use taxes that have been determined to be due and not reported from reviewing the permit-holder's actual records. These examiners also review a monthly Department computer listing of any sales and use tax permits that are located in a city with a local sales tax that have not reported or remitted any local tax. Those permit-holders are notified accordingly and the local option sales and use tax is collected.

V. Current and Future User Control Considerations Over the Nebraska Department of Revenue's Collection and Distribution of the Local Option Sales and Use Tax System

User Controls in Place Presently

The Department [provides monthly information on sales and use tax](#) remitted to municipalities on its website that can be reviewed and used for control purposes.

Municipalities are allowed by statute to request annual rosters of businesses (names and addresses) that have collected local option sales and use taxes for the municipality for the previous fiscal year. This information can be used for determining if all businesses are licensed properly and remitting local option sales and use taxes.

Municipalities can also contact the Department if they suspect that a business is not licensed or reporting sales and use taxes properly. The Department will then investigate that situation to ensure that the business is properly licensed and reporting.

Future User Controls

Municipal Inspection of Sales Tax Returns (LB 209 – Operative Date: July 19, 2012)

A municipality that has adopted a local option sales and use tax may inspect, upon written request, sales tax returns of businesses remitting sales tax from locations located within the municipality's boundaries. Procedures and processes are currently being developed by the Department for the implementation of this legislation.