



NEBRASKA AUDITOR OF PUBLIC ACCOUNTS

Mike Foley
State Auditor

Mike.Foley@nebraska.gov
PO Box 98917
State Capitol, Suite 2303
Lincoln, Nebraska 68509
402-471-2111, FAX 402-471-3301
www.auditors.nebraska.gov

December 18, 2014

Kim Conroy, Tax Commissioner
Department of Revenue
301 Centennial Mall South, 2nd Floor
Lincoln, Nebraska 68509-5026

Dear Ms. Conroy:

We have audited the basic financial statements of the State of Nebraska (State) as of and for the year ended June 30, 2014, in accordance with auditing standards generally accepted in the United States of America and standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and have issued our report thereon dated December 16, 2014. In planning and performing our audit, we considered the State's internal control over financial reporting (internal control) as a basis for designing audit procedures for the purpose of expressing our opinions on the basic financial statements of the State, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control. Accordingly, we do not express an opinion on the effectiveness of the State's internal control.

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 (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 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.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified.

Draft copies of this letter were furnished to the Agency to provide management with an opportunity to review and to respond to the comments and recommendations contained herein. All formal responses received have been incorporated into this letter. 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, 2014.

1. Improper Accrual

The Department of Administrative Services State Accounting Division (State Accounting) prepares the State Comprehensive Annual Financial Report (CAFR) and requires all State agencies to determine and report payable and receivable amounts at the end of the fiscal year on an accrual response form. A good internal control plan requires agencies to have procedures to ensure accurate reporting of financial information to State Accounting.

One receivable tested was overstated by \$5,945,616, due to an error recorded in the Agency's tax system. The Agency inadvertently recorded a July 2014 tax receipt, received in August 2014, as a June 2014 receipt, causing the calculated receivable to be overstated. After the Auditor of Public Accounts discovered the error, a correction was sent to State Accounting for the proper accrual in the financial statements.

We recommend the Agency implement procedures to ensure amounts reported are complete and accurate. Furthermore, we recommend secondary reviews be performed to ensure tax receipts are properly recorded in the Agency's system.

Agency Response: The Department of Revenue (Department) agrees that all material payments should be reviewed to ensure that the tax period reported by the taxpayer at time of payment corresponds to the tax period that created the liability. Although the Department performs a secondary review of accrual information, the error in question originated from a report that was first available on September 4, 2014, and was included with accrual forms forwarded to State Accounting, which were due on September 5, 2014. The Department will implement procedures to ensure adequate time for a thorough review while still meeting State Accounting's CAFR deadline. A subsequent reporting error by this taxpayer in September was caught and the payment was not included in supplemental accrual information provided to State Accounting. As you indicated, the final accrual information was corrected once the Department researched the account involved and determined that the taxpayer had incorrectly indicated the payment was associated with the prior fiscal year.

2. Underpayment of Estimated Tax Penalty

Title 316 NAC 20-002.01 states, in relevant part:

Every corporation or business which is taxed as a corporation under the Internal Revenue Code shall make payments of Nebraska corporation estimated income tax if the Nebraska tax liability for the taxable year can reasonably be expected to be \$400 or more after deducting the total estimated allowable credits . . .

According to Title 316 NAC 20-008.01, “A penalty is due on any underpayment of estimated tax.”

Title 316 NAC 20-008.05 provides, in relevant part:

If there has been an underpayment of estimated tax as of any installment date, a Corporation Underpayment of Estimated Tax, Form 2220N, must be completed and attached to the Nebraska Corporation Income Tax Return, Form 1120N. . . .

A good internal control plan requires that system checks be in place to ensure penalties reported to the Agency are calculated correctly, and tax penalties due are identified and assessed.

The Agency’s corporate tax system (CTX) lacked system checks to ensure corporations were correctly calculating penalties due or that corporations failing to assess and pay penalties were in compliance with the Agency’s rules and regulations.

Furthermore, the Agency did not have procedures in place to manually review the accuracy of penalty forms submitted by corporations or to ensure that all corporate penalties owed were paid. Instead, the Agency’s audit staff performed reviews of corporate tax returns identified as high risk for owing, but not paying, a penalty. According to the Agency, for the tax years 2006 and 2007, 318 accounts were reviewed, and 90 were assessed an underpayment penalty for a total of \$521,856. Two hundred accounts were reviewed for tax year 2008, and 28 were assessed an underpayment penalty for a total of \$246,691. At the time of this audit, the Agency was still in the process of reviewing corporate accounts for tax years 2009, 2010, 2011, and 2012. The Agency indicated it had collected a total of \$279,514 as of September 30, 2014, for tax years 2009, 2010, 2011, and 2012.

Because all corporations were not subject to the Agency’s audit reviews, the number of non-complying corporations or possible unassessed penalty payments remained unknown. However, as of 2010, according to the Agency, approximately 20,500 corporations had filed tax returns in the State of Nebraska.

A similar finding was noted in the prior audit.

When system checks are not in place and procedures are not performed to ensure penalties are properly paid, in compliance with State regulations, penalties are likely to be underpaid by corporations, either intentionally or otherwise.

We recommend the Agency implement procedures or system verifications of corporate penalty forms to ensure that penalties are correctly identified and assessed.

Agency Response: The Department has directed, and continues to direct, considerable resources toward addressing your recommendation in a number of ways. A system change is planned for the 2015 processing year that will allow taxpayer’s Form 2220N information to be data entered and checked for mathematical correctness in specific situations. However, due to the unique nature of the corporation underpayment of estimated tax penalty calculation, developing and implementing a system to identify and assess the penalty automatically is not feasible. Rather, we have developed and implemented a compensating control of auditing accounts with payments

above a certain dollar threshold for corporation underpayment of estimated tax penalty; the Department believes this is the best method to ensure that penalties are correctly identified, calculated, and assessed from a limited resource and materiality perspective. Good internal controls require that risks be identified and minimized, not entirely eliminated. Ultimately it is the Department's responsibility to administer the state revenue laws. This involves difficult, high-level, decisions regarding priorities and resource allocation.

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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 the Agency.

This communication 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 and is not intended to be, and should not be, used by anyone other than the specified parties. However, this communication is a matter of public record, and its distribution is not limited.



Pat Reding, CPA, CFE
Assistant Deputy Auditor