

**DEPARTMENT OF TAXATION**

**REPORT ON AUDIT  
FOR THE YEAR ENDED  
JUNE 30, 2004**



## **AUDIT SUMMARY**

We have audited selected financial records and operations of the Department of Taxation for the year ended June 30, 2004, in support of the Comprehensive Annual Financial Report for the Commonwealth of Virginia. Our audit found:

- proper recording and reporting of transactions, in all material respects, in the Commonwealth Accounting and Reporting System and in Taxation's accounting systems;
- internal control matters that we consider reportable conditions, but not material weaknesses; and
- no instances of noncompliance with applicable laws and regulations tested that are required to be reported under Government Auditing Standards.

The section entitled "Internal Control Findings and Recommendations" includes our findings.

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## INTERNAL CONTROL FINDINGS AND RECOMMENDATIONS

We have included management's views concerning these findings and recommendations, as well as their planned corrective actions, at the end of this report.

### Modify and Adhere to Existing UNIX Policies

Taxation has not applied security patches to any of their servers for quite some time because of the development of the Advantage Revenue System. Taxation's UNIX security policies and procedures require operators to document deviations in set up and maintenance requirements; however, we could not locate any written exceptions related to the installation of patches. Failure to follow established policies and procedures increases the risk of loss of critical and confidential data and system failure. Taxation should document deviations from established policies and procedures.

Additionally, Taxation has removed from their policies and procedures a requirement to periodically review world writeable files and directories on all UNIX systems. World writable files allow anyone with access to the system to alter the files. At the time of the audit, Taxation had not reviewed these database files and directories. Without a review of these files and directories, the security risk to Taxation's system and data cannot be determined. Taxation should add back a removed procedure from a prior version of their UNIX security policies and procedures that called for an automated periodic review of world writable files and directories on all UNIX systems.

### Comply with Established Authorization Levels for Offers in Compromise

Management should enforce established approval limits for offers in compromise related to settlement of tax assessments. Offers in compromise are a process to collect portions of assessments which might otherwise be uncollectible. Often as a result of the offer in compromise, Taxation discharges a part of the assessment or related penalty and interest. In our sample of 15 discharge transactions we found two offers in compromise, for \$92,731 and \$73,073, exceeded the authorizer's limit of \$50,000.

Approval of offers in compromise and subsequent discharges are manual processes which rely on management to escalate a transaction to the appropriate authoritative level. Higher dollar amounts need approval from higher levels of management. In the two exceptions noted, the system did not prevent the authorizer from exceeding the established limits and management did not detect these exceptions. Management should strengthen the internal controls so that an authorizer cannot exceed his limit in order to prevent inappropriate acceptance of offers in compromise and discharges.

### Overview of the Public-Private Partnership Project

In 1998, Taxation contracted with CGI-AMS (formerly American Management System) to develop and implement an Integrated Revenue Management System. Taxation also contracted with Northrop Grumman Information Technology (formerly TRW Systems & Information Technology Group (TRW)) to conduct periodic project performance monitoring and evaluation services. The primary justification for the Partnership Project was the replacement of Taxation's legacy revenue accounting system, STARS (State Tax Accounting and Reporting System), which is approaching 20 years of operation. The project had an original planned conversion date in summer 2003; however, due to a change order executed February 2003 to allow support of the Tax Amnesty Program and data conversion problems in the Spring of 2004 related to the implementation of the Advantage Revenue system, the conversion has been delayed until August 2005, with final completion expected by Spring of 2006. The implementation of Advantage Revenue is the largest milestone defined in the contract with CGI-AMS.

### Partnership Project Funding

Partnership Project funding comes from increased tax revenues generated as a result of technological solutions and improved business processes the Partnership Project developed and implemented. The additional revenues go into the 90 percent fund and the 10 percent fund. By contract agreement, the percentages in these funds changed to 70 percent and 30 percent during fiscal year 2004. The 90 percent/70 percent fund pays CGI-AMS its contractual obligations, while the 10 percent/30 percent fund pays all other expenses attributable to the project. These collections increased approximately \$12 million over the prior year, and as of June 30, 2004, cumulative Partnership Project revenues totaled approximately \$231 million. During fiscal year 2004, the 90 percent/70 percent fund had accumulated sufficient funds to pay the entire CGI-AMS' contract requirements and transfer \$20.6 million to the General Fund.

Partnership Project Revenues			
<u>Fiscal Year</u>	<u>90 Percent / 70 Percent Fund</u>	<u>10 Percent / 30 Percent Fund</u>	<u>Total</u>
1999	\$ 5,695,458	\$ 632,799	\$ 6,328,257
2000	10,487,760	1,165,337	11,653,097
2001	33,140,337	3,682,260	36,822,597
2002	39,522,127	4,391,347	43,913,474
2003	54,457,988	6,050,887	60,508,875
2004	<u>50,592,907</u>	<u>21,682,674</u>	<u>72,275,581</u>
Total	<u>\$ 193,896,577</u>	<u>\$ 37,605,304</u>	<u>\$ 231,501,881</u>

### Partnership Project Cost

Original contract costs with CGI-AMS totaled \$123 million. In addition, Taxation agreed to pay CGI-AMS interest on any interim billing if the 90 percent fund did not have the resources to pay. Taxation initially estimated that interest payments would total \$17 million over the life of the contract.

Due to various change orders, including Tax Amnesty, the contract price has risen to \$166 million, but as of June 30, 2004, Taxation projected interest costs of \$2.1 million rather than the original \$17 million. This interest projection decreased \$1 million from June 30, 2002, and resulted from the project initiatives generating revenues in a shorter-than-expected period and project expenses have been incurred at a slower than expected rate.

Taxation is incurring other project costs in addition to the CGI-AMS payments discussed above. These additional costs include overhead and miscellaneous expenses such as Northrop Grumman payments supported by the 10 percent/30 percent fund, as well as Taxation staff time spent directly on the projects, primarily supported by Taxation's operating general fund budget. Beginning July 1, 2004, Taxation will fund all additional costs through its operating budget (see additional discussion below).

The following chart highlights that total anticipated costs exceed \$220 million, including interest payments and Taxation payroll projections. The chart also summarizes the corresponding actual cost incurred during fiscal 2004 and for the project to date through June 30, 2004.

	<u>Anticipated Costs as of June 30, 2003</u>	<u>Anticipated Costs as of June 30, 2004</u>	<u>Fiscal Year 2004 Activity</u>	<u>Activity through June 30, 2004</u>
Partnership Project contract cost (90 percent / 70 percent fund)	\$ 166,210,690	\$ 166,210,690	\$ 20,273,385	\$ 130,195,403
Partnership Project interest cost (90 percent/70 percent fund)	2,075,586	2,075,586	-	1,075,586
Northrup Gruman (10 percent/ 30 percent fund)	5,000,000	5,126,130	978,030	4,626,130
Overhead/miscellaneous (10 percent/30 percent fund)	14,768,974	20,492,610	12,516,781	20,492,610
Taxation payroll (Taxation General Fund)	36,825,466	37,789,811	4,486,475	30,789,811
Maintenance costs and Taxation Overhead (Taxation Operating Budget)	-	3,882,500	-	-
Totals	<u>\$ 224,880,716</u>	<u>\$ 235,577,327</u>	<u>\$ 38,254,671</u>	<u>\$ 187,179,540</u>

#### Ongoing Operating Costs

Prior to starting the project, Taxation estimated its ongoing annual operating costs would increase by \$10 million as a result of the partnership project initiatives. Under the contract, CGI-AMS was responsible for carrying the added operating costs for the first five years. Taxation assumed responsibility for these costs beginning July 1, 2003.

Due to the economic conditions at that time, Taxation provided fiscal year 2004 funding through an adjustment to the fund retention figures from 90/10 to 70/30, rather than through increased general fund appropriations. This change allowed Taxation to accumulate \$7.4 million more in their administrative account to pay operating cost increases. For allowing this change, Taxation agreed to lengthen the payback period from ten to 11 years; however, this did not affect the total cost of the contract.

Since Taxation has collected sufficient funds to cover the cost of the contract, it is no longer retaining revenues in the administrative account to pay for the operating cost increases. Therefore, for fiscal years 2005 and 2006, Taxation requested and received additional general fund base appropriations to cover its ongoing operating expenses, totaling \$11,387,569 and \$10,868,026, respectively. Taxation does not anticipate any further increases in general fund base appropriations as a result of the implementation of the final component, Advantage Revenue during calendar year 2005.



# Commonwealth of Virginia

**Walter J. Kucharski, Auditor**

**Auditor of Public Accounts  
P.O. Box 1295  
Richmond, Virginia 23218**

December 14, 2004

The Honorable Mark R. Warner  
Governor of Virginia  
State Capitol  
Richmond, Virginia

The Honorable Lacey E. Putney  
Chairman, Joint Legislative Audit  
and Review Commission  
General Assembly Building  
Richmond, Virginia

## INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE

We have audited selected financial records and operations of the Department of Taxation (Taxation) for the year ended June 30, 2004, in support of the Comprehensive Annual Financial Report for the Commonwealth of Virginia. We conducted our audit in accordance with Government Auditing Standards, issued by the Comptroller General of the United States.

### Audit Objectives, Scope, and Methodology

Our audit's primary objective was to evaluate the accuracy of Taxation's financial transactions as reported in the Comprehensive Annual Financial Report for the Commonwealth of Virginia for the year ended June 30, 2004. In support of this objective, we evaluated the accuracy of recording financial transactions on the Commonwealth Accounting and Reporting System and in Taxation's accounting records, reviewed the adequacy of Taxation's internal control, tested for compliance with applicable laws and regulations, and reviewed corrective actions of audit findings from prior year reports.

Our audit procedures included inquiries of appropriate personnel, inspection of documents and records, and observation of the Department's operations. We also tested transactions and performed such other auditing procedures as we considered necessary to achieve our objectives. We reviewed the overall internal accounting controls, including controls for administering compliance with applicable laws and regulations. Our review encompassed controls over the following significant cycles, classes of transactions, and account balances.

- Cash and Cash Equivalents
- Accounts Receivable
- Deferred Credit
- Deferred Revenue
- Accounts Payable
- Other Liabilities

- Tax Revenues
- Interest, Dividends, Rents, and Other Investment Income
- Other/Miscellaneous Revenue
- General Government Expenditures

We gained an understanding of the overall internal controls, both automated and manual, sufficient to plan the audit. We considered materiality and control risk in determining the nature and extent of our audit procedures. We performed audit tests to determine whether Taxation's controls were adequate, had been placed in operation, and were being followed in the following operational areas:

- Tax Return Processing
- Tax Revenue Collection
- State Tax Accounting and Reporting System (STARS)
- Lifeworks System
- Total Automated Capture System
- Virginia Tax On-line
- Joint Electronic Filing System
- Financial Reporting

Management has responsibility for establishing and maintaining internal control and complying with applicable laws and regulations. Internal control is a process designed to provide reasonable, but not absolute, assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

Our audit was more limited than would be necessary to provide assurance on internal control or to provide an opinion on overall compliance with laws and regulations. Because of inherent limitations in internal control, errors, irregularities, or noncompliance may nevertheless occur and not be detected. Also, projecting the evaluation of internal control to future periods is subject to the risk that the controls may become inadequate because of changes in conditions or that the effectiveness of the design and operation of controls may deteriorate.

#### Audit Conclusions

We found that Taxation properly stated, in all material respects, the selected financial records reviewed in support of the Comprehensive Annual Financial Report for the Commonwealth of Virginia listed in the scope section of this report.

We noted certain matters involving internal control and its operation that we consider to be reportable conditions relative to the Comprehensive Annual Financial Report for the Commonwealth. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect Taxation's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial records. These reportable conditions, entitled "Modify and Adhere to Existing Unix Policies" and "Comply with Established Authorization Levels for Offers in Compromise", are described in the subsection entitled "Internal Control Findings and Recommendations." We believe that neither of the reportable conditions is a material weakness.

Taxation has taken adequate corrective action with respect to audit findings reported in the prior year that are not repeated in this letter.



The results of our tests of compliance with applicable laws and regulations disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

This report is intended for the information and use of the Governor and General Assembly, management, and citizens of the Commonwealth of Virginia and is a public record.

#### EXIT CONFERENCE

We discussed this letter with management at an exit conference held on January 26, 2005.

AUDITOR OF PUBLIC ACCOUNTS

MSM:whb  
whb:XX



# COMMONWEALTH of VIRGINIA

## *Department of Taxation*

January 27, 2005

Mr. Walter J. Kucharski  
Auditor of Public Accounts  
P.O. Box 1295  
Richmond, Virginia 23218

Dear Mr. Kucharski:

Thank you for the opportunity to provide the Department of Taxation's (TAX) comments and action plans to address the audit findings identified as part of your office's audit of TAX's financial records and operations for the year ended June 30, 2004.

The Department strives to maintain TAX's strong record of ensuring that internal controls and business processes reflect standards of the highest integrity without sacrificing critical operating efficiencies. Based on this year's audit findings, it appears that the record is intact, that substantial effort continues to guarantee that these important objectives are achieved and that there are no material weaknesses or repeat findings.

A recap of TAX's plan in response to the audit follows:

➤ Modify and Adhere to Existing UNIX Policies:

TAX agrees that the UNIX policies and procedures were not being fully adhered to regarding security patches being current and that written exceptions were not developed for discrepancies with the UNIX policies and procedures at the time of APA's review. It should be noted that security patches have been applied since that time and continue to be applied on a regular basis. TAX has drafted a detailed patch management strategy for all TAX systems going forward.

TAX agrees that a periodic review of world writeable files and directories on all UNIX systems, shown in a prior version of TAX's UNIX policies and procedures, should be added to the current version and that this is a necessary control in order to prevent system



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compromise. With the reestablishment of these policies and procedures, TAX has already begun performing quarterly reviews of world writeable files and directories on all UNIX systems. While not in APA's comment, it should be noted that while the frequency of the reviews was not in accordance with the referenced policies and procedures, UNIX Security Administrators were performing periodic reviews of world writeable files as part of their normal systems monitoring role.

➤ Comply with Established Authorization Levels for Offers in Compromise:

TAX subsequently conducted a review of the decisions made in the two cases cited and found the terms of the Offers in Compromise to be appropriate. While TAX believes the existing procedures are adequate if the performance of responsibilities by the three parties involved in such transactions is done diligently, TAX did evaluate two additional options that would help identify cases, such as those noted in the APA report, where all three individuals failed to exercise their responsibilities diligently. TAX added a field on the cover sheet to clearly identify the dollar amount in question. This will make the amount more readily visible to everyone in the process. Also, TAX will continue to evaluate a systemic way to prevent an authorizer from exceeding their approval level. This is more challenging, however, because nearly all of those involved in approving higher dollar amounts do not have access to STARS (State Tax Accounting and Reporting System).

Again, I appreciate the opportunity to provide the Department of Taxation's comments as part of your office's report of TAX's financial records and operations for the year ended June 30, 2004.

Sincerely,



Kenneth W. Thorson  
Tax Commissioner

c: The Honorable John M. Bennett  
Secretary of Finance

DEPARTMENT OF TAXATION

Richmond, Virginia

Kenneth W. Thorson, Commissioner

Gerald H. Gwaltney, Deputy Tax Commissioner

L. Farley Beaton, Jr., Executive Commissioner for Technology

Janie E. Bowen, Executive Commissioner for Policy and Administration

Robert P. Schultze, Executive Commissioner for Customer Relations