

**LETTER FROM THE AUDITOR OF PUBLIC ACCOUNTS  
KENTUCKY DEPARTMENT OF REVENUE**

**In Reference to the Statewide Single Audit  
of the Commonwealth of Kentucky**

**For the Year Ended June 30, 2004**



**CRIT LUALLEN  
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CRIT LUALLEN  
AUDITOR OF PUBLIC ACCOUNTS

Robbie Rudolph, Secretary  
Finance and Administration Cabinet  
Department of Revenue

**MANAGEMENT LETTER**

Pursuant to KRS 43.090 (1), which states, “[i]mmediately upon completion of each audit and investigation, except those provided for in KRS 43.070, the Auditor shall prepare a report of his findings and recommendations,” we are providing this letter to the Department of Revenue to comply with KRS 43.090.

This letter presents the results of the work performed at the Department of Revenue, as part of our annual audit of the Commonwealth of Kentucky’s financial statements.

In planning and performing our audit of the basic financial statements of the Commonwealth for the year ended June 30, 2004, we considered the Department of Revenue’s internal control in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on internal control. However, we noted certain matters involving the internal control and its operation that we considered to be reportable conditions under standards established by the American Institute of Certified Public Accountants. 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 the Department of Revenue’s ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily disclose all matters that might be reportable conditions. In addition, because of inherent limitations in internal control, errors or fraud may occur and not be detected by such controls.

As part of our audit of the Commonwealth’s basic financial statements, we also performed tests of the Department of Revenue’s compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. The results of those tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.



Robbie Rudolph, Secretary  
Finance and Administration Cabinet  
Department of Revenue  
(Continued)

Some findings are Other Matters that we have included in this letter to communicate with management in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards*.

Included in this letter are the following:

- ◆ Acronym List
- ◆ Findings and Recommendations (Reportable Conditions and Other Matters)
- ◆ Summary Schedule of Prior Year Audit Findings

We have issued our Statewide Single Audit of the Commonwealth of Kentucky that contains the Department of Revenue's findings, as well as those of other agencies of the Commonwealth. This report can be viewed on our website at [www.auditor.ky.gov](http://www.auditor.ky.gov).

This letter is intended solely for the information and use of management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Respectfully submitted,



Crit Luallen  
Auditor of Public Accounts

February 28, 2005

**LIST OF ABBREVIATIONS/ACRONYMS**

ACH	Automated Clearinghouse
CARS	Compliance And Receivable System
CAFR	Comprehensive Annual Financial Report
Commonwealth	Commonwealth of Kentucky
C1	Cash Receipt Document
DOR	Department of Revenue
EFT	Electronic Fund Transfers
E-Pay	Electronic Payment
FAC	Finance and Administration Cabinet
FY	Fiscal Year
FYE	Fiscal Year End
COT	Commonwealth Office of Technology
JV	Journal Voucher
KRC	Kentucky Revenue Cabinet
KRS	Kentucky Revised Statutes
MARS	Management Administrative Reporting System
MFE	Modernized Front End
MIXERS	Miscellaneous Tax Registration System
MOA	Memorandum of Agreement
MVU	Motor Vehicle Usage
N/A	Not Applicable
OSBD	Office of the State Budget Director
REV	Department of Revenue
Revenue	Department of Revenue
RCW	Record of Control Weakness
W-2	Individual Wage Information Form

**FINANCIAL STATEMENT FINDINGS*****Reportable Conditions Relating to Internal Controls and/or  
Reportable Instances of Noncompliance*****FINDING 04-REV-1: The Department Of Revenue Should Ensure All Sales And Use Tax Returns Are Processed Accurately And Reconciled Monthly And All System Changes Are Adequately Tested**

Our audit revealed that Department of Revenue (Revenue) data entry, program code and system design problems resulted in the Department of Technology, Systems Support Branch's failure to successfully reconcile actual Sales and Use Tax processed control totals to the statistical database control totals for the months of September 2003 through January 2004. Although some corrective action has been taken to prevent additional errors, adequate controls were not established to identify and correct certain data entry errors and there is still an unexplained discrepancy of \$989. Our review revealed that testing of program changes performed prior to implementation of the new Sales and Use Tax – Electronic Escrow system did not include all possible transaction types, which allowed these system errors to occur.

The Sales and Use Tax - Electronic Escrow system was implemented in October 2003 to ensure taxpayers only receive a bill for the total amount due minus all payments made on the return, even if their payments were submitted separate from the return. After returns are posted to a transaction database, the program matches Sales and Use Tax payments that come in without a return (204 payments) to returns received without a payment (transaction code 12 – no pay return). If a match is found, the return leaves escrow, is processed, and is posted to the master and statistical databases. If a match is not found the transaction is held in escrow and not posted.

Systems Support performs a monthly reconciliation of the Sales and Use Tax activity. For the months of September 2003 through January 2004 there was a total \$59,606 in discrepancies between the Sales and Use Tax processed control totals per the statistical database and the actual total processed for the months. Of this amount, \$34,208 is attributed to transactions being held in escrow, as the partial payments could not be matched to an associated return. Also, in November a data entry error of \$18,463 was identified during reconciliation, but this transaction was reversed in December during processing to fully correct this out of balance figure.

The following issues were noted for the remaining \$6,935.

Seven transactions totaling \$3,825 were attributed to a problem with the program code. A program glitch inappropriately changed transactions that should have been coded with a pay code of '2' (a part-pay) to a pay code of '3' (a 204 payment) indicating that the return was received without a payment. Additionally in attempting to obtain the total amount paid on partially paid returns, returns were being held and the amount paid fields were manipulated to reflect all monies that had come in with the return plus any additional monies that had been posted to the master database. In instances where an additional

**FINANCIAL STATEMENT FINDINGS*****Reportable Conditions Relating to Internal Controls and/or  
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payment was not found on the master database the amount paid field was being changed to \$0.00, instead of adding zero for the additional payments to the partial payment amount sent in with the return. These transactions did not post to the master or statistical database. These discrepancies have been corrected with seven (7) one-side journal vouchers to post the payments to the appropriate taxpayer's account on both the statistical and master databases.

Four (4) transactions totaling \$2,121 were attributed to a design problem. All transactions were matched to an account and posted to the master database REVSU01. Revenue then coded the part-pay transactions with a pay code of '3' (indicating a 204 payment) not realizing that this pay code would prevent the transaction from posting to the statistical database. The transaction was then returned to the transaction database (REVSU08) for processing. Sales and Use tax processing extracts transactions from the transaction database and updates the master and statistical databases with transactions that have not previously been processed. This measure was intended to prevent payment postings from being duplicated. Since the master database had already been updated with the four transactions, the statistical database was not updated with the partial payments during processing. Because of the Escrow Project Team's uncertainty of the effect of making adjustments to these accounts, no adjustments were made to the statistical and/or master database. The design problem was remedied by removing partial payments from the Electronic Escrow process on December 29, 2003.

One (1) of the four (4) transactions was a \$1,000 payment on an account with an original amount due of \$5,077. Previously, two (2) separate \$1,000 payments were made on the account for a total of \$3,000 paid, making the new amount due \$2,077.

The payment kicked out of the system with an error code of '028' - underpayment of \$1,000 or more. Additionally, as a result of the pay code being erroneously changed to a '3', as discussed above, the error report reflected a code of '138' (204 payment) instead of '128' (part-pay). This resulted in the \$1,000 payment sent in with the return to reflect the total of \$3,000 that had been paid on the account. The compliance section staff member working the report added the two (2) \$1,000 payments previously made (but already included in the \$3,000) to account for all three (3) payments. This duplicated the \$2,000 in credits to the taxpayer's account, erroneously bringing the amount paid to \$5,000 and the new amount due to \$77.

**FINANCIAL STATEMENT FINDINGS*****Reportable Conditions Relating to Internal Controls and/or  
Reportable Instances of Noncompliance*****FINDING 04-REV-1: The Department Of Revenue Should Ensure All Sales And Use Tax Returns Are Processed Accurately And Reconciled Monthly And All System Changes Are Adequately Tested (Continued)**

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Compensating controls were not in place to identify or correct this type of error and/or alert compliance section staff of the duplicated payments. This error was not addressed until it was noted during the auditor's follow-up on this out of balance transaction on November 3, 2004. A tax due notice for this account dated November 4, 2004, was issued to correctly reflect the outstanding balance plus any applicable penalties and interest.

January 2004, there was a balancing discrepancy of \$989 that could not be attributed to part-pay returns. Neither the Systems Support Branch nor the Electronic Escrow Project team could provide an explanation for this outstanding discrepancy.

Additionally the Systems Support Branch provided the auditor with incomplete supporting documents for the balancing discrepancies in October and November. Supporting documentation was provided to the Systems Support Branch, by the Electronic Escrow Project team prematurely and did not include an explanation for all out of balance amounts for these months and resolution. This information was not made available to the Systems Support Branch until it was provided to the auditor during fieldwork. Subsequently, updated copies were forwarded to Systems Support branch staff to include with monthly balancing work papers.

Without consideration of all possible scenarios during the system design and testing phase management increases the risk of developing and implementing systems that involve inefficient, ineffective, and/or inaccurate processing of data. The design of newly developed systems and function of associated program code may be fallible. The integrity of the data processed through the Sales and Use Electronic Escrow system may be questioned when balancing discrepancies exist as a result of inadequate system design and testing procedures, or the lack of controls governing the identification and resolution of errors.

System design and testing controls should ensure that newly developed systems function properly. Accurate balancing of the monthly Sales and Use Tax worksheets will ensure that all taxpayer accounts are credited properly. All out of balance amounts must be researched to determine the cause of any discrepancy and a required resolution. The applicable Revenue staff should develop and maintain documentation of errors and their eventual resolution.

**FINANCIAL STATEMENT FINDINGS*****Reportable Conditions Relating to Internal Controls and/or  
Reportable Instances of Noncompliance*****FINDING 04-REV-1: The Department Of Revenue Should Ensure All Sales And Use  
Tax Returns Are Processed Accurately And Reconciled Monthly And All System  
Changes Are Adequately Tested (Continued)**

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**Recommendation**

We recommend Revenue staff in conjunction with the Electronic Escrow Tax Project team:

- Ensure testing of new systems or system changes are adequate to prevent loss of data, or require time and effort to investigate issues that arise following implementation. System testing should include all possible scenarios and types of applicable tax returns/payments.
- Ensure adequate documentation is prepared to explain any out of balance amounts and include this documentation with the monthly reconciliation support.
- Develop controls that will ensure transaction error codes are accurately applied.
- Determine the cause of the \$989 amount that was outstanding for the month of January 2004, document and resolve appropriately.

**Management Response and Corrective Action Plan**

*The Department of Revenue takes very seriously the responsibility of testing new systems or system changes. An effort was made to try to include all possible scenarios when the Electronic Escrow Tax Project was tested. However, sometimes due to process changes, human error, etc., not every possible combination can be tested for. Systems cannot always be built to handle exemptions but should be built to handle the normal processing of returns and payments. The Department will make every effort to ensure testing on future systems or system enhancements will be as thorough as possible. Time and effort will be devoted to investigate issues arising from the new system and to finding a solution.*

*Documentation will be prepared for out of balance issues in future.*

**FINANCIAL STATEMENT FINDINGS*****Reportable Conditions Relating to Internal Controls and/or  
Reportable Instances of Noncompliance*****FINDING 04-REV-1: The Department Of Revenue Should Ensure All Sales And Use  
Tax Returns Are Processed Accurately And Reconciled Monthly And All System  
Changes Are Adequately Tested (Continued)**

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**Management's Response and Corrective Action Plan**

*If the above recommendation was referring to the below issue, then it should be noted that a production cut over was completed on 11/07/03 to remedy the situation and this should not occur in the future.*

*The payment kicked out of the system with an error code of '028' - underpayment of \$1,000 or more. Additionally, as a result of the pay code being erroneously changed to a '3', as discussed above, the error report reflected a code of '138' (204 payment) instead of '128' (part-pay). This resulted in the \$1,000 payment sent in with the return to reflect the total of \$3,000 that had been paid on the account. The compliance section staff member working the report added the two \$1,000 payments previously made (but already included in the \$3,000) to account for all three payments. This duplicated the \$2,000 in credits to the taxpayer's account, erroneously bringing the amount paid to \$5,000 and the new amount due to \$77.*

*Compensating controls were not in place to identify or correct this type of error and/or alert compliance section staff of the duplicated payments. This error was not addressed until it was noted during the auditor's follow-up on this out of balance transaction on 11-03-2004. A tax due notice for this account dated 11-04-2004 was issued to correctly reflect the outstanding balance plus any applicable penalties and interest.*

*While staff was unable to resolve the January out of balance, they had identified a production problem and were able to correct it. The production fix was cutover on 12/29/03. After January, no further out of balance issues have been noted in the process. If more information becomes available that would enable us to produce a report on the January out of balance issue, then we would document that information as we did for the other months that had an out of balance issue.*

## **FINANCIAL STATEMENT FINDINGS**

### *Other Matters Relating to Internal Controls and/or Instances of Noncompliance*

#### **FINDING 04-REV-2: Motor Fuels Dealer Reports Should Be Crosschecked For Accuracy To Ensure All Taxes Have Been Remitted**

Revenue's motor fuels tax section has a significant backlog in crosschecking motor fuels dealer reports. Fuel dealers and transporters file reports with the motor fuels tax section monthly. The transporter must provide one duplicate of this report so Revenue can associate it with the appropriate monthly dealer's reports.

There were about 817 dealers filing monthly reports, approximately 8,004 total reports for FY 04. The backlog was 26,232 as of May 2004, down from 33,000 during the FY 03 audit. In the prior year, Revenue agreed with our finding and stated in their corrective action plan that additional staff had been hired/assigned to reduce the backlog. These efforts began to reduce the backlog; however, the motor fuels tax section lost two trained staff members.

When dealer reports are not crosschecked there may be errors or omissions that are not detected in a timely manner. The Commonwealth may not be receiving all taxes timely. The loss of several trained staff members have impacted the speed with which reports can be crosschecked.

Good internal controls dictate that motor fuels dealer reports are crosschecked for accuracy to ensure all taxes have been remitted to Revenue.

#### **Recommendation**

Revenue should:

- Continue to research available computer packages and, if the available packages are not sufficient, consider developing an in-house computer application or tailoring an existing computer package to meet Revenue's specific needs. This would streamline the crosschecking of dealer reports by creating a database that would allow the dealer reports to be crosschecked electronically.
- Provide opportunities for dealers to receive training on proper completion of the reports and remittance of the tax. For convenience, consider providing the training at state parks or other locations throughout the state.
- Provide internal training to new employees so they will know how to cross check the reports quickly and accurately.

**FINANCIAL STATEMENT FINDINGS*****Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-REV-2: Motor Fuels Dealer Reports Should Be Crosschecked For Accuracy To Ensure All Taxes Have Been Remitted (Continued)**

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**Management Response and Corrective Action Plan**

*Revenue concurs with the auditor's findings on the crosschecking of motor fuels tax dealer reports. Reports in inventory were reduced materially from a high of 33,000 in FYE 03 to a low of 24,617 at the close of December 2004. This 25 percent reduction was the result of concerted effort and consistent staffing levels. As documented in the auditor's findings the Motor Fuels Tax section had lost two trained staff members. Additionally, the Section lost a supervisor and another employee. Retention of trained employees continues to impact the area. Efforts to replace essential staff are under way. Revenue also concurs with the auditor's findings concerning the need for a computer application that performs the crosschecking function in a timely and efficient manner. To that end Revenue has contacted several states that are currently using electronic data capture and compliance verification packages. Two vendors have been contacted and initial fact finding has begun. Revenue recently submitted a Proposed Capital Project Plan and is moving forward with the intent of utilizing available federal money via the Transportation Cabinet to purchase a system that will facilitate the timely verification of motor fuels tax report data and assure that revenues due the Commonwealth are remitted in full. Revenue agrees that training taxpayers and staff is essential to sound compliance. Regional training has been suggested by the auditor. However, proprietary information concerns have limited taxpayer involvement in the past in group settings. The Motor Fuels Tax Section offers on site taxpayer training when requested or warranted.*

**FINANCIAL STATEMENT FINDINGS*****Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-REV-3: Computer Systems Should Be Updated To Remove System Limitations**

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We recognize that Revenue has incorporated the Sales and Use Tax Returns into the MFE 2 (Modernized Front End) process, which reduces manual processing and increases mathematical accuracy; thus reliability of the mainframe data is increased. However, Revenue's Sales Tax Database does not process payments that equal or exceed \$1,000,000; thus, a single transaction exceeding \$1,000,000 will show up on the Revenue mainframe as 999,999 in a succession of lines with the bottom line total as the balancing amount.

In FY 01, this system limitation resulted in two (2) accelerated payments overstating receipts in Revenue's mainframe system by \$7.5 million. No errors were noted in the subsequent FYs or the current FY, but the weakness that caused the overstatement still exists.

While the financial statement information was not affected, the system limitation could affect the accuracy and reliability of the Revenue reporting system.

Good internal controls dictate that all receipts post properly to Revenue's Sales Tax Database from supporting documentation, regardless of the receipt amount.

**Recommendation**

We recommend Revenue complete the new Sales and Use Tax System, which is being designed to meet the requirements of the national Streamline Sales Tax Agreement, and incorporate the capability to process large dollar receipts into the new system.

**Management Response and Corrective Action Plan**

*Revenue agrees that updating the mainframe system to accommodate payment transactions greater than \$1,000,000 would provide more concise, accurate, and efficient information for end users. During FY 2004, work has progressed on the replacement system for the current Sales and Use Tax system. Mapping of the current system and business requirements for the new system are being finalized. The first phase of the replacement system will become operational in FY 2006 with two additional phases to come online thereafter. The new system will handle payments larger than \$1,000,000 as well as process any accelerated returns.*

**FINANCIAL STATEMENT FINDINGS***Other Matters Relating to Internal Controls and/or Instances of Noncompliance***FINDING 04-REV-3: Computer Systems Should Be Updated To Remove System Limitations (Continued)**

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**Management Response and Corrective Action Plan**

*Procedures are in place and being followed to accommodate the accelerated returns until the replacement system becomes fully operational. A select number of trained employees are dedicated to working the accelerated returns with direct supervision and internal controls to ensure proper oversight in the current environment. Until the new system is fully operational, management will strive to ensure the accuracy and reliability of the reporting system.*

*While the current system may be difficult to interpret, payment transactions are represented in the system in their entirety. In addition, as noted, no errors were identified while testing the system for FY 2004.*

## FINANCIAL STATEMENT FINDINGS

### *Other Matters Relating to Internal Controls and/or Instances of Noncompliance*

#### **FINDING 04-REV-4: The Department of Revenue Should Ensure Key Information Is Correctly Reported**

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Revenue's system to input and reconcile critical information to the mainframe system did not include an employer of the Commonwealth. The reconciliation system generates exception logs when information does not match; however, our test identified an employer that did not appear on an exception log. No exception log has been generated for FY 03 yet, and only limited reports have been generated for FY 02. Revenue waits until most employers have filed information and extensions have expired before generating a complete list of exceptions, otherwise the list would be unmanageable.

Employers not registered to do business in the Commonwealth may go undetected if Revenue does not generate and resolve exceptions timely. As time passes, it becomes more difficult to locate employers and resolve exceptions, especially if the employer leaves the state or goes out of business.

Failure to agree information timely can result in incorrect information going undetected for several years. Kentucky may not receive the correct amount of tax due timely.

Good internal controls dictate Revenue generate and resolve exceptions timely to ensure taxpayers (both employees and employers) report information correctly.

#### **Recommendation**

Revenue should:

- Evaluate options to encourage taxpayers to submit information timely.
- Explore ways to use the system to generate specific types of exception logs.

#### **Management Response and Corrective Action Plan**

*Revenue agrees with the auditor's findings the good internal controls dictate Revenue generate and resolve exceptions timely to ensure taxpayers report W-2 information correctly.*

*The department has implemented a Web based online filing method for W-2 information and requires employers of more than 100 employees to file W-2s by electronic means. It is anticipated that both of these measures will improve the time frame for creating the exception reports. Programming has been requested, and will be completed as COT resources allow.*

*Revenue also agrees that penalties encourage more timely submission of W-2s. After implementation of Tax Amnesty, the penalty for employers who fail to file W-2's has increased from a minimum \$10 to \$25 for tax year 2002, and to a minimum of \$100 for 2003 and future years.*

**FINANCIAL STATEMENT FINDINGS*****Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-REV-5: Monthly Reconciliations Should Be Performed Timely And Any Reconciling Items Resolved**

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Revenue personnel reconcile each account in the Management Administrative and Reporting System (MARS) to Revenue's recorded receipts on a monthly basis. We reviewed reconciliations for five (5) months in FY 04 and noted a problem with the Tax Revenue Clearing Account posting insufficient funds for E-Pay transactions. There were numerous reconciling items for the clearing account and many of them were carried forward from the September 2003 reconciliation to the June 2004 reconciliation.

Revenue discovered that numerous reconciling items for the clearing account were due to the Finance and Administration Cabinet (FAC) posting unhonored electronic checks to the clearing account instead of the unhonored check account. Revenue, on the other hand, posted any unhonored amount to the unhonored check account. To correct this problem for FY 05, FAC and Revenue are both processing the same amount through the clearing account and any "cold check" amount will be processed through the unhonored check account. This means a C1 debits the unhonored check account and then a journal voucher (JV) is done to credit the unhonored check account and debit the appropriate receipt account. We reviewed the July reconciliation and the reconciling items that had been carried forward in the clearing account were resolved and there were no new reconciling items related to electronic cash receipts in the clearing account.

Also, we noted the March 2004 reconciliation was completed in May 2004 and the reconciliations for both June and July 2004 were completed in August 2004.

When an account has multiple, recurring reconciling items, it is time consuming and difficult to manually perform reconciliations.

If monthly reconciliations are done two (2) months after the close of the month, any problems noted may not be resolved timely.

Good internal controls dictate that MARS and Revenue's recorded receipts reconcile and any reconciling items are resolved and thus not carried forward on subsequent months' reconciliation.

Also, good internal controls dictate that monthly reconciliations are completed timely in order to discover and resolve problems.

**Recommendation**

We recommend Revenue:

- Continue to post electronic cash receipt documents for E-Pay returned items to the unhonored check account, just like all other unhonored checks. This is the reason the July reconciliation no longer contained reconciling items from previous months.

**FINANCIAL STATEMENT FINDINGS*****Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-REV-5: Monthly Reconciliations Should Be Performed Timely And Any Reconciling Items Resolved (Continued)**

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**Recommendation**

- Consider performing an electronic reconciliation between the FAC and Revenue receipt records. This would greatly reduce the man-hours necessary for the reconciliation, regardless of the number of reconciling items, and increase the speed of the reconciliations so problems could be detected and resolved quickly.

**Management Response and Corrective Action Plan**

*The Kentucky Department of Revenue (DOR) agrees with the auditor's recommendations related to reconciliation of the unhonored electronic payment transactions which are processed through the E-Payment Gateway. FAC staff, in the Office of the Controller, will continue to post the "cold check" transactions to the Unhonored Check Clearing Account. This will allow DOR staff to continue to process these transactions electronically, and subsequently post them to the correct receipt account.*

*DOR also agrees that an electronic reconciliation process, if it can be implemented, is a more efficient manner of doing the reconciliations. DOR will investigate the feasibility of doing electronic reconciliation during the FYE 6/30/05.*

*FAC is working with Revenue to identify taxpayer accounts where the billing transactions are consistently returned because of various reasons such as insufficient funds, closed accounts, stop payments, etc.*

**FINANCIAL STATEMENT FINDINGS*****Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-REV-6: Motor Vehicle Usage Receipts Should Be Timely Transferred Or Deposited**

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In the prior year, we found instances where motor vehicle usage receipts had not been timely transferred or deposited. We noted the same problem on nine (9) of 25 motor vehicle usage recapitulation reports reviewed during current year testing. As a result of the prior year finding, Revenue implemented a log in March 2004 to track late deposits and transfers and determine the penalties owed to the Commonwealth. Revenue determined that the penalties between April 1, 2004 and June 15, 2004 totaled \$244,693 for late transfers and \$92,439 for late deposits. KRS 138.464 allows Revenue to impose penalties for failure to make required deposits or transfers and Revenue imposed penalties in October 2004 by sending letters and copies of the logs to each county.

In the current year, prior to our reporting an untimely bank reconciliation problem in our FY 03 audit, we also found instances of Revenue employees documenting errors in their monthly reconciliations and carrying them forward to subsequent reconciliations instead of resolving the errors. After management implemented the corrective action (from our prior year finding), we did not note any unresolved reconciliation errors.

The State loses potential interest when monies are not deposited in the State Treasury timely. Also, by not imposing penalties, Revenue has not provided the counties with an incentive to make timely and accurate deposits and transfer of State funds to the State Treasurer.

Prior to the corrective action, valuable employee time was spent tracking the bank reconciling items over extended periods rather than correcting the problems.

Revenue receives motor vehicle usage receipts from various county clerks via temporary deposit accounts. The county clerks deposit the State's portion of receipts in an account and then call-in the deposit amount to trigger the transfer to the State Treasurer. In relation to the Revenue's motor vehicle usage receipts, KRS 138.464 states:

The clerk shall deposit motor vehicle usage tax collections not later than the next business day following receipt in a Commonwealth of Kentucky, Revenue Cabinet account in a bank designated as a depository for state funds. The clerk may be required to then cause the funds to be transferred from the local depository bank to the State Treasury in whatever manner and at times prescribed by the secretary of the Revenue Cabinet or his designee . . . Failure to deposit or, if required, transfer collections as required above shall subject the clerk to a penalty of two and one-half percent (2.5%) of the amount not deposited or, if required, not transferred as required above.

Also, good internal controls dictate that monthly reconciliations are completed in order to timely discover and resolve problems.

## FINANCIAL STATEMENT FINDINGS

### *Other Matters Relating to Internal Controls and/or Instances of Noncompliance*

#### **FINDING 04-REV-6: Motor Vehicle Usage Receipts Should Be Timely Transferred Or Deposited (Continued)**

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##### **Recommendation**

Revenue should:

- assess penalties in accordance with KRS 138.464.
- evaluate the costs of employees spending time resolving the problems associated with temporary deposit accounts for 120 counties versus the potential benefit and cost of using Electronic Fund Transfers (EFTs) to collect the motor vehicle usage receipts and continue to correct reconciling items on the bank reconciliation when the item is first reported.

##### **Management Response and Corrective Action Plan**

*Revenue concurred and implemented a delinquency control compliance program that monitors late deposits and ACH [Automated Clearinghouse] transfers. As of October 2004 failure to comply with KRS 138.464 leads to the issuance of a penalty assessment. The following timeline details the events and chronology related to the implementation of this delinquency control:*

- *February 4, 2004: Response letter from Secretary of Finance was created and sent to the State Auditor of Public Accounts acknowledging issue and commitment to resolve.*
- *March 5, 2004: Meeting with Revenue Operations to formulate a plan to bring the remaining 19 counties on board with ACH transfer calls. Also discussed EFT possibilities.*
- *March 11, 2004: Contact COT to update CARS [Compliance and Receivable System] to allow for the billing of penalties for type tax 59. When CARS was created it did not have the capability to bill penalties per day with a minimum and maximum limitation per KRS 138.464.*
- *April and May: Developed penalty implementation strategy. Began working on the Commissioner's letter to the County Clerks and MVU's letter to the County Clerks explaining the amount of penalties that would have been assessed had we been billing for late ACH and Late deposits.*
- *June 3, 2004: Commissioner's letter explaining the findings of the Auditor of Public Accounts with regards to the late deposits and ACH transfer calls mailed to the County Clerks.*
- *August 1, 2004: MVU penalty updates implemented into CARS.*
- *September 20, 2004: Nine of the remaining 19 counties began making ACH transfer calls.*
- *October 1, 2004: Letter sent to all 120 County Clerks detailing the instances of late deposits and late ACH transfer call. This letter also included the total amount the Clerk would have been billed.*

**FINANCIAL STATEMENT FINDINGS**

*Other Matters Relating to Internal Controls and/or Instances of Noncompliance*

**FINDING 04-REV-6: Motor Vehicle Usage Receipts Should Be Timely Transferred Or Deposited (Continued)**

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**Management Response and Corrective Action Plan**

- *October 25, 2004: Due date for responses from all 120 counties explaining the delinquencies detailed in the October 1, letter.*
- *November 17, 2004: MVU Tax Section began billing penalties for late deposits and/or late ACH transfers made by the County Clerks.*
- *November 2004: Developed and implemented Form 73A070 (Request for Extension of Deposit / ACH Call-In).*
- *December 15, 2004: Last 10 counties began making ACH transfer calls.*

*As noted in the timeline all 120 counties are on board with ACH transfers. Revenue continues to review the benefit of possibly having a direct EFT to the Commonwealth, however the temporary deposit accounts referred to in the recommendation are currently mandated in statute.*

**FINANCIAL STATEMENT FINDINGS*****Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-REV-7: The Department Of Revenue Should Consistently Process Local Distribution Journal Vouchers**

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Revenue does not consistently process fourth quarter local distribution journal vouchers. General Property Tax-Real (R251), General Property Tax-Tangible (R252), General Property Tax-Tangible Motor (R253), Public Service Companies Tax (R260), Omitted Tangible Property Tax (R265), and Apportioned Vehicle Property Tax (R266) are tax types for which Revenue collects taxes for local taxing units and then distributes the money back to the local taxing units on a quarterly basis. Revenue processes multiple journal vouchers to distribute the money to and from the appropriate funds.

In FY 02, we discussed the inconsistent processing of the local distributions with Revenue. Revenue decided to make the distributions after June 30. Revenue made the local distributions before June 30 in FYs 00, 01, and 04. Revenue made the distributions after June 30 in FYs 97, 98, 99, 02, and 03.

In FY 04, transferring the money from the general fund to the special revenue fund (for R251, R252, R260, and R266) before June 30 decreased the general fund and increased the special revenue fund by a total of \$9,911,206. Also for FY 04, the transfer from the special revenue fund (R253) to agency fund (R265) before June 30 increased the agency fund and decreased the special revenue fund by \$730,339.

Good internal controls dictate that financial reports are comparable from year to year. Financial reporting should help users make comparisons among years.

**Recommendation**

We recommend Revenue develop a standard policy for processing the fourth quarter distributions (either before or after June 30) and consistently apply the policy.

**Management Response and Corrective Action Plan**

*The Department of Revenue, with input from the OSBD [Office of the State Budget Director], will work on developing a policy to address when the journal vouchers mentioned in this RCW are done. Both entities will also work together to draft an MOA which states that written notification by the OSBD will be provided when timing of journal vouchers is changed in order to maintain budgetary flexibility.*

**FINANCIAL STATEMENT FINDINGS*****Other Matters Relating to Internal Controls and/or Instances of Noncompliance*****FINDING 04-REV-8: The Department Of Revenue Should Determine The Reason An Unhonored Check Processed Incorrectly And Fix The Problem**

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An EFT for \$20,555,012 was unhonored. While reviewing documentation of the unhonored check, the auditor was made aware of a computer problem. The Miscellaneous Tax Registration System (MIXERS) processed the entire \$20,555,012 because the amount appears on the receipt screen and the Revenue Unhonored Check Reports. However, both the Unhonored Check Month End Journal Vouchers report and the on-line unhonored check inquiry screen showed \$555,012 as the amount of the unhonored check. This appears to be a system limitation in the number field.

Finance used the Unhonored Check Month End Journal Vouchers report to enter the cold check JV into MARS. The report was incorrect so Finance had to do a correcting JV for \$20 million (JVL00007478). Revenue's cold check clearing account was correct. MARS and Revenue systems were out of balance until the correcting JV was done.

If Revenue personnel reviewed the unhonored check clearing account on the computer, they would not know the correct amount of the unhonored check, unless they subsequently reviewed the Unhonored Check Report.

Good internal controls dictate that the entire amount of the unhonored checks should be properly posted to both MARS and Revenue's computer system.

**Recommendation**

We recommend Revenue review the unhonored check system to determine the cause of the error and implement corrective action so this situation does not re-occur.

**Management Response and Corrective Action Plan**

*The Department of Revenue agrees with the Auditor's findings and will do a project request to have the cold check processing system modified to accept amounts greater than \$9,999,999.*

**SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS**  
**FOR THE YEAR ENDED JUNE 30, 2004**

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<b><u>Reportable Conditions</u></b>					
<i>(1) Audit findings that have been fully corrected:</i>					
FY 03	03-REV-1	The Kentucky Revenue Cabinet Should Improve Communication Between Divisions To Ensure Taxpayer Information Is Protected	N/A	0	Resolved during FY 04.
FY 03	03-REV-2	The Kentucky Revenue Cabinet Should Update Its Computer Systems To Remove System Limitations Affecting Accuracy And Reliability Of Reporting	N/A	0	Due to improvements, this finding is downgraded to an Other Matter for FY 04. This finding is no longer required to be reported under <i>Government Auditing Standards</i> .  See 04-REV-4.
FY 03	03-REV-3	The Revenue Cabinet Should Strengthen The Security Surrounding Administrator Accounts	N/A	0	Resolved during FY 04.
FY 03	03-REV-4	The Revenue Cabinet Should Ensure All User Accounts On Its Agency Machines Are Necessary	N/A	0	Resolved during FY 04.
FY 03	03-REV-5	The Kentucky Revenue Cabinet Should Develop A System For Reconciling Critical Information And Investigating Any Discrepancies	N/A	0	Resolved during FY 04.
FY 02	02-REV-1	The Kentucky Revenue Cabinet Should Ensure Confidential Taxpayer Information Is Protected And Preserved As Required By Statute	N/A	0	Resolved during FY 04.
FY 02	02-REV-2	The Kentucky Revenue Cabinet Should Update The Sales Tax Database And Automate Processing Of Accelerated Tax Returns	N/A	0	Due to improvements, this finding is downgraded to an Other Matter for FY 04. This finding is no longer required to be reported under <i>Government Auditing Standards</i> .  See 04-REV-3.
FY 02	02-REV-4	The Kentucky Revenue Cabinet Should Strengthen The Security Surrounding Administrator Accounts	N/A	0	Resolved during FY 04.

**SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS**  
**FOR THE YEAR ENDED JUNE 30, 2004**

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
<b><u>Reportable Conditions</u></b>					
<i>(1) Audit findings that have been fully corrected:</i>					
FY 02	02-REV-6	The Kentucky Revenue Cabinet Should Ensure All User Accounts On Their Agency Servers Are Necessary	N/A	0	Resolved during FY 04.
FY 01	01-REV-1	The Revenue Cabinet Should Update The Sales Tax Database And Automate Processing Of Accelerated Tax Returns	N/A	0	Due to improvements, this finding is downgraded to an Other Matter for FY 04. This finding is no longer required to be reported under <i>Government Auditing Standards</i> .  See 04-REV-3.
FY 01	01-REV-3	The Revenue Cabinet Should Have A System In Place To Reconcile Critical Information	N/A	0	Resolved during FY 04.

*(2) Audit findings not corrected or partially corrected:*

No findings for this section.

*(3) Corrective action taken is significantly different from corrective action previously reported:*

No findings for this section.

*(4) Audit finding is no longer valid:*

No findings for this section.

**SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS**  
**FOR THE YEAR ENDED JUNE 30, 2004**

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
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**Material Weaknesses/Noncompliances**

*(1) Audit findings that have been fully corrected:*

FY 02	02-REV-3	The Kentucky Revenue Cabinet Should Have A System In Place To Reconcile Critical Information	N/A	0	Resolved during FY 04.
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*(2) Audit findings not corrected or partially corrected:*

No findings for this section.

*(3) Corrective action taken is significantly different from corrective action previously reported:*

No findings for this section.

*(4) Audit finding is no longer valid:*

No findings for this section.

**SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS**  
**FOR THE YEAR ENDED JUNE 30, 2004**

<b>Fiscal Year</b>	<b>Finding Number</b>	<b>Finding</b>	<b>CFDA Number</b>	<b>Questioned Costs</b>	<b>Comments</b>
<b><u>Other Matters</u></b>					
<i>(1) Audit findings that have been fully corrected:</i>					
FY 03	03-REV-7	The Kentucky Revenue Cabinet Should Document The Motor Vehicle Usage Recap Reports Receipt Date And Impose Fines For Late Reports As Allowed By KRS 138.464	N/A	0	Resolved during FY 04.
FY 03	03-REV-8	The Revenue Cabinet Should Ensure That Security Information Leakage Concerning Agency Devices Is Minimized	N/A	0	Resolved during FY 04.
FY 03	03-REV-9	The Kentucky Revenue Cabinet Password Policy Should Be Consistently Applied To All Local Area Network Machines	N/A	0	Resolved during FY 04.
FY 03	03-REV-10	The Revenue Cabinet Should Ensure That All Open Ports On Agency Machines Have A Business-Related Purpose	N/A	0	Resolved during FY 04.
FY 03	03-REV-12	The Kentucky Revenue Cabinet Should Ensure Mathematical Accuracy And Completeness Of Key Information	N/A	0	Resolved during FY 04.
FY 03	03-REV-13	The Division Of Property Valuation Education And Research Branch Should Reconcile Receipts To MARS And Ensure Checks Are Timely Deposited	N/A	0	Resolved during FY 04.
FY 02	02-REV-8	The Kentucky Revenue Cabinet Should Date Stamp Motor Fuels And Motor Vehicle Usage Tax Reports	N/A	0	Resolved during FY 04.
FY 02	02-REV-12	The Kentucky Revenue Cabinet Should Ensure That Security Information Leakage Concerning Agency Devices Is Minimized	N/A	0	Resolved during FY 04.

**SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS**  
**FOR THE YEAR ENDED JUNE 30, 2004**

<b>Fiscal Year</b>	<b>Finding Number</b>	<b>Finding</b>	<b>CFDA Number</b>	<b>Questioned Costs</b>	<b>Comments</b>
<b><u>Other Matters</u></b>					
<i>(1) Audit findings that have been fully corrected:</i>					
FY 02	02-REV-13	The Kentucky Revenue Cabinet Password Policy Should Be Consistently Applied To All Local Area Network Servers	N/A	0	Resolved during FY 04.
FY 01	01-REV-5	The Revenue Cabinet Should Ensure That All Tax Files Are Safeguarded	N/A	0	Resolved during FY 04.
FY 01	01-REV-9	Revenue Password Policy Should Be Consistently Applied To All Local Area Network Servers	N/A	0	Resolved during FY 04.
FY 01	01-REV-10	Revenue Cabinet Should Ensure That Information Leakage Concerning Agency Devices Is Minimized	N/A	0	Resolved during FY 04.
FY 98	98-KRC-1	The Revenue Cabinet Should Properly Safeguard Corporation Tax Returns	N/A	0	Resolved during FY 04.
FY 97	97-KRC-7	The Revenue Cabinet Should Properly Safeguard Corporation Tax Returns	N/A	0	Resolved during FY 04.
<i>(2) Audit findings not corrected or partially corrected:</i>					
FY 03	03-REV-6	The Kentucky Revenue Cabinet Should Develop Computer Applications To Streamline The Crosschecking Of Motor Fuels Dealer Reports	N/A	0	See 04-REV-2.
FY 03	03-REV-11	Motor Vehicle Usage Receipts Should Be Timely And Properly Deposited With The State Treasurer	N/A	0	See 04-REV-6.
FY 02	02-REV-7	The Kentucky Revenue Cabinet Should Implement A System For Crosschecking Motor Fuels Dealer Reports	N/A	0	See 04-REV-2.
FY 01	01-REV-4	The Revenue Cabinet Should Implement A System For Crosschecking Motor Fuels Dealer Reports	N/A	0	See 04-REV-2.

**SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS**  
**FOR THE YEAR ENDED JUNE 30, 2004**

Fiscal Year	Finding Number	Finding	CFDA Number	Questioned Costs	Comments
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**Other Matters**

*(2) Audit findings not corrected or partially corrected (Continued):*

FY 98	98-KRC-3	The Revenue Cabinet Should Ensure That Motor Fuel Reports Are Crosschecked As Required	N/A	0	See 04-REV-2.
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*(3) Corrective action taken is significantly different from corrective action previously reported:*

No findings for this section.

*(4) Audit finding is no longer valid:*

No findings for this section.

