ALASKA STATE LEGISLATURE LEGISLATIVE BUDGET AND AUDIT COMMITTEE

Division of Legislative Audit

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February 28, 2011

Honorable Members of the Alaska State Legislature

The Honorable Sean Parnell Governor State of Alaska

The Honorable Daniel R. Levinson
Inspector General
Office of the Inspector General
U.S. Department of Health and Human Services

We are pleased to transmit the Single Audit of the State of Alaska for the fiscal year ended June 30, 2010. The audit was conducted in accordance with auditing standards generally accepted in the United States of America; Government Auditing Standards issued by the Comptroller General of the United States, and complies with the federal Single Audit Act Amendments of 1996 and the related OMB Circular A-133 issued by the U.S. Office of Management and Budget.

The report includes an opinion on the basic financial statements of the State of Alaska for FY 10, recommendations on financial and compliance matters, and required auditor's reports on internal controls and compliance, and the Schedule of Expenditures of Federal Awards.

The findings and recommendations included in this report are organized by department and include prior financial/compliance findings not fully corrected by the departments. Our FY 09 Single Audit contained 25 recommendations; this report presents a total of 30 recommendations, eight of which were presented at least in part last year. Included in this year's recommendations are four recommendations made to Alaska Housing Finance Corporation whose audit was performed by other auditors. With your active support and encouragement, we hope to continue seeing improvement in the implementation of these recommendations by the state agencies.

We would again like to acknowledge the professional assistance and cooperation of the Department of Administration's Division of Finance. The division has a strong professional commitment to excellence in the financial accounting and reporting for the State of Alaska. Its continued efforts towards resolving statewide accounting and reporting concerns are commendable.

We would also like to acknowledge the cooperation of all other state agencies involved during the conduct of this audit.

The dedicated staff of the Division of Legislative Audit remains committed to improving the financial accountability of the State of Alaska. Your active involvement is critical to improving that accountability. We are available to assist you in that effort.

Pat Davidson, CPA Legislative Auditor

DEPARTMENT OF REVENUE

One recommendation was made to the Department of Revenue (DOR) in the *State of Alaska*, *Single Audit for the Fiscal Year Ended June 30, 2009*. Prior year Recommendation No. 2 is not resolved and is reiterated in this report as Recommendation No. 4.

No new recommendations have been made during the FY 10 statewide single audit.

Recommendation No. 4

<u>DOR's commissioner should ensure staff within its Tax Division implement controls to improve the auditing of oil and gas severance tax revenues.</u>

Prior Finding

In FY 08 and FY 09 significant deficiencies in controls were reported over the auditing of severance tax revenues by DOR's Tax Division. Control deficiencies included insufficient audit oversight, a lack of standard procedures to guide the audit process, inadequate reviews of audits, and untimely reviews and reconciliations of tax returns.

Title 43 of the Alaska Statutes gives DOR the authority to collect tax revenues for the State and to ascertain the correctness of such revenues. The department's main tool for ascertaining the correctness of severance tax revenues is its Tax Division audit section. There are no statutory requirements that DOR's tax auditors conduct their audits in accordance with industry audit standards such as those issued by the American Institute of Certified Public Accountants or the Government Accountability Office. Historically, DOR's audit section has relied upon standard audit programs and supervisor review and oversight to ensure that their audits are timely, accurate and that audit results can withstand the scrutiny of the administrative appeal process and, in some cases, litigation.

With the passage of PPT² and ACES³ legislation, management's controls over the auditing of severance taxes deteriorated. The new laws are more complex to audit. The hiring and retention of experienced, competent audit staff has proven challenging. Delays in drafting PPT and ACES regulations have further disrupted the audit process.

Legislative Audit's Current Position

Significant control deficiencies continued over the auditing of oil and gas severance tax revenues in FY 10. A loss of experienced audit staff during FY 10 compounded the struggles that the audit section was already experiencing.

Our review of DOR's oil and gas severance tax audits and inquiries with DOR staff noted the following deficiencies:

- The division continues to conduct audits without developing standard processes including audit plans and procedures.
- A significant portion of an audit's methodology and results were insufficiently documented.
- The deficiencies in audit documentation forced the tax section to issue a less detailed report than what is issued as part of their standard report format.

²Petroleum Profits Tax (enacted in August 2006).

³Alaska's Clear and Equitable Share (enacted in November 2007).

- Audit supervisors did not review and approve audit methodology prior to audits being conducted.
- Audit supervisory reviews were limited, sporadically documented, and only conducted at the end of the audit.

Oil and gas severance taxes, totaling approximately \$2.6 billion in FY 10, are a significant source of revenue for the State of Alaska. Insufficient internal controls over the auditing of severance tax revenue may result in the loss of revenue and increase the risk that tax revenue assessments will not hold upon appeal.

We recommend that DOR's commissioner take action to ensure that Tax Division management improves controls over the auditing of severance tax revenues. Specifically, standardized audit processes should be developed and implemented. Auditors also need more oversight and timely feedback during the audit process.

Agency Response – Department of Revenue

Item 1: The division continues to conduct audits without developing standard processes including audit plans and procedures.

We disagree. The division is, and has been, in the process of developing Response: standard processes including audit plans and procedures. Development of standard processes is an ongoing project. As you are aware, the legislature significantly changed the way oil and gas production tax is calculated with the passage of the Petroleum Profits Tax (PPT) in 2006. In 2007, the legislature made further changes to the production tax through the passage of Alaska's Clear and Equitable Share (ACES) legislation. These two major pieces of legislation completely overhauled the production tax scheme and instituted a new tax credit program. The Division has worked diligently over the last four years to implement the changes while continuing to work on audits of tax returns filed under the previous tax structure. Implementation includes not only developing standard processes, but also drafting regulations, hiring and training new auditors, developing tax return forms, establishing tax credit audit and examination procedures, educating taxpayers, and various other duties that accompany the implementation of what is basically a new tax program. You are aware that the oil and gas production tax is administered without automated systems. This means that all processes are performed manually which further strains the Tax Division's limited resources. Although development of standard processes is not yet complete, this does not mean that the Division is not and has not been working on developing those processes.

Item 2: A significant portion of an audit's methodology and results were insufficiently documented.

Response: We agree. The audit in question was started by a highly experienced individual who retired a few months after the audit was opened. The audit was then

transferred to another senior auditor who resigned his position before the audit was completed. The audit was transferred yet again to another senior auditor who had to quickly familiarize himself with all issues within the audit and complete the audit within a short period of time. As stated above, oil and gas production tax audits are conducted without the assistance of automated systems. All audit work, including transaction sampling and testing, is performed manually. Data for this particular audit included over 2 million documents with thousands of transactions per document. During the course of the audit, the auditors manually tested over 1 million transactions. The time it took to perform the manual testing caused the auditor to run out of time to complete proper documentation of audit findings prior to expiration of the statute of limitations. The Tax Division took the position that it was in the best interest of the state to issue the audit with insufficient documentation and with a less detailed audit report than to miss the statute of limitations and, in effect, issue no audit at all. The auditor was instructed to issue the audit, but continue to document audit findings and complete the audit report after the fact. The taxpayer was informed that it would receive a more comprehensive explanation of our adjustments at a later date.

Item 3: The deficiencies in audit documentation forced the tax section to issue a less detailed report than what is issued as part of their standard report format.

Response: We agree. See explanation under Item 2, above.

Item 4: Audit supervisors did not review and approve audit methodology prior to audits being conducted.

Response: We agree, but disagree that this in an issue. It is not common practice for the Tax Division to approve audit methodology prior to audits being conducted. Audits are assigned to auditors based on their level of experience and their job class. Audits of the largest oil and gas production taxpayers are assigned to Oil and Gas Revenue Auditor IV's (OGRA IV). Under the class specifications, OGRA IV's "serve as lead auditor having complete responsibility for the largest oil and gas production tax... audits." The particular audit in question was assigned to an OGRA IV who was required to perform the audit with no day-to-day oversight. Audit methodology is at the auditor's discretion provided, however, that the end result is that the auditor has accurately evaluated tax liabilities. As stated previously in this letter, the Tax Division is still implementing what is essentially a new tax program and specific audit methodology has not yet been defined for these audits.

Item 5: Audit supervisory reviews were limited, sporadically documented, and only conducted at the end of the audit.

Response: We agree. Audit reviews in all programs are conducted at the end of audits. That is common practice in all audits in the audit profession. We also agree that supervisory reviews were limited and sporadically documented in some of the audits closed during the fiscal year. Again, this was due to the continual implementation of PPT, ACES and the new credit program. Implementation has put a strain on audit resources. Money requested to continue contract audits has been reduced which put further strain on our resources.

However, management continually communicates with staff on tax issues via meetings and emails, and has discussions about the proper application of statutes and regulations. As a result of the poor documentation of the audit identified in issues 2 and 3, management has instituted the practice of meeting with the audit leads and team members on the largest audits at least once a month to discuss the progress of the audit and any issues that may have arisen that require management input.

The bulk of the findings in the audit report are attributable to:

- staff turnover, particularly at the supervisory level;
- the inability to recruit senior level auditors at current pay levels, despite intensive recruitment efforts over the last two years; this means (1) less experienced auditors are working major audits, and (2) supervisors are having to spend time conducting complex audits, instead of using that time to supervise and developing audit manuals, processes and procedures; and
- lack of automated tax processing systems to manage and share information; this dramatically increases the amount of time needed to complete audits and review returns, and thus, siphons resources away from program development.

As junior auditors in the Production Tax Audit Group gain experience, they will be able to take on more complex and higher volume audit work. This should relieve some of the resource strain, provided these auditors continue working for the Department once they reach senior levels. Over the last three years, great efforts have been made by the Department to obtain an automated tax processing system to manage and share information, but funding for this project has not yet been forthcoming.

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Legislative Auditor's Additional Comments

We reviewed DOR's response and nothing in the response persuades us to revise the recommendation.