

A Review of the

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# Revenue Audit Function of the Texas State Treasury: The Tobacco Tax Revenue Process



**Office of the State Auditor**  
Lawrence F. Alwin, CPA

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November 1994

Report No. 95-018



## OFFICE OF THE STATE AUDITOR

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November 10, 1994

Members of the Legislative Audit Committee:

Our review of the revenue audit function of the Texas State Treasury identified opportunities to improve controls over the tobacco revenue collection and audit processes. Specifically, the Treasury should make the following improvements:

- Strengthen controls over the revenue collection and audit functions through better segregation and documentation of duties in the Cigarette Tax Stamp section.
- Take prompt action to collect approximately \$48,000 in outstanding tax liability from a participant of the Cigarette Tax Recovery Trust Fund who defaulted on taxes to the State.
- Develop a written audit work plan that clearly specifies audit performance expectations for tobacco tax audits to be performed by the Comptroller of Public Accounts.

Treasury management concurs with the recommendations in this report. We have included their responses.

We appreciate the cooperation and assistance of management and staff of the Texas State Treasury during this audit.

Sincerely,

A handwritten signature in cursive script, appearing to read "Lawrence F. Alwin".

Lawrence F. Alwin, CPA  
State Auditor

LFA:asc/rmn/enclosure

## Key Points of Report

### **A Review of Revenue Audit Function of the Texas State Treasury: The Tobacco Tax Revenue Process November 1994**

#### **Key Facts And Findings**

- Controls over the revenue collection and auditing functions could be strengthened through better segregation and documentation of duties in the Cigarette Tax Stamp section.
- Prompt action should be taken, including working with the Attorney General's Office, to eliminate and collect an outstanding tax liability of about \$48,000 caused by a distributor defaulting on taxes owed to the State.
- A written work plan that clearly specifies audit performance expectations is needed to ensure that contracted services accomplish the Treasury's audit-related goals.
- In fiscal year 1994, \$572 million of cigarette and tobacco tax revenues was collected.
- For every dollar of audit cost, \$2.96 in additional revenues was identified for collection, based on the 64 audits performed by the Treasury in fiscal year 1994.

#### **Contact:**

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*This review of the Texas State Treasury's revenue process was conducted under the authority of Government Code, Section 321.015.*

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## Issues and Recommendations

Section 1:

### **Opportunities Exist To Improve Controls Over Tobacco Tax Revenue Collection And Auditing**

We identified opportunities to improve the Texas State Treasury's revenue audit function as well as other revenue processes that impact the auditing function. The Treasury's revenue process includes permitting, identification and education of taxpayers, collection and processing of taxes, and the auditing and enforcement of amounts due to the State. Improvements could be made in the controls for collecting tobacco tax revenues and the auditing of tobacco tax taxpayers.

Section 1-A:

### **Improve Segregation and Documentation of Duties in the Cigarette Tax Stamp Section**

Proper segregation of duties currently does not exist in the Cigarette Tax Stamp section. This section, which has two employees, processes approximately \$500 million dollars annually. Controls over 98 percent of the cigarette tax stamp revenues are adequate since they are collected through electronic fund transfers. However, controls are not adequate for the two percent, or \$10 million, of funds not collected through electronic fund transfers. We identified the following weaknesses:

- Either of the two employees can handle a transaction through every step of its processing. As a result, existing controls over the cash receipts is inadequate.
- One of the employees, the supervisor, performs every aspect of the balancing, reconciling, and reporting procedures.

- The balancing, reconciling, and reporting procedures are not formally documented.
- No other employee has been cross-trained to perform the balancing, reconciling, and reporting procedures.

Ideally, proper segregation of duties requires that no one employee performs multiple duties that are incompatible due to their nature. As a result of the lack of segregation of duties over cash receipts, errors, or irregularities could occur and not be detected in a timely manner, putting collections at risk.

In addition, the lack of documentation and cross-training on the procedures performed only by the supervisor would put the Treasury at risk should other employees have to perform them.

To improve current controls over cash receipts, the Treasury's internal auditor has recommended that the Cigarette Tax Stamp section set up a lock box in the Treasury's lock box program to handle payments involving cash items. Internal audit also proposed that they perform unannounced reviews on the section to further compensate for the segregation weaknesses.

#### Recommendations:

We encourage management to implement the internal auditor's recommendations to compensate for the segregation weaknesses.

The Treasury Department should formally document significant procedures and duties performed only by the supervisor. Also, other employees should be cross-trained on these procedures.

## Issues and Recommendations

### Management's Response:

*Tobacco Tax and Lock Box personnel will meet to discuss implementing a lock box system for the tobacco tax cash receipts. Once a system is in place, the section's responsibilities will be reviewed and assigned accordingly. Procedures will be documented and cross training provided to minimize the agency's risk. As an additional control, Internal Audit will perform unannounced reviews of the section.*

Section 1-B:

### **Take Action to Allocate a Distributor's Outstanding Tax Liability to Other Participants of the Cigarette Tax Recovery Trust Fund**

As trustee, the Treasury's prior and current administrations have not effectively administered the requirements of the Cigarette Tax Recovery Trust Fund upon becoming aware that a distributor failed to pay its tax liability to the State in February 1991. Prompt action by the Treasury will help maximize any amount that is still recoverable from the outstanding tax deficiency of approximately \$48,000.

Approximately 80 percent of all Cigarette Tax Revenue, or over \$400 million annually, is collected from Cigarette Tax Recovery Trust Fund participants. According to the Cigarette Tax Recovery Trust Fund [Texas Tax Code, Section 154.051(g)], the Treasurer shall withdraw money from the other participants' accounts in the fund to satisfy a tax liability caused by a participating distributor failing to pay taxes due. By not appropriately assessing the deficiency against the participants, earned state revenues amounting to about \$48,000 have not been collected.

### Recommendation:

The Treasury's current administration should take prompt action and work with the Attorney General on the most appropriate way to eliminate an outstanding tax deficiency in a defaulting distributor's Cigarette Tax Recovery Trust Fund account.

### Management's Response:

*There is an outstanding tax deficiency of \$74,312.50, of which \$26,188.63 is secured by the defaulting distributor's Cigarette Tax Recovery Trust Fund balance. The remaining outstanding tax deficiency of \$48,123.87 may be secured depending on the effect of a court order issued in the distributor's bankruptcy case. Management will work with the Attorney General to determine the effect of the bankruptcy order on the disposition of the outstanding tax deficiency.*

Section 1-C:

### **Use Written Work Plans With Performance Expectations To Ensure That Contracted Services Accomplish The Treasury's Audit-Related Goals**

Performance expectations and implementation procedures for the Comptroller of Public Accounts performing tobacco tax audits were not sufficiently documented. Only 68 audits of the targeted 1994 performance measure of 145 were completed in fiscal year 1994.

Of the 68 audits completed, only four were performed after the January 1994 effective date of an interagency contract in which the Comptroller performs most of the tobacco tax functions for the Treasury, including the audit function. Also, audit revenues identified for collection fell from \$1.3 million in fiscal year

## Issues and Recommendations

1993 to under \$300,000 in fiscal year 1994. Detailed written performance expectations, agreed upon by both the Treasury and Comptroller's Office, would have helped set priorities and monitor progress at both agencies.

Due to the statute of limitations, receipt of tobacco tax audit revenues is only delayed, not necessarily lost. Revenue collections are delayed from fiscal year 1994 until the audits are completed, thereby delaying the State's access to these revenues.

### Recommendations:

Develop and formally adopt a written audit work plan that clearly specifies audit performance expectations for tobacco tax audits to be performed by the Comptroller's Office. This work plan should include criteria such as the number of tobacco tax audits to be completed; the estimated completion dates; and when the Comptroller is to receive the necessary information to select, plan, and perform the audits.

### Management's Response:

*The implementation of the Tobacco Tax Contract between the Comptroller and the Treasury, (the "Contract"), with respect to tax audits was adequately planned. The audit objectives under the Contract were clear to both the Comptroller and the Treasury though not fully reduced to writing. Comptroller personnel met numerous times with the Treasury audit staff prior to implementation.*

*Both agencies understood that the frequency of audits would be reduced under the Contract. The performance expectations for Fiscal Year 1995 have been adjusted to reflect this reduction for the first full year of the Contract. The State Auditor rightfully*

*recognizes that revenue collections for Fiscal Year 1994 were delayed but not lost. Any tax deficiency subsequently identified as outstanding but not collected in Fiscal Year 1994 will bear interest at the rate of 12%, more than offsetting the State's delayed access to the revenue.*

*A document will be drafted and signed by both agencies formally adopting our verbal understanding, and clearly specifying audit performance expectations for Tobacco Tax audits to be performed by the Comptroller's office.*

Section 2:

## **Timely Implementation Of Audit Recommendations Reduces Risks**

The Treasury's administration missed opportunities to improve operations. Only 2 of the 13 recommendations from the State Auditor's 1992 review of the revenue auditing functions were implemented prior to the 1994 audit. Five more recommendations were implemented during this audit, three are in the process of being implemented, and three are no longer considered issues.

The three recommendations which have not been fully implemented include the following:

- 1) The Treasury should adhere to its system development life cycle manual to promote the development of properly documented automated systems. This methodology helps reduce the risk of failure in new developments and major modifications of automated systems.
- 2) The Tobacco Tax Division should reconcile control totals to ensure that information transferred from one

## Issues and Recommendations

electronic media to another is complete and accurate.

- 3) The Unclaimed Property Division should refine its system edit checks in order to promote efficiency of application performance.

By implementing the seven recommendations, the Treasury has developed clear policies and procedures so operations could become more efficient and effective, reduced the State's cost for making payment on Unclaimed Property claims, and strengthened computer access controls.

### Recommendation:

- Internal audit should monitor the three recommendations currently being implemented.
- Develop an action plan and timelines, along with assigning responsibility, for implementing audit recommendations.

### Management's Response:

*Internal audit will include as part of their annual audit plan a follow-up review of the implementation of recommendations made by all external auditors. The follow-up review will be scheduled within the 6 month period following the issuance of the audit report.*

## Appendices

Appendix 1:

### **Objectives, Scope, and Methodology**

The State Auditor's review of the Texas State Treasury's revenue audit function was conducted under the authority of Government Code, Section 321.015. The audit's objective was to identify opportunities to improve efficiency and effectiveness.

The scope of our audit included gaining an understanding of the Treasury's revenue audit function and other revenue process functions which have an impact on auditing, such as permitting, taxpayer identification and education, revenue collection, and enforcement. The Treasury is responsible for auditing tobacco tax and unclaimed property revenues. Based on the significance of revenues, this audit concentrated on the tobacco tax revenue. We evaluated the effectiveness of the interagency contract under which the Comptroller of Public Accounts performs many of these functions. (The audit function of the Comptroller is being reviewed separately by the State Auditor's Office.)

To achieve the objectives for this audit, the following work was performed:

- conducted follow-up work on recommendations from our prior report on the tax audit function
- reviewed documentary evidence provided by Treasury staff
- interviewed Treasury personnel
- observed some of the functions in progress
- collected tax audit performance data, performed trend analysis, and determined

whether there were appropriate explanations for significant trends

The on-site fieldwork was conducted from July 5, 1994, through September 2, 1994. The audit was conducted in accordance with Generally Accepted Government Auditing Standards.

The audit work was performed by the following members of the State Auditor's Office staff:

- Duane J. McNaney, CPA (Project Manager)
- John Randall Davis, CPA
- Randy Townsend, CPA (Audit Manager)
- Craig D. Kinton, CPA (Director)



## Appendices

Appendix 2:

### Background and Trend Information

#### The Cigarette and Tobacco Tax Function

The State's Cigarette and Tobacco Tax function issues permits, collects taxes, audits cigarette and tobacco distributors, and enforces the Tax Code. The collection and enforcement authority for this function was transferred from the Comptroller to the Treasury, effective September 1, 1989, at which time the Treasury began performing all aspects of the Cigarette and Tobacco Tax function. Effective January 11, 1994, the Treasury entered into an interagency contract

to have the Comptroller perform all parts of the Cigarette and Tobacco Tax function except for cigarette tax collection, yet the Treasury retains authority and responsibility for all of this function.

Figure 1 depicts collections from cigarette and tobacco taxes, audits, permit fees, and enforcement actions made by the Cigarette and Tobacco Tax function in fiscal years 1990 to 1994. Due to the interagency contract, the Treasurer and Comptroller each made collections during fiscal 1994 in all categories except cigarette tax.

**Figure 1**  
Cigarette and Tobacco Tax Collections

FY	CIGARETTE TAX	TOBACCO TAX	AUDIT COLLECTION	PERMIT AND ENFORCEMENT	TOTAL
90	\$400,779,646	\$31,221,147	\$ 308,048	\$ 39,440	\$432,348,281
91	592,415,240	43,886,294	704,033	63,600	637,069,167
92	532,846,755	48,210,617	1,590,538	113,730	582,761,640
93	564,813,131	51,880,491	881,151	120,992	617,695,765
94	518,087,590	53,707,193	738,653	149,538	572,682,974

Source: Texas Treasury Department and Comptroller of Public Accounts (unaudited)

Note: The large increase in total collections from fiscal years 1990 through 1991 was due to a statutory increase in the tax rates for cigarette stamps and other tobacco products. Total collections are higher in the second year of the biennium (1991 and 1993) because all outstanding receivables are due at the end of each biennium.

## Appendices

Figure 2 shows information about the Cigarette and Tobacco Tax function's audit performance in fiscal years 1992 to 1994.

**Figure 2**  
Audit-Related Information

FY	Number of Distributors Audited	Total Audit-Generated Revenues Identified for Collection	Total Audit Costs	Amount of Audit-Generated Revenues Identified for Collection per \$1 of Audit Cost	Targeted Efficiency Measure
92	183	\$ 1,707,527	\$ 211,852	\$ 8.06	\$ 3.11
93	198	1,327,195	224,188	5.92	3.44
94	68*	260,507*	88,009*	2.96*	3.50

Source: Texas Treasury Department (unaudited)

- \* - The Treasury completed 64 of the 68 audits shown above before the audit function was contracted out to the Comptroller in the second quarter of fiscal year 1994. The Comptroller completed four audits in fiscal year 1994 after the contract went into effect. The Cigarette and Tobacco Tax function's audit performance measures for fiscal year 1994 shown above were based on the 64 audits performed by the Treasury.

Figure 3 shows the numbers of the various types of permittees for fiscal years 1992 through 1994.

**Figure 3**  
Permittee Information

FY	Number of In-State Cigarette Distributors	Number of In-State Tobacco Distributors	Number of Cigarette and Tobacco Retailers
92	116	169	**
93	85	202	40,830
94	83	217	45,829

Source: Texas Treasury Department and Comptroller of Public Accounts (unaudited)

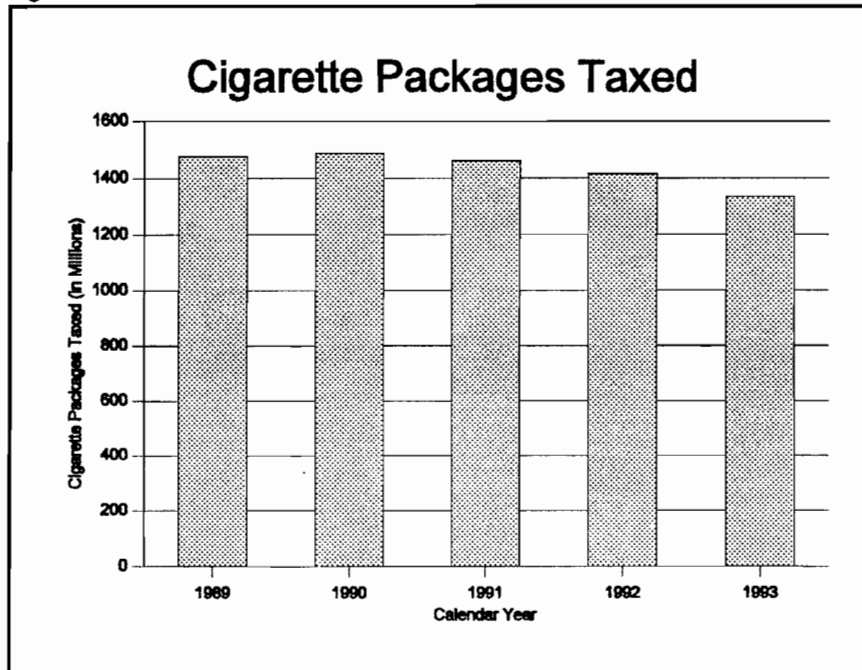
- \*\* - Retailers were first required by law to obtain a permit effective June 1, 1992.

## Appendices

Cigarette distributors and tobacco distributors are the permittees who paid the cigarette taxes and tobacco taxes shown in Figure 1, as well as the audit revenues.

Figure 4 indicates the number of cigarette packages taxed during each of the calendar years 1989 through 1993. Texas ranked third nationally in each of these years, behind California and New York, for the total number of cigarette packages taxed.

Figure 4



Source: Tobacco Institute (Unaudited)

Copies of this report have been distributed to the following:

## **Legislative Audit Committee**

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Honorable Bob Bullock, Lieutenant Governor, Vice Chair  
Senator John Montford, Chair, Senate Finance Committee  
Senator Kenneth Armbrister, Chair, Senate State Affairs Committee  
Representative Robert Junell, Chair, House Appropriations Committee  
Representative Tom Craddick, Chair, House Ways and Means Committee

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