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STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

May 27, 2003

Mr. Arthur Roth
Commissioner
Department of Taxation and Finance
State Office Campus – Building #9
Albany, NY 12227

Re: Processing of Quarterly Fuel Use Tax Returns
Report 2002-S-22

Dear Mr. Roth:

Pursuant to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution and Article II, Section 8 of the State Finance Law, we have audited the Department of Taxation and Finance's internal controls over the processing of quarterly fuel use tax returns for the period July 1, 2000 through December 15, 2002.

A. Background

The Federal Intermodal Surface Transportation Efficiency Act requires all states that set and collect fuel use taxes to participate in the International Fuel Tax Agreement (IFTA). IFTA is an agreement among the 48 contiguous states and 10 Canadian provinces (a total of 58 jurisdictions) to simplify the reporting of fuel use taxes by interstate motor carriers (carriers). Fuel use taxes are paid by the carrier at the pump when fuel is purchased. Fuel use tax rates generally vary by jurisdiction. The carrier is required to pay the fuel use tax rate in effect in the jurisdiction where the fuel is used (based on miles driven). For example, if a carrier purchases fuel in a jurisdiction that has a relatively low tax rate but travels most of the miles in a jurisdiction with a higher tax rate, then additional fuel use tax would be owed to the jurisdiction with the higher tax rate. For the accurate distribution of fuel use taxes, each carrier must maintain records of fuel purchased, fuel use tax paid and miles traveled in each jurisdiction. Carriers include this information on the quarterly fuel use tax return (return) that they are required to file with their base jurisdiction (i.e., the state or province in which a carrier's motor vehicles are registered). The base jurisdiction then collects and distributes carrier fuel use tax payments to other IFTA jurisdictions.

To facilitate the administration of IFTA and provide other jurisdictions with services relating to processing returns, in 1996 the New York State Department of Taxation and Finance (Department) initiated the Regional Processing Center (RPC). The RPC provides a range of services from which participating jurisdictions may select to carry out IFTA's fuel tax processing requirements. Such services include printing and mailing quarterly returns to carriers, data entry of carriers' quarterly return information, and monthly settlement of taxes owed to the various jurisdictions. The Department also manages the services provided by Fleet Bank (Fleet), which is under contract to provide various services relating to the RPC, such as depositing the remittances sent by carriers, data entering information from the carriers' quarterly returns, and delivering such data to the Department for processing on its IFTA system.

The RPC administers IFTA for New York and the following 15 participating jurisdictions: Alabama, California, Connecticut, Delaware, Georgia, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Brunswick, New Jersey, Pennsylvania, Rhode Island, and Texas. Seven of the 16 jurisdictions, including New York, have contracted with Fleet to data enter return information and to deliver such information to the RPC. The remaining nine jurisdictions provide carrier return information to the RPC through other methods.

Fleet data enters carrier return information onto its own system, resolves data entry discrepancies between fuel use tax information as submitted by the motor carrier on the return and fuel use tax information as data-entered at Fleet, sends the original return back to each jurisdiction, and remits a tape to the Department for download onto the IFTA System. The jurisdictions have access to reports available through the IFTA System for purposes of reviewing return information and resolving exceptions with individual carriers, such as mathematical errors or incomplete carrier return information.

For New York State carriers, the Department's Return Processing and Control Unit identifies exceptions from reports generated by the IFTA System and resolves them on a daily basis. The Return Processing and Control Unit resolves approximately 4,000 exceptions each quarter. According to Department officials, data from returns containing exceptions are not reflected in the individual accounts used for billing and refunding purposes until the exceptions are resolved.

A return is also classified as an exception whenever a carrier based in New York State requests a refund. In such cases, the return is forwarded to the Department's Transaction and Transfer Tax Bureau (Bureau) IFTA Desk Audit Unit for review and authorization. In addition, as required by IFTA, the Bureau's IFTA Field Audit Unit conducts an annual audit of three percent of the New York State carrier returns.

B. Audit Scope, Objective and Methodology

We audited the Department's internal controls over the processing of quarterly fuel use tax returns for the period July 1, 2000 through December 15, 2002. Our audit focused on controls over the data entry of fuel use tax return information performed by Fleet and the controls over issuing IFTA refunds for New York-based carriers. The objective of our performance audit was to determine whether adequate internal controls exist over processing quarterly fuel use tax returns.

Our audit did not address the system applications involved in calculating the fuel use tax payments or billings to other jurisdictions.

To accomplish our objective, we reviewed State laws and regulations, Department policies and procedures, the IFTA Memorandum of Understanding between the 16 jurisdictions for the development of the RPC, and components of the contract between the Department and Fleet relating to performance standards. We conducted interviews with Department officials regarding their monitoring and oversight responsibilities associated with processing IFTA returns. In addition, we interviewed officials at Fleet, the Bureau, and the Return Processing and Control Unit. We also examined a random sample of 50 refunds issued to New York State carriers to determine the authenticity of the carrier.

We conducted our audit in accordance with generally accepted government auditing standards. Such standards require that we plan and perform our audit to adequately assess those operations of the Department which are included within our audit scope. Further, these standards require that we understand the Department's internal control structure and its compliance with those laws, rules and regulations that are relevant to the operations which are included in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions and recommendations.

We use a risk-based approach when selecting activities to be audited. This approach focuses our audit efforts on those operations that have been identified through a preliminary survey as having the greatest probability for needing improvement. Consequently, by design, finite audit resources are used to identify where and how improvements can be made. Thus, little audit effort is devoted to reviewing operations that may be relatively efficient or effective. As a result, our audit reports are prepared on an "exception basis." This report, therefore, highlights those areas needing improvement and does not address activities that may be functioning properly.

C. Results of Audit

We found that adequate controls are in place over the data entry of carrier return information. However, the Department needs to improve controls over the processing of refunds for New York State carriers.

1. Internal Controls Over Data Entry

Seven jurisdictions contract with Fleet to provide data entry services for carrier returns. Data entry of return information is a manual process and in itself presents a high inherent risk for the likelihood of errors to occur. Therefore, it is important that adequate controls be in place to ensure that information contained on the carrier's return is data entered in an accurate and complete manner. Generally, we found that controls over the data entry of carrier return information were adequate.

We reached this conclusion since our audit identified several controls in place that minimize the risk of data entry errors. Fleet requires that two employees independently enter information from all returns. In addition, for returns that include a remittance, a third employee keys in the dollar amount of the remittance from the check itself, to determine whether the actual remittance is consistent with the dollar amount recorded on the return. Fleet officials stated that when inconsistencies are identified during this stage of the data entry process, a senior employee reviews the carrier's return and again enters the data. In addition, Fleet officials stated that their system contains about 150 electronic edits to detect possible data entry errors so that such errors can be resolved. For example, there are edits to identify instances where total miles driven by the carrier are indicated as negative or where an invalid fuel type is indicated.

2. Processing of Refunds for New York State Carriers

Good internal controls reduce the risk of fraudulent activity or wrongful acts occurring or going undetected. Internal controls should require adequate separation of key tasks and responsibilities, written procedures to document employee roles and responsibilities, and supporting documentation to show that required activities were properly performed. Where tasks cannot be effectively separated, increased supervision can help provide a compensating control.

The IFTA Desk Audit Unit is responsible for reviewing and authorizing all IFTA refund requests submitted by New York State carriers. The Department identified previous internal control weaknesses over the processing of carrier refunds that enabled a Bureau employee to create several fictitious carriers and file invalid returns, which generated \$265,000 in refunds. According to Department officials, this employee was removed from his position and convicted on two felony charges related to the theft of funds. Subsequent to these fraudulent transactions, the Department's Bureau of Internal Audit and Quality Control audited the IFTA refund process and made three recommendations that specifically addressed the control weaknesses which allowed the fraudulent transactions to occur. We followed up with Bureau officials and determined that although they implemented the three recommendations, there is a need to further strengthen controls over refunds. Specifically, we noted the need for better separation of duties, formal written procedures for the supervisory review of refunds, and documentation to demonstrate that supervisory reviews are conducted.

The IFTA Desk Audit Unit is comprised of the following employees: one State Grade (SG)-9, two SG-14's, one SG-18, one SG-23, and one SG-27. In general, Department procedures allow all employees to do the initial review of any refund. However, in practice, the SG-9 and SG-14's are primarily responsible for this function. Once a refund request has been initially reviewed, depending upon the refund amount, it may require additional review and authorization before the transaction is complete. Department procedures require the following:

- Refunds under \$5,000 do not require a secondary review or authorization;
- Refunds up to \$10,000 must be reviewed and authorized by an SG-14 or above;
- Refunds up to \$20,000 must be reviewed and authorized by an SG-18 or above;
- Refunds up to \$50,000 must be reviewed and authorized by an SG-23 or above; and
- Refunds in excess \$50,000 must be reviewed and authorized by an SG-27.

According to data provided by the Bureau, for the period October 1, 2001 through September 30, 2002, a total of 5,486 refund requests totaling nearly \$2.3 million were processed. Of the 5,486 refund requests, 5,401 (98.5 percent) were under \$5,000 and totaled nearly \$1.5 million. Therefore, based on Department procedures, the same employee could perform the review and authorization of a refund request for 98.5 percent of the refund transactions. As a compensating control, Bureau officials indicated that IFTA Desk Audit Unit staff performs random reviews of completed refunds. They stated that the SG-18 randomly selects approximately 10 completed refund transactions twice each week for review and that the SG-23, as time permits, randomly selects approximately 10 completed refund transactions that are under \$4,000 for review. However, the Bureau has no formal written procedures for this practice. Bureau officials stated that during these reviews, returns are examined for mathematical accuracy, completeness and authenticity of the carrier.

As noted above, the IFTA Desk Audit Unit does not have formal written procedures for conducting periodic supervisory reviews nor does the Unit maintain documentation to show that such reviews had taken place. The absence of such a formalized process results in a risk that periodic supervisory reviews will not be performed in a manner consistent with Bureau expectations or will not be done at all. In addition, under the IFTA Desk Audit Unit's existing informal supervisory review process, some of the SG-18's work may not be subject to any periodic supervisory review. The SG-23's periodic reviews are limited to refunds under \$4,000. As a result, when developing formal procedures for periodic supervisory reviews, the Bureau should require that all refund transactions be potentially subject to a random, independent review.

As part of our audit, we also examined the authenticity of the carrier for a random sample of 50 refund transactions from data provided by the Bureau for the period October 1, 2001 through September 30, 2002. Although our sample did not identify any fictitious carriers, the lack of a formal process for periodic, supervisory review of transactions reduces management's assurance that the carriers who submit these returns are authentic.

(In response to our draft audit report, Department officials noted that, in order to identify fraudulent reporting, the Department generates a report each quarter which lists companies that are registered for IFTA only, and reviews companies on the list for authenticity. Additionally, reports are generated and reviewed twice each week which list companies reporting more than 100,000 miles driven per quarter. Department officials also stated that our recommendation to develop formal written procedures for providing periodic, supervisory oversight of refund transactions pertains only to IFTA refund transactions under \$5,000 because the Department has written procedures for supervisory oversight of refund transactions over that amount which are followed.)

Auditors' Comments: We point out that there are many motor vehicle carriers who do not fall into the category of IFTA only, therefore these companies would not be part of this review. Also, miles traveled flags would not identify fraudulent companies who report less than 100,000 miles driven per quarter. We acknowledge that the department has written procedures requiring a second signature on IFTA refund transactions over \$5,000. However, our recommendation addresses the need to formalize procedures for conducting the periodic supervisory reviews where IFTA returns are examined for mathematical accuracy, completeness and authenticity of the carrier.

Recommendations

1. *Develop formal written procedures for providing periodic, supervisory oversight of refund transactions. Such procedures should allow for all transactions to be potentially subject to a random, independent review.*
2. *Develop a process to formally document the performance of periodic supervisory reviews.*

We provided Department officials with a draft copy of this report for their review and comment. Their comments have been considered in the preparation of this report and included as Appendix A. Officials indicate agreement with each of our recommendations and that action has been taken to implement them.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Commissioner of the Department of Taxation and Finance shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

Major contributors to this report were Arthur Smith, Karen Bogucki, Kevin Kissane, Cindy Herubin, David Pleeter, Alex Marshall, and Paul Bachman.

We wish to thank the management and staff of the Department of Taxation and Finance for the courtesies and cooperation extended to our auditors during this audit.

Very truly yours,

Steven E. Sossei
Audit Director

cc: Deirdre Taylor, DOB



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ANDREW S. ERISTOFF
EXECUTIVE DEPUTY
COMMISSIONER

April 21, 2003

Mr. Steven Sossei
Audit Director
Office of the State Comptroller
State Audit Bureau
110 State Street, 11th Floor
Albany, New York 12236

Dear Mr. Sossei:

Thank you for the opportunity to comment on the draft report of your audit entitled, "Processing of Quarterly Fuel Use Tax Returns" (2002-S-22). We agree with the report's recommendations, however, we find it necessary to also comment on certain statements contained in the report that we believe to be misleading.

Recommendation 1:

Develop formal written procedures for providing periodic, supervisory oversight of refund transactions. Such procedures should allow for all transactions to be potentially subject to a random, independent review.

Response:

The Department has taken action to implement this recommendation as it applies to IFTA refunds. However, we must point out to the readers of your report that this recommendation pertains only to IFTA refund transactions under \$5,000 because the Department has formal written procedures for supervisory oversight of refund transactions over that amount which are followed. We think it is also important for proper perspective to point out that historically, about 70 percent of these refunds are under \$200. We believe this is important to properly assess the risks involved.

Recommendation 2:

Develop a process to formally document the performance of periodic supervisory reviews.

Response:

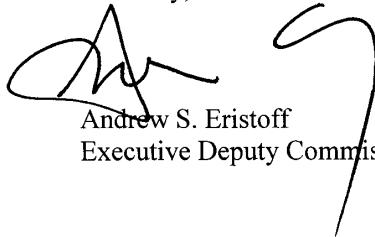
The Department has taken action to implement this recommendation.

Additional Comment:

The last paragraph of the report states "the lack of a formal process for periodic, supervisory review of transactions reduces management's assurance that the carriers who submit these returns are authentic." This seems to indicate that the Department makes no effort to identify fraudulent reporting. However, this is not the case.

The Department generates a report each quarter which lists companies that are registered for IFTA only. These companies are then reviewed for authenticity. Additionally, reports are generated and reviewed twice each week which list companies reporting more than 100,000 miles per quarter. This would be indicative of possible fraudulent reporting. We believe these procedures are significant in our effort to ensure that returns are authentic.

Sincerely,



Andrew S. Eristoff
Executive Deputy Commissioner