DEPARTMENT OF REVENUE

STATE OF LOUISIANA

FINANCIAL AUDIT SERVICES
MANAGEMENT LETTER
ISSUED DECEMBER 19, 2018

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Louisiana Legislative Auditor
Daryl G. Purpera, CPA, CFE

Department of Revenue

December 2018

Audit Control # 80180106

Introduction

As a part of our audit of the State of Louisiana's Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2018, we performed procedures at the Louisiana Department of Revenue (LDR) to provide assurances on financial information that is significant to the state's CAFR; evaluate the effectiveness of LDR's internal controls over financial reporting and compliance; and determine whether LDR complied with applicable laws and regulations. In addition, we determined whether management has taken actions to correct the findings reported in the prior year.

Results of Our Procedures

Follow-up on Prior-year Findings

Our auditors reviewed the status of the prior-year findings reported in the LDR management letter dated December 20, 2017. We determined that management has resolved the prior-year finding related to Ineffective Controls over Severance Tax Collections and Refunds. The prior-year finding related to Overpayment of Sales Tax Distributions to Local Government will not be repeated because LDR revised the agreement to match the calculation method that has been done in years past.

Current-year Finding

Inadequate Preparation of the Annual Fiscal Report

LDR incorrectly reported net receivables and the estimated amount of protested taxes to be transferred to the general fund in its 2018 Annual Fiscal Report (AFR), which is used by the Division of Administration (DOA), Office of Statewide Reporting and Accounting Policy (OSRAP) to compile the CAFR. Net receivables were overstated by $31.1 million, and protested taxes to be transferred to the general fund were overstated by $25.8 million.

- Net receivables were overstated by $31.1 million, including a $59.5 million overstatement of qualified receivables and a $28.4 million understatement of proposed assessments. The net overstatement is the result of the difference in collection rates used for the two classifications of receivables. Qualified receivables, which are tax receivables generally based on an actual tax return, are considered nearly 100% collectable. Proposed assessments, which are estimated tax receivables, are considered on average only 5% collectible when based on prior filings or other information obtained by LDR and 50% collectible when based on audits performed by LDR. These misstatements occurred because LDR classified all final debt as qualified receivables, but the nature and historical collectability of those accounts do not support such a high collection rate and low allowance.

- The amount of protested taxes to be transferred to the general fund was overstated by an estimated $25.8 million due to a reporting error by LDR Financial Services. LDR could not provide supporting documentation for the methodology used to report the additions, deletions, and ending balance estimated to be transferred to the general fund at June 30, 2018.

The misclassification of receivables is a result of the overreliance on system classifications to determine the collection rate of accounts. Classifying receivables as qualified receivables indicates that the receivable is nearly 100 percent collectible. In the case of protested taxes, the errors occurred due to the heavy reliance on system reports during AFR preparation without an adequate understanding of the reporting process or the information included in those reports. This resulted in the use of incorrect reports and the misuse of the information in those reports.

Misstatements in LDR's AFR can result in misstatements of the state's CAFR. Good internal controls over financial reporting should include adequate procedures to record, process, and compile financial data needed to prepare an accurate and complete AFR; adequate training and supervision of staff; and an effective review of the AFR so that errors can be detected and corrected before submitting the AFR to OSRAP for inclusion in the state's CAFR. In addition, AFR preparers should have an adequate understanding of system reports before using them to prepare the AFR.

Management should ensure that the AFR, including the information as entered in OSRAP's AFR Portal, is reviewed in detail prior to its submission to OSRAP. Management should also develop and implement written procedures for classifying receivables and ensure that the calculation of allowances for uncollectible accounts accurately reflects the historical collection rate of receivables. Management did not concur that net receivables were overstated. Management did concur that the amount of protested taxes estimated to be transferred to the general fund were overstated; however, management did not agree that there was a lack of understanding of the reporting process and system reports, and that there was no supporting documentation for the amounts reported.

Additional Comments: Management did not concur that net receivables were overstated, stating that the classification of receivables is determined through a detailed review by experienced staff. Regardless of the classification of the account, net receivables were overstated because the allowance calculation did not properly consider the historical collectability of accounts.

In relation to the overstated protested taxes estimated to be transferred to the general fund, management did not agree that there was a lack of understanding of the reporting process or information included in system reports, or that there was no supporting documentation for the additions, deletions, and ending balance estimated to be transferred to the general fund. Management represented that the true cause of the overstatement was inadequate testing of the new electronic AFR submission system (AFR portal) developed by OSRAP; however, there is no indication of an error with the AFR portal. As a follow-up to the department's response, auditors again requested the supporting documentation for the calculation of the additions, deletions, and ending balance estimated to be transferred to the general fund, which has not been provided.

Comprehensive Annual Financial Report (CAFR) – State of Louisiana

As a part of our audit of the CAFR for the year ended June 30, 2018, we considered internal control over financial reporting and examined evidence supporting certain account balances and classes of transactions as follows:

> **Revenues** - Corporate Income and Franchise tax, Individual Income tax, Sales tax, Severance tax, and Gasoline and Special Fuels tax
>
> **Receivables** - Full Accrual and Modified Accrual Receivables on the revenues listed above
>
> **Note Disclosures** - Refunds Payable and Tax Abatement Programs

Based on the results of these procedures, we reported one finding related to Inadequate Preparation of the Annual Fiscal Report, as described previously. In addition, the account balances and classes of transactions tested, as adjusted, are materially correct.

Other Procedures

In addition to the CAFR procedures noted above, we performed certain procedures that included obtaining, documenting, and reviewing LDR's internal control and compliance with related laws and regulations over the audits of Sales Tax returns and claims of certain tax incentives.

Sales Tax Audits

LDR currently has 62 auditors assigned to the Field Audit Sales Tax Division, who conduct audits to ensure taxpayers have filed and paid in accordance with State law. Audited accounts are selected due to identified issues within an industry, errors on a return, observations from the audit staff, and random selection. The number of audits conducted increased by 377 (48%), from 782 audits in 2017 to 1,159 in fiscal year 2018. However, the number of audits performed covers less than 1% of all sales tax filers. LDR audit findings related to sales tax audits completed in 2018 totaled $62,678,941 and collections related to sales tax audits in fiscal year 2018 totaled $19,675,634. Due to the high productivity of these audits, LDR should continue to focus on increasing the number of audits performed annually.

During our fiscal year 2018 audit procedures, we tested a sample of sales tax payments and refunds that were recorded during the year. The related returns that we reviewed included many exemptions, allowed by law, without the filing of any supporting documentation. Taxpayers are required to keep the qualifying evidence on file; however, they are only required to submit the documentation if they are audited.

On average over the past three fiscal years, sales tax exemptions have caused a loss in tax revenue of approximately $2.7 billion a year. LDR has reported sales tax revenue collections averaging $3 billion per year.

Claims of Tax Incentives

The state of Louisiana has 78 tax incentives in statute that are currently available to taxpayers. The claims for these incentives are processed through LDR in the form of reductions to income tax liability or, in some cases, as rebates. As part of our audit procedures for fiscal year 2018, we evaluated the procedures implemented by LDR to verify the accuracy of the incentives claimed. Specifically, we obtained and reviewed the procedures related to claims of the Inventory/Ad Valorem Tax Credit, Louisiana Quality Jobs Program, Rehabilitation of Historic Structures, and Motion Picture Production Tax Credits. In the most recent Tax Exemption Budget (TEB) reporting fiscal year 2017 revenue losses, LDR reported a revenue loss of $709.7 million related to these four incentives.

Inventory/Ad Valorem Tax Credit

The Inventory/Ad Valorem (Inventory) Tax Credit is a credit against income or corporate franchise tax for ad valorem taxes paid to political subdivisions for inventory held by manufacturers, distributors, and retailers. LDR reported a fiscal year 2017 revenue loss of $312.7 million in the TEB attributable to the Inventory tax credit. During our procedures, we determined that the fiscal year 2017 revenue loss is approximately $190 million, a difference of $120 million or 39% from the amount reported by LDR. This difference is due to prior year credits that were already included in prior TEBs, also being included in the fiscal year 2017 data because of the return being amended or changed.

Louisiana Quality Jobs Program

The Louisiana Quality Jobs Program encourages businesses in certain targeted industries to locate new and/or expand existing operations in Louisiana. The program is intended to benefit businesses that create well-paid jobs and promote economic development. This program allows for payroll rebates on gross payroll attributed to new, direct jobs; state sales and use tax rebates on approved capital expenditures; and project facility expense rebates on total capital investments. The amount reported as revenue loss in the TEB for fiscal year 2017 is $99.3 million. Five of the 134 companies that benefitted from this program in 2017, received 43% of the total rebates issued.

Rehabilitation of Historic Structures

The Rehabilitation of Historic Structures credit encourages the rehabilitation of historic structures located in downtown development districts and certified cultural districts. A credit is allowed on 25% of the eligible costs and expenses of rehabilitation incurred prior to January 1, 2018; and 20% of the rehabilitation incurred on or after January 1, 2018. Qualified rehabilitation expenditures must exceed ten thousand dollars in order to earn the tax credit and taxpayers are allowed to transfer unused credits to another individual or entity. The taxpayer must submit in writing to LDR a notification of any transfer or sale of tax credits within ten business days after the transfer or sale of such tax credits. The Department of Culture, Recreation, and Tourism (CRT) reported a total investment of $546,301,265 million in commercial historic buildings in fiscal year 2017, including $406,719,701 million in qualified rehabilitation costs and $139,581,564 million in non-qualified costs. In the 2017 TEB, LDR reported $91.9 million in claims of the Rehabilitation of Historic Structures credit during fiscal year 2017. Corporate taxpayers made up 39% of the claims and individual taxpayers accounted for the remaining 61%. Of the tax credits claimed, 44% were transferred or sold by the individual or business that earned the credit.

Motion Picture Production Tax Credit

A Motion Picture Production Tax Credit encourages the development of a strong capital and infrastructure base for motion picture production in order to achieve an independent, self-supporting industry in Louisiana. A maximum 40% credit is allowed on qualified in-state production expenditures. Available credits include a 25% base investment credit, 10% additional credit for Louisiana screenplay productions, 5% additional credit if outside of the New Orleans Metro Statistical Area, 15% Louisiana resident payroll credit, and 5% visual effects credit. Total Louisiana expenditures must exceed $300,000 (or $50,000 for Louisiana screenplay productions) to earn the tax credit. Motion picture production companies who applied for the program before July 1, 2017, can claim these credits at 100% of their value, transfer or sell them to someone else, or transfer the credits back to the state at 85% of face value. For applications received on or after July 1, 2017, credits earned may be claimed by the taxpayer at 100% of their value or transferred back to the state for 90% of face value with the payment of a 2% transfer fee effectively making it 88% of face value. LDR reported $205.8 million in fiscal year 2017 motion picture credits in the TEB. Of the $205.8 million credits claimed, $205.3 million, or

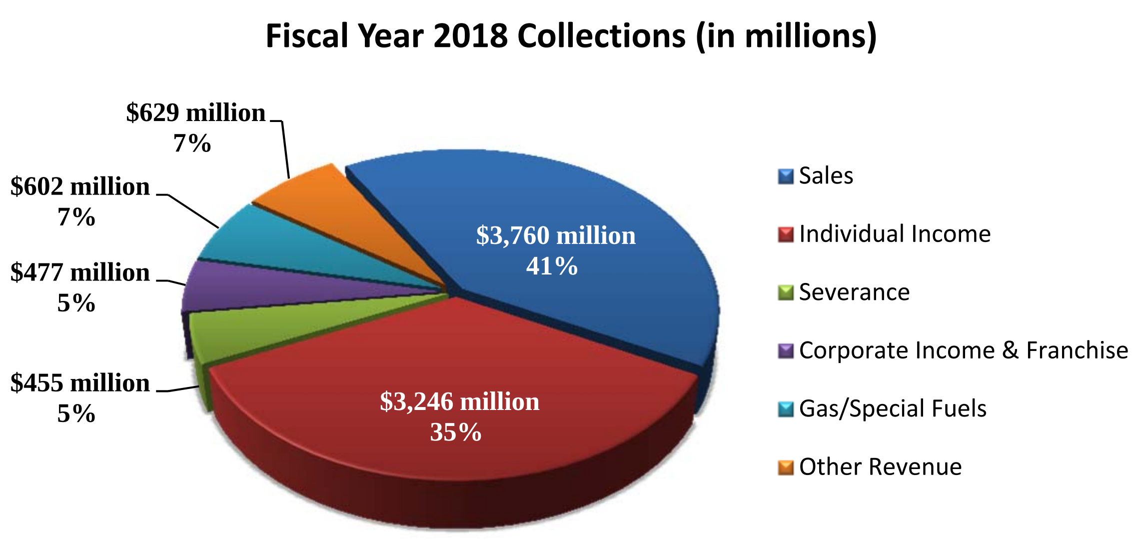
99.8%, were transfers of credits back to the state by motion picture production companies at 85% of face value.

Taxpayers claiming the Inventory tax credit are required by the department to submit tax assessments and proof of payment of inventory taxes to local governments. The Quality Jobs and Motion Picture incentive programs include a requirement to enter into an approved contract with Louisiana Economic Development (LED). LDR verifies that the credits claimed under these programs are within the parameters of the approved contracts obtained from LED. When taxpayers claim the Rehabilitation of Historic Structures credit, they must submit an Agency Certification of Credits and Project Certification approved by CRT along with the credit registration form. Given the transferrable nature of this credit, a notification of transfer letter may also be required if the credit is claimed by a taxpayer other than the original beneficiary.

We determined through inquiry and detailed review of accounts that LDR requires adequate support prior to the approval of refunds resulting from the Corporate and Individual Income tax credits claimed for these incentive programs.

Trend Analysis

We compared the most current and prior-year financial activity using LDR's Annual Fiscal Reports and/or system-generated reports and obtained explanations from LDR management for any significant variances. We also prepared an analysis of fiscal year 2018 tax revenue collections. The majority of revenues collected by LDR, 76% of total tax revenues, is composed of Individual Income tax and Sales tax.



Source: Fiscal Year 2018 Department of Revenue Annual Fiscal Report

The recommendation in this letter represents, in our judgment, that which will most likely bring about beneficial improvements to the operations of LDR. The nature of the recommendation, its implementation cost, and its potential impact on the operations of LDR should be considered in reaching decisions on courses of action.

Under Louisiana Revised Statute 24:513, this letter is a public document, and it has been distributed to appropriate public officials.

Respectfully submitted,

Daryl G. Purpera

Daryl G. Purpera, CPA, CFE
Legislative Auditor

BDM:EMS:BQD:EFS:aa

LDR2018

APPENDIX A: MANAGEMENT'S RESPONSE

State of Louisiana
Department of Revenue

John Bel Edwards
Governor

Kimberly Lewis Robinson
Secretary

December 3, 2018

Mr. Daryl G. Purpera, CPA, CFE
Legislative Auditor
Louisiana Legislative Auditor
Post Office Box 94397
Baton Rouge, LA 70804-9397

Re: Department's Response to Inadequate Preparation of the Annual Fiscal Report

Dear Mr. Purpera:

This correspondence serves as Louisiana Department of Revenue's (LDR) official response to the finding referred to above. Each summation supporting your finding will be addressed separately. The finding is comprised of two issues and each will be addressed separately in our response. Basically, we **concur in part** with the finding and submit the following information in support of our position:

Net Receivables were overstated by $31.1 million

In short, we disagree with your conclusion that Net Receivables were overstated in the Annual Fiscal Report by less than four percent (4%). The manner in which receivables have been determined for fiscal report purposes has existed for a long time. As stated in your finding, LDR has two classifications of receivables and they are Qualified and Proposed. By definition, qualified receivables represent definitely fixed non-appealable debt which is equivalent to a court ordered judgment. Proposed receivables are comprised of audit assessments and estimates which were determined using the prior filing history of the taxpayer. The distinct differences in the two types of receivables explain to a large degree the variation in treatment from a valuation perspective for financial reporting purposes. Specifically, to the central point of this section of the finding, qualified receivables are evaluated individually by experienced staff prior to making a determination of currently not collectible (CNC). This is due to the many collection tools that are statutorily available and in some cases takes months and possibly years before an account is deemed uncollectible. As is the case with judgments, collection

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opportunities more numerable and successful outcomes are greater, all of which support the manner in which the allowance is determined. The information presented above is in direct contradiction to your statement that "The misclassification of receivables is a result of the overreliance on system classifications to determine the collection rate of accounts." In fact, the classification of receivables is determined by a detailed review by the appropriate business unit staff.

Protested taxes estimated to be transferred to the general fund was overstated by $25.8 million

We agree that the amount of protested taxes estimated to be transferred to the general fund was overstated. This was predominantly due to inadequate testing of the new Annual Fiscal Report's electronic submission system developed by OSRAP. Basically, the electronic system did not include the ability to take a percentage of the actual end of the year balance of the Taxes Paid Under Protest Escrow Account. Instead, the entire year-end balance was reported as the amount to be transferred to the general fund. This is the inaugural year for the new electronic submission system. Contrary to the point raised in this part of the finding, LDR has detailed data supporting all additions, deletions and balances estimated to be transferred to the general fund. This oversight has been reported to OSRAP and will be corrected prior to any future submissions.

As it relates to protested taxes, we disagree with the auditor's notion that there is a lack of understanding of the reporting process or the information included in reports generated for reporting purposes. The reports generated and utilized for reporting purposes were not the cause of the error, as explained above.

The issues identified in the finding do not warrant the levying of criticism such as that stated in the last two paragraphs of the official report. Suggestions that LDR lacks good internal controls over financial reporting, inadequate training and supervision of staff, and an ineffective review of the AFR are unfounded. In addition, LDR management does review the information entered in the AFR Portal in detail and staff has written procedures for classifying receivables. These procedures are reviewed annually and are adjusted as needed.

As mentioned above, we have reported to OSRAP the error discovered in the online portal and this will be corrected prior to any future filings. Although we believe our system for reporting receivables is sound, your recommendations will be considered during the routine review of our filing and reporting requirements.

We will continue to evaluate other recommendations mentioned in your report and make the necessary adjustments as warranted by our analysis.

Clarence Lymon, Undersecretary, is the person responsible for implementing the corrective actions discussed above.

Sincerely,

Kimberly Lewis Robinson
Secretary

APPENDIX B: SCOPE AND METHODOLOGY

We performed certain procedures at the Louisiana Department of Revenue (LDR) for the period from July 1, 2017, through June 30, 2018, to provide assurances on financial information significant to the State of Louisiana's Comprehensive Annual Financial Report (CAFR), and to evaluate relevant systems of internal control in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States. The procedures included inquiry, observation, review of policies and procedures, and a review of relevant laws and regulations. Our procedures, summarized below, are a part of the audit of the CAFR for the year ended June 30, 2018.

- We evaluated LDR's operations and system of internal controls through inquiry, observation, and review of its policies and procedures, including a review of the laws and regulations applicable to LDR.

- Based on the documentation of LDR's controls and our understanding of related laws and regulations, we performed procedures to provide assurances on certain account balances and classes of transactions to support our opinions on the CAFR.

- We compared the most current and prior-year financial activity using LDR's Annual Fiscal Reports and/or system-generated reports to identify trends and obtained explanations from LDR management for significant variances.

In addition, we performed procedures on audits of Sales Tax returns and claims of certain tax incentives. The scope of these procedures was significantly less than an audit conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States.

The purpose of this report is solely to describe the scope of our work at LDR and not to provide an opinion on the effectiveness of LDR's internal control over financial reporting or on compliance. Accordingly, this report is not intended to be, and should not be, used for any other purposes.

We did not audit or review LDR's Annual Fiscal Report, and accordingly, we do not express an opinion on that report. LDR's accounts are an integral part of the State of Louisiana's CAFR, upon which the Louisiana Legislative Auditor expresses opinions.