NEBRASKA AUDITOR OF PUBLIC ACCOUNTS

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December 19, 2019

Tony Fulton, Tax Commissioner
Nebraska Department of Revenue
301 Centennial Mall South
PO Box 94818
Lincoln, Nebraska 68509

Dear Tax Commissioner Fulton:

In planning and performing our audit of the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Nebraska (State), as of and for the year ended June 30, 2019, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, we have issued our report thereon dated December 19, 2019. In planning and performing our audit, we considered the State's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements of the State, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control. Accordingly, we do not express an opinion on the effectiveness of the State's internal control.

In connection with our audit described above, we noted certain internal control or compliance matters related to the activities of the Nebraska Department of Revenue (Department) or other operational matters that are presented below for your consideration. This comment and recommendation, which has been discussed with the appropriate members of the Department management, is intended to improve internal control or result in other operating efficiencies.

Our consideration of internal control included a review of prior year comments and recommendations. To the extent the situations that prompted the recommendations in the prior year still exist, they have been incorporated in the comments presented for the current year. All other prior year comments and recommendations (if applicable) have been satisfactorily resolved.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as discussed below, we identified a certain deficiency in internal control that we consider to be a significant deficiency.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. We did not identify any deficiencies in internal control that we consider to be material weaknesses.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the comment below (Lack of Supporting Documentation for Tax Incentive Payments) to be a significant deficiency.

That comment will also be reported in the State of Nebraska's Statewide Single Audit Report Schedule of Findings and Questioned Costs.

Draft copies of this letter were furnished to the Department to provide management with an opportunity to review and to respond to the comment and recommendation contained herein. Any formal response received has been incorporated into this letter. Such response has been objectively evaluated and recognized, as appropriate, in the letter. A response that indicates corrective action has been taken was not verified at this time, but it will be verified in the next audit.

The following is our comment and recommendation for the year ended June 30, 2019.

Lack of Supporting Documentation for Tax Incentive Payments

The Department provided tax incentives under the Nebraska Advantage Act (Neb. Rev. Stat. §§ 77-5701 through 77-5735 (Reissue 2018)) and the Employment and Investment Growth Act (Neb. Rev. Stat. §§ 77-4101 through 77-4112 (Reissue 2018)). The tax incentives were provided to encourage new businesses to relocate to Nebraska, retain existing businesses, aid expansion, and promote and retain quality jobs. The tax incentives can substantially reduce or eliminate the State and local tax liability of a qualifying company with major investments in employees and/or property. Once the taxpayer is approved, an incentive agreement is executed, and a qualification audit is performed by the Department when the taxpayer believes it has qualified to receive tax credits. In order to claim a refund of sales and use taxes from the incentives tax credits, the taxpayer must file a form, typically on a quarterly basis. The company provides documentation, primarily consisting of a list of invoices and copies of said invoices, to support the credits claimed, which is then reviewed by the Department to ensure that each item claimed is qualified under the act. Total tax incentives paid during the fiscal year ended June 30, 2019, was $111,687,623.

During testing of 15 companies that received incentive payments during the fiscal year, we noted that the Department did not retain adequate supporting documentation to substantiate the tax credits paid for four companies. The Department had no invoices on file to support the tax credits paid. The four companies were paid $10,112,052 during the fiscal year. The Department had performed a field audit and did not maintain copies of the invoices tested.

Good internal controls require policies and procedures to ensure that adequate documentation is retained to support audit procedures performed by the Department for tax incentive payments.

Without such policies and procedures, there is increased risk the Department will pay tax incentives inappropriately, increasing the risk of material noncompliance with State law.

We recommend the Department implement policies and procedures to ensure that audit documentation, such as invoices, is retained to support the tax incentive payments.

Department Response: The DOR internal control memo provided annually to the APA has historically noted that invoices may not be available for the APA to observe if the Department has just finished a field audit of the taxpayer because the invoices are observed in the field and copies are not required. This was a management decision made by the DOR to avoid the detrimental impact on the Department's operations from scanning thousands of documents during the field audit, which would also have a material negative impact on its financial statements. The DOR completes a thorough review of documents in the field, similar to the review completed in the office, which are reviewed by the in-charge auditor with a final review and approval by an Audit Manager in the office. However, in order to provide the APA with adequate documentation for their internal control review, the DOR is proposing a compensating control that would avoid the inefficient use of resources required for copying and retaining thousands of documents, but provide additional assurances regarding accuracy of invoices reviewed in the field. Under this plan, an Audit Manager will request a sample of invoices to verify that the amounts scheduled by the field auditor for refund tie to the actual invoices. Those sampled invoices will also be retained for APA review.

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Our audit procedures are designed primarily on a test basis and, therefore, may not bring to light all weaknesses in policies or procedures that may exist. Our objective is, however, to use our knowledge of the Department and its interaction with other State agencies and administrative departments gained during our work to make comments and suggestions that we hope will be useful to the Department.

This communication is intended solely for the information and use of management, the Governor and State Legislature, others within the Department, Federal awarding agencies, pass-through entities, and management of the State of Nebraska and is not intended to be, and should not be, used by anyone other than the specified parties. However, this communication is a matter of public record, and its distribution is not limited.

Pat Reding

Pat Reding, CPA, CFE
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