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OFFICE OF THE LEGISLATIVE AUDITOR

State of Minnesota • James Nobles, Legislative Auditor

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On March 7, 2011, Pamela Dellis, a former employee of the Minnesota Department of Revenue, pled guilty to creating $1.9 million of false tax refunds from January 12, 2005, through September 17, 2010, and using the proceeds for personal benefit. Shortly after the fraud was initially detected, officials at the Department of Revenue and the Office of the Legislative Auditor (OLA) agreed that a criminal investigation should proceed through the coordinated efforts of state and federal investigative offices. OLA agreed to defer a separate review until after the criminal investigation and prosecution had concluded.

The primary objective of the OLA review was to assess whether the Department of Revenue sufficiently resolved the control weaknesses that allowed the fraud to occur undetected for over five years. The purpose of this letter is to convey our findings to the Legislative Audit Commission and other interested parties.

The Department of Revenue hired Ms. Dellis in 1982. Since 2001, she worked in the department's MinnesotaCare (MnCare) tax unit, initially as a revenue tax specialist intermediate and, since 2007, as a revenue tax specialist senior.[1] [2] She was a trusted employee who had an in-depth understanding of the department's taxpayer computer systems. She often assisted in training other employees, including training for new audit staff in the department's audit process and training about how to use the taxpayer computer system. Ms. Dellis used her expertise, experience, and authority to exploit weaknesses in the department's processes and perpetrate the fraud.

In deference to the criminal investigation and on-going sentencing process, OLA did not interview Ms. Dellis. However, we obtained documents related to the fraud and interviewed department officials and employees who worked directly with Ms. Dellis.

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[1] The state's MinnesotaCare program pays for medical services for adults and children in Minnesota who do not have affordable health insurance. The Department of Revenue's role is to collect taxes from healthcare providers, hospitals, and certain other healthcare related businesses; these taxes partially fund the program.
[2] Ms. Dellis's position changed several times due to organizational changes in the department.

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How the Fraud Occurred

According to a statement issued by the Minnesota United States Attorney's Office,[3] Ms. Dellis committed the fraud in the following way:

> *"Ms. Dellis conspired with her sister and niece to steal about $1.9 million by creating false tax returns and using those refund proceeds for personal benefit. As an auditor with the Minnesota Department of Revenue, Dellis's job, in part, was to process tax overpayments. In numerous instances, however, she falsified records so as to create the impression that a taxpayer was owed a refund due to an overpayment when, in fact, that was not the case. Then, she drafted a refund check or a "transfer of funds," made payable to her sister or niece, for the false refund amount. To make it more difficult for anyone to detect that the refunds were not legitimate, Dellis admitted using variations of her co-conspirators' names on the checks and transfers.*
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> *To cash the checks, Dellis and her co-conspirators sometimes sought the services of a check-cashing business and then divided the check proceeds. On other occasions, the checks were deposited into an account, in an effort to conceal the source of the funds, and then withdrawn and shared by the co-conspirators. In all, Dellis was responsible for more than 200 fraudulent tax refund payments, totaling approximately $1.9 million."*

Ms. Dellis used the department's older computer system to perpetrate the fraud. She started the fraud by issuing fraudulent MnCare tax refunds. When the department converted that tax type to its new computer system in December 2008, Ms. Dellis shifted the fraud to the corporate tax refunds. When the department converted that tax type to the new system in December 2009, she shifted the fraud to individual tax refunds. Ms. Dellis retired in September 2010, a few months before the department converted individual taxes to its new computer system.

During a fiscal year 2010 audit, OLA auditors flagged numerous corporate tax refunds processed by Ms. Dellis. The refunds were suspect because they represented a high number of corporate refunds to a person rather than to a business. Simultaneously, but independently, department personnel also flagged transactions processed by Ms. Dellis. The department found the transactions suspect because they represented multiple individual tax refunds being made to the same, legitimate social security number. Shortly thereafter, OLA and Department of Revenue officials met to discuss their concerns and agreed that a coordinated, state-federal criminal investigation should proceed as quickly as possible. As a result of the investigation and actions by the U.S. Attorney's Office in Minneapolis, Ms. Dellis plead guilty to one count of conspiracy to commit mail fraud and one count of money laundering.

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[3] United States Department of Justice, United States Attorneys' Office, District of Minnesota, dated March 7, 2011.

Control Weaknesses that Allowed the Fraud to Occur

The Department of Revenue did not have adequate internal controls to prevent or detect the fraud. Adequate controls would include controls to prevent erroneous or inappropriate payments and controls to detect those payments if they occurred. The department had weaknesses in both its preventive controls and its detective controls, as follows:

- **Missing Preventive Control: Segregation of Incompatible Duties –** The department granted Ms. Dellis computer system access that allowed her to perform incompatible duties. Incompatible duties are those that allow a single individual to control all phases of a transaction: initiation, authorization, and record keeping. Ms. Dellis had access to create an entity, file tax returns on behalf of the entity, change entity information, and process transactions to create refund payments. Ms. Dellis created about 80 fictitious businesses and, using her knowledge of the system's reports and edits, manipulated the data to avoid detection. For example, because she identified a fictitious business as "inactive" before the business's creation date, the business did not show up on the department's reports of past due tax returns. Ms. Dellis also edited business names and addresses to generate refund payments to either her sister or niece and then changed the information back to its original form.

- **Missing Preventive Control: "Least Privilege" Access –** The department did not limit Ms. Dellis's computer system access to the types of transactions and data she needed to perform her assigned duties. She had access to process refunds not related to the duties of her position in the MnCare tax unit, allowing her to process corporate and individual tax refunds. The "least privilege" principle, a basic principle in system security, expects that an employee would be assigned the fewest privileges consistent with their assigned duties and functions.

- **Missing Preventive Control: Appropriate Supervisory Review and Approval of Transactions –** The department allowed Ms. Dellis to select employees that would approve her transactions, and she selected three employees who reported to her. These three employees approved all of Ms. Dellis's fraudulent transactions. A supervisor's review and approval helps to ensure a transaction is appropriate, reasonable, and accurate. A subordinate may not raise questions about a transaction because of either a lack of knowledge or deference to the higher level staff. For example, a subordinate may not question why a higher level employee is initiating a transaction in a tax type not related to that employee's duties.

- **Missing Detective Control: Analysis and Review of Processed Transactions –** Although the department was aware that a significant number of employees had incompatible access to its tax systems,[4] it did not review or examine the transactions processed by these employees to ensure they were appropriate, reasonable, and accurate. A common control to mitigate the risk of employees with incompatible duties is to periodically review the transactions processed by those employees. A knowledgeable reviewer would likely have questioned why Ms. Dellis was processing certain types of transactions, especially the corporate and individual tax refunds she processed that were not related to her MnCare assigned duties. A review such as this could have lead to an earlier detection of the fraud.

- **Missing Detective Control: Analysis of Refund Payments –** The department did not analyze refund payments to identify unusual transaction trends, such as multiple payments sent to the same address or bank account. Ms. Dellis generated 256 fraudulent refund payments that the department mailed to her sister's or niece's home address or electronically deposited in their bank accounts. Had the department developed a report to identify multiple refunds going to the same address or account, it likely would have identified these inappropriate transactions.

Department Actions to Resolve Control Weaknesses

As of April 2011, the department had adequately assessed its processes to identify weaknesses, and it had designed and begun to implement stronger controls. The department had taken the following actions:

- The department removed unnecessary system access from employees. The department is reviewing and adjusting employee access within its new computer system to ensure that employees only have the access necessary to perform their job duties. The department has also developed policies and procedures requiring supervisors to periodically review security access for their employees.

- The department implemented a written policy on issuing and approving refunds. The policy states that the employee approving refund transactions must be in a position higher than the employee requesting the refund. The department also required each tax division to have its own refund policy in place by June 1, 2011. In addition, the department was in the process of developing several reports to detect transactions with inappropriate approvals and requiring supervisors to review those transactions and take appropriate action.

[4] Since 2007, the Office of the Legislative Auditor has reported findings to the Department of Revenue about employees with incompatible access to its computer systems, including report 07-22, finding 6, issued on August 30, 2007; report 08-02, finding 10, issued on February 11, 2008; and report 10-01, finding 2, issued on February 11, 2010.

- The department was in the process of developing several other monitoring reports; it had created some of the reports and was using them to review transactions employees processed in the department's new computer system.

Ensuring the adequacy of internal controls is an ongoing process. The department will need to continue to monitor its processes, risks, and controls to ensure that the controls remain effective in addressing the risks in a changing environment. The OLA will also continue to monitor the adequacy of the department's internal controls as part of our annual audits.

This review was conducted by David Poliseno, CPA, CISA, CFE (Audit Manager), Kayla Borneman, CPA (Auditor-in-Charge), and Sonya Johnson, CPA, CFE (Director of Investigations). We received full cooperation from the Minnesota Department of Revenue.

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