

Audit Report

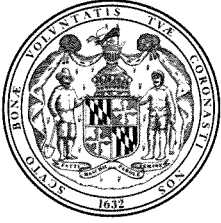
**Comptroller of Maryland
Compliance Division**

January 2014



OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

January 14, 2014

Karl S. Aro
Executive Director

Thomas J. Barnickel III, CPA
Legislative Auditor

Senator James C. Rosapepe, Co-Chair, Joint Audit Committee
Delegate Guy J. Guzzone, Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have audited the Comptroller of Maryland – Compliance Division for the period beginning February 23, 2010 and ending January 8, 2013. The Division is primarily responsible for enforcement of all tax laws administered by the Comptroller of Maryland, including those relating to individual income taxes and business taxes such as corporate income, withholding, and sales and use taxes. The Division is also responsible for administering the Uniform Disposition of Unclaimed Property Act.

Our audit disclosed that taxpayer data provided by certain other states and available to the Division through a multi-state clearinghouse were not used to help identify invalid tax credits claimed by Maryland taxpayers for taxes paid to another state. Out-of-state tax credits claimed by Maryland taxpayers on their 2011 income tax returns totaled \$233.6 million. We also noted that the Division lacked formal policies and procedures addressing certain aspects of the business tax audit assessment process to promote consistency and to ensure adjustments were properly applied to taxpayer accounts. Furthermore, estimated tax assessments required when business taxpayers failed to file required tax returns were not always prepared timely, and we noted assessments that had not been prepared for more than two years.

Our audit also identified certain internal control deficiencies with respect to information system security and cash receipts.

An executive summary of our findings can be found on page 5. The Comptroller of Maryland's response to this audit, on behalf of the Division, is included as an appendix to this report. We wish to acknowledge the cooperation extended to us during the course of this audit by the Division.

Respectfully submitted,

Thomas J. Barnickel III, CPA
Legislative Auditor

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* Denotes item repeated in full or part from preceding audit report

Executive Summary

Legislative Audit Report on the Comptroller of Maryland Compliance Division January 2014

- **Taxpayer data provided by certain other states and available to the Division through a multi-state clearinghouse were not used to help identify invalid out-of-state tax credits claimed on Maryland income tax returns. An out-of-state tax credit is available to Maryland residents who paid taxes to another state for income earned in that state that must be reported on their Maryland tax return. Out-of-state tax credits claimed by Maryland taxpayers totaled \$233.6 million for tax year 2011. Our limited review of the data provided for tax year 2010 and corresponding Division records disclosed questionable credits totaling \$1.8 million (Finding 1).**

The Division should use the aforementioned data to help identify invalid out-of-state tax credits, and should take appropriate action, including disallowing the credit, when invalid credits are identified.

- **The Division lacked certain formal policies and procedures to promote consistency in determining assessments resulting from audits of entities conducting business in the State and to ensure adjustments were accurately applied to taxpayer accounts. We noted differences in how certain assessments of taxes, penalties, and interest were determined and applied, and the differences were not explained. During fiscal year 2012, assessments totaling approximately \$195 million were processed as a result of audits conducted (Finding 2).**

The Division should establish formal policies and procedures to promote consistency in determining and recording audit results, and to ensure critical adjustments are determined in a manner consistent with established policies and are verified to appropriate supporting documentation.

- **Estimated tax assessments required when taxpayers failed to file required business tax returns, such as for sales and use taxes and withholding taxes, were not always prepared on a timely basis, and sometimes were not prepared at all. For example, we noted that an assessment had not been prepared for 10 of 15 taxpayer accounts reviewed even though the accounts had been designated for assessment for more than two years, nor had a determination been made that other collection action would be more appropriate (Finding 3).**

The Division should establish procedures to ensure that required estimated tax assessments are prepared on a timely basis.

- **Certain control deficiencies were noted with respect to the Division's information system security (Finding 4) and cash receipts (Findings 5 and 6). For example, software on 11 information system workstations tested had not been updated to address possible security vulnerabilities.**

The Division should take the recommended actions to improve its controls over information system security and cash receipts.

Background Information

Agency Responsibilities

The Compliance Division's primary responsibilities include enforcement of all tax laws administered by the Comptroller of Maryland, including those relating to individual income taxes, as well as business taxes such as corporate income, withholding, and sales and use taxes. Primary functions include conducting taxpayer audits and investigations, collecting delinquent taxes, and performing other taxpayer compliance activities. In conjunction with these functions, the Division levies tax assessments and processes tax appeals. Collection tools used by the Division include filing tax liens, issuing bank attachments, employing independent collection agencies, and other steps such as preventing the renewal of an individual's driver's license. The Division uses the Comptroller of Maryland's automated State of Maryland Tax (SMART) system to access, retrieve, and record tax data and other information as necessary. The Division is also responsible for administering the Uniform Disposition of Unclaimed Property Act.

According to the Division's records, as of June 30, 2013, outstanding individual income taxes (excluding penalties and interest) and business taxes that were subject to collection by the Division totaled approximately \$520 million and \$301 million, respectively. According to the State's records, during fiscal year 2013, the Division's operating expenditures totaled approximately \$32.1 million.

Status of Findings From Preceding Audit Report

Our audit included a review to determine the status of the two findings contained in our preceding audit report dated February 11, 2010. We determined that the Division satisfactorily addressed one of these findings. The remaining finding is repeated in this report.

Findings and Recommendations

Out-of-State Tax Credits

Background

Generally, Maryland residents who have income earned in another state must report that income on their Maryland income tax return, but are entitled to a credit against their Maryland tax liability for taxes paid to the other state. Although taxpayers who claim an out-of-state tax credit on their return may be required to submit documentation supporting the credit they claimed (such as a copy of the tax return filed with the other state), there is no assurance that such documentation is authentic or valid, and not all taxpayers who claim a credit are required to submit documentation. For example, taxpayers who submit their returns electronically are generally only required to submit the documentation if selected for a post-processing review.

In order to more effectively ensure the validity of out-of-state tax credits claimed by taxpayers, certain states, including Maryland, have joined a centralized returns clearinghouse. The states contribute individual income tax return data, including income, taxes withheld, and taxes due, to the clearinghouse which is maintained by one of the participating states. While that state hosts the clearinghouse, a third-party vendor cross matches the data to provide participant states with various data, including “high risk” leads to help them identify invalid credits claimed. For example, a state may be notified when a credit claimed by a taxpayer for taxes paid to another participating state does not agree with the taxpayer’s liability to that state.

Currently, eight states participate in the clearinghouse project. Maryland has been a participating state since implementation of the project in 2007, and the Comptroller of Maryland – Compliance Division has received data files through the project for tax years 2004 through 2010. As of July 2013, Maryland had paid a total of \$265,140 to participate in the project.

The following table lists, for tax years 2007 to 2011, the total amount of out-of-state tax credits claimed by taxpayers on their Maryland income tax returns filed within one year after the tax year noted.

Table 1 Out-of-State Tax Credits Claimed by Residents	
Tax Year	Credits Claimed (in millions)
2011	\$233.6
2010	237.8
2009	222.6
2008	221.8
2007	245.8

Source: Comptroller of Maryland - Revenue Administration Division records

These amounts represent credits taken for taxes paid to all states, including the states participating in the clearinghouse project. According to the Division's records for tax year 2010, credits totaling more than \$113 million were claimed for taxes paid to participating states.

Finding 1

Taxpayer data received through the clearinghouse project were not used to help identify invalid out-of-state tax credits.

Analysis

Although data have been received by the Division through the clearinghouse project since 2007, none of the data have been used to help identify invalid out-of-state tax credits claimed on Maryland income tax returns. According to the Division, project data have been used to identify certain individuals who failed to file required tax returns and, as a result, the Division has collected approximately \$330,000 from Maryland non-filers. However, the Division advised that other priorities and limited staffing have delayed implementation of any procedures to use project data for purposes of identifying invalid out-of-state tax credits.

Our limited review of certain project data for tax year 2010 disclosed questionable out-of-state tax credits totaling approximately \$1.8 million. The results of our review do not provide conclusive evidence that these credits are invalid, but do indicate the value of evaluating and analyzing clearinghouse data for further follow-up.

- Our comparison of Maryland income tax return data to corresponding project data for one of the other seven participating states disclosed 535 out-of-state tax credits claimed by Maryland taxpayers, totaling approximately \$1.6

million, for which the project data indicated that no 2010 income tax return had been filed by the taxpayer with the other state. The failure to file a tax return in the other state calls into question the validity of the out-of-state tax credit claimed. This finding was based on our review of \$10.6 million in credits claimed by 3,352 Maryland taxpayers for taxes paid to the one participating state.

- We also examined project data for 75 Maryland tax returns claiming credits totaling \$1 million for taxes paid to various participating states, and for which the project had automatically classified the credits as presenting a high risk of being invalid. Of the 75 returns examined, we noted 41 for which taxpayers claimed credits that exceeded, by \$218,400, the actual tax liabilities they owed to the other states. For example, one taxpayer claimed on their Maryland tax return a credit of \$44,000 for taxes paid to a participating state even though the project data indicated that the taxpayer had no tax liability owed to that state. Taxpayers are not permitted to claim an out-of-state tax credit for more than their corresponding tax liability to the other state.

After our inquiries, the Division prepared draft procedures for using the project data to help identify invalid out-of-state credits. While the draft procedures contained certain steps to help identify improper out-of-state credits claimed by the taxpayers, these steps could be enhanced to make the process more comprehensive. For example, there was no provision for identifying taxpayers who claimed a credit for taxes paid to another state, but did not file a tax return in that state. In addition, the Division may now be prohibited from collecting any taxes that may be due for certain prior tax years since State law generally limits an assessment of income taxes beyond a three-year period.

We recognize that the Division has limited resources and must prioritize their use. However, the recently prepared draft procedures indicate the Division's acknowledgement that a priority should be placed on identifying invalid out-of-state credits claimed, especially considering their magnitude and Maryland's participation in the clearinghouse project since 2007.

Recommendation 1

We recommend that the Division

- a. develop and implement comprehensive procedures to utilize the clearinghouse project data to help identify invalid out-of-state tax credits claimed on Maryland income tax returns; and**
- b. investigate questionable credits identified, including the credits we noted, and take appropriate action, such as disallowing the credit, for credits found to be invalid.**

Field Audits

Background

The Division's field audit unit is responsible for performing certain audits of entities conducting business in the State to determine if additional taxes, such as sales and use tax and corporate income tax, are due the State. Based on the results of those audits, assessments and other adjustments to taxpayer accounts in the State of Maryland Tax (SMART) system may be necessary. During fiscal year 2012, the field audit unit conducted 1,425 business tax audits that resulted in liability assessments, including penalties and interest, totaling approximately \$195 million. As part of its audit responsibilities, the unit also processed other critical adjustments (reductions to taxpayer liability amounts recorded in SMART) totaling approximately \$75 million.

Finding 2

The Division lacked certain formal policies and procedures to promote consistency in determining audit assessments and to ensure adjustments were accurately applied to taxpayer accounts.

Analysis

The Division lacked certain formal policies and procedures to promote consistency in determining assessment amounts resulting from its business audits and accurately applying the amounts to taxpayer accounts in SMART. Our review disclosed inconsistencies in how certain assessments of taxes, penalties, and interest were determined and applied, and these differences were not adequately explained.

We were advised by the Division that assessments recorded in SMART as the result of an audit should normally reflect the tax, penalty, and interest amounts documented by auditors in the audit results that have been approved by audit management; however, these amounts are subject to adjustment before being finalized. For example, the interest recorded may differ depending on whether the business contests the audit results. However, no formal policies existed to guide these adjustment decisions and for documenting the basis for such changes.

Our review of 10 audits conducted during fiscal years 2012 and 2013 disclosed 5 for which the related tax, penalty, and/or interest amounts assessed against the taxpayers' accounts in SMART did not agree with the corresponding approved amounts resulting from the audits, and the differences were not explained. For example, in one audit that covered multiple years and required a separate assessment for each year, the amount of interest assessed agreed to the audit results for certain years, but not for others, and the Division did not know why

this inconsistency occurred. Differences between the amounts assessed in SMART and the approved audit results for all tax years covered by these 5 audits totaled approximately \$108,000 for taxes (two audits), \$131,000 for penalties (four audits), and \$320,000 for interest (all five audits).

Furthermore, procedures were not in place to verify adjustments processed by the unit, including these audit adjustments, for propriety and proper posting in SMART. For example, reductions to taxpayer liabilities reflected in automated output reports were compared to other SMART reports rather than to the appropriate supporting documentation.

Recommendation 2

We recommend that the Division establish formal policies and procedures to promote consistency in determining and recording audit results, including assessments of taxes, penalties, and interest, and to ensure that critical adjustments recorded in SMART are determined in a manner consistent with established policies and are verified to appropriate supporting documentation.

Estimated Tax Assessments

Finding 3

The Division did not ensure that estimated tax assessments were prepared and recorded as required.

Analysis

The Division's business tax collection unit did not ensure that estimated tax assessments were prepared timely, recorded in SMART, and billed to taxpayers who failed to file required business tax returns, such as for sales and use taxes and withholding taxes. When these accounts are identified, a notice and demand letter for the outstanding return(s) is sent to the taxpayer who is provided 10 days to respond. If the taxpayer fails to respond, the account is flagged for an estimated tax assessment. An assessor calculates the estimated tax assessment, including penalties and interest, using historical data for the delinquent business or industry-wide data for like companies. The estimated tax assessment is subsequently posted to the taxpayer's account in SMART and is automatically billed to the taxpayer.

Although accounts for taxpayers who failed to respond were being flagged for assessment, the accounts were not adequately monitored to ensure that assessments were being prepared and posted in a timely manner. For example, available aging reports were not consistently reviewed. During fiscal year 2012, assessments against businesses who failed to file required business tax returns for sales and use taxes and withholding taxes totaled approximately \$10.4 million, according to the Division's records.

Our review of 15 assessments prepared during fiscal years 2012 and 2013, totaling approximately \$885,000, disclosed 7, totaling \$362,000, that were prepared 4 to 38 months after the notices and demand letters had been sent to the taxpayers. None of the 7 taxpayers had responded to the letters within 10 days as required. This review also disclosed an assessment for \$36,710 that was prepared timely, but was never posted to the taxpayer's account in SMART and, accordingly, the taxpayer was not billed. Furthermore, we reviewed 15 other accounts that had been designated for assessment for more than two years as of May 2013. Our review disclosed 10 for which an assessment had not yet been prepared, nor had a determination been made that other collection action would be more appropriate.

Recommendation 3

We recommend that the Division

- a. adequately monitor to ensure that required estimated tax assessments are prepared and recorded on a timely basis,**
- b. properly record the assessment noted for \$36,710, and**
- c. evaluate the 10 accounts noted as pending an assessment to determine their proper disposition.**

Information System Security and Controls

Background

The Division utilizes the computer services of the Comptroller of Maryland – Information Technology Division to process and record tax information. A security system is maintained to control access to the SMART databases containing tax information related to individual income taxes, sales and use taxes, withholding taxes, corporate income taxes, and other taxes and fees.

Finding 4

Procedures for maintaining and securing the Division's workstations need improvement.

Analysis

Procedures for maintaining and securing the Division's workstations need improvement. Our test of 11 of the Division's workstations disclosed the workstations were not running up-to-date software and one workstation was inappropriately configured with administrator rights. Specifically, we noted the following conditions:

- One user had local administrator rights to the workstation and did not require such access. Administrator rights are the highest permission level that can be granted to users and allow users to install software and change configuration settings. As a result, if this workstation were to be infected with malware, the malware would run with administrative rights and expose the workstation to a greater risk of compromise than if the workstation user account operated with only user rights.
- None of the 11 workstations had the latest updates for several well-known software products. These products are recognized as having significant security-related vulnerabilities and the related vendors frequently offer updates and patches to address these vulnerabilities. For example, one of the products tested had not been updated for two years for 6 of the 11 workstations tested. We were advised by Division personnel that a standardized process is not in place to update these software products.

The Department of Information Technology's *Information Security Policy* states, "System hardening procedures shall be created and maintained to ensure up-to-date security best practices are deployed at all levels of IT [information technology] systems (operating systems, applications, databases, and network devices)." In addition, the Policy states that, "Agencies shall implement an appropriate change management process to ensure changes to systems are controlled by...restricting access to system configuration settings and provide the least functionality necessary."

Recommendation 4

We recommend that

- a. all workstation users (other than network administrators) operate as a system "user" rather than administrator, and**

- b. the Division adopt a standardized change management process to help ensure that all workstations are kept up-to-date for all critical security related updates to potentially vulnerable software installed on these workstations.**

Cash Receipts

Finding 5

Controls were not established to ensure collections were properly accounted for and deposited.

Analysis

Controls over collections, consisting primarily of tax receipts totaling \$107.4 million during fiscal year 2012, were not sufficient. These collections were initially received by the Division's accounting unit, and then distributed as necessary to other units for processing and recording in an automated check log. All collections were subsequently forwarded to the Comptroller's Revenue Administration Division (RAD) for deposit. We noted the following conditions under which errors or other discrepancies could occur without timely detection:

- The automated check log system used by the Division's units allowed any of the 50 employees with update access to the log to record a transaction under the name of another user, thereby reducing accountability over transactions posted. All users also had the capability to delete a check from the log without supervisory approval. Furthermore, our examination of 10 of the 50 employees disclosed 9 who did not require access to the log to perform their normal job duties. Adequate control over the check log is critical since it is used to account for collections received and to verify that all collections were forwarded to RAD for deposit.
- Independent verifications were not performed to ensure that all collections received by the Division were forwarded to RAD for deposit. Although RAD provided the Division with documentation confirming the collections it received, that documentation was not compared to the Division's automated check log by an independent employee. Instead, one of the two employees in the accounting unit who processed collections and who had access to adjust the check log also verified the check log to collections received by RAD.
- Eight employees with the capability to post critical adjustments to taxpayer accounts in SMART, such as to reduce a tax liability, also had access to the related collections and could remove a payment recorded in the automated

check log without supervisory review. Although adjustments to SMART were subject to post-processing reviews by supervisory personnel, employees who have access to adjust taxpayer accounts should not have access to the related collections as a means to help prevent an impropriety from occurring.

- Procedures established by the Division to help ensure the proper disposition of collections designated for return to payers were not effective. Checks designated to be returned were initially logged and then returned using certified mail. Supervisory personnel subsequently compared the certified mail receipts returned by the post office to supporting documentation of checks designated for return rather than to the control log. Consequently, this procedure did not provide assurance that all checks designated to be returned per the log were actually returned.

Furthermore, our test of 10 checks designated to be returned, totaling approximately \$271,000, disclosed 3 checks totaling \$14,000 for which a certified mail receipt was not available to confirm return of the checks. Since payers would not necessarily expect return of their remittances, ensuring the proper disposition of such checks is critical. According to the Division's records, returned checks totaled approximately \$344,000 during fiscal year 2012.

The Comptroller of Maryland's *Accounting Procedures Manual* requires the establishment of sufficient internal controls over collections, including adequate separation of cash receipt processing duties, independent verification of collections to deposit, and initial accountability over collections received.

Recommendation 5

We recommend that the Division

- a. improve controls over the automated check log by restricting access to the check log and ensuring initial accountability over recorded collections, providing for supervisory review of deleted checks, and removing access from employees who do not require it for their job duties;**
- b. ensure that an employee independent from the cash receipts process verifies that all collections recorded on the automated check log were received by RAD for deposit;**
- c. ensure that employees who have critical access to SMART do not have access to collections;**
- d. ensure the proper disposition of checks designated for return to taxpayers by verifying documentation of such checks in the log to certified mail receipts; and**

- e. ensure the proper disposition of the three checks noted without receipts.

We advised the Department on accomplishing the necessary separation of duties using existing personnel.

Finding 6

The Division lacked initial accountability over the receipt of certain unclaimed property checks.

Analysis

The Division lacked initial accountability over certain unclaimed property checks received. Consequently, there was a lack of assurance that all such checks were deposited. Unclaimed property includes, for example, abandoned bank accounts received from holders such as banks, insurance companies, and other financial institutions.

The employee who initially received checks for unclaimed property from property holders also often received the corresponding holder reports. These reports, which documented the property being submitted and the property owners on record, were used to initially record and account for the property. Property holders could choose to submit the reports along with the checks, or could submit the reports separately (in paper or electronically). When the checks and reports were submitted together, this employee received both and, therefore, had complete control over these collections. The nature of the receipts makes it impractical to control them in advance, such as through an accounts receivable record.

A similar condition was commented upon in our preceding audit report. In that report, we recommended that two employees jointly process such transactions. In its response to the report, the Division indicated that assigning two employees was not justified, but that it would continue its efforts to encourage holders of unclaimed property to electronically file holder reports and remit unclaimed property by lockbox or electronically. However, according to the Division's records, during fiscal year 2012, the Division still received 4,715 checks totaling approximately \$90 million, and only 1,276 were associated with holder reports received electronically. The specific quantity and dollar amount of checks that were received with the applicable holder reports, rather than separately, could not be determined through the Division's records.

Recommendation 6

We recommend that when receipts and related holder reports are received together, adequate accountability be established over these receipts, such as by requiring these transactions to be initially processed by two employees (repeat).

Audit Scope, Objectives, and Methodology

We have audited the Comptroller of Maryland – Compliance Division for the period beginning February 23, 2010 and ending January 8, 2013. The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

As prescribed by the State Government Article, Section 2-1221 of the Annotated Code of Maryland, the objectives of this audit were to examine the Division's financial transactions, records and internal control, and to evaluate its compliance with applicable State laws, rules, and regulations. We also determined the status of the findings included in our preceding audit report.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. The areas addressed by the audit included the identification, assessment and collection of individual income taxes and various business taxes, as well as the identification, collection, and distribution of unclaimed or abandoned property. Our audit procedures included inquiries of appropriate personnel, inspections of documents and records, and observations of Division's operations. We also tested transactions and performed other auditing procedures that we considered necessary to achieve our objectives. Data provided in this report for background or informational purposes were deemed reasonable, but were not independently verified.

Our audit did not include certain support services provided to the Division by the Comptroller of Maryland – Office of the Comptroller. These support services (such as processing of invoices, maintenance of accounting records, and related fiscal functions) are included in the scope of our audits of the Office of the Comptroller. Our audit also did not include certain support services provided to the Division by the Comptroller of Maryland – Information Technology Division related to the procurement and monitoring of information technology equipment and services and the operation of the Annapolis Data Center. The operation of the Annapolis Data Center includes the development and maintenance of Division applications and maintenance of the operating system and security software environment. These support services are included in the scope of our audits of the Comptroller of Maryland – Information Technology Division.

The Division's management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that objectives pertaining to the reliability of financial records, effectiveness and efficiency of operations including safeguarding of assets, and compliance with applicable laws, rules, and regulations are achieved.

Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

Our reports are designed to assist the Maryland General Assembly in exercising its legislative oversight function and to provide constructive recommendations for improving State operations. As a result, our reports generally do not address activities we reviewed that are functioning properly.

This report includes conditions that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect the Division's ability to maintain reliable financial records, operate effectively and efficiently, and/or comply with applicable laws, rules, and regulations. Our report also includes findings regarding significant instances of noncompliance with applicable laws, rules, or regulations. Other less significant findings were communicated to the Division that did not warrant inclusion in this report.

The response from the Comptroller of Maryland, on behalf of the Division, to our findings and recommendations is included as an appendix to this report. As prescribed in the State Government Article, Section 2-1224 of the Annotated Code of Maryland, we will advise the Comptroller of Maryland regarding the results of our review of its response.

APPENDIX



Peter Franchot
Comptroller

David F. Roose
Deputy Comptroller

January 9, 2014

Mr. Thomas J. Barnickel III, CPA
Legislative Auditor
Department of Legislative Services
Office of Legislative Audits
301 West Preston Street, Room 1202
Baltimore, MD 21201

Dear Mr. Barnickel:

Enclosed is the Comptroller's response to your report on the Compliance Division for the period beginning February 23, 2010 and ending January 8, 2013.

We have carefully reviewed each finding, and we believe that our responses fully address each recommendation contained in the report. Should you need additional information or clarification, please contact Michelle Bohlayer, Director Internal Audit Division by email at mbohlayer@comp.state.md.us or by telephone at 410.260.6252.

The Comptroller appreciates your objective appraisal of our operations and your recommendations for continuous improvement, and commends your auditors for their professionalism and thorough review.

Very truly yours,



David F. Roose
Deputy Comptroller



Sharonne R. Bonardi
Director, Compliance Division

cc: Honorable Peter Franchot, Comptroller

Out-of-State Tax Credits

Finding 1

Taxpayer data received through the clearinghouse project were not used to help identify invalid out-of-state tax credits.

Division Response: The Compliance Division agrees and has long recognized that a project for reviewing the validity of out-of-state tax credits would help the State of Maryland enforce tax compliance; however, the priority for this project was determined within the context of the many other projects that were initiated. The Agency has been going through the arduous process of implementing a data warehouse which has resulted in many new compliance programs and has generated more than \$240 million in additional revenues over the past six years.

While the use of NESTOA data for a compliance program examining out-of-state tax credits may be a beneficial program, it must be looked at within the context of the many other projects that have been ongoing and started during this time. Challenges that have been presented by the use of NESTOA Centralized Returns Processing Project include:

- *Resources devoted to the data warehouse implementation. The Division remains committed to the continued implementation of automated projects utilizing reliable data, including NESTOA data, as appropriate, to ensure that taxpayers are in compliance with applicable laws. However, as the Division investigates and plans for new projects, it will continue to balance the use of available resources to meet operational needs, develop future projects, and to determine the most efficient and effective use of resources to best serve the State of Maryland.*
- *Potential issues with the data. The Office of Legislative Audits has assumed that data supplied by participating states is accurate. Further review of the NESTOA data, as an ongoing part of implementing this project, indicates that the data may not be reliable as a basis to determine potential taxpayer liability. The use of data that is not complete and/or accurate could produce erroneous results and overstate/understate taxpayer liabilities.*

Additionally, the NESTOA data relates to personal income tax information supplied by other states (8 states for the 2011 Tax Year), but due to a limited number of participating states, does not address all out-of-state credits claimed on Maryland returns. Of note, the participating states do not include many of the jurisdictions that border Maryland, i.e. Virginia, West Virginia, Pennsylvania and the District of Columbia.

- *Complexity of the program. Out-of-state tax credit review is very complex and requires more time by the Compliance Division for evaluation and follow-up than many of the other projects that have been started and completed during this time.*

The Compliance Division will continue to pursue accurate, effective, efficient implementation of this resource-intensive, analytically complex program as a significant component of our overall compliance portfolio.

Field Audits

Finding 2

The Division lacked certain formal policies and procedures to promote consistency in determining audit assessments and to ensure adjustments were accurately applied to taxpayer accounts.

Divisions Response: The Division agrees with this finding and affirms that there are no findings of fraud or misappropriation of funds resulting from the lapse in procedure.

- a. *The Division notes that adjustments by the Field Audit Unit are not processed to reduce a liability. These adjustments are completed to adjust the interest on the tax liability and ensure that the audit results agree with financial data entered into SMART. Due to an inherent limitation within the SMART system, interest on sales tax assessments is not accurately computed. As a result, adjustments are necessary to accurately reflect the correct amount of interest that corresponds to the audit results and related audit interest computation. The Division reviewed twenty six (26) negative adjustment items from the list provided by OLA with a dollar amount greater than \$500,000. These items represented 69% of the total negative amounts. Included in this review was a single adjustment for **\$11.4 million** which pertained to an interest adjustment on an assessment which had a beginning period date of 1994. This function, by no means, decreases the tax liability in the same manner in which an abatement is handled. All interest and penalty abatements are handled independently from the Field Audit Section by either the Collections or the Hearing and Appeals sections and always contain the required requestor and approval authorizations.*

- b. *The Division has also implemented a revised adjustment review procedure on October 10, 2013. During the review process, the clerical staff makes approved audit adjustments to the Maryland State Integrated Tax (SMART) System. The Chief Auditor then verifies that all audit assessment and adjustments are properly calculated and correctly input into SMART. The Division emphasizes that these adjustments are necessary because interest and/or penalty were over-calculated by SMART or a hearing determination necessitated a change.*

Estimated Tax Assessments

Finding 3

The Division did not ensure that estimated tax assessments were prepared and recorded as required.

*Division Response: The Division agrees with this finding with the following explanation. During the test period of FY'12 and FY'13, the Business Tax Collection Unit completed **171 estimated assessments totaling \$10,409,661.84**. The audit revealed that \$362,000 (3% of the total assessments issued) were prepared more than 4 months past the date on which they were to be prepared pursuant the division's operational standards. The audit also disclosed that one assessment totaling \$36,710 (0.3% of the total assessments issued) was prepared timely, but was never posted to the taxpayer's account in SMART and, accordingly, the taxpayer was not billed. The Division recognized that there was a backlog of these accounts; however, the Division found no revenue loss to the State. Although an account is routed to a "closed" work state, liens were placed on these accounts to ensure that the State's interest is protected. There was also no loss of revenue on test item #10, since it was determined that the entity had been filing returns on an incorrect Central Registration number and had opened this account in error. The Division also determined that the reason the returns were not filed resulted from the fact that the business entities were actually closed and no longer operational. In these instances, there would be no collection activity to pursue.*

The Division further notes that action has been taken on all of the aged accounts, and the work state now reflects only entries that are 30-45 days old.

- a. Procedures are in place requiring the supervisor of the Business Tax Collection Assessment Unit to verify that all assessments are posted in SMART. The Division will now use the Data Warehouse to run a monthly query to ensure that these accounts will be worked timely.*
- b. The \$36,710.00 assessment was recorded in SMART on 7/30/13.*
- c. The disposition of the 7 cases is documented in Exhibit A.¹*

*As stated above, the Division maintains its position that as a result of the liens being placed on test items #3, #6, and #8 listed in Exhibit A, and the fact that the businesses' close date preceded the two year period for test items # 2, #3, #5, #6, #8, and #9 (**which has now been completed**), there was no loss of revenue to the State. There was also no loss of revenue on test item #10, since it was determined that the entity had been filing returns on an incorrect Central Registration number and had opened this account in error. The Division also determined that the reason the returns were not filed resulted from the fact that the business entities were actually closed and no longer operational. In these instances, there would be no collection activity to pursue.*

¹ Exhibit A contains confidential information and is not included in this report.

Information System Security and Controls

Finding 4

Procedures for maintaining and securing the Division's workstations need improvement.

Division Response:

The Division agrees that all workstation users should operate as a system "user" rather than administrator, and it is our current policy.

- a. This audit finding was related to a specific end-user who, at one time, required local administrator privileges to her computer. The access was removed. Moving forward, ITD has adopted a procedure to maintain an exceptions list of local workstation administrators. This list will be reviewed on an annual basis to determine if the level of access is still required.*
- b. The Division agrees with the recommendation for a standardized change management process for workstations; however ITD would require the flexibility to exclude some workstations based upon software requirements of various business systems. The ITD will update existing change management processes.*

Cash Receipts

Finding 5

Controls were not established to ensure collections were properly accounted for and deposited.

Division Response: The Division agrees with the recommendations. The Division notes that there was no evidence of employees adding or deleting information to and from the check log and that there was no finding of fraud or abuse of access relating to this recommendation. In response to this finding, the Division has addressed this control issue by instituting a cashier function in the Baltimore Office, wherein all non-Unclaimed Property checks will be received in the Cashier's Office. The Cashier function will be managed by the Revenue Administration Division (RAD). The concerns raised in this finding will no longer be problematic, as all non-Unclaimed Property checks will be processed by the RAD. The cashier function is to be instituted on or before February 1, 2014. Until such time the cashier function is implemented, the Division will ensure that the recommendations offered in this report are adhered to as follows:

- a. The 50 authorized users of the check-log system are granted access, so that the Division will have adequate backup resources in each unit. The Division, with the assistance of the IT Division, has established procedures to ensure the propriety of checks deleted from the check log. The Division is also requested its IT Division to develop enhancements to the check log to prevent employees from recording transactions in the log under another employee's name. The Division is also requesting its IT Division to shore up the internal controls of the check log.*
- b. The Division has instituted a policy that will ensure that an employee independent from the cash receipts process verifies that all collections recorded on the automated check log were received by RAD for deposit;*
- c. The Division will periodically verify that employees with critical access to the check log require it for their normal job duties and remove access for any employees who do not require it. There is an existing policy requiring all employees to complete the access forms. The Division will ensure that access forms are on file for employees granted critical access to the check log.*
- d. The Division has instituted a policy wherein the Assistant Director will conduct a monthly review process to ensure the appropriate disposition of checks designated for return to taxpayers by verifying documentation of such checks in the log to certified mail receipts.*
- e. The Division has reviewed the three checks at issue and has confirmed that the three checks were from titling companies for mobile home sales/transfers that are reported to the Comptroller. The Division further documented that these checks were returned to the appropriate titling companies who then reissued checks for the correct amounts due to the State of Maryland.*

Finding 6

The Division lacked initial accountability over the receipt of certain unclaimed property checks.

Division Response:

The Division agrees with this finding. In order to mitigate the identified risk, the Division has reallocated existing resources to address OLA’s concerns by having two employees open the Unclaimed Property Unit's mail daily and immediately restrictively endorse all checks received. The Division notes that the Office of Legislative Audits (“OLA”) did not find any evidence of fraud or misappropriation of state funds during this review and agrees to continue to improve its internal processes to ensure control over its unclaimed property receipts.

The Division attempted to address this issue in its last audit by positioning the mail processor in a centralized location where the employee can be observed by supervisory personnel. The OLA did not find that this was an acceptable alternative. Having regard for limited personnel resources, the Division did not believe that requiring two employees to process these checks was warranted. Based on previous recommendations, the Division strengthened its internal controls by relocating the mail opening function to a centralized location where there is high visibility. A supervisor was positioned in close proximity to the mail opening function to oversee the mail opening process. The Division believed that this was the most cost beneficial procedure for controlling these receipts. The Division also implemented a Lock Box specifically for these remittances. All holder reporting documents and the Comptroller’s website direct holders to use the Lock Box address. Steps had already been implemented to alert all holders of the correct mailing address. The Division has noted that the largest report holders transmit their reports through the website, and most follow up with their remittance either being transmitted via ACH direct debit or wire transfer. Only a small percentage of the actual annual remittances are submitted via paper reports and check.

AUDIT TEAM

Paul R. Denz, CPA

Audit Manager

Richard L. Carter, CISA

Information Systems Audit Manager

Adam M. Auerback

Michael J. Murdzak, CPA

Senior Auditors

Christopher D. Jackson

Information Systems Senior Auditor

Jessica A. Foux

Kelly M. McNemar

James J. Podhorniak

Staff Auditors