Audit Report

Comptroller of the Treasury
Compliance Division

April 2008

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

Karl S. Aro
Executive Director

Bruce A. Myers, CPA
Legislative Auditor

April 25, 2008

Senator Verna L. Jones, Co-Chair, Joint Audit Committee
Delegate Steven J. DeBoy, Sr., Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have audited the Comptroller of the Treasury – Compliance Division for the period beginning July 1, 2003 and ending December 31, 2006.

While the Division uses various techniques to identify individuals and businesses that are non-compliant with applicable tax laws and regulations and to collect delinquent taxes due, we have identified certain procedures that we believe would enhance these existing techniques. For example, many individuals identified by a computer match who had not filed for tax year 2004 were excluded from further follow-up action and a match was not performed for the 2003 tax year. Procedures were also not in place for identifying taxpayers who improperly itemized deductions or claimed the earned income credit on their State tax returns without filing a corresponding federal return, as required. Our audit identified a number of such taxpayers who had not filed the required federal return.

Our audit also disclosed that, even though it has taken certain actions, including referral of the matter to its legal counsel, the Division has been unable to resolve the failure of certain local subdivisions to withhold liquor licenses from businesses with delinquent tax liabilities. In addition, we found that controls over certain cash receipts were not sufficient, and access to make critical adjustments to taxpayer accounts was not always adequately controlled and monitored.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

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Executive Summary

Legislative Audit Report on the Comptroller of the Treasury
Compliance Division
April 2008

- **Procedures used to detect individuals who failed to file required tax returns could be improved because many potential non-filers identified by a computer match for tax year 2004 were excluded from further follow-up action and a match was not performed for the 2003 tax year. We selected 25 individuals who had significant earnings for tax year 2004 but who failed to file a State tax return for the year; we found that 11 individuals, with wages totaling approximately $21 million, were not detected by the Division's match procedures.**

  The Division should improve the procedures it uses to identify and follow up on individuals who fail to file required income tax returns.

- **The Division had no procedure for identifying and investigating taxpayers who itemized deductions or who claimed the earned income credit on their State tax returns without filing a corresponding federal return, as required. At our request, the Division examined a limited number (169) of such occurrences in which records initially indicated that no federal return had been filed. In about 70 cases, the Division confirmed that no federal returns had been filed and, therefore, these taxpayers would not have been eligible to itemize deductions or claim the earned income credit.**

  The Division should develop procedures for identifying and investigating taxpayers who itemize deductions or who claim the earned income credit on their State tax returns without filing a corresponding federal return, as required.

- **The potential benefit of using certain automated matching procedures was not adequately assessed to help identify businesses that failed to file required Maryland tax returns. For example, automated reports identifying employers who reported employee wages to DLLR for unemployment insurance purposes, but who failed to file withholding tax returns, were not generated or investigated.**

The Division should perform, on a pilot basis, the recommended automated techniques to help identify businesses that fail to file required tax returns. Based on the results of the pilot, the Division should also evaluate the costs and benefits to determine whether these techniques should be continued.

- **The Division has been unable to resolve the failure of two local subdivisions to withhold liquor licenses from businesses with delinquent tax liabilities in spite of its efforts, which included referring the subdivisions to legal counsel. Because licensees are required to conform to all laws and regulations relating to their businesses, the Comptroller's legal counsel has previously concluded that the renewal of a liquor license for a licensee that has an unpaid State tax liability is contrary to State law. As of November 2006, 198 licensees in these two subdivisions owed approximately $4 million in unpaid State taxes.**

  The Division, in conjunction with the Office of the Comptroller and the Office of the Attorney General, should take the necessary action to resolve this matter.

- **Controls over certain cash receipts were not sufficient, and employee access to make critical adjustments to taxpayer accounts was not always adequately controlled and monitored.**

  The Division should take the recommended steps to improve controls over cash receipts and account adjustments.

Background Information

Agency Responsibilities

The Compliance Division's primary responsibilities include enforcement of all tax laws administered by the Comptroller of the Treasury, 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, processes tax appeals, and enforces certain sanctions such as asset liens provided for by law. The Division is also responsible for administering the Uniform Disposition of Unclaimed Property Act. According to the Division's records, as of June 30, 2007, outstanding individual income taxes and business taxes which were subject to collection by the Division totaled approximately $347.1 million and $151.3 million, respectively. According to the State's records, during fiscal year 2007, the Division's operating expenditures totaled approximately $25.1 million.

Current Status of Findings From Preceding Audit Report

Our audit included a review to determine the current status of the seven findings contained in our preceding audit report, dated May 26, 2004. We determined that the Division satisfactorily addressed these findings. Our audit also included a review to determine the current status of two findings contained in a preceding audit report of the Comptroller of the Treasury's Revenue Administration Division, dated November 20, 2003. We determined that the Division satisfactorily resolved these findings.

Findings and Recommendations

Identifying and Investigating Taxpayer Noncompliance

Background
The Division currently uses various techniques to identify individuals and businesses that are non-compliant with applicable tax laws and regulations, and to collect delinquent taxes due. To allow time for taxpayers to file and to obtain relevant federal tax data, the Division typically performs matches at least two years after the filing year. Our audit has identified certain additional techniques and enhancements to current procedures which we believe would further help the Division to effectively identify and investigate noncompliant taxpayers. The Division has advised us that it agrees that it is desirable to expand compliance programs, but in doing so, it must consider the availability of human and system resources and the most effective use of those resources. We were also advised that the Comptroller requested funding for additional positions and technology resources in its budget for fiscal year 2009. While we recognize that there are limits on available resources and that decisions must be made as to their most effective use, we believe that the following recommended practices would enhance existing collection techniques and procedures.

Finding 1
Procedures used to help detect individuals who failed to file required tax returns could be improved.

Analysis
Procedures used by the Division to help detect individuals who failed to file required income tax returns could be improved. We found that the Division did not follow up on many potential non-filers identified by the match results, and not all tax years were included in the match process that was performed. The Division performed matching procedures for tax years 2001 and 2002 by comparing W-2 wage data from the Comptroller's database to tax return data on the Comptroller's automated tax system. However, matching procedures were discontinued for tax year 2003, and when resumed for tax year 2004, the procedures used by the Division resulted in excluding many potential non-filers.

We selected 25 individuals who had significant wages (that is, between $396,000 and $4.1 million) reported in the Comptroller's database for tax year 2004 but who had not filed a State tax return for that year. We determined that, while 14 of the 25 non-filers were included in the Division's match results for 2004, 11 were not. In total, these 11 individuals had wages totaling approximately $21 million. The Division advised us that this may have occurred because it had refined its match results to include only individuals currently employed in Maryland. Specifically, the Division advised that it initially determined that approximately 138,000 individuals had wages of at least $15,900 but had not filed a tax return for the year. From this total, approximately 78,000 were identified as having a current employer and, therefore, further follow-up action was being taken. The Division decided that the remaining 60,000 would not be pursued through the match project. According to the Division, this decision was made in order to better focus its collection techniques and resources. Although we recognize the Division's intent to better utilize its collection resources, we believe that the methodology used excluded potential non-filers that should have been pursued.

At our request, the Division determined that the aforementioned 11 individuals had tax withholdings totaling approximately $1 million, which ranged from no withholdings for 3 individuals to withholdings of approximately 8 percent for 1 individual. We recognize that an individual who fails to file a tax return may not owe any additional taxes because of amounts already withheld and submitted to the Comptroller. However, the extent to which withholding amounts are sufficient to satisfy tax liabilities is unknown without the corresponding tax return and possible further investigation. Regardless of whether additional taxes are due, State law requires a return to be filed by individuals meeting specified criteria and provides for fines and penalties for the willful failure to file a required return.

Recommendation 1

We recommend that the Division improve the procedures it currently uses to identify and follow up on individuals who fail to file required income tax returns. Specifically, we recommend that the Division include for follow-up, at least on a test basis, non-filers who do not have a current employer. For example, the Division might focus these efforts on individuals with significant reported earnings for the tax year in question. Furthermore, we recommend that the Division perform the matches for each tax year. Finally, we recommend that the Division take steps to investigate, at least on a test basis, non-filers for tax year 2003, as well as the 11 non-filers noted above for tax year 2004.

Finding 2
The Division lacked procedures for identifying and investigating taxpayers who itemized deductions or who claimed the earned income credit on their State tax returns, without filing a corresponding federal return, as required.

Analysis
The Division had no procedures to identify and investigate individual taxpayers who itemized deductions or who claimed the earned income credit on their State income tax return, without filing a corresponding federal return, as required. State law stipulates that only those individuals who itemize deductions on their federal income tax returns may elect to itemize deductions on their State returns. Similarly, the law provides that a taxpayer is eligible to receive an earned income credit on his or her State return only if the taxpayer was eligible to receive the federal earned income credit and the credit was claimed on the corresponding federal tax return. Therefore, failing to file a corresponding federal return would preclude a taxpayer from itemizing deductions and from claiming the earned income credit on his or her State return.

At our request, the Division generated automated reports of individuals who had itemized deductions or who had claimed the earned income credit on their State tax returns for tax year 2004, but who had failed to file federal tax returns for the same year. These reports initially identified over 12,000 such occurrences. The Division's investigation of 169 of these occurrences disclosed that, although many taxpayers had actually filed a federal return (often under a separate identification number), there were approximately 70 occurrences (approximately 40 percent of cases reviewed) for which a corresponding federal return had not been filed. Therefore, these taxpayers were not eligible to itemize deductions or to claim the earned income credit on their State returns.

Recommendation 2
We recommend that the Division develop procedures, such as using automated reports like those noted above, to specifically identify and investigate taxpayers who itemized deductions or who claimed the earned income credit on their State tax returns, but who failed to file corresponding federal returns. We also recommend that the Division further investigate those taxpayers noted above as having failed to file federal returns and take appropriate follow-up action, such as denial of itemized deductions or the earned income credit, and recovery of any applicable refunds and taxes due, including any applicable interest and penalties. Finally, we recommend that the Division further evaluate the 12,000 taxpayers noted above for ineligible itemized deductions and earned income credits, and take appropriate follow-up action.

Finding 3
The Division did not adequately assess the potential benefit of using certain automated matching procedures to help identify businesses that failed to file required tax returns.

Analysis
The Division did not adequately assess the potential benefit of using certain automated matching procedures to help identify businesses that failed to file required Maryland tax returns. For example, the Division did not generate and investigate automated reports identifying employers who reported employee wages to the Department of Labor, Licensing and Regulation (DLLR) for unemployment insurance purposes, but failed to file withholding tax returns. Furthermore, the Division did not adequately investigate Maryland businesses that received significant payments for goods or services from State agencies to ensure sufficient income was reported for tax purposes.

The Division advised us that it had made certain attempts to perform procedures related to the DLLR match but the results were, for the most part, not worthwhile and that these efforts would not be continued. However, our review of the Division's efforts disclosed a general lack of documentation as to the results. In addition, we noted, in some cases, a lack of adequate follow-up when the Division investigated Maryland businesses receiving significant payments.

For example, our review of the Division's follow-up efforts for 10 businesses that received significant State payments in 2003 disclosed that the Division's efforts for 8 businesses were not sufficient. The Division sent letters to 7 of the 8 businesses requesting additional State and federal tax return information. Three of the entities did not respond and 4 responded with insufficient information. However, no additional investigation of these businesses was conducted by the Division. Furthermore, for the remaining business, an accurate vendor address could not be located, and the case was not pursued further.

Recommendation 3
We recommend that the Division perform, on a pilot basis, the automated techniques described above to help identify businesses that fail to file required returns. Based on the results of the pilot, we also recommend that the Division formally evaluate the costs and benefits to determine whether these techniques should be continued. We further recommend that documentation of the Division's evaluations be maintained for future verification purposes.

Liquor License Renewals

Finding 4
Certain local subdivisions allowed businesses with delinquent tax liabilities totaling approximately $4 million to renew their liquor licenses in apparent violation of State law; the Division has been unable to fully resolve this matter.

Analysis
The Division has been unable to fully resolve the failure of certain local subdivisions to withhold liquor licenses from businesses (licensees) with delinquent tax liabilities, even though the subdivisions' position has been deemed contrary to State law. This issue was commented upon in our preceding audit report and most subdivisions now withhold liquor licenses from businesses with delinquent tax liabilities at renewal. However, notwithstanding the Division's efforts, including referral to legal counsel in May 2005, two subdivisions still do not. According to the Division's records, as of November 2006, 198 licensees in these two subdivisions owed approximately $4 million in unpaid State taxes.

Under the Comptroller's Liquor License Renewal Project, the Division informs the State's subdivisions of licensees that have delinquent tax liabilities. The subdivisions are then required to withhold liquor licenses from such businesses at renewal. Because licensees are required to conform to all laws and regulations relating to their businesses, the Comptroller's legal counsel has previously concluded that the renewal of a liquor license for a licensee that has an unpaid State tax liability is contrary to State law. The Comptroller's legal counsel also advised that bringing a lawsuit against the two subdivisions may be the only recourse to gain compliance. At the time of our review, no further legal action had been taken. According to the Division's records, approximately $4.9 million was collected under the Project during the period from January 2006 through June 2006.

Recommendation 4
We recommend that the Division, in conjunction with the Office of the Comptroller and the Office of the Attorney General, take the necessary action to resolve this matter.

Cash Receipts

Finding 5
Controls over certain receipts collected by the Division's accounting and unclaimed property units were not sufficient.

Analysis
Controls over certain receipts collected by the Division's accounting and unclaimed property units were not sufficient. Collections processed by the accounting unit, such as delinquent tax payments, were recorded and forwarded to the Comptroller's Revenue Administration Division (RAD) for deposit. Collections received by the unclaimed property unit were processed and deposited directly by the unit. Unclaimed property collections may come from holders of the property, such as banks, or from the subsequent sale of tangible unclaimed property at auction. According to the Division's records, collections submitted to RAD during fiscal year 2006 totaled approximately $85 million, and collections received directly by the unclaimed property unit in the same year totaled approximately $108 million. Our review disclosed the following conditions:

- Independent verifications were not always performed to ensure that all recorded collections received by the accounting unit were forwarded to RAD for deposit. Our test of 20 days of collections totaling approximately $24 million disclosed that the required verifications were not performed for certain receipts totaling approximately $773,000 collected over 3 days.

- Deposit verifications of unclaimed property receipts were not adequately documented and were not performed in a timely manner. Although the dates the verifications were performed were not documented, we were advised by the employee who performs the verifications that the procedure was being performed one to three months after the deposits were made.

- The employee who initially received unclaimed property checks from property holders could also receive the corresponding reports which documented the property being submitted. The reports, which could be submitted by holders separately or directly with the checks, were used to initially record and account for the property. When the checks and reports were received together, this employee had complete control over the collections since the nature of the receipts makes it impractical to control them in advance, such as through an accounts receivable record.

Recommendation 5
We recommend that verifications of recorded collections to deposit be performed consistently in a timely manner by an employee independent of

the collections process, and that these verifications be adequately documented. We also recommend that two employees, working together, open unclaimed property collections, with one processing the collections and one processing any accompanying property reports.

Account Adjustments

Finding 6
System access to make critical adjustments to taxpayer accounts was not always adequately controlled and monitored.

Analysis
Certain employees had system access to make critical adjustments to taxpayer accounts, such as to reduce a taxpayer's liability, without such adjustments being subject to supervisory review. In addition, some employees had access to make adjustments even though they did not require it for their job responsibilities. Furthermore, we noted that supervisory reviews of adjustments processed to abate penalties and interest were not always performed on a timely basis or were not performed at all.

The Division had established certain procedures to provide for supervisory review of critical adjustments posted to taxpayer accounts on the automated tax system. Approximately 90 employees had access to make adjustments. However, we noted that 11 of these employees had access to make adjustments which were not subject to these verification procedures since a supervisor was not given responsibility for reviewing the employees' adjustments. In addition, we noted 5 employees who had access to post adjustments even though that access was not necessary for them to perform their job duties.

Furthermore, our test of 10 adjustments, totaling approximately $210,000, processed to abate penalties and interest, disclosed 5 totaling $184,000 that were not reviewed until three to eight months after they were recorded, and 2 totaling $13,500 which had not been reviewed at all. We were advised that, although the Division's procedures provide for a review of all recorded abatements of penalties and interest, this was not always done because of some confusion regarding which employee was responsible for this function.

Recommendation 6
We recommend that the Division ensure that all critical adjustments posted to taxpayer accounts are subject to supervisory review and approval. In addition, we recommend that system access to record account adjustments be restricted to employees who need it for their job duties. Furthermore, we

recommend that all adjustments recorded to abate penalties and interest, including the two for $13,500 noted above, be reviewed for propriety in a timely manner in accordance with the Division's procedures.

Audit Scope, Objectives, and Methodology

We have audited the Comptroller of the Treasury – Compliance Division for the period beginning July 1, 2003 and ending December 31, 2006. 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 current status of the findings contained in our preceding audit report of the Compliance Division and the current status of two findings contained in our audit report of the Comptroller of the Treasury's Revenue Administration Division, dated November 20, 2003.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. Our audit procedures included inquiries of appropriate personnel, inspections of documents and records, and observations of the 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 the Treasury – 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 the Treasury – Information Technology Division related to the procurement and monitoring of information technology equipment and services. These support services are included in the scope of our audits of the Information Technology Division.

Our audit scope was limited with respect to the Division's cash transactions because the Office of the State Treasurer was unable to reconcile the State's main bank accounts during a portion of the audit period. Due to this condition, we were unable to determine, with reasonable assurance, that all Division cash transactions prior to July 1, 2005 were accounted for and properly recorded on the related State accounting records as well as the banks' records.

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 findings relating to conditions that we consider 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, and regulations. Other less significant findings were communicated to the Division that did not warrant inclusion in this report.

The Office of the Comptroller's response 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 Office regarding the results of our review of its response.

COMPTROLLER of MARYLAND
Serving the People

Peter Franchot
Comptroller

Linda L. Tanton
Deputy Comptroller

April 24, 2008

Mr. Bruce A. Myers, CPA
Legislative Auditor
Department of Legislative Services
Office of Legislative Audits
301 West Preston Street, Room 1202
Baltimore, MD 21201

Dear Mr. Myers:

Enclosed is the Comptroller's response to your report on the Compliance Division for the period beginning July 1, 2003 and ending December 31, 2006.

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 our internal auditor, Ms. Rhea Reed, by email at rrreed@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,

Linda L. Tanton
Deputy Comptroller

James T. Loftus
Director, Compliance Division

cc: Honorable Peter V.R. Franchot, Comptroller

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Identifying and Investigating Taxpayer Noncompliance

Finding 1
Procedures used to help detect individuals who failed to file required tax returns could be improved.

Division Response: This is a question of resource allocation. We agree that use of automated matching procedures to detect non-filers is desirable and useful. However, the resulting "matches" require non-automated, case-by-case investigation before any assessment is possible. After the prior legislative audit finding regarding detection of non-filers, the agency submitted a budget request for additional personnel to work these manual cases. That request was denied by the Department of Budget and Management. We renewed the request in our 2008 budget request, and sixteen new positions were approved for the Compliance Programs section. Additionally, our request for a data warehouse has been approved, which will enable us to work these cases in an automated fashion.

We are in the process of investigating the eleven 2004 non-filers identified by the auditors. To date, three have filed returns and we have assessed a fourth; there are questions regarding residency in the other seven cases that must be resolved before a determination can be made. We will document our efforts and take appropriate action as indicated. Additionally, with the implementation of our new positions and data warehouse technology, we will develop an automated non-filer program that will provide effective follow-up action including assessments based on various sources of income. This automated program will be implemented for tax years 2005 and forward. We will perform further investigations for tax years 2003 and 2004 manually on a limited basis.

Finding 2
The Division lacked procedures for identifying and investigating taxpayers who claimed itemized deductions or who claimed the earned income credit on their State return, without filing a corresponding federal return, as required.

Division Response: Once again, this is a resource issue rather than a lack of procedures. The Comptroller does have some programs for identifying abuses related to the earned income credit (EIC) and excessive deductions. In response to a recommendation in the recent audit of the Revenue Administration Division, RAD QRDT has implemented a procedure for comparing all EIC claims greater than $10 to IRS data. This process will identify those taxpayers who have not filed a federal return using a Maryland address. Additionally, the Division has a STAX IDP (itemized deduction program using IRS data) that identifies excessive itemized deductions.

In response to the discussion note in the instant audit, we are working the list of 12,000 taxpayers identified by the auditors as having claimed EIC or itemized deductions in Maryland in 2004 but failed to file a federal return. We selected a statistically valid *sample of the two types of cases, and are investigating 500 IDP cases and 219 EIC cases. Of the 500 returns under investigation for propriety of itemized deductions, 272 had actually filed federal returns and in each case the federal itemized deductions matched the Maryland deductions claimed. We sent notices and made adjustments for the remaining 228. Additionally, we sent notices and made adjustments to the accounts for the 219 EIC cases. We will do follow-up on these cases, maintain documentation of our work and results, take appropriate action and make resource allocation decisions accordingly.*

Finding 3
The Division did not adequately assess the potential benefit of using certain automated matching procedures to help identify businesses that failed to file required tax returns.

Division Response : In response to the auditors' concerns, we generated an updated report and worked it on a test basis. The report, which was the result of matching employers who reported employee wages to the Department of Labor, Licensing and Regulation (DLLR) for unemployment purposes, to the Comptroller's Central Registration files generated a total of 1803 items, and we selected 71 for review. We were able to close 47 accounts - 24 that were under a different FEIN and 23 that do not have employees subject to withholding. We are continuing to investigate the remaining cases, and we will document our efforts, take appropriate action and again make resource allocation decisions based on the results. We will retain documentation of this effort for future audit.

Regarding State payments, the Division had initiated a project in the Compliance Programs section to verify that companies receiving State payments properly report such payments for tax purposes. It became apparent very early in the project, however, that an actual audit would be necessary to make such a determination. Therefore, the scope of that compliance program was changed to identify businesses receiving State payments who were not filing a return. Accordingly, we confirmed the 8 businesses identified by the auditors had filed a 2003 Maryland return. These businesses will be subject to the possibility of audit in the normal selection process. We are continuing to review cases and will document our efforts and the results, and take appropriate action as indicated.

Liquor License Renewals

Finding 4
Certain local subdivisions allowed businesses with delinquent tax liabilities totaling approximately $4 million to renew their liquor licenses in apparent violation of State law; the Division has been unable to fully resolve this matter.

Division Response: This matter was referred to the Attorney General in May 2005. Pending resolution by that office, the Division will pursue collection by other means permitted to the Comptroller. For example, we will schedule sales and use tax license revocation hearings for liquor licensees with delinquent tax liabilities in those two subdivisions.

Cash Receipts

Finding 5
Controls over receipts collected by the Division's Accounting and Unclaimed Property units were not sufficient.

Division Response: We agree with the auditors' recommendation. Timely verification of deposits by an employee independent of the collections process is an integral part of the Division's written cash receipts procedures. The legislative auditors found that the verifications for collections received by the accounting unit and forwarded to the Revenue Administration Division (RAD) had not been performed for three days' deposits during the audit period. Subsequent testing by the Comptroller's internal auditors confirms that this lapse was an isolated instance. Furthermore, we have confirmed that the receipts for the three days in question were properly deposited by RAD.

Additionally, the auditors found inadequate documentation of timely verifications for unclaimed property receipts. While we do not excuse this situation, it is instructive to note that there was a window of time in this audit period during which the workload in the unclaimed property section increased substantially without a corresponding increase in personnel. For example, the number of claims paid by the unit in FY05 represented a 230% increase over FY04, while reports received from holders increased by 39% and notices sent to owners increased by 29%.

We have reemphasized to all Division personnel the importance of strict adherence to this and all procedures to maintain adequate internal controls over our processes.

As for the recommendation that two employees open mail to prevent mishandling when reports and checks are received together, it is important to consider the millions of pieces of mail that contain checks and associated reports received by the Comptroller every *year. Besides paper filings of income tax returns by individuals and businesses, the Comptroller also receives reports and checks for sales and use tax, withholdings, admissions and amusement, motor fuel and alcohol, Bay Restoration fund, etc. The Comptroller does not have adequate personnel to assign two employees to open and process mail, nor would it be a cost-effective use of resources. The Comptroller has a well-developed system of internal controls to prevent and detect defalcations, which includes controls for opening and processing collections received by mail.*

Specifically, the risk associated with abandoned property collections received by mail does not justify assigning two employees, particularly in a time of scarce resources. An employee would need system access to the holder reports and the checks to be assured that he/she could pocket a check without detection. Employees who open mail in the unclaimed property section do not have system access. Furthermore, fewer than 20% of holders send paper checks, and most of those holders file their reports electronically, even though they may include a copy of the report with the check. Finally, the delinquency control function helps detect missing checks and reports from existing holders.

Adjustments

Finding 6
System access to make critical adjustments to taxpayer accounts was not always adequately controlled or monitored.

Division Response: We agree that system access should be limited to employees' current job responsibilities and certain transactions, including adjustments, should be reviewed in a timely manner. Division policies and procedures require both, and we have re-emphasized management's responsibility for ensuring adherence. In response to the auditor's findings, we have undertaken a comprehensive review of the system access of all Division employees and are creating new user classes to match the functions of employees in the various sections. In the future, employees who require a change of access due to a change in responsibilities will have their old access deleted and new access established; this will help to prevent carryover of unnecessary access related to previous job responsibilities.

It is important to note that the five employees who had the unnecessary access made no improper adjustments; four had made no adjustments at all and one had made adjustments only as required by previous job responsibilities. Additionally, each of the seven adjustments reviewed by the auditors that were determined to have not been reviewed timely or at all have subsequently been reviewed and determined to be proper. These adjustments were requested by a hearing officer from the Hearings and Appeals Section after review by the Business Tax Audit Section and Division administration. We *have re-emphasized the necessity of supervisory review to ensure adjustments as entered in the system reflect the reviewed and approved adjustments.*

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