Audit Report

Comptroller of Maryland
Compliance Division

February 2011



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

February 11, 2011

Karl S. Aro
Executive Director

Bruce A. Myers, CPA
Legislative Auditor

Delegate Guy J. Guzzone, Co-Chair, Joint Audit Committee
Senator James C. Rosapepe, 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 January 1, 2007 and ending February 22, 2010. 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.

In December 2010, the Comptroller suspended work on the development and implementation of the component of the Modernized Integrated Tax System (MITS), which was intended to replace the Comptroller's current automated tax processing systems. The Office of the Comptroller advised that work on the component, which had cost $17.9 million, was suspended for several reasons, including cost concerns and the contractor's failure to meet deliverables.

Our audit disclosed that the Division's procedures for controlling and monitoring cash receipts and critical adjustments to taxpayer accounts, such as to reduce a tax liability, were not comprehensive.

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 our audit by the Division.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

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, processes tax appeals, and enforces certain sanctions such as asset liens provided for by law. 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, 2010, outstanding individual income taxes and business taxes that were subject to collection by the Division totaled approximately $590 million and $243 million, respectively. According to the State's records, during fiscal year 2010, the Division's operating expenditures totaled approximately $27 million.

Integrated Tax System Project - Major Component Terminated

In December 2008, the Board of Public Works approved a multi-year contract for development and implementation of the Modernized Integrated Tax System (MITS). The MITS project consisted of two components: (1) an integrated tax system (ITS) to replace the Comptroller's current automated tax processing and recordation system, known as SMART (State of Maryland Tax system), as well as the existing business tax collection system, and (2) a data warehousing component to compile and store relevant taxpayer data for tax compliance enforcement purposes. The SMART system is used to process tax return information and issue refunds for individual income taxes, as well as for certain other taxes, such as corporate income taxes, employer withholding taxes, and sales and use taxes. When the MITS design and implementation contract was executed, the estimated total cost was approximately $72.3 million, and the projected completion date was July 2013; this excludes other related project costs, such as for maintenance and training.

In December 2010, the Office of the Comptroller informed the contractor for the MITS project that it was exercising its right under the contract to suspend all further work on the ITS component of the project. The data warehousing component would continue. According to the Office, this decision was based on several factors, including cost concerns and failure on the part of the contractor to meet deliverable deadlines. According to the Office's records, as of January 10, 2011, costs incurred to date for the suspended ITS component totaled approximately $17.9 million, and $24.5 million remained on the contract; for the data warehousing portion, $18 million had been spent to date, with $11.9 million remaining on the contract. Office management personnel advised that no further payments to the contractor are anticipated for the ITS component, and discussions are underway with the contractor to determine what, if any, portion of the costs incurred to date would be paid back to the State. The Office further advised that, for now, the Comptroller would continue to use SMART as the State's integrated tax system, as well as the existing business tax collection system.

Status of Findings From Preceding Audit Report

Our audit included a review to determine the status of the six findings contained in our preceding audit report dated April 25, 2008. We determined that the Division satisfactorily addressed five of these findings. The remaining finding is repeated in this report.

Findings and Recommendations

Taxpayer Account Adjustments

Finding 1
Critical adjustments to taxpayer accounts were not always controlled in an adequate manner.

Analysis
Although the Division had established certain review procedures to help ensure the propriety of critical adjustments made to taxpayer accounts on SMART (such as to reduce a tax liability), we noted that these procedures were not always effectively applied. Account adjustments were processed primarily by three units, with the majority being processed by the business collections unit. Although the dollar total of adjustments processed was not readily available, based on our review of the Division's records of five days of critical adjustments processed by the business collections unit during September to December 2009, we found that

the Division processed, on average, adjustments totaling approximately $96,500 per day. We noted the following conditions:

- Two business collection employees had been assigned system capabilities that allowed them to make adjustments to taxpayer accounts without such adjustments being subject to supervisory review and approval.

- The Division advised that, as of June 2010, adjustments processed by employees in the business collections unit during calendar year 2009 had not been reviewed by supervisory personnel as required.

- Nineteen employees, primarily from the business collections unit, had access to make critical adjustments to taxpayer accounts even though that access was not necessary for them to perform their job responsibilities.

In our preceding audit report, we commented upon similar conditions regarding employees having access to make critical adjustments which would not be subject to supervisory review, as well as unnecessary employee access to make adjustments.

Recommendation 1
We recommend that the Division

a. ensure that all critical adjustments posted to taxpayer accounts are subject to supervisory review and approval (repeat); and

b. ensure that system capabilities that allow individuals to record account adjustments are restricted to employees who need those capabilities to perform their job responsibilities (repeat).

Cash Receipts

Finding 2
Controls over certain cash receipts were not sufficient.

Analysis
Sufficient controls were not established over certain collections received by the Division's accounting and unclaimed property units. We noted the following conditions:

- The Division lacked procedures for ensuring the proper disposition of collections processed by the accounting unit to be returned to taxpayers.

Periodically, checks were received by the accounting unit for which the proper disposition could not be immediately determined. Although these checks were initially logged, pending investigation, adequate procedures were not in place to ensure that checks designated for return to the taxpayers were actually returned. In this regard, three employees in the accounting unit who had routine access to collections, prior to deposit, could record checks as returned. Since taxpayers would not necessarily expect return of their remittances, ensuring the proper disposition of such checks is critical. During the course of the audit, we discussed with the Division several viable options for establishing control over these checks, such as returning them via certified mail, or depositing them until the proper disposition could be determined. According to the Division's records, returned checks totaled approximately $739,000 during the six month period from January 2010 to June 2010.

- The employee who initially received unclaimed property checks from property holders, such as banks, also often received the corresponding holder reports, which documented the property being submitted and the property owners on record. These 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 these collections since the nature of the receipts makes it impractical to control them in advance, such as through an accounts receivable record. In an attempt to address this issue, the Division established a lockbox account and directed holders to submit payments either electronically or to the lockbox. However, according to the Division's records, a large number of checks with the related holder reports were still received directly by the Division. In total, according to its records, the Division received approximately 2,000 holder reports during fiscal year 2010, reflecting property valued at $5.5 million. Approximately 1,300 of these reports also contained the related checks. To establish accountability over these receipts, the Division could require two employees to jointly open and account for unclaimed property collections.

Recommendation 2

We recommend that the Division implement procedures

a. to ensure that collections designated for return to taxpayers were in fact returned; and

b. when receipts and the related reports are received together, establish accountability over these receipts, such as by requiring these transactions to be jointly processed by two employees.

Audit Scope, Objectives, and Methodology

We have audited the Comptroller of Maryland – Compliance Division for the period beginning January 1, 2007 and ending February 22, 2010. 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 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 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 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. These support services are included in the scope of our audits of the 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 findings relating to 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 audit did not disclose any significant instances of non-compliance with applicable laws, rules, or regulations. Other less significant findings were communicated to Division that did not warrant inclusion in this report.

The Comptroller of Maryland's response, 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

COMPTROLLER of MARYLAND
Serving the People

Peter Franchot
Comptroller

Linda L. Tanton
Deputy Comptroller

February 4, 2011

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 January 1, 2007 and ending February 22, 2010.

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 Renee Kenney, Director Internal Audit Division by email at rkenney@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

Sharonne R. Bonardi
Director, Compliance Division

cc: Honorable Peter V.R. Franchot, Comptroller

80 Calvert Street • P.O. Box 466, Annapolis, Maryland 21404-0466 • 410-260-7806 • Fax: 410-974-2030 • ltanton@comp.state.md.us
Maryland Relay 711 • TTY 410-260-7157 • www.marylandtaxes.com

Taxpayer Account Adjustments

Finding 1
Critical adjustments to taxpayer accounts on SMART were not always adequately controlled.

Recommendation 1:
a. ensure that all critical adjustments posted to taxpayer accounts are subject to supervisory review and approval (repeat).

Division Response: The Division concurs with the auditor's recommendation. The review of the section's adjustments were brought up to date and remain current, adhering to the Division's established approval process for adjustments. Division supervisors have received additional training and guidance to help ensure compliance with the Division's policies and procedures. The Section Manager is monitoring the adjustment process.

Recommendation 1:
b. ensure that system capabilities that allow individuals to record account adjustments are restricted to employees who need those capabilities to perform their job responsibilities (repeat).

Division Response: The Division concurs with the recommendation. There has been an established procedure to review the security and access levels for all employees. The Division strengthened its current procedures for reviewing system access requirements, including additional monitoring responsibilities for the Assistant Director. In addition, upon learning of the issue, the Division immediately changed the SMART user class codes for those employees who did not require adjustment access.

Cash Receipts

Finding 2
Controls over cash receipts were not sufficient

Recommendation 2:
a. to ensure that collections designated for return to taxpayers were in fact returned

Division Response: Although no audit exceptions were identified, the Division agrees with the recommendation and has strengthened its procedures over the return of taxpayer checks. As stated in the audit report, the checks in question were properly logged pending investigation. It is also important to note, that 94% of the return check total ($739,000) was made up of three large dollar checks. The strengthened procedures include guidelines for 24 hour checks (i.e., checks that require a 24 hour response time), mail delivered to other sections within the Division, and mis-delivered mail. The strengthened procedures also require additional periodic review of the return check procedure by the Assistant Director.

Recommendation 2:
b. when receipts and the related reports are received together, establish accountability over these receipts, such as by requiring these transactions to be jointly processed by two employees.

Division Response: The Division agrees that best practice supports segregating responsibilities associated with opening mail which may contain cash or other receipts. The Division also understands the importance of strengthening internal control in this area, and will continue its efforts to educate holders of unclaimed property on the Comptroller's on-line holder reporting options (e.g., utilize lockbox or electronic submission). However, management must have a full understanding of the associated risks and costs before implementing any controls.

As stated in our response to the Comptroller of the Treasury Compliance Division Audit Report dated April 2008, "the risk associated with abandoned property collections received by mail does not justify assigning two employees." For this current review, management completed an analysis of remittance processes and actual remittances received (see diagram below) to determine if assigning a second employee to collections was supported by the inherent risk.

Actual Remittances:

FY10

Remittances	# Received	Dollar Amount	% of Checks
Paper Holder	1,312	$ 5,524,805	6.3%
Total Received Excluding Electronic Payments	8,065	$122,337,453	

In response to this note, the Division researched the number of remittances received with paper holder reports (1,312 totaling $5,524,805), as compared to the total number of remittances (8,065 totaling $122,337,453) received in the Unclaimed Property Unit. The Division determined that 6.3% of checks are received with paper returns.

Based on the above analysis, Division Management cannot justify assigning two employees to abandoned property collections received by mail. However, to strengthen internal controls and mitigate the identified risks, the Division is relocating the mail opening function to an area in the office that is in close proximity to an office supervisor where the function will have an increased oversight.

AUDIT TEAM

Paul R. Denz, CPA
Audit Manager

Richard L. Carter, CISA
Information Systems Audit Manager

Abdullah I. Adam, CFE
Laura J. Hilbert, CPA, CFE
Senior Auditors

John C. Venturella
Information Systems Senior Auditor

Cristen M. Ervin
LaTeasa R. Robertson
Ryan P. Stecher
Henry H. Startzman, IV
Staff Auditors