

STATE OF CONNECTICUT



**AUDITORS' REPORT
DEPARTMENT OF REVENUE SERVICES
FOR THE FISCAL YEARS ENDED JUNE 30, 2011 AND 2012**

AUDITORS OF PUBLIC ACCOUNTS
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October 6, 2014

AUDITORS' REPORT DEPARTMENT OF REVENUE SERVICES FOR THE FISCAL YEARS ENDED JUNE 30, 2011 AND 2012

We have made an examination of the financial records of the Department of Revenue Services (DRS) for the fiscal years ended June 30, 2011 and 2012. This report on that examination consists of the Comments, Condition of Records, Recommendations and Certification that follow.

Financial statements pertaining to the operations and activities of the Department of Revenue Services for the above mentioned fiscal years are presented and audited on a Statewide Single Audit basis to include all state agencies and funds. This audit examination has been limited to assessing compliance with several provisions of financial related laws, regulations and contracts, and evaluating internal control structure policies and procedures established to ensure such compliance.

COMMENTS

FOREWORD

The Department of Revenue Services operates principally under the provisions of Title 12, Chapters 201, 202 and 207 through 229 of the General Statutes. The department is responsible for administering and ensuring compliance with applicable provisions of this title and certain other statutes related to the assessment and collection of taxes. Major functions of the department include collecting and processing tax revenues, developing tax regulations and providing information and services to taxpayers.

Records pertaining to sales taxes collected by the Department of Motor Vehicles but credited to the Department of Revenue Services are examined as part of our audit of the Department of Motor Vehicles.

Section 12-1a of the General Statutes provides that the department is under the direction of a commissioner. Richard D. Nicholson served as commissioner from July 1, 2009 through January 2011. Kevin B. Sullivan was appointed as commissioner effective January 10, 2011 and continued to serve in that position through the remainder of the audited period.

Legislative Changes

Notable legislative changes that took effect during the audited period are summarized by tax type and presented below:

- **Income Tax:**

Public Act 11-1 of the June 2011 Special Session of the General Assembly reduced the Connecticut earned income tax credit from 30 percent to 25 percent of the earned income tax credit claimed and allowed for the same taxable year under Section 32 of the Internal Revenue Code .

Public Act 11-6, effective May 4, 2011, increased the personal income tax rates, adjusted the credit tables and phased out the 3 percent tax rate for certain filers commencing January 1, 2011.

Public Act 11-6, effective July 1, 2011, reduced the income tax credit for property taxes paid from \$500 to \$300. The act also changed the phase-out of the credit from 10 percent to 15 percent for every \$10,000 of income commencing January 1, 2011.

- **Sales and Use Tax**

Public Act 11-6, effective July 1, 2011, increased the general sales and use tax rate from 6 percent to 6.35 percent. The act also increased the room occupancy tax from 12 percent to 15 percent. In addition, the act eliminated certain sales tax exemptions and extended the tax to new services as well as changed the tax on car rentals from 6 percent to 9.35 percent. It also imposed a luxury goods tax of 7 percent on certain motor vehicles, boats, jewelry and clothing. It required certain remote sellers to collect sales tax on their taxable sales in the state.

Public Act 11-61, effective upon passage, allowed a sales and use tax exemption on specialized equipment installed in motor vehicles at the time of sale or resale , used by drivers with disabilities. It also made some adjustments to the changes in sales tax exemptions provided in Public Act 11-6 and made adjustments to the collection of taxes from remote sellers.

- **Corporation Business Tax**

Public Act 11-1 of the October 2011 Special Session of the General Assembly established the Job Expansion Tax Credit Program effective, January 1, 2012. The

program creates a credit equal to \$500 per month for each new employee hired and \$900 per month for each qualifying employee or veteran hired. The act also reduced from \$100,000 to \$25,000, the minimum cash investment a taxpayer must make to qualify for the angel investor income tax credit.

Public Act 11-6, effective July 1, 2011 increased the corporation business tax surcharge from 10 percent to 20 percent for calendar years commencing, January 1, 2012 and January 1, 2013.

Public Act 11-61, effective upon passage, extended from three to six years the time DRS can make a deficiency assessment against an employer that fails to include in reportable wages any amount in excess of 25 percent of wages actually reported.

Public Act 11-61, effective July 1, 2011, provided that any person purchasing a business be held liable for the seller's withholding tax liability, unless the purchaser requests a tax clearance from DRS.

Public Act 11-61, effective October 1, 2011, provided that a corporation which has overpaid its corporation business tax can credit the overpayment to its first estimated tax payment for the following year.

Public Act 11-78, effective July 1, 2011, provided that business taxpayers investing in certain business development projects may qualify for both urban and industrial sites reinvestment tax credits as well as federal new markets tax credits. Projects are required to meet both the state and federal eligibility criteria and are subject to federal rules for repaying the tax credits.

Public Act 11-86, effective July 1, 2011, increased the cap on the total amount of business tax credits available for creating new jobs from \$11 million to \$20 million and on urban and industrial sites reinvestment program from \$500 million to \$750 million.

Public Act 11-140, effective July 1, 2011, provided tax incentives for small manufacturers to save for training workers, acquiring facilities and equipment as well as for certain graduates to save toward buying their first home. Also, the act extended the Neighborhood Assistance Act tax credit eligibility to companies subject to the state business entity tax and increased the total credits that can be claimed, effective October 1, 2011. In addition, the act allowed business taxpayers to transfer insurance reinvestment tax credits to affiliates.

- **Cigarette and Tobacco Taxes:**

Public Act 11-6, effective July 1, 2011, increased the tax on cigarettes from \$3.00 to \$3.40 per pack of twenty cigarettes. The act also increased the tax on snuff tobacco from 55 cents to \$1 per ounce and on all other tobacco products from 27.5 percent to 50 percent of the wholesale price.

Public Act 11-37, effective July 1, 2011, allowed certain franchise operators to be licensed as cigarette distributors and qualify as chain stores for purposes of the cigarette tax.

- **Estate and Gift Taxes:**

Public Act 11-6, effective upon passage, reduced the estate and gift tax threshold from \$3.5 million to \$2 million commencing on or after January 1, 2011.

- **Other Taxes:**

Public Act 11-6, effective July 1, 2011, increased the tax on alcoholic beverages by 20 percent. The act also allocates the following to a non-lapsing Municipal Revenue Sharing Account in the General Fund: (1) 1.57 percent of the 6.35 percent sales tax revenue, (2) 1.43 percent of the 7 percent luxury tax revenue, (3) 33 percent of the revenue from real estate conveyance tax on sales of unimproved land and certain bank foreclosures and on the first \$800,000 of the sale price of residential property, and (4) 20 percent, of sales on nonresidential property and any amount of the sale price of residential property that that exceeds \$800,000 .

Public Act 11-13, effective October 1, 2011, required that the Connecticut Lottery Corporation verify whether a lottery winner has delinquent taxes using a list provided by DRS and offset the lottery winnings if taxes are due.

Public Act 11-30, effective upon passage, allowed the disclosure of certain tax information to the Attorney General if the information is relevant to arbitration or other dispute resolution proceedings under the Tobacco Master Settlement Agreement or any amendment to the agreement.

Public Act 11-44, effective July 1, 2011, imposed a 4.6 percent quarterly tax on hospitals' net patient revenue.

Public Act 11-61, effective for a tax period starting on or after January 1, 2012, established a \$2,500 penalty for a first offense, \$10,000 for a second offense and 10 percent of liability for a third and subsequent offenses when taxpayers fail to file electronically, effective for a tax period starting on or after, January 1, 2012. The act also allowed electronic payments to be initiated on or before the due date.

Public Act 11-145, effective October 1, 2011, allowed a waiver to a taxpayer from electronic tax filing or payment if the taxpayer can prove an undue hardship to comply with the requirement.

Public Act 11-233, effective upon passage, exempts electricity generated exclusively through the use of fuel cell, alternative energy system or a resource recovery facility from the electric generation tax.

Public Act 12-4, effective upon passage, caps the petroleum products gross earnings tax at \$3 per gallon on the first sale of gasoline and gasohol.

RÉSUMÉ OF OPERATIONS

General Fund Revenues and Receipts

General Fund tax revenues, license fees and all other revenues and non-revenue receipts totaled \$13,222,434,929 and \$14,906,624,419 for the fiscal years ended June 30, 2011 and 2012, respectively. Revenues other than taxes included payments for licenses to collect sales and use taxes and to sell cigarettes and tobacco products, service-of-process fees and costs related to tax warrants, expenditure refunds and federal funding.

General Fund tax refunds, budgeted as reductions of tax revenues, were \$964,593,351 and \$1,108,752,911 for the fiscal years ended June 30, 2011 and 2012, respectively.

A summary of tax revenues, net of refunds, for the fiscal years ended June 30, 2011 and 2012, with 2010 figures presented for comparative purposes, is presented below:

(In Millions of Dollars)	2009-2010	2010-2011	2011-2012
Personal Income	\$ 5,751	\$ 6,482	\$ 7,319
Sales and Use	3,065	3,378	3,685
Corporations	505	667	692
Inheritance Taxes	168	227	175
Public Service Companies	275	278	257
Insurance Companies	204	188	203
Alcohol/Cigarettes/Tobacco	433	450	476
Petroleum Companies	246	299	382
Real Estate/Controlling Int.	97	92	102
Nursing Homes	123	121	144
Admissions and Dues	34	35	34
Hospital Net Patient Revenue	-	-	262
All other Taxes	20	40	67
Total	\$ 10,921	\$ 12,257	\$ 13,798

As presented in the above analysis, net General Fund tax revenues increased by approximately 12 percent annually during the years under review. The increases were primarily due to personal income and sales and use tax revenues. Revenues from sales and use and personal income tax receipts accounted for approximately 80 percent of tax revenues in fiscal years ended June 30, 2011 and 2012.

General Fund Expenditures

A summary of General Fund expenditures from department appropriations for the fiscal years ended June 30, 2010, 2011, and 2012, is presented below:

	<u>2009-2010</u>	<u>2010-2011</u>	<u>2011-2012</u>
Personal Services	\$ 54,658,546	\$ 55,772,096	\$ 56,979,111
Other Expenses	7,420,417	7,185,374	8,008,861
Equipment	-	-	-
Total Budgeted Accounts	\$62,078,963	\$62,957,470	\$64,987,972
Restricted Appropriations	(30,070)	63,122	(21,975)
Totals	<u>\$ 62,048,893</u>	<u>\$ 63,020,592</u>	<u>\$ 64,965,997</u>

As presented above, operating expenditures increased over the audited period. The increase was primarily attributable to increases in personal service costs and other expenses.

The number of filled positions changed during the audited period, as compared to the previous year. Below is a summary of positions as of June 30, 2010, 2011, and 2012:

	<u>June 30, 2010</u>	<u>June 30, 2011</u>	<u>June 30, 2012</u>
Full-Time	690	669	631
Part-Time	12	13	60
Temporary or Durational	1	1	1
Total	<u>703</u>	<u>683</u>	<u>692</u>

Special Transportation Fund

In accordance with the provisions of Section 13b-61 of the General Statutes, motor fuel taxes and related fees collected by the department, pursuant to Chapters 221 and 222 of the General Statutes, were deposited into the Special Transportation Fund.

Special Transportation Fund receipts for the department totaled \$485,147,527 and \$492,547,702 for the fiscal years ended June 30, 2011 and 2012, respectively.

Special Transportation Fund tax refunds, budgeted as reductions of tax revenues, totaled \$6,767,366 and \$7,006,094 for the fiscal years ended June 30, 2011 and 2012, respectively.

A summary of Special Transportation tax revenues, net of refunds, for the audited period is presented below:

(In Millions of Dollars)	2009-2010	2010-2011	2011-2012
Motor Fuel Tax	\$ 370	\$ 367	\$ 360
Special Motor Fuel Tax	106	98	111
Motor Carrier Tax	18	13	15
Total	\$ 494	\$ 478	\$ 486

Audit Assessments

Audits were conducted by examiners within the department's Audit Division to ensure taxpayer compliance, with regard to the filing of returns and the remitting of tax payments. Assessments were generated as a result of both office and field audit efforts. Based upon statistics provided by the Audit Division, assessments totaled \$395,184,057 and \$477,264,370, respectively, for the fiscal years ended June 30, 2011 and 2012. A summary of assessments by tax type for the audited period, as provided by the Audit Division, is presented below:

(In Millions of Dollars)	2009-2010	2010-2011	2011-2012
Corporation and Other Business-related Taxes	\$ 291	\$ 158	\$ 244
Sales and Use Taxes	103	98	102
Personal Income Tax	55	96	67
Excise Taxes	15	10	14
Public Service Taxes	15	20	42
All other Taxes	12	12	8
Total	\$ 491	\$ 394	\$ 477

Appellate Division

The department's Appellate Division administers appeals from taxpayers disputing audit assessments. Following written protests, hearings with taxpayers are held. Based upon information presented, appellate decisions are made concerning the validity of assessments. Further appeals are available to taxpayers by means of litigation.

Appellate Division activity reports, reflecting resolution activity for the fiscal years ended June 30, 2010, 2011, and 2012, are presented below. Revisions resulted from both court and Appellate Division decisions.

	2009-2010	2010-2011	2011-2012
Cases Resolved	1,281	1,455	1,351
Original Assessments	\$ 201,231,363	\$ 106,860,577	\$ 242,698,581
Revised Assessments	115,640,543	57,145,462	93,495,073
Assessment Reductions	\$ 85,590,820	\$ 49,715,115	\$ 149,203,508
Percentage Reduction	43%	47%	61%

Accounts Receivable

The department's accounts receivable are derived from various sources, including audit assessments, delinquency assessments, penalty and interest charges, and returns filed without remittances or filed with an underpayment of tax liability. A summary of accounts receivable as of June 30, 2010, 2011, and 2012, is presented below:

	<u>June 30, 2010</u>		<u>June 30, 2011</u>		<u>June 30, 2012</u>
Taxes Receivable:	\$		\$		\$
Corporation Tax	109,568,930		104,399,396		45,564,395
Income Tax	377,042,602		426,653,335		260,287,414
Sales and Use Tax	201,575,807		218,140,878		217,122,683
Other Taxes	<u>3,385,600</u>		<u>34,486,839</u>		<u>52,024,394</u>
Total Taxes Receivable	<u>\$721,572,939</u>		<u>\$783,680,448</u>		<u>\$574,998,886</u>
Reductions:					
Credits	(126,100,076)		(145,211,975)		(126,500,586)
Appellate Reductions	(135,252,795)		(142,224,846)		(67,402,020)
Estimated Uncollectible	<u>(187,876,676)</u>		<u>(194,506,566)</u>		<u>(168,108,119)</u>
Total Reductions	<u>(449,229,547)</u>		<u>(481,943,387)</u>		<u>(362,010,725)</u>
Net Taxes Receivable	<u>\$272,343,392</u>		<u>\$301,737,061</u>		<u>\$212,988,161</u>

The receivable balances reflect reductions for payments that were made on account by taxpayers to avoid the continued accrual of interest on assessments under protest and credits due taxpayers. The reductions from taxes receivable include credits, appellate and court reductions, and aged taxes receivables estimated to be uncollectible.

Penalty Waivers

Provisions of certain statutes impose penalties for failure to satisfy taxes due within specified times. The Commissioner of Revenue Services is authorized to waive penalties, subject to the provisions of Section 12-3a of the General Statutes, in cases where the failure to pay the tax was due to reasonable cause and was not intentional or due to neglect. Section 12-3a requires approval of a Penalty Review Committee comprised of the commissioner of the Department of Revenue Services, the Secretary of the Office of Policy and Management and the State Comptroller for all penalty waivers over \$500.

A summary of the penalty waiver activity for the fiscal years ended June 30, 2010 through 2012, as provided by the Department, follows:

	<u>Requests</u>		<u>Denied</u>		<u>Approved Waivers</u>	
	<u>Cases</u>	<u>Penalties</u>	<u>Cases</u>	<u>Penalties</u>	<u>Cases</u>	<u>Penalties</u>
2009-2010	5,539	\$3,311,234	3,443	2,563,714	2,096	\$747,520
2010-2011	3,441	\$3,461,198	2,816	2,949,761	625	\$511,437
2011-2012	4,053	\$6,259,842	2,603	2,723,709	1,450	\$3,536,133

Collections and Enforcement Division

The Collections and Enforcement Division is comprised of revenue agents who pursue collections through direct contact with taxpayers, field agents who issue tax warrants to delinquent taxpayers, hearing officers who provide an initial hearing process for delinquent taxpayers and enforcement agents who investigate cases involving tax evasion. Records of the Collections and Enforcement Division indicated revenues collected by the division were \$105,951,887 and \$126,333,146 during the 2011 and 2012 fiscal years, respectively.

The commissioner, upon the approval of an Abatement Review Committee, may abate any tax payable to the state that has been present on its suspense tax book for seven years and determined to be uncollectible. The committee did not hold a meeting during the audited period.

In accordance with Section 12-3b of the General Statutes, it is the practice of the department to remove from its active accounts receivable file accounts considered to be uncollectible and transfer the amounts to the tax suspense book. The amounts transferred will eventually be considered, due to the statutorily required seven-year waiting period, for inclusion on abatement approval requests. Accounts totaling \$79,603,212 and \$60,063,036 were referred to this status during the 2010-2011 and 2011-2012 fiscal years, respectively.

STATE AUDITORS' FINDINGS AND RECOMMENDATIONS

Our audit of the Department of Revenue Services identified the following areas that need improvement and warrant comment:

Failure to Adopt Regulations as Required by Statute

Criteria: Subparagraph (B) of subsection (40) of Section 12-412 of the General Statutes states that the Commissioner of the Revenue Services shall adopt regulations requiring the periodic registration for purposes of the issuance of fisherman tax exemption permits.

Condition: As indicated in the prior audit report, the department has not adopted the required regulations.

Effect: There are no regulations in place to carry out the legislative mandate.

Cause: The department has not made adopting the regulations required under Section 12-412 of the General Statutes a high priority.

Recommendation: The Department of Revenue Services should implement regulations requiring periodic registration for the issuance of fisherman tax-exempt permits in accordance with Section 12-412 of the General Statutes. (See Recommendation 1.)

Agency Response: “The department agrees with this finding. The department intends to adopt regulations pertaining to Conn. Gen. Stat. 12-412(40). However, the fact that regulations have not yet been adopted continues to reflect relatively low priority and has not adversely affected continuous implementation of the law in terms of periodically registering commercial fishermen in order to issue fisherman tax exemption permits.”

Human Resources Unit – Investigations of Alleged Improprieties

Background: Most agencies have a human resources and/or affirmative action unit to manage most facets of the personnel function. Many times, these units become involved in investigations related to accusations of discrimination, harassment, and violations of most workplace rules.

Criteria: In order to provide assurance that the conclusions reached and actions taken as a result of investigations are reasonable and consistent, the Human Resources Unit should conduct its investigations following a formal, written set of procedures. In addition, the unit’s administrator

should formally document the review of the investigations conducted and agreement with the conclusions reached by staff.

Condition: Our review disclosed that the department's Human Resources Unit has not implemented any standardized written procedures for the purpose of conducting investigations. As a result, a number of case file documentation related to the Human Resources Unit's investigations disclosed a lack of documented evidence to support the human resources administrator's review of the case files prepared and agreement with conclusions reached by staff.

Effect: The lack of both standardized written procedures for conducting investigations and formal documented reviews by the human resources administrator increases the risk that the conclusions reached and actions taken as a result of such investigations may be inconsistent.

Cause: We were informed that due to lack of resources, the Human Resources Unit has not implemented any standardized written procedures for the purpose of conducting and documenting investigations.

Recommendation: The Department of Revenue Services Human Resources Unit should implement standardized written performance and review procedures relative to its investigation process. Such procedures should include documentation to substantiate the human resources administrator's review of the case files prepared and agreement with the conclusions reached by staff. (See Recommendation 2.)

Agency Response: "The department agrees with this finding. The department is currently in the process of implementing standardized written procedures to conduct investigations and a standardized investigation report to summarize and document investigations."

Performance Evaluations

Criteria: Section 5-237-1 (a) (4) of the Regulations of State Agencies indicates that the appointing authority shall cause a service rating to be filed on the form prescribed by the Commissioner of the Department of Administrative Services annually for each permanent employee. The said annual rating is to be filed in the office of the appointing authority at least three months prior to the employee's annual increase date. All service ratings are to be discussed with the employee by the employee's immediate supervisor. The employee shall be asked to sign such report as a confirmation that the employee has seen the form and discussed it with their supervisor.

Section 5-210 of the General Statutes authorizes the Commissioner of the Department of Administrative Services to establish state incentive plans for managerial or confidential employees based on annual performance appraisals.

A Performance Assessment and Recognition System (PARS) Handbook, established by the Department of Administrative Services, details the processes and forms required to be filed at the beginning of the fiscal year for each managerial employee. These forms are a Planning and Appraisal record and an Annual Review form. The purpose of PARS is to:

- Facilitate joint planning between a manager and supervising manager on what the manager is expected to accomplish.
- Establish clear, achievable, measurable, results-oriented performance objectives, consistent with the agency's priorities and mission, and considered fair by both the manager and the supervising manager.
- Promote ongoing communication between the manager and the supervising manager concerning expectations, how well the manager is meeting these expectations, and what steps must be taken to ensure that objectives are met.
- Guide regular evaluations of progress and promotion of the manager's professional development.
- Identify corrective action needed when a manager has not accomplished a performance objective.
- Provide a basis for differentiating among levels of performance and thus serve as a basis for a manager's annual salary increase or bonus payment.
- Improve individual job performance and thereby increase the effectiveness of the agency.

Condition: Our review revealed that performance evaluations were not completed for five managers since 2008. Based on our finding, we inquired whether evaluations were completed for other managers who were not in our sample. We were informed that the same situation exists for all managers.

Effect: When annual performance evaluations are not prepared, there is no formal feedback to management and the employee about compliance with rules and productivity expectations. In addition, the lack of annual evaluations enhances the risk that managerial employees will improperly receive increases.

Cause: It appears that lack of administrative oversight contributed to this condition.

Recommendation: The Department of Revenue Services should ensure that annual performance evaluations are performed on all of its managerial employees. (See Recommendation 3.)

Agency Response: “The department agrees with this finding. The department completed formal performance evaluations for managers for all fiscal years a merit increase was paid. Informal performance evaluations were conducted for several fiscal years when merit increases were not paid. Beginning with fiscal year ending June 30, 2013, the department reinstated a formal performance evaluation for managers, regardless of a merit increase.”

Alternative Work Schedule

Criteria: The Administrative and Residual (P-5) Collective Bargaining Union Contract - Article 16A – Section Two states that employees should submit their quarterly alternative work schedule (AWS) for the following quarter to their supervisors for approval.

Condition: We noted that three employees out of 20 selected for payroll testing were on the AWS. However, two of the employees did not submit a schedule for approval. One employee submitted a schedule for approval, but the schedule was not approved.

Effect: There is lack of assurance that the time charged by employees on the AWS represents the actual time worked.

Cause: It appears that lack of administrative oversight might have contributed to this condition.

Recommendation: The Department of Revenue Services should ensure that alternative work schedules are submitted and approved and to comply with the Administrative and Residual (P-5) Bargaining Union Contract. (See Recommendation 4.)

Agency Response: “The department agrees with this finding. The department will review our current practices to ensure compliance in the future.”

Petty Cash Fund

Criteria: The State Accounting Manual requires that employees authorized to receive travel advances must sign a statement acknowledging the amount of cash advanced and submit an employee travel reimbursement form within five working days after returning from travel.

- Condition:* Our examination of 44 travel advances for the fiscal year ended June 30, 2011 and 2012 revealed that in 11 cases, the travel reimbursement forms were submitted by employees four to eight days late.
- Effect:* The department is not in compliance with the State Accounting Manual.
- Cause:* The requirements to ensure the timely submission of the travel reimbursement forms were not followed.
- Recommendation:* The Department of Revenue Services should ensure that employees submit travel reimbursement forms in compliance with the requirements of the State Accounting Manual. (See Recommendation 5.)
- Agency Response:* “The department agrees with this finding. The Business Office currently sends weekly “dunning notices” to remind staff of the requirement to submit their travel reimbursement form within 5 business days after returning from travel. However, due to the extensive travel of our employees, the department has requested an extension of the 5-day filing requirement.”

Recording of Actual Receipt Dates to Verify Timely Deposit

- Criteria:* Section 4-32 of the General Statutes requires that state agencies deposit and account for monies received within 24 hours of receipt if the amount received by an agency exceeds \$500. DRS receives more than \$500 every day, but has received exemptions from the State Treasurer, allowing additional time to deposit and record certain tax payments.
- Condition:* In our current and prior audit, we found that the tax payments sent directly to DRS (instead of the lockbox) are recorded on the books of DRS using the postmark date as the receipt date. However, it does not appear as though the postmark date could always accurately reflect that the deposits were made in a timely manner.
- Effect:* There is reduced assurance that these payments are being deposited timely in accordance with the statutory requirements and applicable extensions received from the State Treasurer.
- Cause:* The department believes that the cost and effort to record the actual receipt dates for these tax payments is excessive compared to the benefit. In addition, DRS has failed to establish, or otherwise apply, a consistent standard to determine the postmark date and, thus, the receipt date for the payments.

Recommendation: The Department of Revenue Services should establish a consistent standard for defining the postmark date to apply to the payments mailed directly to DRS to ensure they are deposited in accordance with Section 4-32 of the General Statutes. (See Recommendation 6.)

Agency Response: “The department disagrees with this finding. The department has a consistent standard for defining the date recorded in ITAS and applies this standard to payments/returns mailed directly to the department that ensures accuracy of the taxpayer’s account. However, the department acknowledges this standard does not facilitate independent validation of our compliance with Section 4-32 of the General Statutes. The department will explore the possibility of expanding ITAS to include the receipt date, in addition to the postmark date, to allow validation testing of timely deposits to be performed.”

Auditors’ Concluding Comment: DRS is correct to acknowledge that the standard used for defining the postmark date for payments or returns mailed directly to the department does not facilitate independent validation of its compliance with Section 4-32 of the General Statutes.

Review and Approval of Audits

Background: The department’s Audit Division now conducts its audit in an electronic format. In the virtual audit environment, all the evidence in support of the taxpayer audit, including procedures performed, audit findings, and administrative reviews and approvals, are maintained in an electronic format. With respect to the audits performed and maintained in a paper document format, the supervisory and managerial reviews and approvals of the examiner’s performance and relevant documentation were evidenced, or otherwise acknowledged, by the actual signing and dating of the appropriate audit review forms. However, in the virtual audit environment, the support for the supervisory and managerial level reviews and approvals relative to the performance, completeness and quality of the audit is evidenced, in part, via email correspondence between the audit examiner, audit supervisor and audit manager.

Criteria: The state has established laws and regulations for the collection of taxes and ensuring that taxpayers comply with tax collection efforts. The department has established policies and procedures for the establishment of the state’s tax collection laws and regulations, including the department’s Audit Division, which performs taxpayer audits based on established criteria. The Audit Division ensures that its revenue examiners perform the taxpayer audits in accordance with the

department's policies and procedures primarily through its supervisory and managerial level reviews of taxpayer audit files.

Condition: We found that throughout the Audit Division, the virtual audit files forwarded from one supervisory level to the next via email correspondence sometimes did not provide specific language referencing or otherwise acknowledging that the necessary supervisory and managerial level reviews were performed and approvals were received.

Effect: The department's virtual audits may be considered approved and in compliance with the department's policies and procedures without any formal or definitive evidence to support the supervisory level reviews and approvals, leading to questionable accountability relative to the performance and quality of such audits.

Cause: The policies and procedures established by the department are not consistently being followed.

Recommendation: The Department of Revenue Services, Audit Division should consistently follow its established policies and procedures regarding the necessary supervisory and managerial level reviews and approvals of its virtual audit files. (See Recommendation 7.)

Agency Response: "The department agrees with this finding. The department has been in the process of developing an alternative method for supervisory and managerial level reviews which will utilize functionality within the integrated tax administration system (ITAS) to systematically document the reviews of the virtual audit files as they pass through each level of review/approval process."

Processing of Suspended Transactions

Background: Tax returns and payments entered into the department's tax administration system are sometimes unable to be processed, thereby entering into a suspended status. There are many different reasons for transactions going into suspense, including a payment that does not match the coupon that is submitted, or a taxpayer name that does not match the social security number on file. Most suspended transactions are assigned a severity code based on the impact that it could have on a taxpayer's account.

The resolution of suspended transactions is part of the routine procedures that should take place in any data processing environment, either on an ongoing basis or through the efforts of special projects designed to eliminate these transactions.

- Criteria:* Sound business practices dictate that suspended transactions should be resolved in a timely manner to prevent a delay in the processing of subsequent returns and to avoid repetitive errors.
- Condition:* Our current test of 16 transactions selected from a listing of approximately 4,000 high priority transactions disclosed that four (25 percent) of the tested transactions were not pursued or otherwise corrected in a timely manner. These transactions were suspended for periods ranging from seventeen months to thirty months.
- Effect:* Transactions that have been suspended and not resolved in a timely manner may prevent the department from readily identifying patterns that could be indicative of a potential problem and may result in the creation of a liability in the form of interest owed for late refunds.
- Cause:* The department's current practices fail to ensure the consistent and proactive follow-up on those suspended transactions considered high priority.
- Recommendation:* The Department of Revenue Services should strengthen its internal control procedures to ensure the timely resolution of suspended transactions, with emphasis on those transactions considered either high priority or identified as having a potential financial impact for the state. (See Recommendation 8.)
- Agency Response:* "The department agrees with this finding. The department will review our current procedures to ensure suspended transactions are pursued in accordance with the indicated criteria. It must be noted however that some suspended transactions cannot be corrected without a response from the taxpayer."

Collection and Enforcement Division and Audit Division – Outdated Procedures

- Background:* The Department of Revenue Services Collection and Enforcement Division is responsible for the collection of overdue taxes and the enforcement of the state tax statutes and regulations.
- The department's Audit Division ensures that all taxes due are reported accurately and in compliance with pertinent laws.
- Criteria:* Proper internal control dictates that formal written procedures should be established, maintained and disseminated to provide guidance to employees in the performance of their assigned duties.

The responsibility of designing and implementing internal controls is a continuous process. As conditions change, control procedures may become outdated and inadequate. Management must anticipate that certain procedures will become outdated, inadequate or obsolete, and that it will become necessary to modify its internal controls in response.

Condition: We found that the Collection and Enforcement Division Manual as well as the Audit Division Field Audit Documentation Standards Manual were outdated.

Effect: The ability to train employees, as well as the effectiveness and efficiency of the functions performed within the Collections and Enforcement Division and the Audit Division may be diminished.

Cause: The updating of formal, comprehensive written procedures for the Collections and Enforcement Division and the Audit Division does not appear to be a high priority of the department.

Recommendation: The Department of Revenue Services should improve its internal controls by updating and maintaining its formal, comprehensive written procedures related to the functions of its Collection and Enforcement Division and Audit Division. (See Recommendation 9.)

Agency Response: “The department agrees with this finding. After the prior audit report was issued, an organizational restructuring of the Audit and Compliance Division caused the department to review its audit and collection processes. As a result of this review, the department recently completed an update of the Collection and Enforcement Division Manual which is currently being finalized and is expected to be issued in the near future. In addition, the department is in the process of updating the Field Audit Documentation Standards and expects this document to be completed later this year.”

Administration of Internal Audit Unit

Criteria: Professional internal auditing standards are recommended guidelines that an internal audit organization can choose to adhere to for purposes of achieving quality and consistency in the performance of its work. These guidelines address the concepts of organizational independence, objectivity, proficiency, due professional care, continuing education, and the planning, performance, reporting and follow-up of engagements. In order to promote compliance with such standards, they should be in written form and formally adopted by the organization.

- Condition:* We noted that the Internal Audit Unit has not adopted professional standards to guide in the performance of its duties. The Internal Audit Unit has not produced, in conjunction with management, a risk assessment to help justify the timing and frequency of the audits performed.
- Effect:* The lack of adherence to established standards impedes the ability of the Internal Audit Unit to achieve the highest level of consistency and effectiveness. The failure of the unit to use documented risk assessments can impact the allocation of resources, preventing those resources from being used in a manner that results in the largest expected benefit.
- Cause:* We were informed that the condition exists because of a lack of resources.
- Recommendation:* The Department of Revenue Services should consider adopting professional internal auditing standards to facilitate the operation of the Internal Audit Unit. (See Recommendation 10.)
- Agency Response:* “The department agrees with this finding. The department will develop a plan of action to adopt professional standards for the internal audit activities. The department is in the process of increasing the staff within the Internal Audit Unit, which currently consists of the director and one other employee. Full implementation of the action plan will be dependent upon staffing and available resources.”

Noncompliance with Section 12-39aa Subsection (a) of the General Statutes

- Criteria:* Section 12-39aa subsection (a) of the General Statutes provides that “if any return, claim, statement, or other document required to be filed with or any payment required to be made to DRS within a prescribed period on or before a prescribed date under authority of any provision of the general statutes is, after such period or such date, delivered by United States mail to DRS, the date of the United States postmark stamped on the cover in which such return, claim, statement, or other document, or payment, is mailed shall be deemed to be the date of delivery or the date of payment, as the case may be.”
- Condition:* During the current and prior audit, we found that the department has been following a practice of allowing a grace period in determining the timeliness of receipt of required tax returns or payments when received after the prescribed period or due date. For instance, with respect to required resident individual income tax return filings, we were informed that the department’s general practice has been to accept, as timely filed in compliance with Section 12-39aa subsection (a) of the General

Statutes, any filing received within the grace period of three business days immediately following the prescribed period or due date, regardless of the postmark date.

Effect: The department is not in compliance with the provisions of Section 12-39aa subsection (a) of the General Statutes.

Cause: The department believes that the use of a grace period allows for the more effective and efficient use of its limited resources, and, therefore, enhances its staff's productivity during those periods immediately following a prescribed period or due date, when the demands on its resources are the greatest due to the large volume of filings.

Recommendation: The Department of Revenue Services should establish the procedures necessary to ensure that it is in compliance with Section 12-39aa subsection (a) of the General Statutes. (See Recommendation 11.)

Agency Response: "The department agrees with this finding. The department continues to perform cut-off testing for returns received during the grace period. That testing substantially confirms the mail is postmarked on or prior to the due date, in compliance with the requirements of Section 12-39aa. Returns received after the grace period are examined and posted using the date of the postmark stamped on the envelope, when provided."

Equipment Inventory and Reporting

Criteria: The State Property Control Manual provides guidelines to agencies regarding the management and record-keeping of equipment and other property. These guidelines indicate that the cost of normal repairs and maintenance are not capitalized.

Condition: Our review disclosed that two servers were incorrectly reported on the Assets Management Inventory Report CO-59 submitted to the State Comptroller. The amounts reported for the servers included maintenance costs of \$7,075 and \$3,323, respectively.

Effect: DRS did not accurately report the value of its inventory on its Asset Management Inventory Report CO-59 to the State Comptroller.

Cause: DRS incorrectly prepared the purchase order for the servers by including the maintenance costs in the total cost of the servers.

Recommendation: The Department of Revenue Services should provide training to appropriate staff concerning the proper recording of equipment inventory. (See Recommendation 12.)

Agency Response: “The department agrees with this finding. The department will review our current practices to ensure compliance in the future.”

IT Disaster Recovery Plan

Criteria: Sound business practices include provisions that organizations have controls in place to provide reasonable assurance that current disaster recovery plans exist to ensure that operations can withstand crisis and continue to operate within a reasonable period of time after a disaster.

Condition: During the audited period, we found that the department does not have a current disaster recovery plan in place for its information technology resources. The last plan was partially updated in January 2011 and has not been finalized.

Effect: The lack of a current disaster recovery plan increases the risk that the department may not be able to resume operations in a timely manner in the event of a disaster.

Cause: Ensuring that a current disaster recovery plan is in place may not be a high priority of the department.

Recommendation: The Department of Revenue Services should ensure that its disaster recovery plan is completely updated and finalized. (See Recommendation 13.)

Agency Response: “The department agrees with this finding. The department is in the process of finalizing the update of the existing disaster recovery plan.”

GAAP Reporting

Criteria: The State Accounting Manual and the State Comptroller’s Generally Accepted Accounting Principles (GAAP) closing and reporting instructions to all state agencies stipulate the procedures for completing reporting forms.

Condition: GAAP Reporting Form No. 5, Contractual Obligations, submitted by the department for fiscal year 2012 was overstated by \$324,456.

Effect: The information submitted to the State Comptroller for contractual obligations was incorrect.

Cause: It appears as though an administrative oversight contributed to the condition.

Recommendation: The Department of Revenue Services should ensure that the GAAP forms submitted to the State Comptroller are prepared accurately. (See Recommendation 14.)

Agency Response: “The department agrees with this finding. The department will review our current practices to ensure compliance in the future.”

RECOMMENDATIONS

Our prior report on the fiscal years ended June 30, 2009 and 2010 contained a total of eight recommendations. Of those recommendations, none has been implemented, resolved, or not repeated. The status of recommendations contained in the prior report is presented below.

Status of Prior Audit Recommendations:

- *The Department of Revenue Services should implement regulations requiring periodic registration for the issuance of fisherman tax-exempt permits in accordance with Section 12-412 of the General Statutes. This recommendation is being repeated. (See Recommendation 1.)*
- *The Department of Revenue Services Human Resources Unit should implement standardized written performance and review procedures relative to its investigation process. Such procedures should include documentation to substantiate the Human Resources Administrator's review of the case files prepared and agreement with the conclusions reached by staff. This recommendation is being repeated. (See Recommendation 2.)*
- *The department should implement the procedures necessary to ensure that it administers its petty cash fund in compliance with the requirements of the State Accounting Manual. This recommendation is being modified to reflect current conditions. (See Recommendation 5.)*
- *The Department of Revenue Services should establish a consistent standard for defining the postmark date to apply to payments mailed directly to DRS to ensure that they are deposited in accordance with promulgated statutes. This recommendation is being repeated. (See Recommendation 6.)*
- *The department's Audit Division should implement the procedures and/or functionality, as necessary, to ensure that its virtual audit process includes the requirement for formal and definitive signatures and/or acknowledgements to substantiate the performance of the requisite supervisory and managerial level reviews and approvals. This recommendation is being repeated to reflect current conditions. (See Recommendation 7.)*
- *The Department of Revenue Services should strengthen its internal control procedures to ensure the timely resolution of suspended transactions, with emphasis on those transactions considered either high priority and/or identified as having a potential financial impact for the state. This recommendation is being repeated. (See Recommendation 8.)*
- *The department should improve its internal controls by updating and maintaining its formal, comprehensive written procedures related to the functions of its Collection*

and Enforcement Division. This recommendation is being repeated. (See Recommendation 9.)

- *The Department of Revenue Services should establish the procedures necessary to ensure its compliance with Section 12-39aa subsection (a) of the General Statutes.* This recommendation is being repeated. (See Recommendation 11.)

Current Audit Recommendations:

- 1. The Department of Revenue Services should implement regulations requiring periodic registration for the issuance of fisherman tax-exempt permits in accordance with Section 12-412 of the General Statutes.**

Comment:

The department has not established regulations as required.

- 2. The Department of Revenue Services, Human Resources Unit should implement standardized written performance and review procedures relative to its investigation process. Such procedures should include documentation to substantiate the human resources administrator's review of the case files prepared and agreement with the conclusions reached by staff.**

Comment:

The case file documentation related to the Human Resources Unit's investigations disclosed a lack of documented evidence to support the human resources administrator's review of the case files prepared and agreement with the conclusions reached by staff.

- 3. The Department of Revenue Services should ensure that performance evaluations are performed on all of its managerial employees.**

Comment:

Our review revealed that performance evaluations were not prepared for five managers in our sample since 2008. We were also informed that evaluations were not completed for the other managers who were not in our sample.

- 4. The Department of Revenue Services should ensure that alternative work schedules are submitted and approved to comply with the Administrative and Residual (P-5) Bargaining Union Contract.**

Comment:

Our review revealed that three employees utilizing the alternative work schedule did not receive the required advance approval.

- 5. The Department of Revenue Services should ensure that employees submit travel reimbursement forms in compliance with the requirements of the State Accounting Manual.**

Comment:

Our review of petty cash expenditures revealed that in 11 cases, Form-17XR-PR was submitted late.

- 6. The Department of Revenue Services should establish a consistent standard for defining the postmark date to apply to the payments mailed directly to DRS to ensure they are deposited in accordance with Section 4-32 of the General Statutes.**

Comment:

Our review revealed that the use of the postmark date as the receipt date does not accurately reflect that deposits were made in a timely manner.

- 7. The Department of Revenue Services Audit Division should consistently follow its established policies and procedures regarding the necessary supervisory and managerial level reviews and approvals of its virtual audit files.**

Comment:

We found that throughout the Audit Division, the virtual audit files forwarded from one supervisory level to the next via email correspondence sometimes did not provide specific language referencing or otherwise acknowledging that the necessary supervisory and managerial level reviews were performed and approvals were received.

- 8. The Department of Revenue Services should strengthen its internal control procedures to ensure the timely resolution of suspended transactions, with emphasis on those transactions considered either high priority and/or identified as having a potential financial impact for the state.**

Comment:

Our test of 16 transactions selected from a listing of approximately 4,000 high priority transactions disclosed that four (25 percent) of the tested transactions were not pursued or otherwise corrected in a timely manner. The transactions were suspended for periods ranging from seventeen months to thirty months.

- 9. The Department of Revenue Services should improve its internal controls by updating and maintaining its formal, comprehensive written procedures related to the functions of its Collection and Enforcement Division and Audit Division.**

Comment:

The Collection and Enforcement Division Manual and the Audit Division Field Audit Documentation Standards Manual are outdated.

- 10. The Department of Revenue Services should consider adopting professional internal auditing standards to facilitate the operation of the Internal Audit Unit.**

Comment:

The Internal Audit Unit has not adopted professional standards as guidance in the performance of its duties. In addition, the unit has not produced in conjunction with management a risk assessment to help justify the timing and frequency of the audits performed.

- 11. The Department of Revenue Services should establish the procedures necessary to ensure its compliance with Section 12-39aa subsection (a) of the General Statutes.**

Comment:

The Department of Revenue Services has been following a practice of allowing a grace period in determining the timeliness of receipt of required tax return filings or payments when received after the prescribed period or due date.

- 12. The Department of Revenue Services should provide training to appropriate staff concerning the proper recording of equipment inventory.**

Comment:

The department included maintenance costs for two servers reported on the CO-59 submitted to the State Comptroller.

- 13. The Department of Revenue Services should ensure that its disaster recovery plan is completely updated and finalized.**

Comment:

The department does not have a current disaster recovery plan in place. The most recent plan was partially updated in January 2011.

- 14. The Department of Revenue Services should ensure the GAAP forms submitted to the State Comptroller are prepared accurately.**

Comment:

The GAAP Form No. 5 submitted to the State Comptroller for fiscal year 2012 was overstated by \$324,456.

INDEPENDENT AUDITORS' CERTIFICATION

As required by Section 2-90 of the General Statutes, we have audited the books and accounts of the Department of Revenue Services for the fiscal years ended June 30, 2011 and 2012. This audit was primarily limited to performing tests of the department's compliance with certain provisions of laws, regulations, contracts and grant agreements and to understanding and evaluating the effectiveness of the department's internal control policies and procedures for ensuring that (1) the provisions of certain laws, regulations, contracts and grant agreements applicable to the department are complied with, (2) the financial transactions of the department are properly initiated, authorized, recorded, processed, and reported on consistent with management's direction, and (3) the assets of the department are safeguarded against loss or unauthorized use. The financial statement audits of the Department of Revenue Services for the fiscal years ended June 30, 2011 and 2012 are included as a part of our Statewide Single Audits of the State of Connecticut for those fiscal years.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Department of Revenue Services complied in all material or significant respects with the provisions of certain laws, regulations, contracts and grant agreements, and to obtain a sufficient understanding of the internal controls to plan the audit and determine the nature, timing and extent of tests to be performed during the conduct of the audit.

Internal Control over Financial Operations, Safeguarding of Assets and Compliance:

Management of the Department of Revenue Services is responsible for establishing and maintaining effective internal control over financial operations, safeguarding of assets, and compliance with the requirements of laws, regulations, contracts and grants. In planning and performing our audit, we considered the Department of Revenue Services' internal control over its financial operations, safeguarding of assets, and compliance with requirements as a basis for designing our auditing procedures for the purpose of evaluating the department's financial operations, safeguarding of assets, and compliance with certain provisions of laws, regulations, contracts and grant agreements, but not for the purpose of expressing an opinion on the effectiveness of the department's internal control over those control objectives. Accordingly, we do not express an opinion on the effectiveness of the Department of Revenue Services' internal control over those control objectives.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct on a timely basis unauthorized, illegal or irregular transactions, or breakdowns in the safekeeping of any asset or resource. *A material weakness* is a deficiency, or combination of deficiencies in internal control, such that there is a reasonable possibility that noncompliance which could result in significant unauthorized, illegal, irregular or unsafe transactions and/or material noncompliance with certain provisions of laws, regulations,

contracts, and grant agreements that would be material in relation to the department's financial operations will not be prevented or detected and corrected on a timely basis.

Our consideration of internal control over financial operations, safeguarding of assets, and compliance with requirements was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial operations, safeguarding of assets, and compliance with requirements that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over the Department of Revenue Services' financial operations, safeguarding of assets, and compliance with requirements that we consider to be material weaknesses, as defined above.

Compliance and Other Matters:

As part of obtaining reasonable assurance about whether the Department of Revenue Services complied with laws, regulations, contracts and grant agreements, noncompliance with which could result in significant unauthorized, illegal, irregular or unsafe transactions or could have a direct and material effect on the results of the department's financial operations, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*. However, we noted certain matters which we reported to department management in the accompanying Condition of Records and Recommendations sections of this report.

The Department of Revenue Services' responses to the findings identified in our audit are included in the accompanying Condition of Records section of this report. We did not audit the Department of Revenue Services' responses and, accordingly, we express no opinion on them.

This report is intended for the information and use of department management, the Governor, the State Comptroller, the Appropriations Committee of the General Assembly and the Legislative Committee on Program Review and Investigations. However, this report is a matter of public record and its distribution is not limited.

CONCLUSION

We wish to express our appreciation for the cooperation and courtesies extended to our representatives by the officials and staff of the Department of Revenues Services during the course of our examination.



Andrea Evans
Principal Auditor

Approved:



John C. Geragosian
Auditor of Public Accounts



Robert M. Ward
Auditor of Public Accounts