

STATE OF CONNECTICUT

**AUDITORS' REPORT
DEPARTMENT OF REVENUE SERVICES
FOR THE FISCAL YEARS ENDED
JUNE 30, 2001, 2002, 2003, AND 2004**

**AUDITORS OF PUBLIC ACCOUNTS
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We have examined the financial records of the Department of Revenue Services for the fiscal years ended June 30, 2001, 2002, 2003, and 2004.

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.

This report on that examination consists of the Comments, Condition of Records, Recommendations and Certification which follow.

COMMENTS

FOREWORD:

The Department of Revenue Services operates principally under provisions of Title 12 (Taxation), Chapters 201, 202 and 207 - 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 examination of the Department of Motor Vehicles.

Section 12-1a of the General Statutes provides that the Department is under the direction of a Commissioner of Revenue Services. Gene Gavin served as Commissioner until February 2003 and Fred H. Lovegrove served as his Deputy Commissioner. Pamela Law was appointed Commissioner in March 2003, she continues to serve with Richard Nicholson as her Deputy Commissioner.

Legislative Changes:

Notable legislative changes, which took effect during the audited period, are presented below:

Public Act 01-6 (June Special Session), effective July 1, 2001, amended and made technical changes to numerous business, income, alcoholic beverage, cigarette, and sales and use tax statutes. Some of the details are as follows:

The Act modifies corporation business tax statutes including amending the research and development tax credits to change certain references from “cash payment” to “credit refund” for budgetary purposes, amends the due date for corporation business tax returns to the first day of the month following the Federal due date and modifies language in the insurance reinvestment fund statutes to clarify the recapture of the credit. In addition, it makes various changes to the personal income tax, such as amending the definition of Connecticut adjusted gross income, clarifying that an individual’s Federal adjusted gross income is not to be further modified in determining Connecticut adjusted gross income, provides for the taxation of non resident’s lottery winnings if over \$5,000, and provides a credit for taxes paid to another state on lottery winnings exceeding \$5,000. It also excludes income tax credits for investments in an insurance reinvestment fund and clarifies the definition of bankruptcy.

The Act amends sales and use taxes by excluding parking services in a railroad parking facility and in a severe non-attainment zone, temporarily suspends the 5.75 percent tax imposed on patient care services until July 1, 2003, caps disbursements to the State’s tourism districts and segregates a portion of room occupancy tax to fund tourism related entities. The Act exempts certain purchases by a fuel cell manufacturing facility located in Connecticut and adds Federally recognized Indian tribes to sales and use tax exemption for services rendered between business entities with a controlling interest in the other. It also extends the period for contractors to obtain a bond, extends the sales tax exemption on caskets to include those used for cremation, and allows telecommunications companies that bundle services to apply tax to the portion of the charges that are subject to the tax.

Public Act 01-102, effective October 1, 2001, amended Section 12-742 of the General Statutes to provide for an offset of any potential personal income tax refunds due to a taxpayer in default of a student loan.

Public Act 02-70, effective July 1, 2002, amended Section 12-692 of the General Statutes to include rental trucks under the motor vehicle rental surcharge.

Public Act 03-01 (June Special Session), effective from passage, June 30, 2003, made the following changes:

- Established a new tax on estates over \$1 million for deaths occurring between July 1, 2004 and January 1, 2005.
- The legislation limits the credits an insurance company may take on premium taxes.
- Established a new 24 percent corporate tax surcharge on any corporation with a tax liability of more than \$250.
- Extends the five percent gross earnings tax on cable TV companies to include satellite providers.
- The phase-out of the sales and use tax on computer and data processing services which was scheduled for July 2004 has been discontinued with the sales and use tax rate remaining at 1 percent.
- The phase-out of the tax on gifts has been delayed two years, until January 1, 2006.
- The sales and use tax on hospital patient care services has been suspended for the two year period July 1, 2001 through June 30, 2003.
- Effective April 1, 2003, the sales and use tax is restored for, advertising and public relations services, and newspaper and magazine sales.
- A loophole in the controlling interest transfer tax has been closed effective August 1, 2003.
- The property tax credit against income tax has been changed from \$500 to \$350 and the \$100 residual tax credit available to higher income taxpayers has been eliminated.
- The Act decreased the amount of 2004 calendar year adjusted gross income that qualified for exemption. In addition the annual phase-in of income exemptions through calendar year 2010 was decreased and set out in a table.
- Corporations must add back certain deductible interest in determining net income.
- The maximum supplemental tax due from a corporation filing a combined return was increased from \$25,000 to \$250,000.

Public Act 04-154, effective July 1, 2004, exempts residential property acquired through employee relocation plans from the real estate conveyance tax.

Public Act 04-201, effective July 1, 2004, enables the Commissioner of Revenue Services to enter into agreements with other States for the collection of taxes, allows the Commissioner of Revenue Services to subpoena persons or evidence. The Act also clarifies the real estate conveyance tax, increases the threshold for imposing the penalty for under paying estimated taxes, repeals the seed oyster tax, and provides a sales tax exemption for gift shops located at for profit hospitals.

Public Act 04-217, effective January 1, 2005, expands the sales tax exemption to motor vehicles transporting hazardous waste.

Public Act 04-218, effective October 1, 2004, establishes new tobacco settlement agreement requirements, reinstates a sales tax free week for certain clothing and footwear, and clarifies the health care centers tax.

RÉSUMÉ OF OPERATIONS:

General Fund Revenues and Receipts:

General Fund tax revenues, license fees and all other revenues and non-revenue receipts totaled \$8,699,699,400, \$7,854,030,180, \$8,282,874,598 and \$9,832,542,916, respectively, for the 2000-2001, 2001-2002, 2000-2003 and 2001-2004 fiscal years. General Fund tax revenues, recorded on the accrual basis, totaled \$9,449,417,756, \$8,589,997,334, \$9,001,275,557 and \$10,705,419,899 for the same periods. Revenues other than taxes included payments for licenses to collect sales and use tax and to sell cigarettes and tobacco products, serving fees and costs related to tax warrants, expenditure refunds and Federal funding.

General Fund tax refunds, budgeted as reductions of tax revenues, were \$737,658,778, \$854,480,552, \$823,347,579 and \$666,867,531 for the fiscal years ended June 30, 2001, 2002, 2003 and 2004, respectively, and were administered by the Department. Non-tax refunds totaled \$7,457, \$10,279, \$9,550 and \$2,188 during the same periods. Public Act 99-173 established a "sales tax rebate" program. Of the amount presented as tax refunds, \$750,728 represented amounts appropriated for sales tax rebate checks during 2001; there were none reported during 2002. During the fiscal year ended June 30, 2000, \$115,612,725 was appropriated for a rebate program.

A summary of tax revenues, net of refunds, for the fiscal years ended June 30, 2001, 2002, 2003 and 2004, is presented below:

(Millions)	<u>2000-2001</u>	<u>2001-2002</u>	<u>2002-2003</u>	<u>2003-2004</u>
Personal income	\$4,230	\$ 3,684	\$3,638	\$ 4,721
Sales and use	3,100	2,977	2,963	3,529
Corporations	384	147	344	405
Succession taxes	258	160	195	153
Public service companies	207	207	240	281
Insurance companies	151	166	183	178
Hospital gross earnings	0	0	24	35
Cigarettes/tobacco	119	158	254	292
Petroleum companies	75	42	108	149
Real estate/controlling interest	112	117	148	204
Alcoholic beverages	41	42	42	48
Admin. Dues & Cabaret	24	27	32	32
All other taxes	10	8	6	11
Total	<u>\$8,711</u>	<u>\$ 7,735</u>	<u>\$8,177</u>	<u>\$10,038</u>

As presented in the above analysis, net General Fund tax revenues increased by 15.2 percent during the years spanning the fiscal years ended June 30, 2001 to 2004. The increases were primarily due to rises in sales and use, corporate, tobacco, real estate and personal income tax revenues. These increases were offset in part by decreases in hospital gross earnings tax. Revenues from sales and use, and income tax receipts accounted for approximately 84.1, 86.1, 80.7 and 82.2 percent of tax revenues in total for the fiscal years ended June 30, 2001, 2002, 2003 and 2004, respectively.

General Fund Expenditures:

A summary of General Fund expenditures from Department appropriations for the fiscal years ended June 30, 2001, 2002, 2003 and 2004, is presented below:

	<u>2000-2001</u>	<u>2001-2002</u>	<u>2002-2003</u>	<u>2003-2004</u>
Personal services	\$47,998,239	\$48,620,959	\$48,775,909	\$44,734,959
Contractual services	9,295,130	9,004,413	9,140,647	8,270,323
Commodities	794,260	845,403	809,171	652,250
Sundry charges	118,110	95,945	67,901	137,679
Office Equipment	50,000	5,562	2,038	269,616
Total Budgeted Accounts	58,255,739	58,572,282	58,795,666	54,064,827
Restricted Appropriations	93,095	154,240	1,589,363	104,684
Totals	<u>\$58,348,834</u>	<u>\$58,726,522</u>	<u>\$60,385,029</u>	<u>\$54,169,511</u>

As presented above, operating expenditures decreased through the audited period. The decrease in operating costs was primarily attributable to a decrease in personal service costs as well as the elimination of the amnesty program with its associated administrative costs.

The number of filled Department positions decreased during the audited period, as compared to the previous year. The average filled positions fell from 910 for the 1999-2000 fiscal year to 743 for the 2003-2004 fiscal year. A summary of those averages is presented below:

	<u>2000-2001</u>	<u>2001-2002</u>	<u>2002-2003</u>	<u>2003-2004</u>
Full-time	801	791	747	669
Part-time or intermittent	26	21	16	20
Temporary or durational	<u>57</u>	<u>48</u>	<u>50</u>	<u>54</u>
Total	<u>884</u>	<u>860</u>	<u>813</u>	<u>743</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 to the Special Transportation Fund.

Special Transportation Fund tax revenues for the Department, recorded on an accrual basis, totaled \$460,525,134, \$473,287,864, \$455,994,266 and \$513,629,687 for the fiscal years ended June 30, 2001, 2002, 2003 and 2004, respectively. Motor carrier registration fees totaled \$310,150, \$299,740, \$301,116 and \$310,856 during the same periods.

Special Transportation Fund tax refunds, budgeted as reductions of tax revenues, totaled \$7,555,733, \$7,776,442, \$8,518,260 and \$8,792,567 for the 2000-2001, 2001-2002, 2002-2003 and 2003-2004 fiscal years, respectively, and were paid from a miscellaneous appropriation administered by the Department.

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

(Millions)	<u>2000-2001</u>	<u>2001-2002</u>	<u>2002-2003</u>	<u>2003-2004</u>
Motor fuel tax	\$354	\$368	\$375	\$416
Special motor fuel tax	45	45	62	66
Petroleum Companies	46	46	0	10
Motor carrier tax	8	7	10	13
Total	<u>\$453</u>	<u>\$466</u>	<u>\$447</u>	<u>\$505</u>

As presented in the above analysis, net Special Transportation Fund tax revenues, which totaled approximately \$453,000,000 during the 2000-2001 fiscal year, fluctuated during the audited period. The Special Transportation Fund tax revenue for the 2003-2004 fiscal year totaled approximately \$505,000,000. The fluctuations were primarily due to changes in the per gallon charge for fuel.

Funds Awaiting Distribution:

During the audited period, the Division held certain monies received in a Department suspense fund until the final disposition was determined. Receipts deposited to this account totaled \$27,827,528, \$23,410,046, \$20,369,414 during the 2000-2001, 2001-2002, 2002-2003 fiscal years, and \$20,276,425 during the 2003-2004 fiscal year. Receipts included transfers from the General Fund of room occupancy sales taxes payable pursuant to Section 32-305 of the General Statutes, security bonds required from taxpayers, and collection of New York State sales taxes pursuant to a reciprocal enforcement agreement with New York.

Disbursements totaled \$27,549,514, \$23,107,711, \$20,441,227 and \$20,358,528, respectively, during the fiscal years ended June 30, 2001, 2002, 2003 and 2004. These amounts were disbursed to the appropriate recipients of the activities described above.

Audit Assessments:

Audits were conducted by examiners within the Audit Division to ensure taxpayer compliance, as regards 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 \$353,330,326, \$429,782,136, \$403,443,132 and \$295,415,506, respectively, for the fiscal years ended June 30, 2001, 2002, 2003 and 2004. A summary of assessments by tax type for the audited period, as provided by the Audit Division, is presented below:

(Millions)	<u>2000-2001</u>	<u>2001-2002</u>	<u>2002-2003</u>	<u>2003-2004</u>
Corporation	\$104.2	\$92.8	\$ 154.8	\$ 89.1
Sales and use	114.2	236.1	129.5	108.0
Personal	75.5	61.7	69.5	51.4
Excise	5.2	5.0	6.1	11.1
Public service	53.7	34.0	30.5	23.9
Admissions, cabaret and dues	.5	.2	13.0	11.9
Total	<u>\$353.3</u>	<u>\$429.8</u>	<u>\$403.4</u>	<u>\$ 295.4</u>

Appellate Division:

The Department's Appellate Division administered 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 appeal is available to a taxpayer by means of litigation.

Appellate Division activity reports, reflecting resolution activity for the fiscal years ended June 30, 2001, 2002, 2003 and 2004 is presented below. Revisions resulted from both court and Appellate Division decisions.

	<u>2000-2001</u>	<u>2001-2002</u>	<u>2002-2003</u>	<u>2003-2004</u>
Cases resolved	1,091	1,169	1,260	1,250
Original assessments	\$143,077,112	\$113,118,035	\$236,448,862	\$162,299,731
Revised assessments	<u>67,076,550</u>	<u>55,107,185</u>	<u>116,784,208</u>	<u>70,120,513</u>
Assessment reductions	<u>\$76,000,562</u>	<u>\$58,010,850</u>	<u>\$119,664,654</u>	<u>\$92,179,218</u>
Percentage reduction	53%	51%	51 %	57 %

Accounts Receivable:

Accounts receivable of the Department emanate 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, 2001, 2002, 2003 and 2004, is presented below:

	<u>June 30, 2001</u>	<u>June 30, 2002</u>	<u>June 30, 2003</u>	<u>June 30, 2004</u>
Business and miscellaneous taxes	\$274,951,189	\$277,459,569	\$213,455,876	\$ 228,579,613
Income tax	174,969,971	197,180,775	185,602,293	189,367,301
Inheritance tax	4,705,311	5,155,227	8,456,199	5,541,704
Total	<u>\$454,626,471</u>	<u>\$479,795,571</u>	<u>\$407,514,368</u>	<u>\$423,488,618</u>
Provisions for uncollectible	<u>(144,720,238)</u>	<u>(202,034,872)</u>	<u>(216,242,314)</u>	<u>(185,326,613)</u>
Net accounts receivable	<u>\$309,906,233</u>	<u>\$277,760,699</u>	<u>\$191,272,054</u>	<u>\$238,162,005</u>

It should be noted that some of the receivable amounts presented above include amounts received and presented within our analysis of receipts, but for which related tax returns had not been filed, at fiscal years' end. The receivable balances presented reflect reductions for payments that were made on account by taxpayers to avoid the continued accrual of interest on assessments under protest. The amounts of such payments on account were approximately \$50,709,000, \$39,582,000, \$45,221,000, and \$11,278,000 at June 30, 2001, 2002, 2003 and 2004, respectively. Additionally, agency records presented credits due taxpayers (refunds payable or deferred revenues) in the amount of \$112,490,075, \$62,789,410, \$79,450,754, and \$111,085,045 at June 30, 2001, 2002, 2003 and 2004, respectively. The provision for the amounts deemed uncollectible is based on estimates of appellate and court reductions, abatements and other cancellations.

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 Tax Review Committee, comprised of the Commissioner 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 penalty waiver activity for the fiscal years ended June 30, 2001, 2002, 2003 and 2004, as provided by the Department, follows:

	<u>Requests</u>		<u>Denied Waivers</u>		<u>Approved Waivers</u>	
	<u>Cases</u>	<u>Penalties</u>	<u>Cases</u>	<u>Penalties</u>	<u>Cases</u>	<u>Penalties</u>
2000-2001	8,003	\$3,576,583	1,498	\$1,781,118	6,505	\$1,795,465
2001-2002	6,400	\$4,294,624	1,541	\$2,638,285	4,859	\$1,656,339
2002-2003	5,238	\$2,829,711	883	\$1,669,602	4,355	\$1,160,109
2003-2004	5,224	\$4,141,590	792	\$1,809,906	4,432	\$2,331,684

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 presented revenues collected by the Division to be \$124,449,226, \$141,295,924, \$144,500,343, and \$106,659,217 during the 2001, 2002, 2003 and 2004 fiscal years, respectively.

The Division, as provided by Section 12-39s of the General Statutes, is also responsible for the cancellation of the unpaid portion of erroneously or illegally assessed taxes. There were no cancellations during the fiscal years ended June 30, 2001 and 2002. The division cancelled \$303,058 and \$53,735 of such taxes respectively in the 2003 and 2004 fiscal years.

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. During the audited period, there were no abatements executed under this Section.

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 but which have yet to be included on abatement approval requests. This is due to the statutorily required seven year waiting period. During the 2000-2001 fiscal year, accounts totaling \$27,741,536 were referred to this status. In addition, accounts totaling \$17,141,092, \$15,474,696, and \$21,912,090 were referred to this status during the 2001-2002, 2002-2003 and 2003-2004 fiscal years, respectively.

The Department also utilizes a separate active suspense tax status to identify accounts receivable deemed to be temporarily uncollectible. Transfers to this status totaled \$3,317,009 during the 2000-2001 fiscal year, and \$3,143,223 during the 2001-2002 fiscal year. The subsequent fiscal years, 2002-2003 and 2003-2004, reported amounts of \$2,819,487 and \$1,489,315, respectively. The majority of accounts receivable placed in this status involve circumstances where liens or pending litigation have been pursued, which would indicate that collection at a future time may be possible.

CONDITION OF RECORDS

Late Deposit of Receipts:

Criteria: Section 4-32 of the General Statutes which generally requires that any State Agency receiving any money or revenues for the State amounting to more than \$500 shall deposit such receipts in depositories designated by the State Treasurer within 24 hours of receipt. The Office of the State Treasurer has granted the Department of Revenue Services an extensive waiver to the 24 hour deposit rule.

Condition: Despite the waiver, our review disclosed numerous instances of late deposit. The procedures for audit of the Department of Revenue Services include the examination of a test sample of deposits for compliance with prompt deposit requirements. The sample contained 8 checks totaling \$14,947,165; two of those checks were deposited between one and five days late. The late deposits totaled \$4,601,553.

Routine examination of a taxpayer file by Agency personnel discovered a check that had not been deposited. The check was received by the Department of Revenue Services on October 20, 2004. The check was discovered in the taxpayer file on February 8, 2005. The check in the amount of \$32,238 was deposited 16 weeks late.

The Connecticut Development Authority (CDA) has the authority to grant waivers to businesses for sales and use tax. The program allows for the recapture of the tax in the event the business does not meet predetermined benchmarks. CDA has the authority to assess and collect the recapture penalty. The revenue is forwarded to the Department of Revenue Services (DRS) for deposit. Four checks totaling \$162,758 which were forwarded to DRS were deposited between 12 days late and 14 months late.

Effect: Late deposits may indicate a breakdown in controls regarding safeguarding the State's assets. Revenues may not be deposited in the Agency's bank account in a timely manner. Delays in deposit result in a loss of revenue to the State. Checks left in an unsecured area may be lost.

Cause: The controls are not adequate to ensure the timely deposit of checks received.

Recommendation: The controls over the receipt of checks should be improved to ensure the prompt deposit of receipts in accordance with statutory requirements and the Agency should verify the deposit of all checks received. (See Recommendation 1.)

Agency Response: “We agree with this finding. The Department discovered the oversight and in all cases informed the Auditors of Public Accounts of the issue. The occurrence of these items was a combination of human error and system limitations, both of which have been addressed. Processes have been put in place to prevent similar incidents from happening in the future.”

Petty Cash Travel Advances:

Criteria: Petty cash requirements as set forth in the State Accounting Manual call for the reporting and settlement of employee travel advances by means of the submission of form CO-17XP-PR with the required supporting documentation. The employee is required to file the form within five working days of the return from the trip.

State travel regulations require the Agency head to verify that each person authorized to use a personally owned vehicle on official State business has a certificate of insurance on file with the Agency.

Condition: Our examination of employee travel advances revealed that for 13 of the 50 advances tested, CO-17XP-PR employee vouchers were not submitted within the required five working days. These 13 employee vouchers were filed between one and 29 working days late. The required proof of insurance was not on file for two of the vouchers.

Effect: Delays such as those presented above violate State of Connecticut travel advance requirements listed above in the “Criteria” section and delay the proper recordkeeping by the Agency. These delays may also prevent replenishment of the petty cash fund in a timely manner, jeopardize the availability of a travel advance balance adequate for Department needs, and prevent the timely return of unspent funds. Lack of verification of proper insurance coverage may leave the State with inadequate protection in the event of an accident.

Cause: We acknowledge that the Agency has instituted procedures to encourage employee compliance with the petty cash travel

regulations pertaining to the submission of travel form CO-17XP-PR. We further acknowledge that some aspects of the process are outside of the Agency's control. However, the Department apparently does not have adequate procedures in place to enforce petty cash travel regulations.

Recommendation: The Department of Revenue Services should implement procedures to monitor and ensure compliance with State of Connecticut petty cash employee travel advance requirements. (See Recommendation 2.)

Agency Response: "We agree with this finding; The Department disagrees with the *Cause* statement that, "*The Department apparently does not have adequate procedures in place to enforce petty cash travel regulations.*"

The Agency uses every means currently available to it to enforce the State's petty cash travel advance requirements. Such actions include the affixation of a preprinted label on each advance check that spells out the replenishment requirements, the issuance of weekly dunning notices to appropriate staff listing over due advances and a policy that prohibits the issuance of a new advance to an employee not in compliance with the petty cash advance requirements. Additionally, the Agency implemented a policy that does not allow petty cash advances to be issued for expenses that could be charged to a State procurement card.

Since the Agency has been historically cited for this condition, it has actively sought advice as to how it can further encourage compliance with the five day replenishment requirement. Unfortunately, it has been advised by State labor relation specialists that existing collective bargaining language severely limits the options available to the agency to encourage compliance. Specifically, progressive disciplinary actions against employees who do not or are unable to comply with the requirements would be difficult to uphold. Additionally, there was concern expressed that the agency's current practice of withholding new advances until outstanding ones are settled could be successfully challenged. It should be pointed out that the agency was severely criticized for having a long over due advance deducted from an employees pay.

The Agency believes that it has taken every action available to it to promote compliance with the five day replenishment requirement. However, as evidenced by the current finding, such actions are not sufficient to insure full compliance. As such, the Agency is

requesting assistance from the Comptroller's Office and the Auditors of Public Accounts in determining how it can increase its compliance rate."

Reporting Requirements:

Criteria: Section 12-7b of the General Statutes requires the Department of Revenue Services to compile an annual report and provide other specific tax information. The statutes also require the Department to compile and report on numerous activities of the Agency.

Section 12-39b of the General Statutes requires the Commissioner of Revenue Services to maintain the records of statements, reports and returns of taxpayers whose tax liability has come under Department audit, review, cancellation or revision in such a manner as to facilitate the identification of the taxpayer. Such records shall set forth the reasons for any cancellation or revision.

Condition: The Department of Revenue Services (DRS) is in the process of implementing a new tax computer system, the Integrated Tax Administration System (ITAS).

Our review revealed that the DRS was not able to compile and report on the activities of the Agency in a timely manner. At the end of the June 30, 2004, fiscal year the DRS was not able to provide a comprehensive report of revenue by tax type. Without the revenue detail of the tax subcategories the DRS was not able to perform a complete and timely reconciliation of revenue to the revenue reported on the Core-CT computer system of the Office of the State Comptroller. The lack of reconciliation or comparison of information between the Core-CT and ITAS systems allowed variances to go undetected which resulted in \$13,600,000 in June 30, 2004, fiscal year revenue not being journalized until the DRS was notified by the State Treasurer of a variance. At the end of our field work in April 2006 an Annual Report for the fiscal year ended June 30, 2004, had not been completed by the Department. The annual report was subsequently issued on line on July 18, 2006.

Effect: The Agency has not been able to compile the 2004 Annual Report. The ability to verify the accuracy of the information contained in the computer systems is hampered by the inability to generate reports. The effectiveness of the internal control process that controls the Agency's ability to record, process, summarize, and report financial data calls into question the Agency's ability to properly report on and safeguard the assets of the State.

The Agency is not in compliance with Section 12-7b of the General Statutes.

Cause: The Integrated Tax Administration System was unable to interface with the Core-CT. The reports produced by the ITAS computer system were not sufficient to produce annual reporting figures.

Recommendation: The Department of Revenue Services should take whatever measures necessary to comply with Section 12-7b of the General Statutes to compile an Annual Report and provide other required specific tax information. (See Recommendation 3.)

Agency Response: “We agree with this finding in part. With the exception of some of the information as prescribed by Section 12-7b of the General Statutes, the Department of Revenue Services has all of the reports required by the General Statutes. The Department is implementing a new Integrated Tax Administration System (ITAS) and as with any new system any reporting that comes out must be thoroughly tested for accuracy before it is issued. Reports are developed and changed as staff becomes more familiar with the system. This is expected whenever any new system is installed. Reports that people have become accustomed to looking a certain way may no longer look the same, but the new report will contain the same if not more beneficial information for Department management to use. In the early stages of developing the reports management had to prioritize which reports they believed were essential for running the daily operations of the Department. We are currently working on completing the Annual Report for the year in question.

The *Condition* listed is misleading; the Department was aware that there were amounts that needed to be journalized. Our first concern was to deposit the funds, the second part was the application of the amounts to the correct revenue accounts. This could not happen until all of the mapping problems and training issues with Core-CT were addressed.”

Matching of Tax Information:

Criteria: Section 12-707 of the General Statutes states that each employer that is required to deduct and withhold tax shall be liable for such tax and shall file a withholding return.

Section 12-732 of the General Statutes states that if any tax has been overpaid, the taxpayer may file a claim for refund in writing with the Commissioner of Revenue Services.

Good internal controls require that claims presented for payment be supported by adequate documentation and verified for accuracy.

The W-2 Wage and Tax Statement reports tax filer income information and the corresponding amount of tax withheld, if any. The W-2 information is entered on the tax return by the taxpayer/filer.

Condition: Although the Department performs procedures to reconcile filer tax returns and filer W-2 information, procedures are not performed to reconcile the filer W-2 information that accompanies the filer's tax return to employer records, prior to the issuance of tax refund payments.

Time and monetary constraints have prevented the Department from capturing and reconciling this information in a front end process. The Department expects the 2006 implementation of phase II of the Integrated Tax Administration System (ITAS) to allow for the comparison and reconciliation of W-2s.

Effect: Tax refund payments are generated prior to tax withholding comparison and matching procedures. Inaccurate W-2 statement information due to error or fraud may go undetected.

Cause: The Department performs procedures to reconcile filer tax returns and filer W-2 statements but does not have a procedure or program in place that compares and matches amounts reported as withheld on an employer's record to that reported by the employee as withheld in the W-2 information section of the employee's tax return.

Recommendation: The Department of Revenue Services should develop and implement additional procedures to examine and verify personal income tax information supporting taxes withheld prior to the issuance of tax refund payments. (See Recommendation 4.)

Agency Response: "We disagree with this finding. As we stated previously the Department of Revenue Services (DRS) has in place many inspection procedures to ensure that returns are accurately processed. Tax returns and W-2 withholding are reconciled when filed. The inspection procedures continue to be refined based upon our own experiences and the exchange of information between other States and other State Agencies. The DRS has additional security measures in place that have proven effective in monitoring fraud. This includes "front and backend processes" to validate discrepancies and potential errors with the return filed. Based upon

the security procedures in place and results of a prior internal study on this very issue, the DRS is confident that the State of Connecticut is adequately protected against fraud.

The DRS has also established a Business and Employment Tax Audit (BETA) Unit to specifically deal with auditing payroll tax issues. The DRS data captures the W-2 information filed with the taxpayers return and performs comparisons with information that is on file to identify those taxpayers that appear to have errors. To perform this on an individual level prior to the issuance of a refund as recommended would require that all Federal and State payroll and income tax filing requirements be changed. This would also require that the Department delay the payment of refunds until all of the information from the employers was received and processed. This would delay the issuance of refunds potentially requiring the payment of interest on the refund and inundate the Department with an insurmountable number of inquiries from taxpayers.”

*Auditor’s Concluding
Comment:*

We acknowledge that the DRS performs procedures to reconcile filer tax returns and filer W-2 information. However, procedures are not performed to reconcile the filer W-2 information that accompanies the filer’s tax return to employer records, prior to the issuance of tax refund payments. Inaccurate W-2 statement information may go undetected.

Software Inventory:

Criteria:

The *State of Connecticut’s Property Control Manual*, issued by the State Comptroller under authority granted by Section 4-36 of the General Statutes, prescribes control policies and procedures relative to the establishment and maintenance of software inventory for State agencies. The software inventory procedures set forth by the Property Control Manual are applicable to all State agencies. Among the specific procedures prescribed by the State Comptroller are the following:

The agency shall establish accounting procedures that document purchases of all software.

Each State agency will produce a software inventory report on an annual basis and these reports will be available to the Auditors of Public Accounts.

A physical inventory of the software library, or libraries, will be undertaken by all agencies at the end of each fiscal year and compared to the annual software inventory report, with the comparison retained by the agency for audit purposes.

In addition, the policy and procedures specifically states that software compliance is a legal responsibility for State agencies and non-compliance can impact the State, as the State may be held financially liable for the use of unlicensed copies of software.

It is up to the Agency to make sure that the information is readily available for management and audit purposes and is maintained with a high degree of accuracy.

Condition: The Agency does not have accounting procedures which enable it to document purchases of all software for comparison to the software inventory report.

The Agency does not prepare an annual software inventory report. The Agency utilizes electronic audit software which automatically records the software as being installed on a particular computer. The process provides a perpetual inventory record.

The Agency does not perform a physical inventory of software at the end of the fiscal year for comparison to the annual software inventory.

Effect: The Agency is not in compliance with the software inventory policy and procedures issued by the Office of the State Comptroller. The unauthorized duplication and/or use of software could occur that both constitutes infringement and creates a financial liability for the State.

Cause: The Agency maintains that they do not have the personnel to perform a physical inventory and once performed would only be good for a particular machine for a particular point in time.

Recommendation: The Department of Revenue Services should implement the internal controls necessary to ensure that its computer software inventory is maintained in accordance with the software inventory policy and procedures as set forth in the *State of Connecticut's Property Control Manual*. (See Recommendation 5.)

Agency Response: "We agree with this finding in part. The Department acknowledges that it has not conducted a formal physical inventory of its software library during the audited period nor has it produced the required annual software reports. The Department will now reinstate

procedures to conduct a physical inventory of its software library annually. The inventory results will be reconciled to the agency's procurement records and included in its Annual Property Inventory Report (CO-59) submission.

With the exceptions noted above, the Department believes that it is in compliance with every other requirement of the State's Software Inventory Control Policy and Procedures. Our Information Services Division maintains an electronic inventory of all purchased software. This electronic inventory contains all related software product information, including when it was purchased, the number of licenses for that product and whether there is media or documentation available. A software library that contains all related media and any certificates for the software is maintained in a locked, central location. The software library and electronic inventory are periodically reviewed to remove no longer used or obsolete software.

Physical inventories of PCs are in essence constantly performed electronically by two separate systems. One system is used to assure that software updates are received on a regular basis to all software loaded on an employee's computer. It also updates a central database that contains all the software loaded on a computer with product names and versions. The second system, tied directly to the ISD inventory tracking system and run less frequently, captures all installed software as well as other pertinent computer information such as brand, serial numbers, speed etc. If unauthorized or unlicensed software is found on a computer, it is immediately removed. Both the user and their supervisor are notified about this breach in policy and appropriate corrective action to deter a reoccurrence is determined."

Incomplete Penalty Waiver Report:

Criteria: Section 12-3a, subsection (a), of the General Statutes creates the Penalty Review Committee which must approve any penalty waiver in excess of \$500 authorized by the Commissioner of Revenue Services.

Section 12-3a, subsection (b), of the General Statutes requires an itemized statement of all waivers approved and makes such record available for public inspection.

Condition: Our review revealed that the DRS has annually made available for public inspection an itemized statement of all waivers approved by

the Penalty Review Committee. However, our field work performed in May 2006, determined that the itemized statement which contained 427 itemized entries that total \$1,820,262, did not include all waivers granted by the Committee. The statement dated June 30, 2004, did not include the 12 Estate Tax penalty waivers granted in the 2003-2004 fiscal year. These Estate Tax penalty waivers totaled \$66,447. Also excluded from the itemized statement were six 2003-2004 fiscal year Sales and Use Tax penalty waivers totaling \$19,284.

Effect: The Department of Revenue Services was not in compliance with Section 12-3a, subsection (b), of the General Statutes. The report furnished to the public was not complete and did not include any Estate Tax penalty waivers or certain Sales and Use Tax penalty waivers granted in the 2003-2004 fiscal year.

Cause: It appears that the record made available for public inspection was not reconciled to the activity of the Penalty Review Committee.

Recommendation: The Department of Revenue Services should take whatever measures necessary to comply with Section 12-3a, subsection (b), of the General Statutes and produce a complete statement of all penalty waivers approved by the Penalty Review Committee. (See Recommendation 6.)

Agency Response: “We agree with this finding. This was an oversight and the report has been corrected.”

RECOMMENDATIONS

Our prior report on the fiscal year ended June 30, 2000, contained a total of four recommendations. Of those recommendations, two have been implemented or otherwise resolved. The status of recommendations contained in the prior report is presented below.

Prior Audit Recommendations:

- The Department of Revenue Services should improve its internal control over receipts and implement procedures to ensure receipts are deposited promptly in compliance with statutory requirements. This recommendation is being repeated. (See recommendation 1).
- The Department of Revenue Services should improve controls over the procurement process to ensure that all statutory requirements pertaining to personal service agreements are adhered to. This recommendation is not being repeated.
- The Department of Revenue Services should improve controls over the payment process to ensure that commitments and expenditures are processed in accordance with established requirements. This recommendation has been satisfied based on current audit testing.
- The Department of Revenue Services should develop and implement additional procedures to examine and verify personal income tax information supporting taxes withheld prior to the issuance of tax refund payments. This recommendation is being repeated. (See recommendation 4).

Current Audit Recommendations:

- 1. The controls over the receipt of checks should be improved to ensure the prompt deposit of receipts in accordance with statutory requirements and the Agency should verify the deposit of all checks received.**

Comment:

Our examination of the DRS receipts revealed that receipts over \$4.7 million were held in excess of 24 hours. The receipts were held for periods ranging from one day to 14 months. The opportunity for the State Treasurer to invest idle money is hindered by such delays.

- 2. The Department of Revenue Services should implement procedures to monitor and ensure compliance with State of Connecticut petty cash employee travel advance requirements.**

Comment:

Our examination of employee travel advances revealed that for 13 advances, employee vouchers were not filed within the required 5 business days. The vouchers were filed between one and 29 business days late. Two travel vouchers did not have the required proof of insurance on file.

- 3. The Department of Revenue Services should take whatever measures necessary to comply with Section 12-7b of the General Statutes to compile an Annual Report and provide other required specific tax information.**

Comment:

Our review revealed that the DRS has not been able to compile and report on the activities of the Agency in a timely manner. At the end of the June 30, 2004, fiscal year the agency was not able to provide a comprehensive report of revenue by tax type. Without the revenue detail the Agency was not able to perform a complete and timely reconciliation.

- 4. The Department of Revenue Services should develop and implement additional procedures to examine and verify personal income tax information supporting taxes withheld prior to the issuance of tax refund payments.**

Comment:

Although the Department performs procedures to reconcile filer tax returns and filer W-2 statements, procedures are not performed to reconcile the filer W-2 statement that accompanies the filer's tax return to employer records, prior to the issuance of tax refund payments.

- 5. The Department of Revenue Services should implement the internal controls necessary to ensure that its computer software inventory is maintained in accordance with the software inventory policy and procedures as set forth in the *State of Connecticut's Property Control Manual*.**

Comment:

The Department does not have procedures in place which enable it to document purchases of all software for comparison to the software inventory report. The Department does not prepare an annual software inventory report.

- 6. The Department of Revenue Services should take whatever measures necessary to comply with Section 12-3a, subsection (b), of the General Statutes and produce a complete statement of all penalty waivers approved by the Penalty Review Committee.**

Comment:

The DRS annually makes available for public inspection an itemized statement of all penalty waivers approved by the Penalty Review Committee. Our review of the June 30, 2004, report determined it to be incomplete.

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, 2001, 2002, 2003 and 2004. This audit was primarily limited to performing tests of the Agency's compliance with certain provisions of laws, regulations, contracts and grants, and to understanding and evaluating the effectiveness of the Agency's internal control policies and procedures for ensuring that (1) the provisions of certain laws, regulations, contracts and grants applicable to the Agency are complied with, (2) the financial transactions of the Agency are properly recorded, processed, summarized and reported on consistent with management's authorization, and (3) the assets of the Agency are safeguarded against loss or unauthorized use. The financial statement audits of the Department of Revenue Services for the fiscal years ended June 30, 2001, 2002, 2003 and 2004, are included as a part of our Statewide Single Audit 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 grants 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.

Compliance:

Compliance with the requirements of laws, regulations, contracts and grants applicable to the Department of Revenue Services is the responsibility of the Department of Revenue Services' management.

As part of obtaining reasonable assurance about whether the Agency complied with laws, regulations, contracts, and grants, 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 Agency's financial operations for the fiscal years ended June 30, 2001, 2002, 2003 and 2004, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants. However, providing an opinion on compliance with these 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 that are required to be reported under *Government Auditing Standards*. However, we noted certain immaterial or less than significant instances of noncompliance, which are described in the accompanying "Condition of Records" and "Recommendations" sections of this report.

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

The management of the Department of Revenue Services is responsible for establishing and maintaining effective internal control over its financial operations, safeguarding of assets, and compliance with the requirements of laws, regulations, contracts and grants applicable to the Agency. In planning and performing our audit, we considered the Agency's internal control over its financial operations, safeguarding of assets, and compliance with requirements that could have a material or significant effect on the Agency's financial operations in order to determine our auditing procedures for the purpose of evaluating the Department of Revenue Services' financial operations, safeguarding of assets, and compliance with certain provisions of laws, regulations, contracts and grants, and not to provide assurance on the internal control over those control objectives.

However, we noted certain matters involving the internal control over the Agency's financial operations, safeguarding of assets, and/or compliance that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of internal control over the Agency's financial operations, safeguarding of assets, and/or compliance that, in our judgment, could adversely affect the Agency's ability to properly record, process, summarize and report financial data consistent with management's authorization, safeguard assets, and/or comply with certain provisions of laws, regulations, contracts and grants. We believe the following findings represent reportable conditions: late deposit of receipts, late filing of petty cash travel advances, late filing of reports, insufficient matching of tax information, insufficient software inventory and incomplete penalty waiver report.

A material or significant weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with certain provisions of laws, regulations, contracts, and grants or the requirements to safeguard assets that would be material in relation to the Agency's financial operations or noncompliance which could result in significant unauthorized, illegal, irregular or unsafe transactions to the Agency being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal controls over the Agency's financial operations and over compliance would not necessarily disclose all matters in the internal controls that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material or significant weaknesses. However, we believe that none of the reportable conditions described above is a material or significant weakness.

This report is intended for the information of 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.

Josepha M. Brusznicki
Principal Auditor

Approved:

Kevin P. Johnston
Auditor of Public Accounts

Robert G. Jaekle
Auditor of Public Accounts