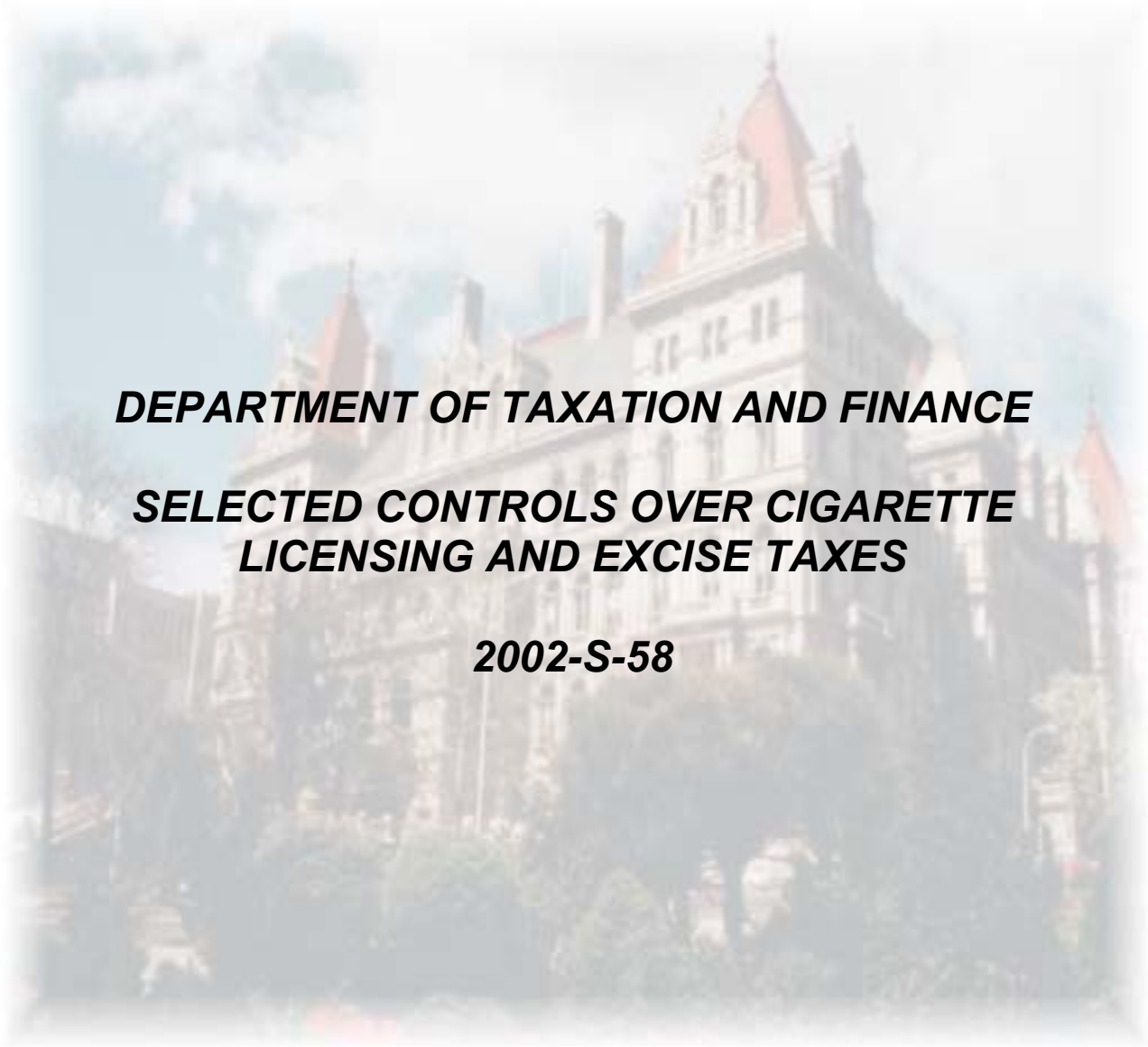
A REPORT BY THE NEW YORK STATE OFFICE OF THE STATE COMPTROLLER

Alan G. Hevesi
COMPTROLLER



DEPARTMENT OF TAXATION AND FINANCE

SELECTED CONTROLS OVER CIGARETTE LICENSING AND EXCISE TAXES

2002-S-58

DIVISION OF STATE SERVICES

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Report 2002-S-58

Mr. Andrew J. Eristoff
Commissioner
Department of Taxation and Finance
State Office Campus – Building #9
Albany, NY 12227

Dear Mr. Eristoff:

The following is our audit report addressing selected controls over cigarette licensing and excise taxes for the period January 1, 2000 through March 31, 2003.

This audit was performed pursuant to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution and Article II, Section 8 of the State Finance Law. Major contributors to this report are listed in Appendix A.

Office of the State Comptroller
Division of State Services

October 21, 2003

EXECUTIVE SUMMARY

NEW YORK STATE DEPARTMENT OF TAXATION AND FINANCE

SELECTED CONTROLS OVER CIGARETTE LICENSING AND EXCISE TAXES

SCOPE OF AUDIT

The New York State Tax Law (Law) authorizes the Commissioner of the New York State Department of Taxation and Finance (Department) to levy and collect a cigarette excise tax (excise tax) on all cigarettes for use and/or sale in New York State (State). The Department collects this tax through the sale of tax stamps (to be affixed to each pack of cigarettes) to its licensed cigarette-stamping agents. Agents subsequently sell the cigarettes, with the appropriate tax stamp (State-only or joint State/New York City) to licensed cigarette wholesalers, who then sell them to retailers for sale to the general public.

The Law requires that agents and wholesalers be licensed through the Department. The licensing function is performed by the Department's Transaction and Transfer Tax Audit Bureau (TTTB). Licenses are renewed periodically at the discretion of the Commissioner but not more than once every three years. Cigarette retailers must obtain an annual certificate of registration (C of R) through the Department's Taxpayer Services and Revenue Division (TSRD). According to the Department, there are approximately 100 agents, 300 wholesalers, and 25,000 retailers authorized to sell cigarettes in the State. A licensed cigarette agent may not sell cigarettes to an unlicensed wholesaler or to a wholesaler whose license has been suspended or revoked, or to an unlicensed retailer. The Department's Office of Tax Enforcement (Enforcement) is responsible for identifying and taking action against agents, wholesalers and retailers who are not complying with the Law. For the fiscal year ended March 31, 2003, excise tax revenue and licensing fees exceeded $1 billion.

Our audit addressed the following question relating to cigarette licensing and excise taxes in the State for the period January 1, 2000 through March 31, 2003:

- Did the Department have adequate controls over cigarette licensing and excise tax revenue?

AUDIT OBSERVATIONS AND CONCLUSIONS

We found that the Department should take some additional steps to strengthen its controls over cigarette licensing and excise tax revenues. Our audit identified a need to improve procedures to detect unregistered retailers, a need to follow up on overdue excise taxes and a need to better control the cigarette tax stamp process.

The Department has not established written procedures that require TSRD to notify Enforcement and licensed wholesalers of retailers that did not renew their C of R and who thus can no longer purchase cigarettes for resale. We identified retailers that did not renew their C of R but continued to sell cigarettes. We also found instances where New York City retailers were inappropriately selling cigarettes with a State-only stamp affixed, resulting in a loss of excise tax revenue to both the State and to New York City. In addition, one retailer, who did not have a valid C of R, was illegally selling cigarettes with no stamp affixed, which in effect was a bootleg sale where no excise tax was paid to the State. (See pp. 4-5)

Effective April 3, 2002, the State's excise tax on cigarettes increased by $.39 per pack to $1.50 for State-only stamped cigarettes and to $1.58 for joint State/New York City stamped cigarettes. As a result, it was necessary for each agent, wholesaler and retailer to determine their inventory on hand at the close of business April 2, 2002 and calculate the excise tax liability owed based on the new tax rate. The Department monitored this process by conducting its own physical inventory counts of cigarettes on hand at 98 agent locations (accounting for 93 agents) and at 13,630 retailers and wholesalers. We found, nearly one year later, that the Department did not always follow up with these agents, wholesalers and retailers to determine whether they submitted the correct amount of excise tax owed. As detailed in our report, we found many discrepancies between what the Department calculated as being owed versus what was actually remitted. As a result, there is an increased risk that the Department has not collected the total tax liability owed. (See pp. 7-9)

Tax stamps are manufactured by a private company in Illinois, and then shipped to and stored at various sites in the State. It is important, as part of an effective system of internal control, for the Department to maintain formal written procedures for safeguarding the production, distribution, and storage of its stamp inventories. In addition, the Department should conduct periodic site visits to ensure that the stamp inventory is accounted for and properly managed in accordance with established procedures. We noted that the Department needs to develop written procedures for the proper control of its stamp inventories. (See pp. 10-12)

COMMENTS OF DEPARTMENT OFFICIALS

The Department agreed with nearly all of the recommendations but took exception to our conclusions regarding the collection and follow-up on the increased excise tax.

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INTRODUCTION

Background

The New York State Tax Law (Law) authorizes the Commissioner of the New York State Department of Taxation and Finance (Department) to levy and collect a cigarette excise tax (excise tax) on all cigarettes for use and/or sale in New York State (State). The Department collects this tax through the sale of tax stamps (to be affixed to each pack of cigarettes) to its licensed cigarette-stamping agents. Agents subsequently sell the cigarettes, with the appropriate tax stamp (State-only or joint State/New York City) to licensed cigarette wholesalers, who then sell them to retailers for sale to the general public. Tax stamps are manufactured under contract by Meyercord, Inc., located in Illinois. Excise tax revenue from the sale of tax stamps to licensed agents is collected, accounted for and distributed to the State and New York City by Fleet Bank (Fleet) under contract with the State. For the fiscal year ended March 31, 2003, excise tax revenue and licensing fees exceeded $1 billion.

Effective April 3, 2002, the State's excise tax on cigarettes increased by $.39 per pack to $1.50 for State-only stamped cigarettes and to $1.58 for joint State/New York City stamped cigarettes. In addition, effective July 2, 2002, legislation allowed New York City to increase its excise tax on cigarettes to $1.50 per pack. The legislation stipulated that the State was entitled to receive 46.5 percent of the $1.50 excise tax until April 1, 2003 and 46 percent thereafter.

The Law requires that agents and wholesalers be licensed through the Department. The licensing function is performed by the Department's Transaction and Transfer Tax Audit Bureau (TTTB). Licenses are renewed periodically at the discretion of the Commissioner but not more than once every three years. The Department began an effort in 2002 to renew Agent's and wholesaler licenses. This was the first renewal since 1988. Cigarette retailers must obtain an annual certificate of registration (C of R) through the Department's Taxpayer Services and Revenue Division (TSRD). TSRD is responsible for processing applications for retailers requesting a C of R and for updating information files. Fees are $1,500 for agents and

wholesalers and $100 for retailers, respectively. According to the Department, there are approximately 100 agents, 300 wholesalers, and 25,000 retailers authorized to sell cigarettes in the State.

No licensed cigarette agent may sell cigarettes to an unlicensed wholesaler or to a wholesaler whose license has been suspended or revoked, or to an unregistered retailer. The Department's Office of Tax Enforcement (Enforcement) is responsible for identifying and taking action against agents, wholesalers and retailers that do not comply with the Law. The Law provides various penalties, including suspensions and fines, for noncompliance.

Audit Scope, Objective and Methodology

We audited selected controls of the Department over cigarette licensing and excise tax revenue for the period January 1, 2000 through March 31, 2003. Our audit focused on the accuracy of the Department's licensing and C of R records. We also audited the Department's handling of the April 3, 2002 excise tax increase and the accuracy of the revenue distribution of the joint State/City excise tax that went into effect July 2, 2002. The objective of our performance audit was to determine whether the Department has adequate internal controls over cigarette licensing and excise tax revenue.

To accomplish our objectives, we reviewed State laws, Department policies and procedures, the contract between the Department and Fleet, and the contract between the Department and Meyercord. We conducted interviews with officials from the Department and from the New York City Department of Finance regarding their monitoring and oversight responsibilities associated with cigarette licensing and excise tax revenue. We reviewed documentation and reports provided by the Department regarding the April 3, 2002 excise tax increase. We visited a judgmental sample of 81 retailers that had not renewed their C of R to verify that they were no longer selling cigarettes. In addition, we interviewed and conducted field visits to Fleet and Meyercord to assess the internal controls in place over the tax stamps.

We conducted our audit in accordance with generally accepted government auditing standards. Such standards require that we plan and perform our audit to adequately assess those

Department operations included in our audit scope. Further, these standards require that we understand the Department's internal control structure and compliance with those laws, rules and regulations that are relevant to the operations included in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgments and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions and recommendations.

We use a risk-based approach when selecting activities to be audited. This approach focuses our audit efforts on those operations that have been identified through a preliminary survey as having the greatest probability for needing improvement. Consequently, by design, finite audit resources are used to identify where and how improvements can be made. Thus, little audit effort is devoted to reviewing operations that may be relatively efficient or effective. As a result, our audit reports are prepared on an "exception basis." This report, therefore, highlights those areas needing improvement and does not address activities that may be functioning properly.

Comments of Department Officials to Audit

A draft copy of this report was provided to Department officials for their review and comment. Their comments were considered in preparing this report, and are included as Appendix B.

In addition to the matters discussed in this report, we have also reported separately to the New York City Department of Finance on the accuracy of the revenue distribution of the joint State/City excise tax that went into effect July 2, 2002.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Commissioner of the Department of Taxation and Finance shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons why.

IDENTIFYING UNREGISTERED RETAILERS

It is important for the Department to have a system in place to identify retailers who do not renew their C of R in order to verify that these retailers are no longer selling cigarettes. To do this, TSRD should monitor registration activity and inform Enforcement and wholesalers of all retail establishments that have not renewed their C of R so that appropriate action can be taken. Such controls are important as part of the Department's responsibility to monitor the selling of tobacco products in the State, to account for revenue owed the State as a result of tobacco sales, and to impose penalties where appropriate to enforce the Law.

The Department has not established written procedures that require TSRD to notify Enforcement and licensed wholesalers of retailers that did not renew their C of R and thus no longer hold a current C of R to purchase cigarettes. In addition, the Department does not routinely provide licensed wholesalers with a listing of registered retailers. As a result, appropriate action may not be taken by Enforcement against retailers who continue to sell cigarettes without a valid C of R and wholesalers may be selling cigarettes inappropriately to retailers.

According to data provided by the Department, 3,788 retailers that were registered for calendar year 2001 and/or 2002 did not renew their C of R for 2003. Using this data, we judgmentally selected a sample of 81 retailers in three geographic regions to determine whether retailers that did not renew their C of R continued to sell cigarettes. Our sample included 20 retailers in the Capital Region, 20 in the Central New York Region and 41 in the New York City area. We found that 18 of the 81 retailers that we selected were no longer in business. Of the 63 retailers still in operation, 21 (26 percent of our sample) continued to sell cigarettes without a current C of R. Since our sample was not drawn randomly, we cannot project our findings to the universe of retailers that did not renew their C of R's. However our sample does identify that more than one quarter of our test cases were selling tobacco products without a current C of R. We believe these results are significant and require the Department's immediate attention. During our visits, we also

found that four New York City retailers were inappropriately selling cigarettes with a State-only stamp affixed, resulting in a loss of excise tax revenue to both the State and to New York City. In addition, one retailer was illegally selling cigarettes with no stamp affixed, which was in effect a bootleg sale where no excise tax was paid to the State.

We provided Enforcement investigators with specifics of our sample results for their follow-up. Subsequent to the end of our audit field work, officials advised us that they were following up on our sample. In one follow-up visit, for example, Enforcement investigators found that a retailer was in fact selling cigarettes without a current C of R for 2003. This retailer had unstamped cigarettes and over 2,700 un-taxed cigars in his inventory, and this retailer was also selling alcoholic beverages without a license. Enforcement seized the inventory and issued seven summonses for criminal violations against the Tax Law and Alcohol Beverage Law.

We believe that controls over this process can be further strengthened by actions that the Department initiated but was prevented from implementing. Department officials stated that their original intention, through the passage of legislation, was to require wholesalers to confirm that retailers they sell to have a valid C of R. The Department was going to facilitate this confirmation process by publishing a list of retailers that possess a valid C of R. This legislation, however, was challenged in the court system and recently concluded in the Department's favor. The Department has developed a website for wholesalers to use for complying with this legislation, and officials expect that the website will be available to wholesalers soon.

Recommendations

1. Expedite the development of the website for wholesalers to use to confirm that retailers possess a valid C of R.

2. Develop written procedures which require TSRD to provide both Enforcement and licensed wholesalers with information identifying retailers who have not renewed their cigarette registration.

3. Continue to follow up on and investigate the exceptions disclosed during our visits to selected retailers and as appropriate impose penalties on those retailers in violation of the Law.

   (Department officials agreed with these recommendations and indicated some have been implemented.)

COLLECTION OF THE APRIL 3, 2002 FLOOR TAX

Based on the scheduled excise tax increase of April 3, 2002, it was necessary for each agent, wholesaler and retailer to determine their inventory on hand at the close of business April 2, 2002 and calculate the excise tax liability owed based on the new tax rate. If this "floor tax" liability was $200 or less, full payment was due by June 20, 2002. However, if the floor tax liability was more than $200, two installments were allowed, with the last payment due by October 21, 2002. The Department monitored the inventory being taken by conducting its own physical inventory counts of cigarettes on hand at 98 locations (accounting for 93 agents) and at 13,630 retailers and wholesalers.

The TTTB and the TSRD had overall responsibility for administering the April 3, 2002 floor tax. TTTB was responsible for conducting the inventory counts and comparing the information submitted by the agents, wholesalers, and retailers to TTTB's corresponding inspection reports. TSRD was responsible for sending out tax returns, reviewing and posting returns, following up on those retailers who chose to pay by installment, and issuing the initial delinquency notices for non-filers. Based on its inventory counts, the Department established databases to record the amount of the potential floor tax liability, and the amount actually remitted, for agents, wholesalers and retailers. The Department also established procedures, based on a specific dollar tolerance amount of the potential liability, to follow up with those agents, wholesalers and retailers that were inventoried but did not submit a floor tax return or submitted a tax return showing no liability (zero-dollar return). We found, however, that the Department did not always follow up with those who failed to file or filed a zero-dollar return but had inventory on hand as of the Department's physical inventory counts. In addition, the Department did not investigate all instances of large dollar discrepancies between its calculated potential liability and the actual amount of the remittance. As a result, there is an increased risk that the Department has not collected the total floor tax liability owed.

Department officials provided us with information from its databases showing the amount of potential liability that they had

calculated based on their physical inventory counts of April 2nd and 3rd 2002 and the actual amounts remitted. We reviewed this data for 93 agents and 49 wholesalers that were inventoried by the Department. We also judgmentally selected 174 inventoried retailers with a Department calculated potential liability greater than $1,000 showing no remittance recorded on the database. (Our sample excluded retailers and wholesalers who are part of a large chain because a combined return may have been filed under another retailer, wholesaler or agent.)

The 93 agents had a total potential liability of $11,985,418 based on the Department's inventory counts. Only one agent had been determined not to have filed a return and that agent is being assessed. Seventeen agents had discrepancies greater than $500 totaling $292,616. We determined that as of June 2003, the Department did not follow up with the agents to resolve the differences. Officials subsequently advised us that TTTB is following up with all agents to resolve any differences in the floor tax inventory.

For the 49 wholesalers that we sampled, the Department calculated, based on its physical inventories, a potential liability of $328,755. At the time of our review, four of these wholesalers did not yet file a floor tax return or filed a zero-dollar return, even though they had a potential liability according to the Department's physical inventory counts. In addition, we determined that 14 of these wholesalers had discrepancies greater than $500 totaling $81,383. For example, one wholesaler had a calculated potential liability of $40,158 but remitted only $16,341, while another wholesaler had a potential liability of $20,085 but remitted only $5,000. The Department did not follow up with these wholesalers to resolve the discrepancies. Officials subsequently advised us that they have contacted all wholesalers who did not file returns or filed a zero-dollar return, and that they are in the process of addressing any large discrepancies.

For the 174 retailers that we selected, the total calculated potential liability amounted to $341,245. At the time of our review, 100 of the 174 retailers had not yet filed a return or filed a zero-dollar return and had no remittance recorded on the database. The total potential liability for these 100 retailers is $198,745. The Department had followed up with only 42 of these retailers. In addition, 22 retailers in our sample filed a return with a discrepancy greater than $500 between the

potential liability calculated by the Department and the actual amount remitted. Total discrepancies for these 22 retailers amounted to $40,116. For example, one retailer with a potential liability of $9,516 based on the Department's physical inventory count remitted only $982. According to Department officials, they did not follow up with these 22 retailers.

In response to our preliminary audit findings, Department officials informed us that TTTB's physical inventories were meant to show the Department's presence in the field and were not meant as an enforcement tool. Department officials stated that their primary objective in conducting the inspections was to inform the public of their floor tax requirements. Officials added that their floor tax project is still ongoing. Therefore, they have concentrated on distributors that they inventoried but had yet to file or had filed a zero-dollar return. Officials advised us that although their initial focus had been on delinquent filers, they are committed to reviewing all large discrepancies and pursuing any corresponding assessments as appropriate. However, due to programming issues, reduced staffing and the volume of non-filers, project completion has been delayed and revised from April 2003 to September 2003.

Recommendations

4. Follow up with agents, wholesalers and retailers who failed to file or filed a zero-dollar return but had inventory on hand as of the Department's physical inventory counts.

5. Investigate all large discrepancies between the Department's calculated potential liability and the actual amount of remittance.

   (Department officials agree with our recommendations, but disagree with our characterization of the administration of the "floor tax" issue. They state that the issue was still being worked upon at the time of our audit. Therefore, it is unfair to judge their efforts prior to completion.)

INTERNAL CONTROLS OVER TAX STAMPS

Approximately every six to eight weeks, TTTB places a telephone order with Meyercord to produce a shipment of tax stamps. Once the stamps are produced, TTTB notifies its Midwestern Regional Office (MRO) in Chicago, Illinois, to verify the accuracy of the shipment. MRO auditors physically count and verify the serial number on each case shipped and also witness the destruction of any extra material not used in producing the stamps. After verification, Meyercord transports the tax stamps to a storage site in Albany where the tax stamps remain until requested by Fleet for distribution to the agents. The Department contracted with Fleet to provide stamp distribution and excise tax accountability services. Specifically, Fleet is responsible for accepting and preparing daily orders from agents, maintaining a master file of authorized agents, verifying agent order accuracy, maintaining a stamp inventory tracking system, processing agent payments, and maintaining other storage sites throughout the State in the event of an emergency, such as a stamp shortage. Fleet is also liable for the movement of the stamp inventory between the main distribution site, and the emergency sites.

It is important, as part of an effective system of internal control, for the Department to maintain formal written procedures for safeguarding the production, distribution, and storage of its stamp inventories. In addition, the Department should conduct periodic site visits to ensure that the stamp inventory is accounted for and properly managed in accordance with established procedures. Such actions provide accountability and give managers reasonable assurance that exposure to risk has been minimized.

The MRO is responsible for verifying each stamp production order. As such, they must physically count and verify the accuracy of the production prior to shipment. This verification involves witnessing the destruction of any extra material used in production. The MRO, however, has not been provided with formal procedures for this verification process, and TTTB officials do not make periodic visits to Meyercord to monitor the production process. During our audit, we visited Meyercord to

witness this process. We noted a significant variance between the tax stamp weights recorded by Meyercord and those recorded by the MRO auditors. According to Meyercord records, one of the pallets of State tax stamps weighed 1,045 lbs. after production; however, on the day of shipment the actual weight was recorded by the MRO auditors as 1,149 lbs., a variance of 104 lbs. Meyercord officials explained that the variance was most likely caused by the warehouse clerk writing down the wrong weight after production. Meyercord and MRO officials told us that there were no formal procedures to guide MRO auditors on how to handle identified weight variances between production and shipment, nor were formalized thresholds established for acceptable weight variances.

Although in the example cited above the shipping weight was greater than the production weight, indicating a possible error in recording the weights, we remain concerned that sufficient procedures are not in place to resolve differences. If the recorded shipping weight was less than the production weight, the MRO auditors could reasonably conclude that some of the excise tax stamps produced were missing at the time of shipment. Therefore, since the State does not collect the proper tax on the stamps until sold to licensed Agents, there is a risk that State excise revenue would be lost if the stamps were stolen and sold illegally.

In addition, we visited the six Fleet emergency sites to review controls over the storage and security of tax stamps at these sites. We interviewed the Fleet manager at all six sites and asked them to show us their formal procedures for managing the stamp inventory. None of the six managers were able to provide us with formal procedures. Furthermore, Fleet officials at the emergency sites told us that neither the Department nor Fleet management make periodic visits to determine whether the stamp inventories are being properly managed, including whether appropriate security controls are in place. Furthermore, Fleet records showed the incorrect name of the stamp custodian at two of the six emergency sites (Buffalo and Syracuse).

In response to the draft report, Department officials provided us with a copy of formal procedures to cover the management of the stamp inventory at the emergency sites. However as noted above, none of the emergency site managers had these procedures in their possession at the time of our audit and thus their value was limited. Department officials agree with the

need to update their formal procedures at Fleet's emergency sites and has updated their procedures for the Department's MRO. Additionally, officials agreed that periodic monitoring would also be incorporated into their oversight responsibilities.

Recommendations

6. Develop and provide formal written procedures to the MRO auditors for monitoring the stamp production and shipment process. Conduct periodic visits to Meyercord to determine whether MRO auditors are complying with procedures.

7. Work with Fleet officials to develop formal written procedures for managing the tax stamp inventory at Fleet's six emergency sites. Conduct periodic site visits to determine whether the stamp inventory is accounted for and properly managed in accordance with procedures.

8. Require Fleet to maintain records that accurately show the name of the stamp custodian at each emergency site.

   (Department officials agree with recommendations six and eight. They disagree with recommendation number seven, stating that procedures did exist for managing the tax stamp inventory at the emergency sites.)

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STATE OF NEW YORK
DEPARTMENT OF TAXATION AND FINANCE
W.A. HARRIMAN CAMPUS
ALBANY, NY 12227

Barbara G. Billet
Executive Deputy Commissioner

September 26, 2003

Mr. Steven E. Sossei
Audit Director
Office of the State Comptroller
110 State Street
Albany, New York 12236

Dear Mr. Sossei:

Thank you for the opportunity to comment on the findings contained in the draft audit report entitled, "Selected Controls Over Cigarette Licensing and Excise Taxes, (2002-S-58)."

The audit report reviews the Department's administration of the April 3, 2002 scheduled excise tax increase. The collection of anticipated "floor tax payments" is close to the actual remittances. The Department has collected $29.5 million in floor tax payments approaching the Division of the Budget's projection of $30.7 million prior to the tax increase.

At the time of your audit, the "floor tax" project was in the process of completion. We feel that some of the purported deficiencies that were cited existed only because we had not yet completed the corresponding phase of the project. Reviewing the completed process would have most likely resulted in more accurate conclusions and provided a basis for more relevant recommendations to improve the process.

* Note 1

We would like to note that on page one of the report, in the second paragraph, New York City increased its excise tax **to** $1.50 per pack **not by** $1.50 per pack.

* Note 2

In the segment of the report "Identifying Unregistered Retailers," a comment in the report recommends that, "Similar notification to Enforcement should be made by TTTB for those agents and wholesalers that are not currently licensed." While the Transaction and Transfer Tax Audit Bureau (TTTB) does not disagree with this proposal, they regularly notify the Office of Tax Enforcement of all cancellations and send them a monthly report of all licenses issued.

* Note 2

We dispute your assertion on page 11, in the second unnumbered paragraph, that there is a risk that State Excise Tax revenue would be lost if the recorded shipping weight of the tax stamps

* Note 3

was less than the production weight. We agree only that a possibility exists. In such a situation, pursuant to our regular practices, the auditors would contact their supervisors for appropriate instructions if they otherwise did not know how to proceed.

Recommendation 1:
Expedite the development of the website for wholesalers to use to confirm that retailers possess a valid C of R.

Response:

The Department recently made operational a website that wholesalers can use to find out whether a retailer has an active or suspended/cancelled registration. This is the same site that contract and common carriers must use in enforcing Internet law which prohibits sales of cigarettes to non-registered persons.

Recommendation 2:
Develop written procedures which require TSRD to provide both Enforcement and licensed wholesalers with information identifying retailers who have not renewed their cigarette registration.

Response:

TSRD will establish procedures to notify the Office of Tax Enforcement (OTE) of retailers who did not renew their Certificate of Registration (C of R). These procedures will document the process of identifying a retailer that did not renew their registration. Those identified will be sent a "failure to file" letter reminding them of their obligation to renew their registration. If the Department does not receive a response to this letter, the information will be referred to OTE for appropriate action.

Recommendation 3:
Continue to follow up on and investigate the exceptions disclosed during our visits to selected retailers and as appropriate impose penalties on those retailers in violation of the Law.

Response:

Enforcement has completed their investigations of these exceptions and TTTB has begun issuing assessments.

Recommendation 4:
Follow up with agents, wholesalers and retailers who failed to file or filed a zero-dollar return but had inventory on hand as of the Department's physical inventory counts.

Recommendation 5:
Investigate all large discrepancies between the Department's calculated potential liability and the actual amount of remittance.

Response:

This response addresses recommendations four and five.

The Department has followed up and investigated the instances of those who failed to file or filed a zero-dollar return but had inventory counts.

We want to correct some impressions in the draft report about the administration of the floor tax.

On page 8, in the second unnumbered paragraph, it is incorrectly asserted that the Department did not follow up with agents to resolve any large discrepancies. As OSC's auditors are aware, the floor tax effort was in process at the time of their visit. We had not reached the point in the process where discrepancies are investigated and resolved. Those matters have since been addressed as a matter of routine and were not the result of OSC's audit activity, as the report implies.

* Note 4

Every agent has been audited, or is currently under review, by our field staff. The scope of these audits includes the floor tax and other operational matters so that we may make better use of our limited resources and minimize inconvenience to the taxpayer.

The report goes on to assert on page 9, in the second unnumbered paragraph, that Department officials asserted "...that TTTB does not have the manpower to follow up on all discrepancies." We did not make this claim and do not believe it would not be cost effective for the Department to expend the resources required to do a follow-up of every return filed.

* Note 2

Recommendation 6:
Develop and provide formal written procedures to the MRO auditors for monitoring the stamp production and shipment process. Conduct periodic visits to Meyercord to determine whether MRO audits are complying with procedures.

Response:

The Department has updated its written procedures in response to the audit and distributed them to the Midwestern Regional Office (MRO).

Recommendation 7:
Work with Fleet officials to develop formal written procedures for managing the tax stamp inventory at Fleet's six emergency sites. Conduct periodic site visits to determine whether the stamp inventory is accounted for and properly managed in accordance with procedures.

Response:

Contrary to the draft report's assertion, procedures to manage the stamp inventory at the six emergency sites did exist at the time of the audit team's field visit. These procedures did require revisions which have been completed. The revised procedures have been issued and distributed to Fleet and the emergency sites.

*
Note 5

We have visited the six emergency sites to account for the entire stamp inventory.

Recommendation 8:
Require Fleet to maintain records that accurately show the name of the stamp custodian at each emergency site.

Response:

Fleet is maintaining an accurate list of the custodians at each emergency site. They report to TTTB on a monthly basis.

Sincerely,

Barbara G. Billet

Barbara G. Billet
Executive Deputy Commissioner

State Comptroller's Notes

1. We believe that the timing of our audit work allowed sufficient time for the Department to follow-up on the delinquent filers and the returns that showed large discrepancies. The returns were due on June 20, 2002, yet our fieldwork nearly one year later showed that delinquent returns had not been followed up on by the Department. The Department admitted that it had difficulties in completing the project and we fully acknowledged their response to us on page 9 of our report. Therefore, based on our observations of project completeness during our audit period, we disagree with the Department's statements and believe our conclusions and recommendations are fair, accurate, relevant and appropriate.

2. A correction has been made to our Final Report document.

3. We stated on page 11 of our report that Meyercord and MRO officials told us that there were no formal procedures to guide MRO auditors on how to handle identified weight variances between production and shipment. We further stated that if the recorded shipping weight was less than the production weight, the auditors could reasonably conclude that some tax stamps produced were missing at the time of shipment. Since the State does not collect the proper tax on the stamps until sold to licensed agents, there is a risk that State excise revenue would be lost if the stamps were stolen and sold illegally.

4. See State Comptroller Note 1. In addition, as stated on page 8 of the report, officials subsequently advised us on June 13, 2003 that TTTB is following up with all agents to resolve any differences in the floor tax liability.

5. Subsequent to the issuance of our draft report, on October 1, 2003, the Department provided us with a copy of procedures from its TTTB section. However, during our on-site visits to the six emergency locations we asked each operation manager for copies of the written procedures they use to manage the tax stamp inventory. In each instance the managers responded that they did not have any formal written procedures. In addition, when the Department responded to our preliminary finding document on March 12, 2003, they stated: "We agree to work with Fleet to implement formal written procedures for the six emergency sites". Therefore, we do not accept that valid, formal procedures were in place at the emergency sites.