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STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

March 14, 2000

Mr. Arthur Roth
Commissioner
New York State Department of
Taxation and Finance
State Campus, Building 9
Albany, NY 12227

Re: Selected Internal Controls Over Taxpayer Estimated Tax Accounts
Report 99-S-10

Dear Mr. Roth:

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, we have audited selected Department of Taxation and Finance internal controls over taxpayer estimated tax accounts. Our audit covered the period January 1, 1996 through September 30, 1999.

A. Background

The Department of Taxation and Finance (Department) administers the State's tax laws and serves as its general tax collection agent. Section 685 of the Tax Law (Law) generally requires that for a given tax year, taxpayers must have paid the lesser of 90 percent of their tax liability for that year or 100 percent of their prior year tax liability. Taxpayers who do not pay withholding tax or who do not have enough tax withheld from their paychecks to meet this liability must make estimated tax payments to satisfy the provisions in the Law. The Department's Estimated Tax unit, which is within the Processing and Revenue Management Division, maintains computer files for approximately 939,000 accounts for taxpayers' personal income tax estimated payments. Revenues from estimated tax payments for the 1998 tax year totaled $6.6 billion. The Department's Audit Division is responsible for assessing penalties to those taxpayers who do not pay enough of their tax liability during the tax year. The Department issued 53,877 penalty assessments totaling $6.4 million for the 1996 tax year, the most recent year for which this information was available at the time of our audit field work.

Estimated tax payments are due quarterly on April 15, June 15, September 15 and January 15 of each year. Taxpayers mail in their quarterly estimated tax payments to Fleet Bank (Bank), the State's contractor for this arrangement. The Bank records the estimated tax payments on its computer system and deposits the money in a State Treasury bank account. The Department receives from the Bank a daily computer tape of the estimated tax payment transactions. This tape is used to reconcile the total amount of the payment transactions to the daily bank deposit. Subsequently, the Department posts taxpayer payment information to the accounts on the Department's computer files.

Estimated tax accounts must be adjusted for necessary credit revisions and to correct inaccurate taxpayer names and social security numbers. For example, the Department's computer will automatically create a new estimated tax account if a social security number is either provided incorrectly by the taxpayer or is data-entered incorrectly by the Bank for an estimated tax payment. In these instances the Department needs to make an adjustment to negate the erroneous account and to credit the correct account. As another example, if a withholding tax payment is erroneously credited to an estimated tax account, an adjustment is necessary to decrease the balance in the estimated tax account and to credit the payment to the appropriate withholding tax account. For the 1997 tax year, the Department reported 45,601 estimated tax account adjustments with a total value of about $622 million.

To ensure account accuracy, the Estimated Tax unit receives periodic computer reports which are produced by the Department's Information Systems Management Division (ISM). Estimated Tax unit employees review account information on the ISM reports to determine whether a correcting adjustment is necessary. Based on this review, the Estimated Tax unit employees authorize such correcting adjustments.

In addition to Estimated Tax unit staff, employees of other Processing and Revenue Management Division units including the Computing unit, the Previous and Prior-Year Return unit, the Amended Return unit and the Customer Service unit can approve adjustments to estimated tax accounts. Also, staff from the Audit Division and the Tax Compliance Division have the ability to authorize adjustments. The Estimated Tax unit is not responsible for and therefore does not verify the validity of adjustments made by other units in the Processing and Revenue Management Division or in other Divisions. The Estimated Tax unit staff batch all electronic and other hard copy adjustment forms received from the various units and Divisions so that these records can be data entered and processed to update computer files of estimated tax accounts.

B. Audit Scope, Objectives and Methodology

We audited selected Department internal controls over taxpayer estimated tax accounts for the period January 1, 1996 through September 30, 1999. The objectives of our economy and efficiency audit were to determine whether estimated tax payments were deposited into the State Treasury and were properly credited to taxpayer accounts, whether adjustments to taxpayer accounts were appropriate, and whether penalties were properly assessed when taxpayers

underpaid their estimated tax liability during the tax year. To accomplish our objectives we performed various audit steps including evaluating the control environment over estimated taxes, tracing estimated tax payments received at the Bank to the State Treasury and to individual taxpayer accounts, testing the approval and support for estimated tax adjustments, reviewing the amounts of penalties assessed and following up on the status of recommendations from our previous audit of estimated tax operations (Report 88-S-16, issued September 30, 1988).

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 that are within 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 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, decisions and judgments made by management. We believe our audit provides a reasonable basis for our findings, conclusions and recommendations.

We use a risk-based approach to select activities for audit. We therefore focus our audit efforts on those activities we have identified through a preliminary survey as having the greatest potential for needing improvement. Consequently, by design, we use finite audit resources to identify where and how improvements can be made. We devote little audit effort to reviewing operations that may be relatively efficient and effective. As a result, we prepare our audit reports on "an exception basis." This report, therefore, highlights those areas needing improvement and generally does not address activities that may be functioning properly.

C. Internal Control and Compliance Summary

We identified significant internal control weaknesses related to adjustments of estimated tax accounts. We describe these weaknesses in Sections E, F, G and H of this report.

D. Results of Audit

We found that the Department accurately accounted for estimated tax revenues, and properly assessed penalties to taxpayers who underpaid estimated taxes. In addition, the Department made other improvements related to certain of the recommendations contained in our previous audit report. For example, the Department revamped its processing to match all income tax returns against the computerized estimated tax files. This enabled the Department to adjust income tax return information to account for estimated taxes that did not appear on taxpayers' returns. As a result, Department officials reported during our current audit that the amount of estimated taxes not accounted for on income tax returns was reduced by about $260 million and, consequently, fewer amended returns were filed. In addition, in our previous report, we noted that there was a significant backlog in the processing of estimated tax transactions. Department officials reported during our current audit that all transactions received are now processed upon

receipt. However, from our current audit we concluded that a strengthened control environment, as well as additional risk-based control procedures, over adjustments to estimated tax accounts were needed. These findings are discussed in more detail in the remainder of this report.

E. Control Environment

The Office of the State Comptroller (OSC) has issued Standards for Internal Control in New York State Government to guide government employees in carrying out their responsibilities to implement a good internal control system. Those standards address five specific control components: control environment, communication, assessing and managing risk, control activities and monitoring. Control environment is the attitude toward internal control and the control consciousness established and maintained by the management and employees of an organization. It is a product of management's philosophy, style, and supportive attitude, as well as the competence, ethical values, integrity, and morale of the organization's people. Control environment is unique because of its pervasive influence on all the decisions and activities of an organization. A positive control environment is the foundation for all other standards of internal control, providing discipline and structure.

We conclude that the Department management's philosophy, style and attitude with respect to internal controls over adjustments to estimated tax accounts needs to be strengthened. This strengthening would foster assurances of the overall propriety and accuracy of account adjustments. We reach these conclusions because Department management did not complete a formal risk assessment covering adjustments to estimated tax accounts and identifying the appropriate procedures and controls to effectively mitigate the risks. In addition, Department management has neither implemented certain of our prior audit report (Report 88-S-16, issued September 30, 1988) recommendations regarding the need for the authorization and verification of estimated tax account adjustments nor proposed alternative procedures. Also, during our current audit we noted the need for improved controls over the documentation needed to support adjustments. These latter two matters are discussed more fully in the sections of this report which follow.

Department officials disagree with our audit conclusions and maintain that if errors or fraud are occurring over adjustments, existing procedures are sufficient to detect these problems. We acknowledge that Department staff react to errors identified through ISM reporting and through customer inquiry. We believe, however, that the dollar value and volume of estimated tax adjustments together with the inherent sensitivity of these transactions requires further development and maintenance of a control environment which follows a rigorous standard of risk assessment and implements audit recommendations or proposes viable alternative procedures.

F. Authorizing Adjustments

Internal controls limit the number of staff who can perform sensitive transactions to those who must have this capability to perform their jobs. In addition, when transactions exceed established threshold values, internal controls often provide for an appropriate secondary review and approval for the transactions. Our prior audit report recommendations to the Department

concerning adjustments to estimated tax accounts were consistent with these internal control objectives. However, the Department did not implement these recommendations.

Department managers maintain that estimated tax account adjustments are often made to correct errors and that the dollar amounts are incidental to the transactions. Department officials indicate that, generally, any employee may be permitted to make adjustments to estimated tax accounts, and the Department does not require that transactions exceeding certain threshold values should have secondary review and approval. Consequently, we noted that clerical employees from the Estimated Tax unit solely authorized two adjustments valued at $280,000 and $171,191, respectively and a technician in the Audit Division solely authorized an adjustment valued at $216,250. In the absence of a formal risk assessment over the adjustment function and given the potential dollar value of adjustments for the approximately 939,000 accounts, the Department's level of control in this area may not provide reasonable assurance of the accuracy and integrity of these transactions.

In addition, we note that the risk associated with an inappropriate estimated tax credit adjustment is similar to the risk associated with an inappropriate refund transaction or an inappropriate credit adjustment to an income tax account. In any of these scenarios, an erroneous payment to a taxpayer may result in connection with the processing of a personal income tax return. Despite the similar risk, the Department's policy governing the authority to approve refunds or credits to income tax accounts is stricter than the policy for estimated tax account adjustments.

The policy for the former transactions is that clerical employees in the Processing and Revenue Management Division may approve transactions up to $1,000 without secondary review and approval and a technician in the Audit Division may approve transactions up to $10,000 without additional review and approval. Such controls appear to take into account the sensitivity of these transactions and the need to establish reasonable dollar value thresholds for when secondary review and approval is necessary. We recommend that the Department conduct a formal risk assessment over the estimated tax account adjustment function to establish to what extent the ability to execute adjustment transactions needs to be limited and at what dollar threshold these transactions require secondary review and approval.

G. Verifying Adjustments

Supervisory oversight and routine monitoring are elements of effective internal controls which can be used to verify the completeness, accuracy and validity of transactions and to assess the quality of performance over time. In our prior audit, we recommended that the Department establish procedures requiring an independent unit to periodically select and verify that adjustments were appropriate. We further recommended that the Department establish procedures requiring supervisors to review and approve adjustments that decrease accounts by specified amounts and to periodically review other adjustments to ensure they were correct. The intent of these recommendations was to reduce the risk that inappropriate transactions would be made and go

undetected. However, the Department has not implemented these recommendations and, therefore, no designated unit or personnel is responsible for these important control functions. Department officials told us that the function of the Estimated Tax unit is to process adjustments, not to monitor, supervise, or determine the appropriateness of these transactions.

We tested the appropriateness of a judgmental sample of 66 higher risk adjustment transactions, such as credit revisions, with a total value of $755,868. We found two instances where, due to clerical error, taxpayers inappropriately received an excess credit of $3,890 and $274, respectively. We believe that if supervisory oversight and/or routine monitoring had been in place, the errors we found may have been detected and corrected by the Department. However, we found no evidence that the Department had monitored any of the 66 adjustments or that supervisors had reviewed or verified these cases. In the two instances cited, the Department would most likely have had to learn from taxpayers that corrective action was needed. Because our sample was not statistical, we could not project the 3 percent error rate from our sample to the universe of 45,601 adjustments totaling about $622 million for the 1997 tax year.

Department policy forbids employees from accessing their own estimated tax accounts. Of necessity, it is acceptable for one employee to adjust the account of another employee. We performed a test to determine whether Department employees had adjusted their own estimated tax accounts or had inappropriately adjusted the accounts of other Department employees. In this regard, we matched Department employee names with the names of taxpayers who had accounts on the estimated tax file for the 1997 tax year. We then further identified those matches where account adjustments had taken place. In total we identified 14 adjustments made to nine employees' estimated tax accounts. Each of these 14 adjustments was supported and performed correctly by an employee other than the employee for which the account was established. We did not identify any instances where a Department employee was accessing and adjusting his own account. Although we found no exceptions in our tests, we encourage the Department to periodically perform such tests to effectively monitor for continued compliance with required policy.

H. Documenting Adjustments

Documentation should enable managers to readily trace sensitive transactions from initial authorization through execution. Although the Department does have written instructions concerning certain aspects of the documentation for estimated tax account adjustments (e.g., a glossary of terms and instructions on how to fill out hard-copy input forms), these procedures are not comprehensive. For example, the procedures neither specify what is required to fully document an adjustment nor establish the period of time for retaining such documentation.

The estimated tax files on the Department's computer do contain certain information pertaining to and documenting certain aspects of adjustments, but the files do not contain identifying information (i.e., name, title or grade level) of the employee making a particular adjustment. To establish this part of the audit trail for adjustments, therefore, depends upon the retention, retrieval and analysis of certain computer information and hard copy forms as well as follow up with various employees involved in the process. We found that the Department could not provide the

appropriate documentation to identify who authorized 3 of the 116 adjustments in our random and statistical sample. When we projected this result to the total population of 45,601 adjustments, we established a range of between 75 to 2,283 adjustments where the Department would not be able to identify the authorizing employees.

Officials told us that the Department is in the process of making changes to their computer system and that those changes may address our findings concerning inadequate documentation. Before finalizing these changes, we recommend that the Department conduct a thorough analysis to determine what enhancements are needed to ensure the availability of an adequate audit trail for documenting estimated tax account adjustments from initial authorization through execution.

Recommendations

1. *Strengthen the control environment over estimated tax account adjustments by further developing and maintaining an operating style, attitude and philosophy that focuses on formal risk assessment and implements audit report recommendations and/or establishes other alternative control procedures to mitigate risks.*

2. *Formally assess risks over adjustments to estimated tax accounts and establish controls that limit access to, establish review and approval levels for, and provide for supervisory oversights and routine monitoring over adjustments in a manner that appropriately mitigates risks. Consider our prior audit report recommendations in completing the risk assessment as well as the test we identify in this audit for checking on adjustments to the estimated tax accounts of Department employees.*

   (Department officials generally agree with recommendation number one and recommendation number two. However, officials maintain that a positive internal control environment exists over estimated tax account adjustments. In addition, Department officials do not agree that estimated tax adjustments are comparable to the issuance of refunds and require the same level of controls. They further indicate that the level of control recommended in the audit report would be costly and result in backlogs and delays and would not be warranted based upon the number and impact of errors found in the audit.)

   Auditors' Comments: Implementing the recommendations should provide greater assurances about the overall strength of the control environment. We agree that a refund transaction is not directly comparable to an estimated tax account adjustment. However, as our audit points out, one risk associated with the incorrect handling of either of these transactions is for an erroneous taxpayer payment to result in connection with the processing of an income tax return. The proper completion of the formal risk assessment that we have recommended should be the determining factor of which controls would be too costly to implement.

3. *Before finalizing current plans to enhance Department computer systems for estimated tax processing, conduct a thorough analysis to determine what enhancements are needed to ensure the availability of an adequate audit trail for documenting estimated tax account adjustments from initial authorization through execution*.

(Department officials agree with recommendation number three.)

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

Within 90 days after the 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 therefor.

Major contributors to this report were Dominick Vanacore, Arthur F. Smith, Joseph W. Quinlan, Richard Gerard, Patrick Hall, Alex Pietkiewicz and Paul Bachman.

We wish to thank the management and staff of the Department for the courtesies and cooperation extended to our auditors during this audit.

Very truly yours,

Jerry Barber
Audit Director

cc: Charles Conaway

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

JUDITH A. HARD
EXECUTIVE DEPUTY COMMISSIONER

March 7, 2000

Mr. Jerry Barber
Audit Director
Office of the State Comptroller
Bureau of Management Audits
A.E. Smith State Office Building, 13th Floor
Albany, New York 12236

Dear Mr. Barber:

Thank you for the opportunity to comment on your draft audit letter report entitled, "Selected Internal Controls Over Taxpayer Estimated Tax Accounts (99-S-10)."

We appreciate your recognition that the Department accurately accounted for estimated tax revenues and properly assessed penalties for underpayment of estimated taxes. We are also pleased with the acknowledgment of improvements made by the Department relative to recommendations contained in the previous audit report.

Recommendation 1:

Strengthen the control environment over estimated tax account adjustments by further developing and maintaining an operating style, attitude and philosophy that focuses on formal risk assessment and implements audit report recommendations and/or establishes other alternative control procedures to mitigate risks.

Recommendation 2:

Formally assess risks over adjustments to estimated tax accounts and establish controls that limit access to, establish review and approval levels for, and provide for supervisory oversights and routine monitoring over adjustments in a manner that appropriately mitigates risks. Consider our prior audit report recommendations in completing the risk assessment as well as the test we identify in this audit for checking on adjustments to the estimated tax accounts of Department employees.

Response to Recommendations 1 & 2:

We will certainly look for opportunities to strengthen the control environment over estimated tax account adjustments. However, we feel that a positive control environment already exists. A formal risk assessment, i.e., internal control review (ICR), was conducted in April of 1999 for Processing Division estimated tax functions, including account maintenance and payments processing. Internal control reviews have been done for units in the Tax Compliance Division, Audit Division and other units in Processing where estimated tax adjustments are authorized but this function has not been signaled out for an internal control review. We agree that it may be beneficial to assess the risk Department-wide.

We do not agree that estimated tax adjustments are comparable to issuance of refunds and require the same level of controls. Estimated tax adjustments generally require little or no judgment to execute and involve moving funds from one account to another, not returning overpayments to the taxpayer. The level of review recommended in your report would be very costly in terms of staff resources and would result in backlogs and delays in making adjustments. With our emphasis on customer service, this is not something we want to happen. Further, we do not believe this meets the reasonable assurance standard, that the risk incurred warrants the expense of the controls. This is especially so in light of the small number and impact of errors found in the audit.

As we indicated in the course of the audit, anyone who works a case, whether in Tax Compliance, Audit or Processing, needs to be able to take the necessary action. Therefore, staff who are authorized to collect tax due, process returns or conduct audits are also authorized to adjust estimated tax accounts. Additional controls to limit who can adjust estimated tax accounts do not appear to be warranted. We will review our position on the recommended controls after assessing the Department-wide risk.

The Office of the Deputy Inspector General will conduct periodic reviews to determine whether employees are adjusting their own accounts.

Recommendation 3:

Before finalizing current plans to enhance Department computer systems for estimated tax processing conduct a thorough analysis to determine what enhancements are needed to ensure the availability of an adequate audit trail for documenting estimated tax account adjustment from initial authorization through execution.

Response:

The Department will undertake a complete analysis in order to assess the requirements to produce an audit trail as recommended.

Sincerely,

Judith A. Hard

Judith A. Hard
Executive Deputy Commissioner

Attachment