

Audit Report

Office of the State Treasurer

July 2007



OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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Karl S. Aro
Executive Director

DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

Bruce A. Myers, CPA
Legislative Auditor

July 24, 2007

Delegate Steven J. DeBoy, Sr., Co-Chair, Joint Audit Committee
Senator Nathaniel J. McFadden, Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have audited the Office of the State Treasurer for the period beginning November 1, 2002 and ending April 30, 2006.

Our audit disclosed that the Office had implemented a number of procedures, which were initiated during fiscal years 2004 and 2005, to address deficiencies related to the reconciliation of the State's main bank accounts that were noted in our preceding audit report. In this regard, the Office identified a \$37 million difference, relating to activity prior to July 1, 2005, in which the cash balance in the Statewide accounting records exceeded the cash in the bank accounts, and the difference was written off by the State Comptroller effective June 30, 2005.

Our current review disclosed that the Office could improve controls over certain aspects of its banking services responsibilities including the bank reconciliation process. For example, we noted that, as of August 31, 2006, there were 1,165 transactions totaling \$44.4 million dollars in which agency deposits recorded in the State's accounting records had not been matched with related items on the bank's records for up to 90 days. Additionally, we found that procedures to ensure all bank accounts maintained by State agencies were authorized were insufficient.

Our audit also disclosed that there was not an adequate separation of duties over the Office's investment activities. Specifically, we found one employee performed essentially all the critical duties related to authorizing and accounting for investments. In addition, payments made for services provided by the Injured Workers Insurance Fund were not properly monitored and controls over claims paid from the State Insurance Trust Fund were inadequate. Finally, we noted a number of other procedural and internal control deficiencies in other areas, such as computer security, other funds maintained by the Office, and appropriations.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

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* Denotes item repeated in full or part from preceding audit report

Executive Summary

Legislative Audit Report on the Office of the State Treasurer July 2007

- **Despite improvement in conditions noted last audit, oversight and control over the State's bank reconciliation process could be further strengthened.**

The Office should take appropriate actions to strengthen the State's bank reconciliation process. For example, the Office should resolve unmatched deposit transactions timely and should independently verify that manual deletions from the automated match process were properly approved.

- **Deficiencies were noted in the Office's oversight of certain aspects of its banking operations. For example, the Office did not routinely analyze existing agency accounts to ensure that all accounts were authorized.**

The Office should take appropriate action to improve its oversight of the State's banking operations. For example, the Office should ensure that all State agency bank accounts are properly authorized and only with banks that currently have contracts with the State.

- **As of September 2006, portions of the contracts with the financial institution that operated lockboxes for State and the financial institution that provided disbursement services for the Office had not been finalized even though the contracts were effective July 1, 2004.**

The Office should, in conjunction with its legal counsel, promptly complete all operation agreements related to banking contracts.

- **Control over the State's investment activities was inadequate. Specifically, one employee performed all critical duties related to the State's investments, investment brokers were not always approved, and required investment broker information was not always obtained.**

The Office should take appropriate actions to improve controls over the State's investment activities.

- **The Office did not take any action to assess the propriety of amounts paid to the Injured Workers' Insurance Fund (IWIF).**

The Office should, at least on a test basis, review amounts previously paid to IWIF for propriety and, in the future, determine the propriety of amounts paid to IWIF.

- **Procedures over claims paid from the State Insurance Trust Fund, which according to the Office's records totaled \$5.6 million during fiscal year 2006, were inadequate.**

The Office should ensure that claims paid from the Fund are adequately reviewed prior to approval. The Office should also have an employee independent of the claims payment process periodically reconcile claims authorized to actual claim payments as recorded in the State's accounting records.

- **Commercial insurance policy solicitations and contract awards were not published in accordance with State law.**

The Office should procure commercial insurance policies in accordance with State law.

- **The Office had not established adequate security over withdrawals from the Local Government Investment Pool (LGIP) which is an investment vehicle for the State and local governments. For example, there was no requirement for a second authorized representative to verify the propriety of withdrawals.**

The Office should strengthen internal control requirements over withdrawals from the LGIP.

- **Sufficient security controls were not in place over significant computer applications including a minicomputer that processed financial applications including printing State of Maryland checks. For example, the firewall used to help secure the Office's network was not properly configured, administered, or monitored and critical minicomputer data and program files were not adequately protected from unwarranted modifications.**

The Office should take the recommended corrective actions to improve security over these critical applications.

Background Information

Agency Responsibilities

The Office of the State Treasurer is responsible for the receipt, disbursement, safekeeping, and investment of the funds of the State Treasury. It is also responsible for reconciling the related bank accounts, procuring banking and financial services for State agencies, and maintaining an insurance program for State property and personnel. The Office also coordinates the State's general obligation debt functions for the Board of Public Works. According to the State's records, operating expenditures for fiscal year 2006 totaled approximately \$38.9 million.

Current Status of Findings From Preceding Audit Report

We reviewed the current status of the 16 items from our preceding audit report dated December 8, 2003. We determined that the Office satisfactorily addressed 7 of these findings. The remaining 9 findings are repeated in this report, 3 of which were combined and presented as 1 finding in this report.

Criminal Conviction

On June 16, 2006, a former Office employee was indicted by an Anne Arundel County Grand Jury on thirteen counts of felony theft, felony theft scheme, fraudulent misappropriation by a fiduciary and conspiracy to commit felony theft. The indictment alleged that, between February 8, 2001 and January 2, 2004, the former employee stole monies from the Office's State Insurance Trust Fund totaling approximately \$52,424. This employee was allowed to resign in January 2004 and was paid for their unused annual leave.

On September 7, 2006, the former employee pled guilty to felony theft in the Circuit Court for Anne Arundel County. On November 2, 2006, this individual received a sentence of five years in the Anne Arundel County Detention Center with all but nine months suspended (individual was to serve one weekend in the Anne Arundel County Detention Center, and the remainder was to be served on home detention). This individual was also sentenced to two years of supervised probation following detention and substance abuse counseling as directed. The former employee had previously made full restitution to the Office.

Certain deficiencies contributing to the failure to prevent this theft are commented upon in this report (see Finding 8).

Potential Liability

The Office is involved in a dispute regarding a claim from a financial institution that it is owed certain fees, which as of September 2005 totaled \$318,000. Additional fees totaling approximately \$26,000 a month could be incurred since October 2005 since the related service has continued to be provided by the institution. Specifically, during fiscal year 2005, the financial institution billed the Office for processing transactions related to certain tax payments made over the telephone. We were advised by Office management that because the fees were not specifically included in the agreement with the institution, the Office had not paid the fees. However, in correspondence from the financial institution, the institution indicated that since the service was being provided and the fees had always been provided on a pass through basis to the State, the institution expected to be compensated.

The Office issued a final notice on December 21, 2005 that the aforementioned \$318,000 in fees would not be paid and that the financial institution had 30 days to appeal to the Board of Contract Appeals. Such action was not taken by the financial institution; however, the Office indicated that the institution still expected to be compensated for related fees. Furthermore, in 2005, the financial institution was compensated by the State for additional related fees totaling \$209,000 and the Office has not been reimbursed for these fees. We were advised that the Office has consulted with the Office of the Attorney General regarding this issue and has acted upon its advice.

Findings and Recommendations

Bank Accounts

Background

The Treasurer's authority as the custodian of the State Treasury and responsibility for the deposit and disbursement of State funds is established in the State Constitution. Accordingly, the Treasurer's Banking Services Division is responsible for procuring the banking needs for all State agencies. This responsibility includes: the maintenance of agency specific depository accounts and disbursement accounts for vendor payments, lockbox services, merchant account services, and contracts and procurements for all other agency banking needs. The Division also performs daily operations on behalf of State agencies to assure the movement of funds into and out of State bank accounts, such as processing the drawdown of funds from federal programs. The State's main bank accounts processed receipts and disbursements totaling approximately \$100 billion in fiscal year 2006.

In our preceding audit report, we commented that the Office had not adequately reconciled the State's main bank accounts with the corresponding statewide accounting records and that the State's cash balance could not be adequately determined. Subsequent to our preceding audit, the Office implemented a number of policies and procedures to address this deficiency:

- A new Director of Banking Services was hired, as was a number of additional staff, to perform the reconciliation
- The Office instituted a daily reconciliation process to monitor the accounts and to help identify and respond to processing errors in a timely manner
- The Office implemented a deposit match reconciliation process
- The Office developed and implemented numerous procedures to track various activities (for example, wire transfers)

As a result of these improved processes, the Office identified a difference of \$37 million in which the cash balance reflected in the Statewide accounting records exceeded the cash in the bank accounts. The Treasurer submitted a request to the State Comptroller to write off this difference, and the cash balance in the Statewide records was reduced by this amount effective June 30, 2005.

One of the primary problems identified in the previous audit was the Office's failure to match deposits recorded in the State's accounting records with deposits recorded in the bank's records. The deposit match process, that was subsequently developed, compared the State's records back to July 1, 2003. The Office lacked

sufficient data to perform the match for periods prior to this date. As a result, although no funds were specifically identified by the Office as missing or misappropriated, the Office cannot determine what may have been identified if a complete reconciliation had been performed.

Finding 1

Despite improvement of conditions noted last audit, oversight and control over the State's bank reconciliation process could be further strengthened.

Analysis

Although the Office's bank reconciliation process improved significantly since conditions noted in our last audit, certain areas were noted in which oversight and control could be improved.

- Unmatched deposit transactions, a component of the reconciliation process for the State's main bank accounts, were not being resolved in a timely manner. For example, the number of items related to agency deposits recorded in the State's accounting records that had not been matched with related items on the bank records for up to 90 days increased from 319 items totaling \$6.3 million at December 31, 2005 to 1,165 items totaling \$44.4 million at August 31, 2006. We also noted that there was a significant increase in the number of unmatched items recorded by the bank. While there will always be some unmatched deposit transactions at a given time due to timing differences, it is imperative that timely action be taken to resolve these items to ensure that these transactions do not represent errors or irregularities.

The increase in the number of unmatched items appears to be attributable, at least in part, to staff shortages. That is, prior to June 30, 2006, the Office used five contractual employees to work primarily on the bank reconciliation process. The contracts for these individuals were discontinued on June 30, 2006 and the Office planned to hire four permanent employees for these duties. We were advised that, as of November, 2006, all four positions had been filled and that, as of April 2007, the unmatched items had significantly declined.

- Controls over certain critical data used in the automated bank reconciliation process were inadequate. For example, 11 Office employees could manually delete unmatched deposit transactions from the automated bank reconciliation records without supervisory approval. Since only two of these employees were usually responsible for deleting the unmatched items, the number of employees with deletion capability could be reduced. In addition, although deletions were required to be approved by supervisory personnel, there was no

independent process to ensure that all deletions were subject to such review and approval. Furthermore, nine employees could initiate and post certain adjustments to the State's accounting records without independent approval, although only two of these employees generally posted these adjustments.

Once the nature of a reconciling item identified by the Office's automated reconciliation process is determined and appropriate corrective action is taken (such as the Office processing an adjustment to reduce cash transactions erroneously recorded in the State's accounting records), the item will be manually removed from the automated reconciliation records. If items are inappropriately removed, it could result in the loss of funds to the State. During February 2006, unmatched deposit items manually removed from the bank reconciliation records totaled approximately \$35 million.

Recommendation 1

We recommend that the Office ensure the timely resolution of unmatched deposit transactions. We also recommend that an independent employee verify that all manual deletions from the automated match process were properly approved. We further recommend that the Office modify the approval requirements in the State's accounting system so that all adjustment transactions must be approved by an employee other than the initiator of the transaction. Finally, we recommend that the Office restrict the capability to manually delete unmatched deposit items from the system records and the ability to process adjustment transactions to the State's accounting records to only those employees who routinely require such access to perform their job duties.

Finding 2

Deficiencies were noted in the Office's oversight of certain other aspects of its banking operations, such as not routinely analyzing existing agency bank accounts to ensure that they had been authorized.

Analysis

Deficiencies were noted in the Office's oversight of certain aspects of its banking operations. For example, our review disclosed the following conditions:

- The Office did not periodically analyze existing agency accounts to ensure that all accounts were authorized. Specifically, until March 2006, the Office had not completed any procedures to identify unauthorized agency bank accounts since 2003. In March 2006, the Office contacted all State agencies to identify their bank accounts and found 163 State agency bank accounts that

had not been approved by the Office as required. The Office directed the agencies to register the accounts with the Comptroller of the Treasury. A similar situation was commented upon in our preceding audit report. State agencies are required to obtain approval of the Office, and the Comptroller of the Treasury, prior to opening a bank account.

In addition, based on the Office's March 2006 contact with State agencies, the Office identified over 130 bank accounts that were authorized but were at banks that no longer had contracts with the State since July 2004. Although the Office notified the agencies that accounts with non-approved banks were required to be closed and reestablished at one of the financial institutions with current contracts with the State, it did not enforce this requirement by following up to ensure accounts with non-approved banks were closed. State law specifies that State agencies may only have accounts with financial institutions that have an agreement with the Office.

- The Office did not ensure that interest earned on State funds on deposit in agency bank accounts was transferred to the General Fund as required. Specifically, the Office did not maintain a record of those accounts for which earned interest was required to be transferred to the State, nor had the Office established a methodology to determine that interest was being transferred to the State. We noted that 7 of the 10 banks that have contracts with the Office did not periodically remit interest earnings to the Office for transfer to the General Fund. Deposits with these banks totaled approximately \$28 million as of January 31, 2006. Contracts between the Office and the banks used by State agencies to deposit State funds require each bank to invest funds for State agency accounts and to remit interest earnings to the General Fund (via the State's main depository account). A similar situation has been commented upon in our five preceding audit reports dating back to September 1993.
- The Office did not ensure that available cash balances from lockbox accounts were transferred daily to the State bank account for investment. Furthermore, the Office did not require agencies to justify why they did not elect to use an auto wire feature, whereby the available balance in lockbox accounts would be automatically transferred daily to the State bank account. Our test of eight agency lockbox accounts disclosed two cases in which agencies did not transfer funds to the State bank account for extended periods. One of these agencies did not transfer any funds from its lockbox for 55 days and then transferred approximately \$1.5 million to the State's account. Funds held in the lockbox accounts do not earn interest on behalf of the State. A similar condition was commented upon in our preceding audit report. The Office's

lockbox contract allows agencies to select an automatic transfer process so that the contractor transfers the available balances each day to the State's depository bank account. Agencies may also elect to transfer the funds themselves. However, agencies were not required to justify why they did not elect the automatic transfer process. As of April 2006, there were 31 agency lockbox accounts under this contract with an average daily balance of \$17 million.

- The Office's procedures to ensure bank accounts were adequately collateralized were not always comprehensive. For example, for one bank, the Office compared the collateral pledged to secure State deposits to the average daily balance of funds on deposit with the bank. However, this comparison would not necessarily detect instances in which the highest daily balance on deposit with the bank exceeded collateral pledged to secure the deposits.

Recommendation 2

We recommend that the Office take appropriate action to improve its oversight of the State's banking operations. Specifically, we recommend that the Office periodically ensure that all State agency bank accounts are properly authorized and only with banks that currently have contracts with the State. We also again recommend that the Office ensure that all interest earned on State funds on deposit in agency bank accounts is transferred to the General Fund as required. Additionally, we again recommend that the Office ensure that the available cash balances of the lockbox accounts are transferred into the State's depository account on a daily basis.

Furthermore, we recommend that the Office require State agencies that elect not to use the automatic transfer process to provide written justification for this decision to the Office. If sufficient justification is not provided, the Office should require the agency to use the automated transfer process. Finally, we recommend that the Office ensure that all bank accounts are fully collateralized.

Finding 3

As of September 2006, all portions of banking contracts had not been finalized even though the contracts were effective July 1, 2004.

Analysis

As of September 2006, portions of the contracts with the financial institution that operated lockboxes for State agencies and the financial institution that provided disbursement services (\$100 billion in disbursements for fiscal year 2006) for the Office had not been finalized even though the contracts were effective July 1,

2004. Specifically, the main contract documents refer to various contractors' operating agreements. These documents were prepared by the contractors and submitted to the Office for approval. However, as of September 2006, the Office's legal counsel was still in the process of reviewing and modifying the operating agreements prepared by the contractors. The contracts covered a 3-year period and contained two 2-year renewal options.

The operating agreements govern significant portions of the State's banking operations. For example, the proposed operating agreement prepared by the financial institution that provides funds transfer (wire transfers) services stated that, if the State does not notify the contractor of errors within 30 days, the contractor is not liable for the error. The Office's legal counsel maintains that the State should have 90 days to identify errors and that the contractor should still be liable for errors even if the State does not promptly detect them. Legal counsel has also objected to various provisions in other operating agreements, which have not been finalized, that limit the contractor's liability. If a dispute arose concerning provisions of the operations governed by the proposed operating agreements, the State's interests could be at risk. Although the Office maintains that the operating agreements are not significant, the Office did indicate that it would consider prohibiting the use of supplemental bank operating agreements in future banking procurements.

Recommendation 3

We recommend that the Office, in conjunction with its legal counsel, promptly complete all operating agreements related to the banking contracts. We also recommend that, in the future, the Office ensure that essential contract requirements are specified in the related solicitation documents and finalize contracts before they become effective.

Investments

Finding 4

One employee had virtually complete control over the State's investment activities, investment brokers were not always approved, and required investment broker information was not always obtained.

Analysis

During the audit period, one employee performed essentially all the critical duties related to authorizing and accounting for the State's investments. Specifically, this employee contacted investment brokers each day to determine the interest rates investment brokers would pay on the State's cash to be invested, selected the

broker(s) for investment, and generally authorized the investment transactions. In addition, this employee controlled the recording of the investments and related redemptions in the State's accounting records. Although the Office's written policy required certain investment documents to be independently approved, in most instances that we reviewed, this employee also executed the approval of the investment transactions by stamping the document with a signature stamp of the Treasurer's signature. Finally, this employee maintained the Office's detail records of outstanding investments and verified that the proper amount of investment income and principal was received for all investments and transferred to the State's disbursement account. According to the State's records, as of December 31, 2005, State investments for which this employee was responsible totaled approximately \$6.5 billion.

We also noted that required broker-dealer information was not on file. For example there were no audited financial statements on file for the more than 20 broker-dealers with outstanding investments. The Office's investment policy requires that dealers authorized to provide investment services to the State must provide audited financial statements before initiating transactions and annually thereafter. The Office's investment policy indicates that audited financial statements must be obtained to ensure that the firms have adequate capital to fulfill their commitments under adverse conditions. We also noted that broker-dealers were not always approved by the Treasurer, as required, and that certain broker-dealer agreements did not indicate the names of the Office's employees authorized to execute transactions.

Recommendation 4

We recommend that the Office define the authority and responsibilities of the Office's investment personnel and that the responsibilities for transaction authority and the related accounting, and record keeping be separated. In addition, we recommend that independent supervisory personnel be required to authorize all investment transactions. We also recommend that the Office obtain and review audited financial statements from brokers-dealers on an annual basis and prior to initiating transactions with any new broker-dealers. Finally, we recommend that the Office only invest funds with approved broker-dealers and that investment agreements specify the Office employees authorized to execute investment transactions.

Injured Workers' Insurance Fund (IWIF)

Background

Under the terms of a 1990 agreement between the IWIF and the Board of Public Works (BPW), IWIF provides claims processing services for workers' compensation claims filed by State employees. The State is self-insured for such claims. The agreement provides that the State Treasurer's Office is responsible for administering the agreement, on behalf of the Board.

As required by the agreement, at the start of each fiscal year, the Office sends a payment to IWIF for State workers' compensation claims for the upcoming year. The payment includes an amount to pay for anticipated workers' compensation claims and an amount for IWIF's administrative costs associated with providing claims processing services to the State. Payments for anticipated claims are based on the actual amount of claims paid, as reported by IWIF, in a prior fiscal year. Payments for administrative costs are based on the Office's proportionate share of IWIF's administrative costs (allocated based on the State's proportionate share of actual losses incurred by the State to actual losses incurred by all insureds of IWIF, including the State). According to the Office's records, during fiscal years 2004 through 2006, payments to IWIF for workers compensation claims and administrative costs totaled \$137.4 million (\$105.3 million for claims, \$30.6 million for administrative costs and an additional \$1.5 million for costs related to the State's risk management program). Claim and administrative costs are recovered through State agency assessments prepared by the Office.

In addition, based on funds included in the State budget, the Office makes payments to IWIF to reduce the State's long-term liability for workers' compensation claims. The long-term liability is the difference between what actuaries have determined is adequate to cover future liability and amounts the State has transferred to IWIF for the liability. According to its records, during fiscal year 2006, the Office paid \$10 million to IWIF to reduce the unfunded liability, which according to IWIF's actuary is estimated at \$230 million as of June 30, 2006.

Finding 5 (Policy Issue)

The services provided by IWIF have not been subject to a competitive bid process and the appropriateness of making advance payments to IWIF has not been adequately assessed.

Analysis

Certain aspects pertaining to the use of IWIF for claims processing services have not been analyzed to determine if they are the most beneficial to the State.

- The contract with IWIF to administer all workers' compensation claims filed against the State has been in effect for over 16 years and has not been subject to a competitive bid process. (We were advised by Office management that these claims processing services have never been competitively bid.) Since this contract was entered into, IWIF has become more autonomous from the State. For example, the requirement that the State Treasurer be the custodian of the IWIF was repealed from State law effective October 1, 2000. Office management advised us that obtaining competitive bids was not considered because the contract with IWIF was approved by BPW and because using IWIF to process workers' compensation claims has been a long-standing practice. While competitive bids are not required for contracts between units of State government, considering the significant amounts paid to IWIF annually (\$10.9 million for administrative costs in fiscal year 2006), as well as the availability of this service from private insurance companies, we believe that a competitive bid process should be used to determine if the State is receiving a fair price for services rendered.
- There was no apparent reason for the State to allow IWIF to hold funds in reserve for its long-term workers' compensation liability rather than maintaining the funds in the State Treasury. As of August 30, 2006, according to information received from IWIF, State funds on deposit with IWIF for the State's long-term workers' compensation liability totaled \$25 million in an account that is interest bearing to the State. Officials in the Office could not provide any reasonable justifications for this practice. Consequently, it was unclear as to the benefit to the State to have IWIF hold the funds as opposed to allowing the funds to be held and invested by the Office.

Under the contract, IWIF is responsible for investigating, defending, and making payment for claims that the State is legally obligated to pay for damages resulting from bodily harm to or death of an employee of the State, resulting from the employee's employment, such as it would for other clients. The contract provides that the State can terminate the contract for any reason after giving IWIF 90 days written notice.

Recommendation 5

We recommend that the Office, in conjunction with BPW, consider obtaining competitive bids for the claims processing services for workers' compensation claims filed by State employees, and take the necessary actions to ensure that these services are obtained in the manner that is most

beneficial to the State. We also recommend that the Office determine the appropriateness of allowing IWIF to hold funds in reserve.

Finding 6

The Office did not adequately monitor the agreement to ensure the propriety of amounts paid to IWIF.

Analysis

The Office did not take any action to assess the propriety of amounts paid to IWIF. Essentially, the Office's only involvement with the agreement was to make payments to IWIF and to recover the assessments from State agencies.

- The Office did not verify that claims reported by IWIF were for actual payments made on behalf of State employees who suffered work-related injuries. Since claims reported by IWIF serve as the basis for payments of approximately \$40 million per year to IWIF, it is essential that the Office verify the propriety of the reported claims.
- Administrative costs requested by, and paid to, IWIF were also not subject to independent verification. Specifically, the Office did not receive documentation that the administrative costs billed by IWIF properly represented the State's share of total administrative costs incurred by IWIF. Since such amounts exceeded \$30 million over a three-year period, these costs should also be periodically verified.
- Although, under the terms of the agreement, amounts paid to IWIF shall be held in a separate account and the State is to receive interest earned on money on deposit with IWIF, the Office did not verify that the State received all interest to which it was entitled. Since the Office pays IWIF at the start of each fiscal year and claims would be expected to be paid throughout the year, interest earnings could be significant.

Recommendation 6

We recommend that the Office, at least on a test basis, review amounts previously paid to IWIF for propriety and, in the future, determine the propriety of amounts paid to IWIF. This verification should be documented and include a review of appropriate supporting documentation such as evidence of amounts paid for injured State workers and documentation of the propriety of administrative costs billed by IWIF. We also recommend that the Office verify that the State receives all interest to which it is entitled.

Unpresented Bond and Coupon Fund

Finding 7

The amount owed to bond holders for unpresented bonds exceeded the cash balance of the Fund by approximately \$645,000 and unredeemed bond funds were not transferred to the Comptroller's Abandoned Property Fund, as required.

Analysis

As of June 30, 2006, the Office's records indicated that the total balance of the amounts owed to bond holders for previously matured bonds, exceeded the cash balance of the Fund by approximately \$645,000 and the Office could not adequately explain the difference. Consequently, the Office may not have adequate resources in the Fund to cover outstanding bond liabilities in the event that all outstanding bonds are presented for payment. In addition, the Office had not been reimbursed for approximately \$200,000 (principal and accrued interest) paid to a bondholder in April 2005 for bearer bonds presented for payment that were issued in 1975 and matured in 1986. Office management advised that it should be reimbursed by one of its paying agents for this amount since funds to redeem the bonds were never transferred to the Office.

We also noted that the Office did not transfer funds for unredeemed general obligation bonds to the Comptroller of the Treasury's Abandoned Property Fund during the period under review. As of August 2006, according to the Office's records, most of the money in the Unpresented Bond and Coupon Fund related to bonds that matured more than three years prior to that date and, in accordance with State law, should have been transferred to the Abandoned Property Fund maintained by the Comptroller of the Treasury and be subject to transfer to the State's General Fund. Certain amounts have remained in the Fund for over 10 years. State law also provides that unclaimed funds are to be transferred from the Abandoned Property Fund to the General Fund annually. A similar condition was commented on in our preceding audit report. Office management advised us that the funds will not be transferred to the Comptroller as abandoned property until the aforementioned discrepancy in the Unpresented Bond and Coupon Fund is resolved.

The Unpresented Bond and Coupon Fund is used to account for funds returned to the Office by the paying agent for bonds that have matured but have not been presented for payment by the bondholders for at least 12 months. As of June 30, 2006, the cash balance of the fund, according to the records of the Comptroller of the Treasury, was approximately \$2.8 million.

Recommendation 7

We recommend that the Office resolve the discrepancy in the Unpresented Bond and Coupon Fund. Additionally, we recommend that the Office take the necessary action to obtain reimbursement for the \$200,000 paid to the above mentioned bondholder. We also again recommend that the Office transfer those funds deemed to be abandoned in the Unpresented Bond and Coupon Fund to the Comptroller's Abandoned Property Fund as required by State law.

State Insurance Trust Fund

Finding 8

Internal controls over claims paid from the State Insurance Trust Fund were inadequate.

Analysis

Our review of procedures over claims paid from the State Insurance Trust Fund which, according to the Office's records, totaled \$5.6 million during fiscal year 2006, disclosed certain internal control deficiencies.

- Although all claims paid from the Fund were included in disbursement transmittals that were subject to supervisory review and approval, the review process was not comprehensive. As previously noted in this report, a former Office employee pled guilty to stealing approximately \$52,000 from the State Insurance Trust Fund between February 2001 and January 2004. A comprehensive review of the transactions by supervisory personnel should have raised questions prior to processing the payments since most of the fraudulent payments were in the name of the former employee's spouse. We were advised by senior management personnel that the review performed was not as thorough as it should have been.
- The Office did not reconcile claims authorized for payment in the Insurance Division's automated claims processing system to claim payments actually made according to the State's accounting records. As a result, claim payments that were not authorized by the Insurance Division may not be detected. Since the aforementioned fraudulent payments were not recorded in the Insurance Division's claims processing system, a reconciliation of actual claim payments made according to the State's accounting records to the system would have detected the payments.

The State Insurance Trust Fund is a self-insurance program designed to cover State agencies and employees for claims related to property, motor vehicles, torts, and officer and employee liability.

Recommendation 8

We recommend that individuals responsible for reviewing and approving disbursement transactions, including claims paid from the Fund, perform a comprehensive review prior to approval. We also recommend that an employee independent of the claims payment processing function periodically reconcile claims authorized in the claims processing system with claim payments actually made, as recorded in the State’s accounting records.

Finding 9

Commercial insurance policies were procured without publicly advertising solicitations and publishing contract awards.

Analysis

The Office procured commercial insurance policies without publicly advertising solicitations and publishing contract awards. State law authorizes the Treasurer to purchase commercial insurance and specifies that the insurance be obtained in accordance with State procurement law. Based on the Office’s records, fiscal year 2006 premiums for policies procured by the Office totaled approximately \$18 million.

To procure insurance policies, the Office contracted with commercial insurance brokers who solicited quotes from insurance carriers, evaluated the quotes received from the carriers and recommended which carrier to select. The Office then approved the brokers’ selections. According to officials from the Office, due to the complexities of the commercial insurance market and the difficulty in obtaining insurance for certain State assets (such as bridges and tunnels), it would be impractical to procure commercial insurance without using brokers. Nevertheless, the Office could take certain actions to comply with the intent of State procurement law and regulations. Specifically, the Office could require that insurance brokers publicly advertise the solicitation of new policies and the award of contracts.

Recommendation 9

We recommend that the Office procure commercial insurance policies in accordance with the requirements of State procurement law by requiring that contract solicitations and awards be published.

Local Government Investment Pool (LGIP)

Finding 10

The Office had not established adequate security over withdrawals from the LGIP.

Analysis

Although the fiscal agent for the LGIP required participants to indicate the designated account to which withdrawals from the LGIP are to be paid as well as those authorized to withdraw funds, there was no requirement for a second authorized representative (that is, dual control) to verify the propriety of withdrawals as well as changes to the participation agreement. Furthermore, even though the participation agreements designate the specific bank account for a withdrawal to be paid to, based on an audit of one of the participants (a Register of Wills), we noted that an authorized representative could independently change the designated account for withdrawals from the LGIP.

The LGIP is established in State law to provide an investment vehicle for available funds of the State and local governments. The Treasurer is responsible for the administration of the LGIP. As allowed by law, the Treasurer has contracted with a fiscal agent to perform investment and administrative services. Based on documents provided by the Office, as of April 30, 2006, the LGIP totaled approximately \$1.85 billion, including State investments totaling \$164 million. There are over 600 LGIP sub-accounts established for various entities including counties, cities, towns, libraries, schools, volunteer firemen entities, and Registers of Wills.

Recommendation 10

We recommend that the Office strengthen internal control requirements over withdrawals from the LGIP. Specifically we recommend that the Office require the fiscal agent to ensure that at least two authorized representatives of the participating entity execute any agreements or changes to agreements. Furthermore, we recommend that any withdrawals to be credited to any account other than the account that is identified in the participation agreement be validated by a second authorized representative of the participating entity.

Unpresented and Undeliverable Checks

Finding 11

Certain unpresented checks were not credited to the Unpresented Check Fund, and the Office could not adequately document that sufficient funds were transferred from both the Unpresented and Undeliverable Check Funds to the General Fund in accordance with State law.

Analysis

As of July 20, 2006, checks issued during fiscal year 2003 totaling approximately \$6 million that were never presented for payment were not credited to the Unpresented Check Fund as required by State law. We were subsequently advised by the Office that these checks were credited to the Unpresented Check Fund. A similar condition was commented upon in our preceding audit report. Additionally, the Office could also not adequately document that sufficient funds were transferred from the Unpresented Check Fund to the General Fund at the end of fiscal years 2005 and 2006 in accordance with State law. For example, the Office transferred \$4.5 million to the General Fund at the end of fiscal year 2006. However, this left a balance of \$2 million in the fund which appeared excessive since disbursements from the fund averaged \$500,000 per year for the period of fiscal years 2003 through 2006. State law requires that the Treasurer identify each check that remains unpresented for two years and credit these funds to the Unpresented Check Fund. Furthermore, the Annotated Code requires the Treasurer to determine a reasonable balance that will be needed to honor each check that is presented after its balance has been credited to the Fund, and transfer the remaining balance to the General Fund at the end of each fiscal year.

Additionally, the Office could not adequately document that sufficient funds were transferred from the Undeliverable Check Fund to the General Fund at the end of fiscal years 2005 and 2006. For example, at the end of fiscal year 2006, the Office transferred \$341,625 from the Undeliverable Check Fund to the General Fund. However, we noted that the balance remaining in the Undeliverable Check Fund at the end of fiscal year 2006 (\$2.5 million) appeared excessive since disbursements from the fund (for reissued checks) averaged only \$600,000 per year for fiscal years 2003 through 2006 and transfers to the Fund have historically exceeded Undelivered Check Fund disbursements. State law requires the Treasurer to cancel a check returned as undeliverable and that the Comptroller credit the amount of the canceled check to the Undeliverable Check Fund. Furthermore, the law requires the Treasurer to determine a reasonable balance that will be needed to honor replacement check requests and transfer the remaining balance to the General Fund at the end of each fiscal year.

Recommendation 11

We again recommend that the Office ensure that checks which remain unrepresented for two years are identified, and that the related funds are transferred to the Unrepresented Check Fund, and ultimately to the State's General Fund, as required by State law. We further recommend that, at the end of each fiscal year, the Office determine a reasonable balance to remain in both the Unrepresented Check Fund and the Undeliverable Check Fund and transfer all remaining amounts to the General Fund and that the Office retain documentation supporting how these balances were determined.

Information Systems Security and Control

Background

The Office operated an internal computer network supporting file and print sharing, email, and Internet connectivity. The Office also operated a minicomputer that processed financial applications, including the printing of State of Maryland checks for vendor invoice payment, public assistance, child support, and retirement benefits. These check disbursements total several billion dollars annually.

Finding 12

The firewall used to help secure the Office's network was not properly configured, administered, or monitored.

Analysis

The firewall used to help secure the Office's network was not properly configured, administered, or monitored.

- Firewall rules allowed unnecessary connections from the Internet to critical Office internal network devices. Accordingly, the Office network was unnecessarily exposed to attack, which could result in a loss of data integrity, the destruction of critical files, or the interruption of services.
- Remote connections for administration of the firewall were made using insecure connection protocols and were not restricted to originating from only authorized firewall administrators. As a result, administration of the firewall could be compromised resulting in unauthorized access to the Office's internal network.
- The log files for the firewall were subject to improper modification and being overwritten, since the logs were retained on the firewall and not stored in a

secure manner. Also, we were advised that the firewall's log files were not regularly reviewed, and the reviews that were performed were not documented.

The Department of Budget and Management's (DBM) *Information Technology Security Policy and Standards* mandates that critical portions of State agency networks be protected by properly configured firewalls. The *Policy* also requires that agencies maintain and perform documented reviews of firewall logs.

Recommendation 12

We recommend that the Office configure its firewall in a secure manner and only allow authorized firewall administrators to administer the firewall using secure connection protocols. We also recommend that the Office store its firewall logs at an appropriate secured location away from the firewall device and that regular documented reviews of the logs be performed.

Finding 13

Procedures for monitoring security of the minicomputer system need improvement.

Analysis

The Office did not adequately protect its critical minicomputer production data and program files from unwarranted file or program modifications. Specifically, minicomputer security reports did not contain information for a number of critical security events. For example, the reports did not include instances of direct modifications to critical production data and programs files or reporting of system management task activity. This condition has been commented upon in our two preceding audit reports.

Recommendation 13

We again recommend that minicomputer security reports be adjusted to contain all critical security events.

Finding 14

The Office's disaster recovery plan was incomplete and outdated.

Analysis

The Office's disaster recovery plan, which was last updated in December 1999, was incomplete and outdated. The plan did not include the following critical

elements specified by the DBM's July 2006 *Information Technology (IT) Disaster Recovery Guidelines*:

- Maximum tolerable downtimes for critical functions
- Current roles and responsibilities of critical personnel
- Remote alternate site processing
- Management acceptance of the disaster recovery plan
- Current listing of hardware and network components

Without a complete and current disaster recovery plan, a disaster could cause significant delays (for an undetermined period of time) in restoring operations above and beyond the expected delays that would exist in a planned recovery scenario. This condition was commented on in our preceding audit report.

Recommendation 14

We again recommend the Office update, and maintain on a current basis, a disaster recovery plan to comply with all relevant elements of DBM's *Information Technology (IT) Disaster Recovery Guidelines*.

Non-Budgeted Funds

Finding 15

Certain fees were retained without authorization.

Analysis

The Office collected certain fees for administrative costs from State agencies participating in the capital lease financing program and retained unspent funds without authorization. Specifically, as of June 30, 2006, the Office had retained related funds totaling approximately \$350,000. Prior to fiscal year 2007 these fees were collected and recorded as non-budgeted funds. Effective fiscal year 2007, the fees are to be recorded as reimbursable funds. A similar comment was included in our preceding report. The Office's response to that report stated that the balance in the non-budgeted fund (which totaled \$238,244 in April 2003), would be reverted to the State's General Fund.

Recommendation 15

We again recommend that the Office revert the balance of unexpended capital lease financing fees in the aforementioned non-budgeted fund to the General Fund and that, in the future, any such balances be reverted at year end.

Appropriations

Finding 16

The Office did not advise the Board of Public Works (BPW) that an information technology contract also included \$660,000 for consulting services.

Analysis

Although the Office advised BPW of a \$128,350 computer system purchase, it did not advise BPW that the same contract also included \$660,000 for consulting services. During fiscal year 2006, the Office executed an information technology contract with a vendor for the period of August 29, 2005 to June 30, 2006. The vendor was selected by the emergency procurement method without obtaining bids. (The Office prepared a written justification for not obtaining bids which stated that the vendor was selected because it had developed many of the computer programs used by the Office and was familiar with the Office's information technology operations.) The system is used by the Office for banking and insurance related activities. According to the State's accounting records, payments related to the contract through June 30, 2006 totaled approximately \$640,000.

State regulations require that emergency procurements be reported to BPW as soon as practicable and that the report include the basis of the emergency, what was procured, the name of the contractor and the amount and type of the contract.

Recommendation 16

We recommend that the Office advise BPW that the contract previously submitted to it also included \$660,000 for consulting services. We also recommend that, in the future, the Office fully and accurately describe contracts submitted to BPW.

Cash Management Improvement Act (CMIA)

Finding 17

The Office did not adequately monitor State agency reporting of CMIA activity.

Analysis

Although the Office requires State agencies to submit quarterly and annual reports of federal assistance program activity subject to CMIA, the Office did not adequately ensure that the information submitted was accurate. Specifically, the

Office did not compare financial data recorded on the quarterly or annual reports to the State's accounting records to detect any instances in the reported federal fund activity. In an audit report dated April 4, 2006, we noted that during the period July 1, 2001 through June 30, 2005, one agency failed to report to the Office federal fund activity totaling \$385 million. A similar condition regarding the lack of adequate monitoring of State agency CMIA reporting has been commented on in our two preceding audit reports.

The Office used the information included in the annual reports submitted by State agencies to prepare the Statewide CMIA annual report detailing interest liabilities due to and from the federal government. Adequate monitoring, reconciliation, and verification of these reports is significant since the CMIA provides that if federal drawdown requests are not properly timed, or reimbursements are not received timely, interest may be payable to or from the federal government. For fiscal year 2005, Federal expenditures subject to the agreement totaled approximately \$5.4 billion, and the Office calculated that the State owed the Federal government approximately \$290,000 in interest.

Recommendation 17

We again recommend that the Office review the reasonableness of annual reports of federal assistance program activity submitted by participating State agencies by comparing them with the State's accounting records.

Cash Receipts

Finding 18

An employee independent of the cash receipts function did not account for prenumbered cash receipt forms used to record collections.

Analysis

An employee independent of the cash receipts function did not account for prenumbered receipt forms used to record collections as to issued, voided, and on-hand. Although the Office performed independent verifications that amounts recorded on the receipt forms were deposited, because there was no independent accounting of the numerical continuity of all cash receipt forms (that is those forms used as well as those voided and on-hand), assurance was lacking that all recorded collections were deposited.

According to the Office's records, cash receipts recorded on prenumbered receipt forms and deposited during fiscal year 2006 totaled approximately \$9.3 million.

Cash receipts were primarily payments of insurance premiums by certain agencies and insurance subrogation payments received from third parties, which are deposited to the credit of the State Insurance Trust Fund.

Recommendation 18

We recommend that an employee independent of the cash receipts function verify the numerical continuity of prenumbered receipt forms issued as part of the daily deposit verification to ensure that that all collections initially recorded on the prenumbered receipt forms were deposited, and periodically account for all prenumbered receipt forms as to issued, voided, or on-hand. We advised the Office on accomplishing the necessary separation of duties using existing personnel.

Contractual Services – Potential Conflict of Interest

Finding 19

A potential conflict of interest involving a management official should be submitted to the State Ethics Commission for re-evaluation.

Analysis

Between April 1998 and March 2002, the Office paid a firm, owned by the spouse of an Office management official, \$63,750 to conduct background investigations of potential employees. However, this business relationship with the agency was not disclosed on any of the official's five annual financial disclosure statements filed with the State Ethics Commission covering the period the payments were made, although the business itself was disclosed. In response to our inquiries, the Office stated that the official mistakenly failed to properly disclose the business relationship on the statements.

Moreover, we noted that the amount paid to the firm for each investigation (\$250 during fiscal year 2002) was several times higher than the \$55 that the Office recently paid to another firm to perform similar background investigations. Office management advised us that they believe that the scope of the investigations were different and that the previous Treasurer had ordered the investigations. However, the Office was unable to document these assertions.

This issue was previously reviewed by the State Ethics Commission as a result of an anonymous complaint. In February 2003, the Commission completed its review and concluded that, to resolve the matter, the management official only had to amend certain financial disclosure statements to disclose the business relationship with the Office. However, our review of the Commission's inquiry, which consisted primarily of interviews with the management official and a

subordinate, disclosed what appear to be several misstatements of fact. Specifically, we noted the following misstatements:

- Ethics information indicated that the management official (whose spouse owned the company) had stated that they had played no part in the procurement or oversight of this vendor. However, certain invoices from the firm and certain portions of some of the background investigations conducted by the firm were addressed directly to this management official.
- During the ethics review, the management official and the subordinate employee indicated that another supervisory employee (who is no longer employed by the Office) had approved the arrangement. However, we spoke to this individual who advised us that no such approval was granted and they had no knowledge of this arrangement.
- Although representations made by the management official during the Ethics inquiry, including a copy of meeting minutes, indicated that the management official had resigned from their position as Treasurer with the spouse's firm in 1995, personal property returns filed in June 2001 and April 2002 with the State Department of Assessments and Taxation (which were signed by the management official's spouse under penalties of perjury) state that the management official was the firm's Treasurer. We were advised by the Office that the listing of the official as the firm's Treasurer was a mistake.
- The management official contended that they received no financial benefits from the spouse's firm; however, the management official drives a luxury vehicle which was purchased new in 2001 and is titled in the firm's name. The official contends that this information was provided to the Ethics Commission; however, the Commission had no record of this information.

State ethics law generally precludes an employee from having a financial interest in an entity that does business with the employee's agency. State law defines financial interest for the employee to include a business entity owned by the employee's spouse. In addition, the State ethics law requires employees to disclose financial interests in business entities, as well as any financial interest of an immediate family member in business entities, as well as a business entity where the employee or an immediate family member did business with the State. We were advised by representatives of the State Ethics Commission that, if representations made during the course of a previous investigation are determined to be untrue, the investigation may be re-opened.

Recommendation 19

We recommend that the Office refer this matter to the State Ethics Commission for re-evaluation.

Audit Scope, Objectives, and Methodology

We have audited the Office of the State Treasurer for the period beginning November 1, 2002 and ending April 30, 2006. The audit was conducted in accordance with generally accepted government auditing standards.

As prescribed by the State Government Article, Section 2-1221 of the Annotated Code of Maryland, the objectives of this audit were to examine the Office's financial transactions, records and internal control, and to evaluate its compliance with applicable State laws, rules, and regulations. We also determined the current status of the findings contained in our preceding audit report.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. Our audit procedures included inquiries of appropriate personnel, inspections of documents and records, and observations of the Office's operations. We also tested transactions and performed other auditing procedures that we considered necessary to achieve our objectives. Data provided in this report for background or informational purposes were deemed reasonable, but were not independently verified.

Our audit scope was limited with respect to Office's cash transactions because the Office was unable to reconcile the State's main bank accounts during a portion of the audit period. Due to this condition, we were unable to determine, with reasonable assurance, that all Office cash transactions prior to June 30, 2005 were accounted for and properly recorded on the related State accounting records as well as the banks' records.

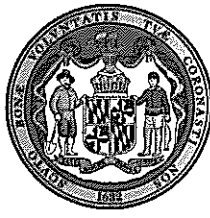
The Office's management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that objectives pertaining to the reliability of financial records, effectiveness and efficiency of operations including safeguarding of assets, and compliance with applicable laws, rules, and regulations are achieved.

Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. In addition, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

Our reports are designed to assist the Maryland General Assembly in exercising its legislative oversight function and to provide constructive recommendations for improving State operations. As a result, our reports generally do not address activities we reviewed that are functioning properly.

This report includes findings relating to conditions that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect Office's ability to maintain reliable financial records, operate effectively and efficiently, and/or comply with applicable laws, rules, and regulations. Our report also includes findings regarding significant instances of noncompliance with applicable laws, rules, or regulations.

The Office's response to our findings and recommendations is included as an appendix to this report. As prescribed in the State Government Article, Section 2-1224 of the Annotated Code of Maryland, we will advise the Office regarding the results of our review of its response.



MARYLAND STATE TREASURER
Nancy K. Kopp

July 20, 2007

Bruce A. Myers, CPA
Legislative Auditor
Office of Legislative Audits
301 West Preston Street
Room 1202
Baltimore, Maryland 21201


Dear Mr. Myers:

Attached is the State Treasurer's Office response to the draft audit report for the period beginning November 1, 2002 and ending April 30, 2006, which I am pleased to forward for your review.

The Office's responses reflect many significant accomplishments over the past five years since the last Legislative Audit, including the Banking Division's institution of daily reconciliation and deposit match processes, enhanced monitoring of agency bank accounts, and improved internal controls in the Investment, Finance and Insurance Divisions. I am proud of all that has been accomplished by the Office during this time and appreciate the benchmarks set by your Office's past audits.

I would also point out for your review the significant progress which the Office staff has already made in resolving the issues raised earlier this year in the process of the present audit. These efforts are a reflection of our strong commitment to ensuring that Maryland's citizenry continue to have confidence in the safekeeping and investment of funds in the State Treasury.

Very truly yours,


Nancy K. Kopp
Treasurer

Bank Accounts:

Finding #1

Despite improvement of conditions noted last audit, oversight and control over the State's bank reconciliation process could be further strengthened.

Recommendation:

We recommend that the Office ensure the timely resolution of unmatched deposit transactions. We also recommend that an independent employee verify that all manual deletions from the automated match process were properly approved. We further recommend that the Office modify the approval requirements in the State's accounting system so that all adjustment transactions must be approved by an employee other than the initiator of the transaction. Finally, we recommend that the Office restrict the capability to manually delete unmatched deposit items from the system records and the ability to process adjustment transactions to the State's accounting records to only those employees who routinely require such access to perform their job duties.

Response:

We concur and are in compliance with the Auditor's initial recommendation. Over the past three years, the Office has made unprecedented strides to ensure the timely resolution of unmatched deposits. However, it should be noted that there will always be a number of unmatched deposits on any given day.

As of July 9, 2007 (the most current reconciliation completed at the date of this response), the unmatched deposits were 441 items totaling \$6.7 million, a level consistent with normal timing differences identified by the Auditors in previous periods. With current staffing and continued training and development, we will be able to keep unmatched deposits at a minimum. We must point out, however, that on any particular day the dollar value and quantity of unmatched items may vary quite significantly, depending on particular State agency and bank anomalies. For example, if an agency makes a deposit to the bank for \$50,425,750.49, and enters the amount in R*STARS as \$50,425,750.48, the deposit will not automatically match. Both the bank and the book amounts will be carried on their respective parts of the reconciliation as unmatched deposits. Therefore, in this instance, a one-cent difference between the bank deposit and the amount entered in to R*STARS by an agency would result in a daily increase in excess of \$50 million in the unmatched deposit totals.

The Office does not agree with the analysis that controls over certain critical data used in the automated bank reconciliation process were inadequate. Verification and independent approval are imbedded in each aspect of the reconciliation process. Banking Services requires that any and all deletions from the unmatched deposit file be approved by a supervisor and documented on the schedule of proposed deletions. We believe that the supervisor's review constitutes an independent verification that all manual deletions from the automated match process are conducted properly.

It should be noted that the deletion process has several effective reconciliation and control checks built into it: 1) Each deletion entered into the worksheet must have a corresponding offset transaction (bank adjustment chargeback, deposit difference chargeback, etc.) to balance the deletion. If there is not an offset transaction, the Deposit Match Reconciliation will not balance; 2) Each offset transaction is approved as part of the schedule of deletions which is also signed off by a supervisor; 3) Similarly, all chargeback transactions are independently reviewed and approved by a third employee, normally the Director or Deputy Director of Banking Services; and 4) A final control feature is the linking of the Deposit Match reconciliation with the overall Cash Reconciliation by an independent employee. Deletions from the unmatched deposit file that do not have an offset transaction will cause the overall Cash Reconciliation to be out of balance and result in immediate follow-up. Thus, there are many checks in the process, both prior and subsequent to deletion.

We agree with the recommendation that the ability to approve adjustments to the transactions should be granted to a more limited number of individuals. We have reduced the access from nine to three employees. However, we note that the procedures currently in place ensure that the transactions are approved by an employee other than the initiator of the transactions. The Banking Director or Deputy Director reviews and approves the batch before releasing it to be posted to the ledger, which is subsequently done by an employee independent of the process.

The Office agrees with the recommendation to restrict the number of employees who can manually delete unmatched deposit items. We have restricted the capability to manually delete unmatched deposit items to three employees who routinely require such access.

It should be noted that the deletion process is a daily, labor intensive function and we will provide access to employees on an as needed basis to provide back-up coverage as well as to assist on days with large volumes of manual deletions.

Finding #2

Deficiencies were noted in the Office's oversight of certain other aspects of its banking operations, such as not routinely analyzing existing agency bank accounts to ensure that they had been authorized.

Recommendation:

We recommend that the Office take appropriate action to improve its oversight of the State's banking operations. Specifically, we recommend that the Office periodically ensure that all State agency bank accounts are properly authorized and only with banks that currently have contracts with the State. We also again recommend that the Office ensure that all interest earned on State funds on deposit in agency bank accounts is transferred to the General Fund as required. Additionally, we again recommend that the Office ensure that the available cash balances of the lockbox accounts are transferred into the State's depository account on a daily basis. Furthermore, we recommend that the Office require State agencies that elect not to use the automatic transfer process to

provide written justification for this decision to the Office. If sufficient justification is not provided, the Office should require the agency to use the automated transfer process. Finally, we recommend that the Office ensure that all bank accounts are fully collateralized.

Response:

We concur with the recommendations and note that the Office began a comprehensive project to analyze agency bank accounts in December 2005. As the auditors noted, all State agencies were contacted in March 2006 and were requested to validate information obtained from the Bank Account Information System (BAIS) which is currently, and has historically been, maintained by the Comptroller's General Accounting Division (GAD).

The 2006 validation process revealed a number of accounts that had not filed the required GAD X-1 authorization. In addition, a number of accounts were open with banks no longer under contract with our Office. The Office has been actively pursuing correction. We learned, after requiring that agencies with unauthorized accounts provide justification for them, that in many cases, accounts actually had already been properly moved to banks with current State agreements, but old accounts had been left open until all outstanding activity could clear. These agencies and their banks have again been notified that such accounts are to be closed or the banks may not be able to bid on the upcoming agency bank account RFP to be released this fall.

We will be performing a comprehensive and documented periodic (bi-annual) analysis of agency bank accounts as recommended by the auditors. In order to enforce the contract provisions, State agencies with unauthorized accounts will be required to provide justification for the account or the account will be closed. As noted above, all agencies have been notified again of this requirement. In addition, our upcoming procurement of agency bank account services will re-emphasize to the banks the requirement to have the Office's approval before opening any State accounts.

We agree with the Auditor's recommendations that all interest earned on State funds on deposit in an agency bank account is to be transferred to the General Fund as required. However, we believe the implementation of the recommendation is as a matter of practical necessity a shared responsibility of the Office and of each State agency using an agency account. There are over 1,225 bank accounts for agency working fund, trust, and escrow services maintained by over one hundred agencies and their subsidiaries. Although this Office procures and approves the banks that may hold these accounts, the daily operations of these accounts are the responsibility of the individual agencies and their financial offices. While the banking contracts require remittance of interest, universal oversight of the requirement has turned out to be impractical due to the very large number of accounts and limited Office staff. Therefore, as permitted by statute, the Treasurer has opted to allow earnings credits as an alternative to interest. When the agency bank account services are re-bid, this mandatory requirement of the contract will be reevaluated.

Acknowledging our role and responsibility, we will develop and communicate a written policy to all State agencies restating the requirements and procedures for handling the interest on agency bank accounts. In addition, we are in discussion with GAD and have been assured that they will include an agency certification of interest earnings and the transfer of the interest to the State's main depository account in their annual year-end bank account reconciliation. The transfer of the responsibility for the Bank Account Information System (BAIS) from the Comptroller to the Treasurer should also facilitate this process. We will also ensure that the banks that have the systems capability to consolidate and transfer interest earned on accounts under the State's ID continue this process.

We concur with the recommendation that the cash balances in the lockbox accounts be transferred into the State's depository account on a daily basis. In fact, we initiated implementation of this recommendation during the last legislative audit when the Office, working with our lockbox provider, converted the majority of the existing accounts to autowire. With respect to those few agencies that elected not to use the autowire transfer process, the Office has requested and received written documentation from the agencies explaining why they are unable to implement this feature. We are continuing to work with the agencies to implement the autowire feature where warranted.

We agree with the Auditor that the bank accounts should be adequately collateralized and, therefore, we currently perform a monthly reconciliation of collateral to ensure all State accounts are collateralized, at least equal to account balances. The Office will verify monthly that the pledged collateral is at least equal to the highest daily collected balance rather than the average daily balance. We would note that the banks have always reported both balance points and have had more than sufficient collateral.

Finding #3

As of September 2006, all portions of banking contracts had not been finalized even though the contracts were effective July 1, 2004.

Recommendation:

We recommend that the Office, in conjunction with its legal counsel, promptly complete all operating agreements related to the banking contracts. We also recommend that, in the future, the Office ensure that essential contract requirements are specified in the related solicitation documents and finalize contracts before they become effective.

Response:

The Auditor's analysis concerning bank operating agreements is essentially a legal, contract-interpretation issue, and consequently the following response has been prepared jointly with the Office's legal counsel, who concurs completely with the response.

Each of the State's banking services is governed (in order of precedence) by: (1) the Contract between the Office and the bank; (2) the Request for Proposals (RFP) describing the services required; and (3) the bank's proposal in response to the RFP. Bank operating agreements do not control any of the banking services provided to the State, unless and until the Office agrees to and executes the operating agreement.¹ The Office disagrees with that part of the Analysis which suggests the State's interests could be at risk because certain bank operating agreements had not been finalized. The State's interests are not at risk due to unexecuted bank operating agreements.

While the Office agrees that certain bank operating agreements have not been finalized for two banking contracts, the Office does not agree that they are "significant." In fact, the referenced banking contracts have been operating successfully since July 2004, with no issues at all related to the un-finalized bank operating agreements. Truly "significant" bank operating agreements, such as Funds Transfer Agreements and ACH Origination Agreements, have been finalized. The Office wishes to again emphasize that at no time have the funds or interests of the State been in any way at risk or unprotected due to the un-finalized bank operating agreements. In fact, the opposite is true as explained below.

In 2004, the Office undertook preparation and advertisement of highly-detailed, performance-based specifications for a Request for Proposals ("RFP") for Banking Services. This comprehensive procurement resulted in several contracts for various banking services, including Lock Box and Disbursement Services. In addition to the explicit, performance-based specifications, in another departure from past practice the Office required proposers to submit for consideration the bank operating agreements they would like the Office to execute as part of the banking services contracts.

Bank operating agreements are drafted by the banks and reflect their preferred methods of operation for a variety of functions, such as Stale Dated Check Service, Image Archiving, and Zero Balance Account Agreements. If approved and signed by the Office, these bank operating agreements would serve to amend the Contract for Banking Services by limiting the performance specification of the RFP to the agreed-upon methods detailed in each bank operating agreement. They typically also seek to limit the banks' liabilities by such means as changing legal jurisdiction to the bank's home state, limiting liability to grossly negligent acts, imposing or shortening timeframes for the State to act, and so on. In short, the bank operating agreements serve to benefit the banks by superimposing their preferred methods of operation on the State's performance-based Contract for Banking Services.²

¹ See RFP for Banking Services, Section IV: Mandatory Requirements and general Questions, Requirement A. 13.: "...offerors *may request* the STO to enter into modified bank operating agreements for all services they propose to provide....Bank operating agreements, *modified to the satisfaction of the STO*, will be incorporated into the contract...." (emphasis added).

² For example, one bank attempted to deduct claimed fees from the State's account, citing one of its operating agreements as authority to do so. In that instance, the Office and the OAG had negotiated amendments to that finalized operating agreement prohibiting such deductions from the State's account. The fees were restored.

In the 30-day error notice cited in the Analysis, under the Contract now in effect, there is no time limit imposed on the State for discovering and reversing bank errors. The bank, by its operating agreement, would have limited the State's time for discovering errors to 30 days. Even if inclined to sign this operating agreement, the Office would have insisted on a minimum 90-day timeframe.

As a result, the bank operating agreements are closely scrutinized by the OAG and the Office, and are extensively modified or amended so as not to conflict with or dilute the performance specifications of the banking services RFP. These modifications then must typically be reviewed by the banks' counsel in their home states (e.g., New York and North Carolina), and negotiated between them and the OAG. There have been extensive discussions and negotiations on the un-finalized banking services contracts.³ In addition, it is not unusual for banks to periodically propose adoption of new or substitute operating agreements as they are developed or revised by their home offices.

The Office and the OAG will renew efforts to finalize all of the appropriate bank operating agreements. In the future, the Office is considering further refinement to the RFP for banking services to incorporate certain banking industry standards in the RFP, and to prohibit the use of supplemental bank operating agreements.

Investments:

Finding #4

One employee had virtually complete control over the State's investment activities, investment brokers were not always approved, and required investment broker information was not always obtained.

Recommendation:

We recommend that the Office define the authority and responsibility of the Office's investment personnel and that the responsibilities for transaction authority and the related accounting, and record keeping be separated. In addition, we recommend that independent supervisory personnel be required to authorize all investment transactions. We also recommend that the Office obtain and review audited financial statements from brokers-dealers on an annual basis and prior to initiating transactions with any new broker-dealers. Finally, we recommend that the Office only invest funds with approved broker-dealers and that investment agreements specify the Office employees authorized to execute investment transactions.

³ After extensive review and exchange of certain modified Lock Box bank operating agreements, in September 2006 the bank's counsel made a wholesale substitution of "new standard documentation for treasury management services" developed by the bank, requiring the review process to begin anew.

Response:

The Office agrees strongly with the importance of separation of duties. For a period of time between the retirement of the former Director of Investment and arrival of his successor, limited resources made it difficult to achieve full separation of duties. However, it is important to note that the Investment Division has external, as well as internal, checks and balances. All transactions are reconciled by the Banking Division. These transactions are reconciled between the Office, the Comptroller's General Accounting Division, the M&T Safekeeping account, and all bank balances. The Safekeeping Agent verifies every investment between trade tickets from the brokers, instructions from the Office and the cash received or disbursed. Furthermore, it should be noted that after testing and zealous scrutiny, all moneys and investments were found to be accounted for as reported.

In addition, personnel enhancements are providing significant internal control improvements, as well. The new Director for Investments, hired at the end of 2006, has authority over all investments and provides a supervisory check for the second Investment staff position. In addition, the Deputy Treasurer for Financial Policy, a recently created and filled position, has been given investment approval authority among her many duties. The Office has hired an additional Treasury Specialist to work with both the Investment and Finance Divisions. This position will provide backup for the daily investment functions. These additions make further separation of duties possible. The authority and responsibilities for investment transactions and the accounting related record keeping will be separated as much as possible for a two-and-a-half person Division.

The Office concurs with the recommendation that audited financial statements from the broker-dealers should be obtained on an annual basis. However, it should be understood that, during the audit period, the Office was using only Primary Broker/Dealers (which number over twenty), as allowed by the governing Investment Policy in effect. The policy recognizes that the New York Federal Reserve sets the capital adequacy standards for Primary Broker/Dealers, and relies on the New York Federal Reserve's assessment of Capital Adequacy of our Broker/Dealers. Audited Financial Statements were required, however, for Non-primary Broker/Dealers if we were to use them, which we did not. Audited Financial Statements are now on file for Non-primary Broker/Dealers doing business with the Office at this time. Rather than relying on the 2004 document, the new Director of Investments is reviewing all Broker/Dealer relationships during 2007 for formal adoption.

Furthermore, it should be noted that all transactions are Delivery Versus Payment (DVP). The Safekeeping Agent ensures that neither moneys nor investments leave the State Treasury unless the investment transaction is totally correct and fulfilled. Therefore, neither cash nor investments are at risk in the event of a Broker/Dealer failure.

Finally, the Master Repurchase Agreements, as the Auditor is aware, were in the process of being updated during the audit period and procedures for annual review are now in place. As of May 15, 2007, the Office sent out 12 Master Purchase Agreements for updating. Of the 12 sent out, 8 have been completed and the firms are now authorized to do business with the State and 4 remain in negotiation. The Office has ceased doing business with the firms in negotiation until such time as the agreements are finalized. In the future, the Office will not conduct business with any firm until a signed agreement has been completed.

Injured Workers Insurance Fund (IWIF):

Finding #5 (Policy Issue)

The services provide by IWIF have not been subject to a competitive bid process and the appropriateness of making advance payments to IWIF has not been adequately assessed.

Recommendation:

We recommend that the Office, in conjunction with BPW, consider obtaining competitive bids for the claims processing services for workers' compensation claims filed by State employees, and take the necessary actions to ensure that these services are obtained in the manner that is most beneficial to the State. We also recommend that the Office determine the appropriateness of allowing IWIF to hold funds in reserve.

Response:

The Office agrees that this is a policy issue, and respectfully suggests that the policy decision is one for the General Assembly, first, and the Board of Public Works, second. It is not a policy decision to be made by the Office, which simply serves as the administrator for the State's contract with IWIF.

The State's workers' compensation claims processing services have *never* been competitively bid. IWIF's predecessor, the State Accident Fund ("SAF"), was established by the General Assembly in 1914 as the State agency charged with guaranteeing workers' compensation coverage for all of Maryland's employers and their employees. In addition to serving the State, the SAF and IWIF have served as workers' compensation insurers of last resort for Maryland employers for 93 years.

Until 1988, the SAF was part of the Department of Personnel. The Office of Legislative Audits (OLA) conducted regular audits of SAF and IWIF until 2002, when the General Assembly granted IWIF greater autonomy. In fact, as a result of OLA recommendations, the General Assembly reorganized the SAF in 1988, and the SAF contract with the State was renegotiated in 1990.

Although there is no statutory mandate that the State contract with IWIF for workers' compensation claims processing services, it is the evident intent of the General Assembly

that IWIF provide such services for the State. The General Assembly created IWIF, granted and amended its powers, periodically reorganized its structure and responsibilities, and annually appropriates funds to pay for its services. In light of the State's historic 93-year relationship with the SAF and IWIF, the Office believes that it would be inappropriate to competitively bid such services absent legislative direction to do so.

The Office concurs with the Auditors' statement that the Office determine the appropriateness of allowing IWIF to hold funds in reserve. However, after a review of the Agreement and in consultation with the Office's Assistant Attorney General, we have determined that if the Office withdraws the funds from the Unfunded Liability Account and deposits them in an account invested by the Office, any interest earned on those funds must be credited to the General Fund. The Treasurer is required to credit interest earned directly to the General Fund except as otherwise specifically provided by law. The Office could find no provision for an exception in this case even if the funds were held in a separate account in the State Treasurer's Office, and, therefore, such interest could no longer be dedicated to the reduction of the long term liability.

In light of the explicit intent of the Governor and the General Assembly to eventually eliminate the unfunded liability, and absent an explicit change in that intent, the Office believes it lacks authority to unilaterally withdraw these funds, thereby resulting in the loss of interest income dedicated to reducing the unfunded liability.

Finding #6

The Office did not adequately monitor the agreement to ensure the propriety of amounts paid to IWIF.

Recommendation:

We recommend that the Office, at least on a test basis, review amounts previously paid to IWIF for propriety and, in the future, determine the propriety of amounts paid to IWIF. This verification should be documented and include a review of appropriate supporting documentation such as evidence of amounts paid for injured State workers and documentation of the propriety of administrative cost billed by IWIF. We also recommend that the Office verify that the State receives all interest to which it is entitled.

Response:

As noted in response to Finding #5, the Agreement between the State and IWIF was renegotiated in 1990. Under that Agreement, IWIF serves as third-party administrator for claims brought against the State under Maryland's Workers' Compensation Law.

The Agreement describes three primary responsibilities which involve the Office. The first requires that the Treasurer decide all matters relating to contract administration and performance. The second requires IWIF to submit an annual invoice to the Treasurer

reflecting the amount of actual losses incurred by the State, as well as an invoice reflecting the balance of the State's account. The third requires IWIF to compile whatever reports the Treasurer determines to be necessary to:

- (a) monitor the performance of the claims administration activity;
- (b) assess the financial liability of the program to the State;
- (c) project loss experience for the purposes of establishing budgets and agency premiums; and
- (d) analyze the causes of losses.

A review of the BPW's files, including the January 31, 1991 agenda item and transcript, does not reveal any other information defining the requirements of this provision, with the sole exception of a general comment made by Treasurer Maurer to the effect that the STO's Insurance Division was working closely with IWIF. Additionally, there is no record to reflect whether these performance reports have ever been deemed "necessary", or have been requested or produced.

Since the inception of the Agreement in 1990, the Office has received an annual report, via the Department of Budget and Management, that identifies the amount the Governor, through DBM, has proposed and the General Assembly has appropriated for workers' compensation coverage, including any appropriation for the unfunded liability. The Office prepares a disbursement transmittal, wires this amount to IWIF, and subsequently collects from each agency its share of the appropriated amounts. In the event that an agency questions the amount of its premium, it is directed back to IWIF to request a report listing all claims for their agency.

While the Office has not routinely requested performance reports from IWIF, a report on the State Assessment for Workers' Compensation was prepared by the Department of Budget and Management in August of 2001 and was submitted to the Office. This report reviewed, analyzed and commented on the amounts the State paid and the administrative costs charged by IWIF. In addition, as a State agency, IWIF was subject to periodic Legislative Audits until 2002. It is now subject to audit by MIA. The Office monitors these audits and notes that, to date, there have been no findings questioning the propriety of IWIF premiums or administrative charges.

The Treasurer acknowledges a 1990 contractual provision regarding monitoring claims administration activity, but notes that there is no definition in the historical records of what this monitoring process was intended to entail and there is no record of a performance report ever having been requested or submitted. Since the Treasurer's responsibilities are based on the 1990 agreement *between IWIF and the BPW*, there are a number of ways to resolve this issue. The Office believes discussions with the Board of Public Works for direction on what type of oversight or information the State deems necessary would be appropriate at this time and will initiate them. If detailed monitoring and oversight, including independent verification that the State's financial interests are adequately protected against a catastrophe, are deemed to be necessary, as the Auditors

suggest, it is likely to require identifying and supplying staff and monetary resources that the Office does not currently have.

The Office concurs with the Auditor's recommendation to verify that the State receives all interest to which it is entitled and will follow-up directly with IWIF to obtain the necessary confirmation.

Unpresented Bond and Coupon Fund:

Finding #7

The amount owed to bond holders for unpresented bonds exceeded the cash balance of the Fund by approximately \$645,000 and unredeemed bond funds were not transferred to the Comptroller's Abandoned Property Fund, as required.

Recommendation:

We recommend that the Office resolve the discrepancy in the Unpresented Bond and Coupon Fund. Additionally, we recommend that the Office take the necessary action to obtain reimbursement for the \$200,000 paid to the above mentioned bondholder. We also again recommend that the Office transfer those funds deemed to be abandoned in the Unpresented Bond and Coupon Fund to the Comptroller's Abandoned Property Fund as required by State law.

Response:

The Office concurs with the finding and has taken action to investigate and resolve the difference between the Unpresented Bond and Coupon Fund and the total of the bondholder registry of unpresented bonds. The difference, all of which relates to bonds which matured prior to July 2001, remains at approximately \$645,000.

After significant effort, the Office developed a strategy and the techniques necessary to break the account into manageable chronological segments, reconcile by fiscal year, and transfer funds related to the more recent registry reports. At this time, the Office has reconciled five bondholder registry reports (for Registry Reports received in Fiscal Year 2003, 2004, 2005, 2006 and 2007) with R*STARS. A registry of outstanding bonds and the related funds for reports received in FY 2003, 2004 and 2005 will be transferred to the Abandoned Property Division of the Comptroller's Office as part of the Fiscal Year 2007 closing. The funds and the unpaid bonds on the registries for FY 2006 and FY 2007 will be transferred after being retained for the requisite two years in the Unpresented Bond and Coupon Account. The Office will continue to transfer future funds that remain abandoned in the Unpresented Bond and Coupon Fund to the Comptroller's Abandoned Property Fund in accordance with State law.

The Office will continue to work diligently to resolve the pre-July 2002 portion of this Finding. However, because of missing information, some of which dates back 17 years,

it will be extremely difficult, if not impossible, to completely reconcile the Unpresented Bond and Coupon Fund account. We will apply the methodology of reconciling individual reports and transferring appropriate related funds to the Comptroller's Office until it is either completed or we have finally determined that it is no longer productive.

In consultation with the Office of the Attorney General, we have continued to investigate paying agent liability for the Office's April 2005 payment of 1975 bearer bonds. Because there are several other unresolved items with the paying agents, additional reconstruction and reconciliation of records is required. The Office, with the concurrence of legal counsel, has determined the best course of action is to complete the reconciliation of records to the extent feasible, and to resolve all the paying agent issues in a comprehensive rather than piecemeal manner. However, as previously noted, there is significant missing information including funds that date to the early 1990's that have never been associated with a registry report. It is possible that these unidentified funds related to the 1975 bearer bonds. After the reconciliation of all reports is completed, the Office, in consultation with the Attorney General, will determine the liability of the paying agents and pursue the appropriate reimbursement.

State Insurance Trust Fund:

Finding #8

Internal controls over claims paid from the State Insurance Trust Fund were inadequate.

Recommendation:

We recommend that individuals responsible for reviewing and approving disbursement transactions, including claims paid from the Fund, perform a comprehensive review prior to approval. We also recommend that an employee independent of the claims payment processing function periodically reconcile claims authorized in the claims processing system with claims payments actually made, as recorded in the State's accounting records.

Response:

This occurrence of theft and the ensuing criminal investigation, adjudication, punishment and restitution has been the subject of extensive review by the Treasurer, Attorney General, and Legislative Committees and has received press coverage. As the Auditor is aware, immediately following the discovery of the theft in January 2004, the Office also enhanced its internal controls to prevent future occurrences. These enhancements included, but were not limited to, recommendations of the Auditor.

It should be noted that during the time period of the theft, the Administration Division had several vacant positions due to budgetary constraints, which contributed in a specific way to the lapse in internal controls. During this time period, the individual who

disbursed the transmittals also had the authority to enter data into the Office's disbursement system. This dual access to the system constituted an internal control weakness which contributed to the thief's temporary ability to perpetrate a crime. This weakness was immediately recognized and corrected in January 2004.

Currently, as the Auditor recommends, the individual approving and disbursing the transactions performs a comprehensive review of the newly implemented Open List Number Report for Insurance and Treasury transactions. This review ensures that once a List Number is created (in either the Insurance or Administration Division), it is transmitted within a reasonable time period; any delays (which might indicate illicit actions) are identified and resolved. Secondly, the Office has recently developed a second management report that identifies duplicate list numbers created in either the Insurance or Treasury System. A review of this report will assure that a similar theft scheme will not occur again. Thirdly, any individual who has data entry responsibilities cannot approve or disburse transactions. Similarly, an individual who approves and disburses transactions cannot enter data into the Insurance or Treasury system.

However, we cannot concur with the recommendation that an employee independent of the claims payment processing function periodically reconcile the claims authorized in the claims processing system with the claim payments actually made, as recorded in the State's accounting records. The significant resources required for this function are not available and we believe that the cost would exceed the benefit to be derived. There are over 3,000 insurance claims authorized and processed each year, many of which are structured in a payment plan schedule, and subject to intermittent adjustments. Because of these periodic, but variable, restructurings, it is not clear that a periodic ("snapshot") reconciliation of these authorized claims, in the claims processing system, to the claims payments in the State's accounting records (R*STARS) would be cost effective or enlightening.

The Office has also enhanced, as the Auditor recommended, internal control procedures in the Insurance Division to ensure that payment authorization forms are signed by the employee who prepares them as well as by the supervisory personnel who approves them. We believe the enhanced internal control procedures currently in place provide a reasonable assurance that the objectives are being achieved in an effective and efficient manner. The Office has improved the internal controls over both the environment and the activities of those involved in data entry and transmittal processing. We have improved the documentation and verification processes and monitor the disbursement activities on a regular on-going basis.

Finding #9

Commercial insurance policies were procured without publicly advertising solicitations and publishing contract awards.

Recommendation:

We recommend that the Office procure commercial insurance policies in accordance with the requirements of State procurement law by requiring that contract solicitation and awards be published.

Response:

We concur in part with the Auditor's finding that commercial insurance policies were purchased without publicly publishing the awards and, in the future, all commercial insurance policy awards will be published. Under sections 4-205 and 10-103 of the Insurance Article of the Maryland Annotated Code, all commercial insurance policies must be purchased through the services of a licensed insurance broker. To date, all insurance broker services' contracts have been procured and published in accordance with Maryland procurement law. We believe that the current procurement process has achieved significant competition among insurance carriers.

The Office currently advertises all insurance broker services' procurements on e-Maryland Market Place and by e-mail to a list of Maryland brokers. Broker services' contract awards are published on e-Maryland Market Place and are reported to the Board of Public Works on the PAAR Reports. The Office's web site is also utilized to solicit bids and to publish awards.

In the future, once insurance broker services are procured, the award will be published on the Office's website. The listing will also invite companies interested in providing State coverage to contact the winning broker. After the Office has approved the broker's coverage recommendations, the policy details and cost will be published on the website and in the PAAR Reports that are submitted to the Board of Public Works.

As one final note, the Office is currently in the process of drafting regulations to address the procedures used to procure insurance broker services and commercial insurance policies.

Local Government Investment Pool (LGIP):

Finding #10

The Office had not established adequate security over withdrawals from the LGIP.

Recommendation:

We recommend that the Office strengthen internal control requirements over withdrawals from the LGIP. Specifically we recommend that the Office require the fiscal agent to ensure that at least two authorized representatives of the participating entity execute any agreement or changes to agreements. Furthermore, we recommend that any withdrawals to be credited to any account other than the account that is identified in the participation agreement be validated by a second authorized representative of the participating entity.

Response:

We concur with the importance of internal controls and met with the fiscal agent and the MLGIP Advisory Committee, comprised of representatives of the local participating fiscal offices, to discuss the concerns raised by the Auditor.

It is important to note that there are many security provisions in effect for the LGIP at this time. The forms necessary to participate in the MLGIP have always required at least two signatures and authorized personnel identification: 1) the Resolution requires the entity's Governing Board to sign and to have the signatures witnessed; 2) the application requires at least two signatures; and 3) the change form requires two signatures.

In response to the Auditor's concerns, the MLGIP Advisory Committee pointed out that the advantage the fund offers is ease of access and flexibility for the smaller entities such as small municipalities or fire boards, which would otherwise deposit funds elsewhere, often with greater risk as well as lower returns. It is these small entities which have difficulties having more than one signatory always readily available.

Recognizing this concern, the Office proposes to strengthen controls by requiring a follow-up letter on official participant letterhead with a confirming signature to be sent to MLGIP within five business days if an account must be changed and only one signatory is available at the time of the transaction.

Unpresented and Undeliverable Checks:

Finding #11

Certain unpresented checks were not credited to the Unpresented Check Fund, and the Office could not adequately document that sufficient funds were transferred from the Unpresented and Undeliverable Check Funds to the General Fund in accordance with State law.

Recommendation:

We again recommend that the Office ensure that checks which remain unpresented for two years are identified, and that the related funds are transferred to the Unpresented Check Fund, and ultimately to the State's General Fund, as required by State law. We further recommend that, at the end of each fiscal year, the Office determine a reasonable balance to remain in both the Unpresented Check Fund and the Undeliverable Check Fund and transfer all remaining amounts to the General Fund and that the Office retain documentation supporting how these balances were determined.

Response:

We concur and have complied with the first recommendation. The FY 2003 unrepresented checks' list was run on November 9, 2006 and the related funds totaling \$5.75 million were credited to the Unrepresented Check Fund on November 21, 2006. In addition, the FY 2004 unrepresented checks' list was run on April 30, 2007 and \$6.38 million was credited to the Unrepresented Check Fund on May 1, 2007. Going forward, the unrepresented check process will be run annually in September and the appropriate amount will be credited to the State's Unrepresented Check Fund and ultimately transferred to the State's General Fund as required by State law.

We agree with the second recommendation and believe that our method of setting a target retention balance is appropriate and in compliance. The Office will document that process more fully. At the end of each fiscal year, a reasonable target balance is determined and retained in the Undeliverable and Unrepresented Funds, with the remainder transferred to the General Fund. The Office will retain documentation supporting how these amounts are determined.

Transfers to the General Fund are made each year as required by State law. The target for the amount to be retained is based on prior years' disbursement levels plus an inflation factor and, where appropriate, an additional factor for recognized extraordinary events. The determination of the amounts to retain in FY 2005 and 2006 was unusually difficult due to certain unique circumstances which led the Office, as the Auditor notes, to be particularly conservative. For example, the Annotated Code of Maryland, State Finance and Procurement, §7-229 and §7-230, was amended effective in October 2004 (FY 2005) to remove the 7 year limitation on the re-issuance of unrepresented and undeliverable checks. In effect, this meant that tens of thousands of checks that were previously not eligible to be re-issued would have to be honored if presented for re-issuance. Removing the 7 year limitation created a significant unknown in terms of the amount that would be required for check re-issuance, and therefore, an unknown in determining the amount needed to be retained.

As we develop documentation of trends resulting from the enactment of the 2004 law, we will be better able to set the related factor to incorporate into the determination of the "reasonable" target balance to be retained. Meanwhile, we will continue to set the retention balance target at a somewhat more conservative level than in the years prior to FY 2005. More detailed documentation of this process will be formalized and retained for audit purposes.

Information Systems Security and Control:

Finding #12

The firewall used to help secure the Office's network was not properly configured, administered, or monitored.

Recommendation:

We recommend that the Office configure its firewall in a secure manner and only allow authorized firewall administrators to administer the firewall using secure connection protocols. We also recommend that the Office store its firewall logs at an appropriate secured location away from the firewall device and that regular documented reviews of the logs be performed.

Response:

The Office concurs with the recommendation to configure the firewall in a secure manner and to only allow access to authorized firewall administrators using secure connection protocols. Some unnecessary access was the result of not removing a rule after being created during firewall testing. This access was detected and the rule was immediately restored to its secured value on June 5, 2006. Secondary security measures have been in place on the internal network devices at all times and the Office has no evidence that any vulnerabilities have been exploited.

The Office's firewall is secure and administration is done using secure connection protocols, is restricted to the IP addresses of authorized firewall administrators, and conforms to DBM's Information Technology Security Policy and Standards.

The Office has configured a separate Syslog server to store the firewall logs. As of June 6, 2006, the Office re-enabled the firewall to e-mail an alert to firewall administrators when an alarm condition occurs. Also, the IT Division implemented a policy to review the firewall event log on a regular basis and to investigate unusual or suspicious items. All such review and investigation documentation are retained for audit verification.

Finding #13

Procedures for monitoring security of the minicomputer system need improvement.

Recommendation:

We again recommend that minicomputer security reports be adjusted to contain all critical security events.

Response:

The Office concurs with the recommendation and the i5 System's Event Log currently tracks all critical security events. The IT Division decided to develop new programming to read the enhanced i5 Event Log and generate individual reports for each event being tracked. The new programming was placed into production on November 30, 2006. The new programming filters the Event Log and produces a daily report for each category including: Unauthorized Objects Access, Authority Changes, Invalid Passwords, Invalid User Id's, Changed User Profiles, Changed Objects, Object Management with Create and Delete Objects, Disabled / Expired Id's and Profiles not used in the last 30 days. These reports assist the IT Division in auditing for any authorized and unauthorized activities to production data and programs. The i5 Security Officer reviews all of the daily reports

and initials a daily check list. This daily check list is reviewed and initialed by the IT Director on a monthly basis and retained for audit purposes.

Finding #14

The Office's disaster recovery plan was incomplete and outdated.

Recommendation:

We again recommend the Office update, and maintain on a current basis, a disaster recovery plan to comply with all relevant elements of DBM's *Information Technology (IT) Recovery Guidelines*.

Response:

The Office concurs with the finding that an update of the formal Disaster Recovery Plan (DPR) document is needed. Current documents, entitled "Disaster Recovery Outline", were approved by management in 2005. Current listings of hardware and network components were on file, and presented to the Auditor. Since the Disaster Recovery Plan of 1999, and the Information Technology Disaster Recovery Quick Plan of September 2003, the IT Division has allocated a great deal of effort towards Disaster Recovery preparedness. The IT Division has focused on improving the following elements by bringing: hardware, programming, procedures, controls, backups, data transmissions, electrical and battery backups up to industry and State standards. An updated Disaster Recovery Plan is in progress and will be incorporated into the updated IT Master Plan.

The IT Division has accomplished the following with regard to Disaster Recovery:

- October 20, 2005: The IT Division contracted with a State vendor to be the Disaster Recovery host site for the Office. A copy of this arrangement was supplied to the Auditor on July 27, 2006.
- November 14, 2005: The IT Division went live on two new IBM i5 systems that replaced the outdated AS/400 systems. The new i5's replaced equipment that was so old that the Office could not get IBM hardware service or operating system support. The risk of hardware failure was very high. The new i5 systems included a Production and a Test System for full testing of new programs that was not possible on the previous Test System. The Test System is also properly sized to be able to operate as the Production System in the event of an emergency.
- May 24, 2006: (Alternate Site). The IT Division executed a Disaster Recovery test at our Disaster Recovery vendor's site. The IT Division successfully restored i5 security settings, data files and programs from Office backup tapes onto the contingency system at the Disaster Recovery vendor's office.

- The Contingency Test focused on STO's most critical daily processing. The test included:
 1. ARP Transmission to M&T of: GAD, Tax and Payroll ACH payments, GAD check register and Tax check register.
 2. Receipt and processing of the Bank of America - ACH File (State Master Account transaction file used for posting to RSTARS and for the Bank Reconciliation).
 3. GAD Check Writing processing (preparation for Check Writing Process).
 4. Child Support Check Writing processing (preparation for Check Writing Process).

The Contingency Test was a complete success and recorded the first time in the Office's existence that a Contingency Plan was ever tested on-site or off-site of State property. Both the internal and external backup systems were successfully tested.

- The IT Division enhanced the i5 program change management process to ensure that programs were properly tested, archived, and also logged in the change management database prior to a program being placed in production.
- The IT Division purchased the Connect: Direct software. This industry standard data encryption and transmission software is used almost exclusively by mainframe systems. ADC encouraged the IT Division, for over 5 years, to acquire Connect: Direct and to eliminate our IBM Net View product. The IBM Net View product would not be supported by ADC if they were to relocate to their contingency site. The IT Division will request ADC keep the IBM Net View available as a contingent method for the Office to retrieve data files. The IT Division negotiated a considerable discount of the quoted software costs. The Connect: Direct software is currently in production and will continue to be rolled out through calendar year 2007. The Connect: Direct software will permit the IT Division to transmit and receive files from the ADC and our banking partners, regardless of where they or the IT Division would be based during a contingency.
- The IT Division increased the i5 and network server backup to a longer tape rotation to provide a longer horizon for restoration of data, program, and security files.
- The IT Division increased the number of members (archives) of data files on the i5 Production System to provide a longer horizon for data recovery or reprocessing.
- The IT Division requested and received ADC programming to perform a daily backup and off-site storage of the daily, weekly, and bi-weekly financial files. This includes all GAD, Retirement, Payroll, CARES, Child Support, and RAD files that are retrieved from ADC and processed by STO. RSTARS reference

files are also included in the backups. If the IT Division were to declare a Contingency, these tapes could be routed to our Contingency site at DPS and permit processing and disbursement to continue. The IT Division also acquired and placed a 3590 Tape Drive, compatible with ADC tapes, at our DPS Contingency site.

- The IT Division acquired new battery backup units to support all of our network equipment, file servers, and IBM i5 systems.
- The IT Division ran new electrical circuits to better balance the electrical needs of the network equipment, file servers, and IBM i5 systems.
- The IT Division updated hardware and network hardware drawings and device lists. These updates were presented to the auditors in May of 2006.
- The IT Division created automated archiving of daily reports on the i5 system. The archived reports save paper and storage needs, and provide users with historical reporting that could be used during a recovery from a catastrophic event.

The IT Division will be working with the Office's Directors to define the Office's: Business Impact, Roles and Responsibilities, and Risk Assessment for the IT Division's Contingency Plan.

The IT Division's Business Recovery Outline was presented and approved by management back in 2005. The Office intends to develop a formal Business Plan for the Office in the near future.

Non-Budgeted Funds:

Finding #15
Certain fees were retained without authorization.

Recommendation:

We again recommend that the Office revert the balance of unexpended capital lease financing fees in the aforementioned non-budgeted fund to the General fund and that, in the future, any such balances be reverted at year end.

Response:

We concur and have fully implemented the recommendation. In accordance with the formalized and documented procedure, on January 5, 2007, the balance of the unexpended Capital Lease Financing Fees, totaling \$354,506.13, was transferred to the State's General Fund. In the future, the Office will revert to the General Fund the

balance of the unexpended Capital Lease Financing Fees on an annual basis as part of the fiscal year-end closing.

Appropriations:

Finding #16

The Office did not advise the Board of Public Works (BPW) that an information technology contract also included \$660,000 for consulting services.

Recommendation:

We recommend that the Office advise BPW that the contract previously submitted to it also included \$660,000 for consulting services. We also recommend that, in the future, the Office fully and accurately describe contracts submitted to BPW.

Response:

The Office concurs with the findings and recommendations.

A request for a sole source procurement of both new computer equipment and consulting services for programming the migration of Office programs to the new computer system was submitted to DBM and approved on August 31, 2005. The STO anticipated replacing the computer system around the end of 2005, with programming services extending through June 2006.

Prior to the execution of a contract and approval by the BPW, and while the Office IT staff was developing a Project Plan for the migration, a serious and progressive increase in hardware failures and capacity errors led the Office, on an emergency basis, to direct the sole source vendor to immediately replace the computer system. A contract was executed by the Office and the vendor for the replacement of the computer system between October 11 and November 14, 2005.

In reporting the emergency procurement to the BPW, The Office's staff focused on the emergency nature of the hardware replacement, and neglected to include the corresponding and necessary consulting services, which were included in the contract and in the DBM approval. This oversight can be attributed to several factors: 1) a new IT Director, unfamiliar with State procurement procedures and concentrating on fixing a computer system to preserve essential State functions (e.g., timely and correct processing of daily State disbursements); 2) the sudden resignation of the Office's procurement officer resulting in a gap in that position during this timeframe; and 3) preparation of the BPW Agenda item by Office staff not familiar with the consulting portion of the contract.

On May 23, 2007, the Board of Public Works's approved the Office's corrected Report of Emergency Procurement for this contract and the Office will ensure that future reports are correctly completed.

Cash Management Improvement Act (CMIA):

Finding #17

The Office did not adequately monitor State agency reporting of CMIA activity.

Recommendation:

We again recommend that the Office review the reasonableness of annual reports of federal assistance program activity submitted by participating State agencies by comparing them with the State's accounting records.

Response:

The Office continues to agree with the goal of the recommendation and agrees that it would be desirable to implement it. Unfortunately, the only truly accurate way to directly reconcile CMIA receipts to R*STARS would be via the CMIA module which could be installed on FMIS, but this installation has never been implemented by the State. In the absence of the CMIA module, however, the Office has been examining other indirect methods to reconcile CMIA receipts to R*STARS.

Effective July 1, 2007, and each quarter thereafter, STO will require State agencies to submit a new CMIA Summary Report for each CMIA Program. In addition to other pertinent information, the new CMIA Summary Report will require State agencies to provide R*STARS documentation. The Summary Reports will be reviewed for accuracy and will be verified to the R*STARS information provided by the State agencies. State agencies that do not use R*STARS will be required to provide documentation that the amounts agree to their Non-R*STARS accounting system. All supporting documentation will be retained for audit purposes.

Given the fact that some of the State agencies do not use the R*STARS system, as well as the fact that some have not been able to supply the R*STARS reconciliations as previously and repeatedly requested by the Office, the Office will search to identify a method to which all State agencies can conform. The Office will investigate the possibility of a consistent methodology by requesting from the Federal Financial Management Service (FMS) a report of draws/receipts that State agencies are making from Federal awarding agencies. If this data is provided to the Office, the Office will explore the possibility of verifying the Federal reports to the state agency's CMIA schedules and then ultimately to R*STARS.

In addition, the STO has worked with the FMIS help desk in order to create a report that would assist us with reconciliations and verification of State CMIA schedules to R*STARS. Unfortunately, the reports provided by the FMIS help desk thus far have not provided the information needed to assist the Office with the reconciliation process. We have also contacted Bearing Point for consulting services regarding CMIA Clearance

Pattern calculations. The estimated cost of assistance with Clearance Pattern calculations was approximately \$40,000. However, the total project cost for reconciliation assistance was indeterminate until Bearing Point had a chance to review the necessary components and provide an estimate.

In Fiscal Years 2005 and 2006, the Office, in fact, did request State agencies to provide R*STARS reconciliations. In Fiscal Year 2006, State agencies provided R*STARS reconciliations for four programs and alternate federal awarding agency documentation to support three programs. The Office randomly sampled transactions for two CMIA programs. The Office was not able to verify documents, or did not receive supporting documentation from State agencies that could be verified to R*STARS or to the Federal granting agencies for the remaining ten CMIA programs. We will attempt to strengthen this effort in the coming year and examine ways to require greater compliance with requests.

We are currently working with the State agency identified by the Legislative Auditor as not reporting \$385 million of federal fund activity to the STO during the period from July 1, 2001 through June 30, 2005. This is being done to determine if the resulting CMIA interest obligation, if any, may be due or reportable to FMS.

Cash Receipts:

Finding #18

An employee independent of the cash receipts function did not account for prenumbered cash receipts forms used to record collections.

Recommendation:

We recommend that an employee independent of the cash receipts function verify the numerical continuity of prenumbered receipts forms issued as part of the daily deposit verification to ensure that all collections initially recorded on the prenumbered receipt forms were deposited, and periodically account for all prenumbered receipt forms as to issued, or on-hand. We advised the Office on accomplishing the necessary separation of duties using existing personnel.

Response:

The Office concurs and has fully implemented the recommendation. As of the February 2007 monthly reconciliation, an employee independent of the cash receipts function has been reviewing and verifying the numerical continuity of the pre-numbered receipt forms, as the Auditor recommended, as part of the daily deposit verification to ensure that all collections initially recorded on the pre-numbered receipt forms were deposited.

In addition, as part of the monthly reconciliation process, we are now accounting for all pre-numbered receipt forms as to issued, voided, or on hand. All supporting documentation will be retained for audit purposes.

Contractual Services – Potential Conflict of Interest:

Finding #19

A potential conflict of interest involving a management official should be submitted to the State Ethics Commission for re-evaluation.

Recommendation:

We recommend that the Office refer this matter to the State Ethics Commission for re-evaluation.

Response:

The Office does not agree with the OLA's characterization of this matter as a potential conflict of interest that involves this Office and notes that the events described occurred prior to the time frame of this audit and prior to this Treasurer's tenure in office. Nevertheless, when this issue was brought to the Office's attention in March 2007, the Treasurer, with the assistance of her Internal Auditor, immediately initiated a process of examining and reviewing all available documents and evidence pertaining to this matter. In addition, the Treasurer personally spoke with the former Executive Director and former General Counsel of the State Ethics Commission, present and past employees of the Office and other relevant parties. Upon completion of this review in May 2007, the Treasurer concluded and notified the OLA that the allegations of misstatements of fact were not supported by the evidence and, therefore, did not provide a sufficient basis upon which to refer this matter further.

Moreover, as the OLA has previously been advised, the documents establish that the spouse's firm was disclosed on schedule H (Employment/Business Ownership) of each annual financial disclosure statement, but mistakenly not replicated on schedules E (Offices, Directorships, Salaried Employment) or B (Interests in Corporations and Partnerships). The amendments that the State Ethics Commission advised the employee to make when the inquiry was closed in 2002 remedied this omission by replicating the information on these schedules. For this reason, there is no basis upon which to refer this matter to the State Ethics Commission for re-evaluation.

With respect to the OLA's observation that the Office paid \$250 for each investigation conducted during fiscal year 2002, the Office has previously established and advised the OLA that the scope of the \$250 background investigations ordered by the prior Treasurer was more expansive than the \$55 computer searches conducted during the current audit period. The record is clear that the earlier investigations were significantly more extensive and required considerably more external background investigative work. The earlier checks required investigation into the history and status of civil and domestic court disputes, and credit investigations including a check for records of liens, judgments, bankruptcies and educational loans. For that reason, the \$250 investigations conducted

during fiscal year 2002 are simply not comparable to the computer searches conducted today. Indeed, a recent market survey conducted by this Office indicated that the cost for a truly comparable background investigation today would range from \$300 (within the Baltimore Metro Area, covering Baltimore Co., Baltimore City, Harford Co., Howard Co. and Anne Arundel Co.) to \$600 (for all other counties in Maryland). Thus, any disparity in the cost of the investigations is due to the scope of the services provided and does not evidence a potential conflict of interest.

With respect to the four alleged misstatements of fact cited by the OLA, documentary and other evidence does not appear to substantiate an allegation of misstatements and thus, does not support a referral.

- The first alleged misstatement is based on the OLA's assertion that invoices addressed directly to this management official contradict the State Ethics Commission information that the management official played no part in the procurement or oversight of this vendor. In fact, at the time of the 1997 procurement, the employee's responsibility was limited to the Office's Administration Division, and did not include control authority over the Office's personnel actions or procurement functions aside from routine purchases of office supplies. Procurement of services (e.g. banking, accounting and auditing) and personnel authority rested with a prior Chief Deputy Treasurer who served as the official Procurement Officer when the enhanced background investigation contract was initiated and authorized. However, invoices for background investigations and any other services and supplies would have been processed by the Administration Division staff like any other accounts payable. Also, results of investigations of applicants for Administration Division positions, if any, might have been addressed to the employee. The Treasurer does not conclude that receipt of investigative results or invoices contradicts the employee's and other staff's statements that the employee played no part in the procurement and oversight of the background investigative firm.

- The second alleged misstatement is that the management official and a subordinate employee indicated that the prior Chief Deputy Treasurer had approved the arrangement, which he apparently denies. In fact, the Treasurer located and reviewed documentation that indicates that the extended background investigations were initiated prior to the departure of the prior Chief Deputy who served as the Office's Procurement Officer. Another employee who has served in the Office for many years and who normally processed procurements of office supplies and other small purchases stated that in 1997, she was directed by the then Chief Deputy Treasurer to expeditiously conduct a procurement of the new background investigative service. The employee attests to soliciting several competing bids, logging them, and keeping the Chief Deputy Treasurer informed of the progress of the procurement. According to this employee, the Chief Deputy Treasurer as Procurement Officer, authorized the solicitation and approved the final contract award as was the standard operating procedure at the time. The Treasurer does not conclude on the basis of evidence any misstatement of facts on the part of the official that would warrant a re-referral to the State Ethics Commission.

- The third alleged misstatement is the listing of the management official as the treasurer of the firm on personal property returns filed in June 2001 and April 2002 with the State Department of Assessments and Taxation when the official had resigned from that position in 1995. The Treasurer found that the State Ethics Commission had already thoroughly reviewed and resolved this issue. As part of its inquiry, the Commission obtained and reviewed copies of minutes of the official 1995 meeting at which the management official resigned as treasurer of the firm as well as copies of the firm's personal property returns, signed by the employee's spouse, which erroneously listed the employee as treasurer. Confirmation that the listing of the employee as treasurer of the firm was a mistake is supported by a letter from the certified public accountant who had prepared the personal property tax returns. That affirmation, which has been provided to the OLA, states that the accounting firm was unaware of the employee's resignation in 1995, and erroneously listed her as an officer on tax returns that were filed subsequent to that date.

In its inquiry, the Commission noted that the employee had been properly listed as the treasurer of the firm on financial disclosure statements through 1995, and had appropriately ceased such disclosure after that year. At the closure of its inquiry, the Commission acknowledged the employee's voluntary agreement to rectify any discrepancies in the paperwork filed on behalf of the spouse's firm. The Treasurer has verified that this action has been taken. Thus, the Commission has already examined this issue and in closing its inquiry found no need to take further action. Consequently, there is no basis here for referring this issue back to the State Ethics Commission for reevaluation.

- The fourth and final alleged misstatement of fact is with respect to a vehicle that the employee drives and which was and remains titled to the spouse's firm. The Treasurer found that the firm, which served corporate clients with assignments throughout the State, employed between 12 and 15 investigators at any one time and these investigators shared access to all of the vehicles (8 to 10) that were titled to the firm, including the vehicle in question. When the firm ceased operation in 2002, the vehicle was retained by the employee's spouse and the employee continues to drive the vehicle. The Treasurer found that the employee had offered all personal and corporate tax returns and corporate records to the State Ethics Commission during the course of its inquiry and that the Commission had access to all of that information. The Treasurer also found, as is known to the OLA, that although there is no specific provision on the financial disclosure forms for use of a corporate vehicle, the management official filed Financial Disclosure Form Amendments for the years 2001 and 2002, disclosing the use of this vehicle. On this basis as well, the Treasurer cannot conclude that re-evaluation by the State Ethics Commission is appropriate.

The Treasurer concurs that State ethics law generally precludes an employee from having a financial interest in any entity that does business with the employee's agency. "Financial interest", however, is not always clear and did not include attributable ownership of an entity by one's spouse until the enactment of SB 719, Chapter 302 of the Laws of Maryland of 1999, effective October 1, 1999. Nevertheless, required or not, the

management official did report their spouse's firm on each annual financial disclosure statement. Furthermore, the employee voluntarily provided the State Ethics Commission with income tax returns showing that neither they nor their spouse received income or profit from the firm. The Commission was fully aware of the firm and any issues of financial interest when it closed its inquiry in February 2003. The Treasurer, recognizing the evidence and documents which the Commission has already reviewed and the results of her own further review, which results have previously been provided to the OLA, has not found evidence of any misstatements of fact warranting referral of this matter to the State Ethics Commission for re-evaluation.

APPENDIX B

Auditor's Comments on Agency Response

The Office of the State Treasurer, in its response (Appendix A) to the audit report, disagreed with our comments and recommendations related to Contractual Services – Potential Conflict of Interest (Finding 19). We have reviewed the Office's detailed response to that issue and provide the following comments:

We continue to believe that the comments made in the report are valid. On a number of occasions, the employee in question failed to disclose on annual financial disclosure statements (as required) that the firm owned by the employee's spouse had conducted business with the State (that is, the Office of the State Treasurer). While the employee subsequently submitted revised disclosure statements, these revisions were only done after the employee's initial submission was challenged by the State Ethics Commission. In addition, the Office's response noted that the State Ethics law that generally precludes an employee from having a financial interest (including ownership by a spouse) in any entity that does business with the employee's agency was not effective until October 1, 1999. However, as stated in our report, the spouse's firm maintained a business relationship with the Office of the State Treasurer through March 2002.

In accordance with State law, all areas of disagreement will be addressed through separate correspondence between this Office and the Office of the State Treasurer.

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