

# Audit Report

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## Office of the Secretary of State

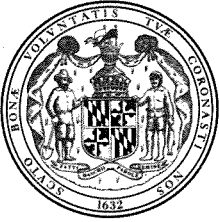
January 2015

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**OFFICE OF LEGISLATIVE AUDITS**  
DEPARTMENT OF LEGISLATIVE SERVICES  
MARYLAND GENERAL ASSEMBLY

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DEPARTMENT OF LEGISLATIVE SERVICES  
OFFICE OF LEGISLATIVE AUDITS  
MARYLAND GENERAL ASSEMBLY

January 9, 2015

Karl S. Aro  
Executive Director

Thomas J. Barnickel III, CPA  
Legislative Auditor

Senator James C. Rosapepe, Co-Chair, Joint Audit Committee  
Delegate Guy J. Guzzone, Co-Chair, Joint Audit Committee  
Members of Joint Audit Committee  
Annapolis, Maryland

Ladies and Gentlemen:

We have conducted a fiscal compliance audit of the Office of the Secretary of State for the period beginning March 2, 2011 and ending June 3, 2014. Under the Maryland Constitution and State statutes, the Office performs a variety of duties including attesting to the Governor's signature on all public papers; registering, regulating, and informing the public about charitable organizations; and administering the Notary Public laws. The Office also includes the Division of State Documents, which compiles and publishes all of the State's administrative regulations.

Our audit disclosed certain record keeping and internal control deficiencies with respect to monitoring charitable organizations and processing cash receipts. In addition, the Office made payments to certain charitable organizations without establishing required agreements with those organizations describing the allowable use of the funds or obtaining reports to account for the expenditures.

The Office's response to our findings and recommendations is included as an appendix to this report. We wish to acknowledge the cooperation extended to us by the Office during the course of this audit.

Respectfully submitted,

Thomas J. Barnickel III, CPA  
Legislative Auditor



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

## **Background Information**

### **Agency Responsibilities**

The Office of the Secretary of State attests to the Governor's signature on all public papers and documents, and is the repository for the Governor's Executive Orders. The Office's Charities and Legal Services Division registers, regulates, and informs the public about charitable organizations (including foundations affiliated with State agencies) and professional solicitors. The Division also administers the Notary Public laws and issues Notary Public commissions, registers trademarks, prepares and processes extraditions and requisitions issued by the Governor, and registers public offering statements for condominiums and timeshares. The Office's Division of State Documents compiles and publishes all of the State's administrative regulations in the Maryland Register and the Code of Maryland Regulations. According to the State's records, the Office's operating expenditures during fiscal year 2014 totaled approximately \$2.3 million.

### **Status of Findings From Preceding Audit Report**

Our audit included a review to determine the status of the five findings contained in our preceding audit report dated October 20, 2011. We determined that the Office satisfactorily addressed three of these findings. The remaining two findings are repeated in this report.

# Findings and Recommendations

## Charitable Organizations

### **Finding 1**

**Procedures and controls were not sufficient to ensure that charitable organizations complied with annual reporting requirements, that registrations were processed timely, and that critical data were accurately recorded.**

### **Analysis**

The Office lacked sufficient procedures and controls to ensure that charitable organizations complied with annual reporting requirements, that registrations were timely processed and that related information received from charitable organizations was accurately recorded. State law requires charitable organizations to register with the State and, thereafter, file certain annual reports within six months after the organization's fiscal year end, unless they meet the criteria for exemption. Exempt organizations include, for example, religious organizations and organizations with less than \$25,000 in annual contributions from the public. Charitable organizations claiming exemption must submit evidence of exemption to the State. As of June 17, 2014, the Office's records showed 13,385 active charitable organizations of which 3,983 were classified as exempt and 2,205 were classified as delinquent due to the failure to submit annual reports.

- Our test of 15 delinquent charitable organizations disclosed that the Office had not performed any follow-up activity on 8 of these 15 organizations. As of June 2014, these 8 organizations had been delinquent for periods ranging from 8 to 12 months. We noted that the Office had properly reported that these 15 charities were not in compliance on its website.
- Our test of 15 additional charitable organizations designated in the Office's database as exempt from registration disclosed that 5 of these organizations did not meet the requirements for exempt status based upon annual contribution amounts reported. These 5 organizations were designated as exempt on the basis of receiving less than \$25,000 in annual contributions; however, the most recent annual reports submitted by these organizations indicated that they received between \$118,500 and \$298,445 in contributions. The failure to properly designate the status on the system may preclude effective monitoring of these organizations to ensure compliance with the additional registration and reporting requirements for organizations receiving \$25,000 or more in charitable contributions.

- Independent verifications were not performed to ensure that the information reported by charitable organizations, including annual contributions, was accurately recorded in the Office's charitable organizations database. Since the database automatically interfaces with the Office's public website and can affect the organization's status as exempt or not exempt, it is critical that these data be accurate. Our review of information recorded for the aforementioned 15 exempt charitable organizations disclosed 5 for which the annual contribution amounts did not agree with supporting documentation submitted by the organizations. For example, the amount reported by one organization (\$194,000) exceeded the amount recorded in the Office's database (\$143,000) by approximately \$51,000.
- As of July 16, 2014, the Office had 3,839 unprocessed new and renewal registration forms that had been outstanding since May 2, 2014. State law requires that charities be notified of any registration deficiency, such as missing documents, within 10 days of receipt; otherwise, the charity is automatically considered registered with the State regardless of any such deficiency. We were advised by the Office that the backlog occurred due to a lack of resources and outdated software.

Similar conditions were commented upon in our preceding audit report.

### **Recommendation 1**

**We recommend that the Office**

- ensure that timely follow-up is performed to obtain annual reports from delinquent organizations (repeat),**
- ensure that organizations designated as exempt meet the required exemption criteria (repeat),**
- perform independent verifications to ensure that information reported by charitable organizations is accurately recorded in the Office's database (repeat), and**
- process applications on a timely basis.**

## **Cash Receipts**

### **Finding 2**

**Adequate controls were not established over cash receipts.**

### **Analysis**

The Office had not established adequate controls over cash receipts. During fiscal year 2014, the Office collected approximately \$2.4 million. These collections



included charity registration fees, notary commission fees, and sales from publications.

- Checks received were not restrictively endorsed immediately upon receipt, but instead were held and endorsed at the end of the day. Furthermore, checks received in person rather than through the mail were stored in an unlocked desk drawer that was accessible to a number of employees throughout the day.
- The supervisory employee who approved voided transactions did not ensure the propriety of the voids by reviewing supporting documentation. Furthermore, this employee was not independent because the employee helped process collections.
- Collections were not verified to deposit by an employee independent of the cash receipts functions. The employee who performed the deposit verification duties also prepared the deposit, recorded collections in the State's accounting records, and initially received collections, in a back-up capacity, when the employee primarily responsible for this duty was unavailable. Furthermore, the Office had no procedure to verify that credit card receipts, which totaled approximately \$204,000 during fiscal year 2013, were properly credited to its account.

The Comptroller of Maryland's *Accounting Procedures Manual* requires that checks be restrictively endorsed upon receipt and safeguarded until deposited. The *Manual* also requires that the reconciliation of the initial record of collections to the amount deposited be performed by an employee independent of the cash receipts function.

Similar conditions regarding the immediate restrictive endorsement and verification of recorded collections to deposit were commented upon in our preceding audit report.

## **Recommendation 2**

**We recommend that the Office**

- a. ensure that checks are restrictively endorsed immediately upon receipt (repeat) and adequately safeguarded prior to deposit;**
- b. ensure that a supervisory employee independent of the cash receipts process verifies the propriety of voided transactions; and**
- c. ensure that an employee independent of the cash receipts function verifies that all collections, including credit card transactions, are subsequently deposited and credited to its account (repeat),**

**We advised the Office on accomplishing the necessary separation of duties using existing personnel.**

## Payments to Charitable Organizations

### **Finding 3**

**Agreements were not prepared for funds provided to certain charitable organizations and accountings for the use of funds were not obtained.**

### **Analysis**

During the period from June 2011 to April 2014, the Office made seven payments totaling \$43,900 to two organizations included in the Office's database of charitable organizations, without establishing agreements to identify the allowable use of those funds as required by law. In addition, the Office did not obtain an accounting of how the funds were used. The Office confirmed that the payments were made as donations or contributions in support of the Maryland Sister States Program which, according to the Office's records, serves as the conduit for Maryland's ten sister state relationships by overseeing an array of international exchanges, promoting a balance of business, educational and cultural interests.

State law requires social organizations, including charitable organizations, to establish an agreement with State agencies providing State aid. The agreement must define the purpose and terms of the aid and require that the organization submit a report that itemizes and accounts for how the aid was spent. The agency is to use the report to determine if the funds were properly expended. However, no such agreement was established with the aforementioned entities.

Furthermore, it does not appear that the payments were properly reflected in the State's records. While \$10,000 of the \$43,900 paid to these two organizations was recorded as grant expenditures, the remaining amounts of \$28,900 and \$5,000 were classified on the Office's records as contractual services and materials and supplies expenditures, respectively.

### **Recommendation 3**

**We recommend that the Office**

- a. establish required agreements with social organizations to which State support is provided, and obtain reports required by such agreements to ensure that the aid provided is properly expended;**
- b. verify that the aforementioned \$43,900 was properly expended; and**
- c. ensure that such expenditures are properly recorded in its records.**

## **Audit Scope, Objectives, and Methodology**

We have conducted a fiscal compliance audit of the Office of the Secretary of State for the period beginning March 2, 2011 and ending June 3, 2014. The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of significance and risk. The areas addressed by the audit included cash receipts, charitable organizations, affiliated foundations, and equipment. We also determined the status of the findings included in our preceding audit report.

To accomplish our audit objectives, our audit procedures included inquiries of appropriate personnel, inspections of documents and records, observations of the Office's operations, and tests of transactions. We also performed various data extracts of pertinent information from the State's Financial Management Information System (such as revenue and expenditure data). The extracts are performed as part of ongoing internal processes established by the Office of Legislative Audits and were subject to various tests to determine data reliability. We determined that the data extracted from this source were sufficiently reliable for the purposes the data were used during this audit. Finally, we performed other auditing procedures that we considered necessary to achieve our audit objectives. The reliability of data used in this report for background or informational purposes was not assessed.

Our audit did not include certain support services provided to the Office by the Executive Department – Governor. These support services (for example, maintenance of accounting records and related fiscal functions) are included within the scope of our audits of the Executive Department – Governor.

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. Also, 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 related to conditions that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect the 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. Other less significant findings were communicated to the Office that did not warrant inclusion in this report.

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.

## APPENDIX

### **STATE OF MARYLAND**

EXECUTIVE DEPARTMENT

**MARTIN O'MALLEY**

GOVERNOR

**ANTHONY G. BROWN**

LT. GOVERNOR



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**JOHN P. MCDONOUGH**

SECRETARY OF STATE

January 5, 2015

Mr. Thomas J. Barnickel III, CPA  
Legislative Auditor  
Office of Legislative Audits  
301 West Preston Street  
Baltimore, MD 21201

Dear Mr. Barnickel:

Thank you for providing me with a copy of the draft report to the Members of the Joint Audit Committee concerning the audit of the Office of the Secretary of State for the period beginning March 2, 2011 and ending June 3, 2014. The Office of the Secretary of State has cooperated openly and fully with the Department of Legislative Services' Office of Legislative Audits to ensure that the Maryland General Assembly, the Executive Branch, and the citizens of Maryland can have the highest confidence in their State Government. Described below are the responses of this Office to the audit findings and recommendations:

*I. Charitable Organizations*

**a. Ensure that timely follow-up is performed to obtain annual reports from delinquent organizations (repeat),**

*We concur with the recommendations. The creation of a designated Assistant Attorney General through HB1352 will allow easier and faster access to legal opinions solely focused on charity investigations and other related legal need of the Office. As well as funding the registration application processing system redesign.*

**b. Ensure that organizations designated as exempt meet the required exemption criteria (repeat),**  
*We concur with the recommendations and have discussed the issue with staff. Clear emphasis was made on the importance of proper designations and random, but regular inspections are being performed. Employees who did not follow established procedures for entering data have been counseled and their work is being monitored regularly.*

**c. Perform independent verifications to ensure that information reported by charitable organizations is accurately recorded in the Office's database (repeat),**

*We concur with the recommendation. In July 2014, the Charities Division Director began random, but regular data entry inspections. During an internal investigation, a single employee's improper data entry was discovered to be the cause of much of the database issues. The employee has been advised of the proper procedures.*

**d. Process applications on a timely basis.**

*We concur with the recommendation. Short term, the Office has adjusted the telephones in the Scanning Room (document retention) to allow both incoming and outgoing calls; this will enable employees to address telephone calls while scanning. In addition, individual scanners will be ordered for employees to have at their desks thus allowing them to multi-task. Other employees are being cross-trained to assist with processing when their primary duties are light. Long term, during the 2014 General Assembly Session, HB1352 was passed and signed into law creating a new special fund for the Charities Division. This fund would be used to upgrade the current manual (paper, U.S. Mail, typing, scanning) Charities' processing system (new program and software) to allow applicants the choice of an online application system. Furthermore, the upgrades would include credit card processing as the current method is by cash or check only. A third Charities employee has been trained and is actively processing charity registration applications. Additionally the office has one full-time temporary employee and one half-time employee working to eliminate the charity registration application backlog. Significant progress has been made to date.*

**2. Cash Receipts**

**a. Ensure checks are restrictively endorsed "for deposit only" immediately upon receipt (repeat) and adequately safeguarded prior to deposit;**

*We concur with the recommendation. Internal controls have been established for mail processing to ensure all incoming checks are restrictively endorsed immediately. A stamp reading "Deposit Only – Secretary of State" is being used by the Certification Desk. Checks are stamped at the time of transaction. The cash drawer at the Certification Desk is kept locked when certification officer is away from his desk. All checks received through in-coming mail are sorted by type, i.e. Charity checks, Notary checks, etc., then immediately scanned and endorsed using an electronic scanner with an endorser attachment.*

**b. Ensure that a supervisory employee independent of the cash receipts process verifies the propriety of voided transactions;**

*We concur with the recommendation. The fiscal officer has begun using the Void Receipt option of our Receipts database to review and initial all voided transactions. A report is prepared weekly of all voids and filed for future reference.*

**c. Ensure that an employee independent of the cash receipts function verifies that all collections, including credit card transactions, are subsequently deposited and credited to its account (repeat),**  
*The Office concurs and has implemented the recommendation. The fiscal officer is performing the independent verification of cash receipts by confirming the Certificate of Deposit reports against the bank deposit tickets, adding machine tapes and related reports on a daily basis. **We advised the Office on accomplishing the necessary separation of duties using existing personnel.** These duties are being accomplished using existing SOS personnel.*

**3. Payments to Charitable Organizations**

**a. Establish required agreements with social organizations to which State support is provided, and obtain reports required by such agreements to ensure that the aid provided is properly expended;**

*The Office concurs with the recommendation and is working with our AAG to prepare an agreement for organizations that manage and distribute contributions/grants on behalf of the Office.*

**b. Verify that the aforementioned \$43,900 was properly expended;**

*The Office concurs with the recommendation and has documents and receipts verifying the proper expenditure of the \$43,900.*

**c. Ensure that such expenditures are properly recorded in its records.**

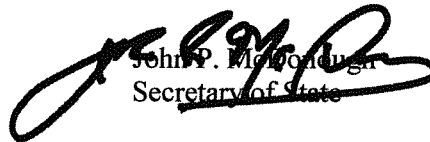
*The Office receives and files reports from the social organizations that detail how the funds were spent.*

*These reports are matched against the contribution amount and purpose to ensure proper use of the grant.*

*The Office is working with our AAG to develop a Grant Agreement form that will be used for all future grants.*

The Office of the Secretary of State appreciates the time and effort taken by the legislative audit staff to conduct our audit. Since our last audit, the Office of the Secretary of State has made tremendous progress discharging its multitude of duties and responsibilities by streamlining operations through improved technology, process analysis, and enhancing the professional capabilities of the staff. We are very proud of our record of providing quality services to the individuals and organizations subject to our administration and regulation, as well as to the citizens of Maryland. Should you have any further questions about the audit, please contact my Director of Finance, Frederick Smalls, at 410-260-3853.

Respectfully,

  
John P. McDonough  
Secretary of State

Cc: Larry Myers  
Director of Financial Administration  
Executive Department

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