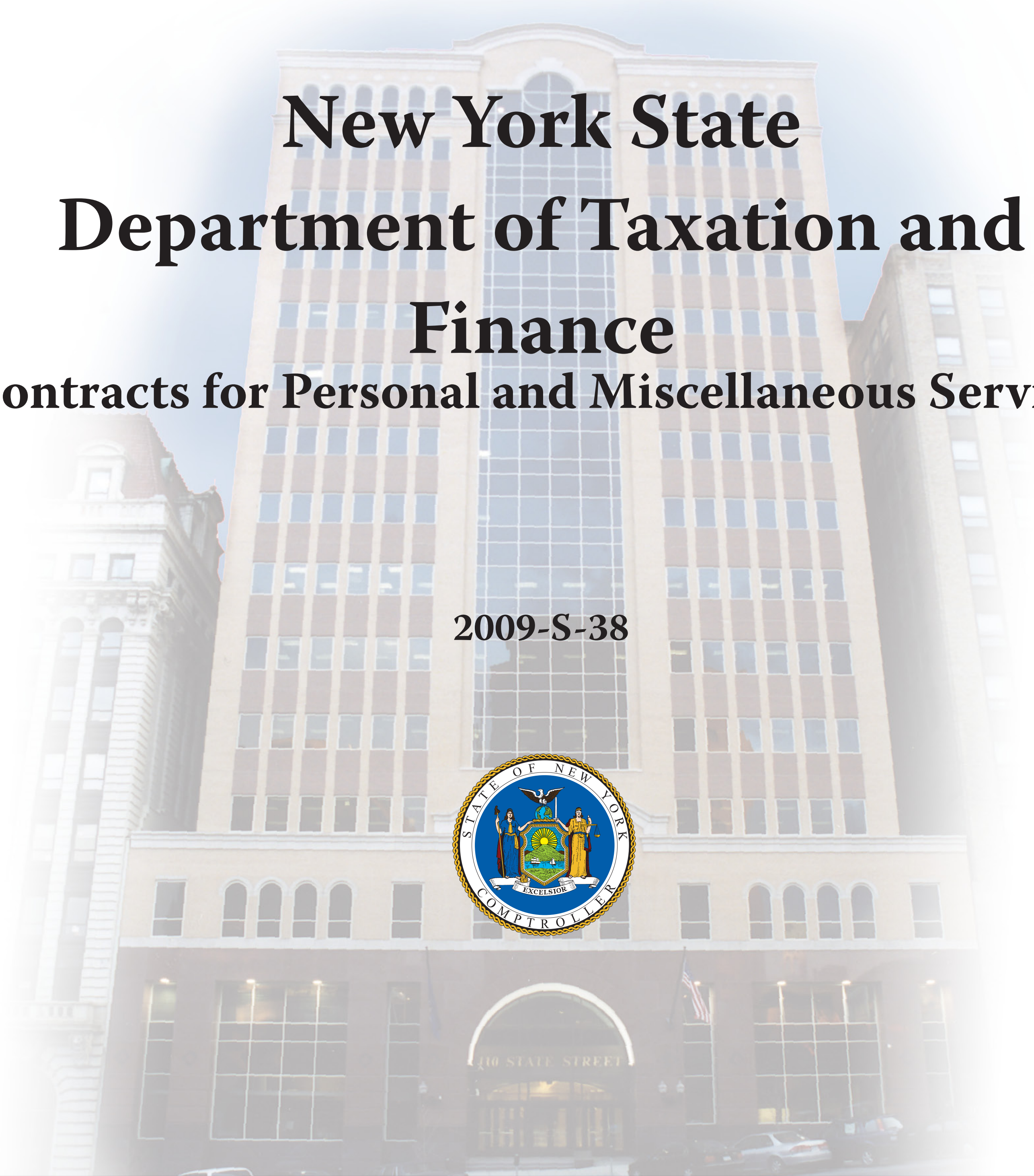
Office of the New York State Comptroller

Division of State Government Accountability

New York State Department of Taxation and Finance

Contracts for Personal and Miscellaneous Services

2009-S-38



Thomas P. DiNapoli

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State of New York
Office of the State Comptroller

Division of State Government Accountability

July 7, 2010

Jamie Woodward
Acting Commissioner
Department of Taxation and Finance
W. A. Harriman Campus, Building 9
Albany, NY 12227

Dear Ms. Woodward:

The Office of the State Comptroller is committed to helping State agencies, public authorities and local government agencies manage government resources efficiently and effectively and, by so doing, providing accountability for tax dollars spent to support government operations. The Comptroller oversees the fiscal affairs of State agencies, public authorities and local government agencies, as well as their compliance with relevant statutes and their observance of good business practices. This fiscal oversight is accomplished, in part, through our audits, which identify opportunities for improving operations. Audits can also identify strategies for reducing costs and strengthening controls that are intended to safeguard assets.

Following is a report of our audit of Contracts for Personal and Miscellaneous Services. This audit was performed pursuant to the State Comptroller's authority under Article V, Section 1, of the State Constitution and Article II, Section 8, of the State Finance Law.

This audit's results and recommendations are resources for you to use in effectively managing your operations and in meeting the expectations of taxpayers. If you have any questions about this report, please feel free to contact us.

Respectfully submitted,

Office of the State Comptroller
Division of State Government Accountability

State of New York
Office of the State Comptroller

EXECUTIVE SUMMARY

Audit Objectives

One objective of our audit was to determine whether the Department of Taxation and Finance (Department) justified the need to contract for personal and miscellaneous services. Another objective was to determine whether the Department periodically reassessed personal and miscellaneous services contracts to identify what work could be deferred, eliminated, or reduced to save State funds.

Audit Results - Summary

Various directives from the New York State Division of the Budget and the Governor's Office include the need for State agencies to justify their personal and miscellaneous service contracts (Service Contracts) and to reassess whether they can be deferred, eliminated or reduced to help achieve overall budgetary reductions and related cost savings. During the three-year period ended March 31, 2009, the Department had 81 active Service Contracts totaling $563.3 million. More than 98 percent of this amount ($554.7 million) related to contracts for either information technology or banking services.

We reviewed six of the contracts for information technology (totaling $77.1 million) and five of the contracts for banking services (totaling $309.6 million). We found that the Department justified the need to contract out for services in all six information technology contracts we reviewed. However, the Department did not support the need to contract out for services in four of the five banking services contracts.

The four banking services contracts, which totaled about $301 million, are for the front-end processing of various types of tax returns. The contracted banks receive the tax returns, deposit the tax payments, scan the returns electronically, and transmit the information to the Department. While these processing activities are necessary, the Department provided no documentation, such as cost-benefit analyses, showing that the activities had to be performed by the banks and could not be performed in-house by Department staff.

The Department has performed periodic reviews of its information technology contracts to determine whether expenses can be reduced by eliminating or reducing contract work. For example, the Department performs an annual review of all information technology contracts to determine whether the contracts should be modified. It also requires the contractors to train Department staff to perform the contracted tasks so that they can eventually take over those tasks. Through these efforts, the Department reports that it has reduced the annual personal service costs of its information technology contracts by about $13.9 million, or almost 50 percent, since the 2006-07 fiscal year.

Although the Department does not perform comparable periodic reviews of its banking services contracts, it is pursuing two major initiatives to reduce its reliance on such contracts. If fully implemented, these two initiatives could result in $12.7 million in annual cost savings. We acknowledge these two initiatives, but note that it might have realized the savings sooner, and avoided an estimated $14.4 million in unnecessary contract extension costs, if it had been periodically performing reviews of its banking services contracts.

Our report contains three recommendations for improving Department efforts to attain savings through justification and reassessment of Service Contracts. Department officials generally agreed with our recommendations and have taken steps to implement changes.

This report, dated July 7, 2010, is available on our web site at: http://www.osc.state.ny.us.
Add or update your mailing list address by contacting us at: (518) 474-3271 or
Office of the State Comptroller
Division of State Government Accountability
110 State Street, 11th Floor
Albany, NY 12236

Introduction

Background

The Department of Taxation and Finance (Department) collects tax revenue and provides associated services in support of government operations in New York State. In fulfilling its responsibilities, the Department collects and accounts for almost $60 billion in State taxes and $40 billion in local taxes; administers 35 State and 7 local taxes, including New York City and City of Yonkers income taxes; and processes approximately 27 million tax returns, registrations, and associated documents each year. The Department also manages the State Treasury, which provides investment and cash management services to various State agencies.

The Department's budget for the 2009-10 fiscal year totaled $487.5 million, including payroll costs of about $320 million for its 5,336 employees. To achieve its mission, the Department enters into personal and miscellaneous service contracts (Service Contracts) such as computer programming, engineering, auditing, printing, advertising, banking, research and analysis, and trash removal. For the fiscal year ended March 31, 2009, the Department spent $68.9 million on these types of contracts, about 41 percent of its total other than personal services expenditures.

During the 3-year period April 1, 2006 through March 31, 2009, the Department had 81 active Service Contracts with a total award value of $563.3 million. The Department obligated more than 98 percent ($554.7 million) of these funds to 47 contracts related to either information technology or banking services.

The following directives issued from the New York State Division of the Budget (DOB) and the Governor set forth expectations for State agencies to make sure that expenditures, including Service Contracts, are justified and are periodically reassessed:

- State Budget Bulletin H-1025, which became effective July 31, 2003, requires agency management to review all contracts (both new and renewals), including those that involve service delivery to affected citizens, to ensure that lower priority, overlapping, or otherwise inefficient activities are eliminated. This Bulletin was in effect until September 2009.
- State Budget Bulletin B-1178, which became effective on April 21, 2008, requires agency management to scrutinize all programs and

operations to identify opportunities to eliminate less important activities and spending on non-essential items. It further requires agencies to develop plans to identify cost-savings and recurring savings. In this regard, under B-1178, agencies are required to scrutinize spending for contractual services among several other items. Furthermore, B-1178 requires agencies to develop plans that include a framework for continuing fiscal year 2008-09 savings through to fiscal year 2011-12.

- State Budget Bulletin B-1183, which became effective August 21, 2008, requires State agencies to review all agency programs and operations to identify opportunities for eliminating less essential activities and spending on non-essential items.
- On June 4, 2008, the Governor issued Executive Order No. 6 (Order) requiring State agencies not to enter into Qualified Personal Services Contracts (e.g., engineering, research and analysis, data processing) exceeding $1 million or more over any 12-month period unless the agency first determined that: (a) the contractor can carry out the task more efficiently or effectively than State employees; (b) the contractor can carry out the task for a lower cost than State employees; or (c) the contract is necessary to protect the public health or safety, or is necessary for some other compelling reason.

Both the Budget Bulletins and the Order have added significance given the State's increasing fiscal difficulties. In this regard, in August 2008, the Governor directed that State agencies evaluate all programs and operations to identify opportunities to eliminate less-essential activities and achieve spending reductions of 10.35 percent in State fiscal year 2008-09. As part of this responsibility, State agencies were to develop a detailed plan that described the agency's proposed process for reviewing/approving non-personal service spending. Agencies were expected to balance personal service and non-personal service reductions so as to not disproportionately impact either, and to ensure recurring savings in both categories.

Audit Scope and Methodology

One objective of our audit was to determine whether the Department justified the need to contract for personal and miscellaneous services. Another objective was to determine whether the Department periodically reassessed Service Contracts to identify what work could be deferred, eliminated, or reduced to save State funds. For the purposes of our audit, Service Contracts are those in which the majority of the costs associated with the contracts are for services and labor. We did not include contracts for commodities or capital construction. Our audit period was April 1, 2006 through November 17, 2009.

To accomplish our objectives, we interviewed Department personnel and reviewed contracts and supporting documentation provided by the Department. We also reviewed State laws, the Order, and DOB Bulletins. We judgmentally selected for review 11 of the 18 Service Contracts that were active as of July 31, 2009, focusing on large-dollar contracts for information technology (six contracts totaling $77.1 million) and banking services (five contracts totaling $309.6 million). Our sample included the only Department contract subject to the reporting requirements of the Order (an information technology contract).

We conducted our performance audit 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.

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State. These include operating the State's accounting system; preparing the State's financial statements; and approving State contracts, refunds, and other payments. In addition, the Comptroller appoints members to certain boards, commissions and public authorities, some of whom have minority voting rights. These duties may be considered management functions for purposes of evaluating organizational independence under generally accepted government auditing standards. In our opinion, these functions do not affect our ability to conduct independent audits of program performance.

Authority

The audit was performed pursuant to the State Comptroller's authority as set forth in Article V, Section 1, of the State Constitution and Article II, Section 8, of the State Finance Law.

Reporting Requirements

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

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

Contributors to the Report

Major contributors to this report include Frank Houston, Albert Kee, Greg Petschke, Scott Heid, Donald Cosgrove, Theirry Demoly and Dana Newhouse.

Audit Findings and Recommendations

Justification of Service Contracts

According to DOB guidelines, when contracting out for services, State agencies should determine whether the services are, in fact, necessary, and if so, whether in-house staff could provide those services instead of outside vendors. In our sample of information technology and banking services contracts, we found that the Department could support the need to contract out for information technology services, but usually could not support the need to contract out for banking services.

Information Technology Contracts

The Department uses information technology (IT) consultants primarily to support its own employees assigned to ongoing projects controlled by the Department. In addition, the consultants are used for system enhancements to support legislative changes, operational support, ad hoc requests, and routine maintenance for new and existing systems. At the time of our audit, the Department had a total of 619 full-time equivalent employees and 70 consultants assigned to its IT program.

We reviewed six IT contracts valued at $77.1 million, with $48.6 million expended as of March 31, 2009. We found that the Department adequately supported the need to contract out for the services in all six contracts. For each of the six contracts, the Department provided documentation (a "needs" statement) outlining the basis for the contract. The Department also sought and received approval from the Office for Technology (OFT) for the five contracts requiring such approval (one contract, for the purchase and maintenance of a mainframe system, did not require OFT approval). In addition, the Department has submitted an annual technology plan to OFT, as required by DOB Bulletin H-300A, and this plan appropriately describes the Department's needs for IT-based contracts.

Under the Order, all State agencies are required to report to the Governor's Task Force on Personal Services Contracting, all contracts entered into on or after August 4, 2008, except those for legal services, for which there is a personal service component of $1 million or more over any 12-month period. In its first required submission under this Executive Order in June 2009, the Department determined that it had one reportable contract (a $4.4-million IT contract for vendor-specific software assistance). We reviewed the Service Contracts entered into by the Department on or after August 4, 2008, and found that the Department was in compliance with the reporting requirements of the Order.

Banking Services Contracts

Generally, the Department contracts with banks to process the various types of taxes it collects. We reviewed five banking services contracts valued at $309.6 million, with $158.7 million expended as of March 31, 2009. We found that the Department could support the need to contract out for the services in one of these contracts (valued at $8.5 million, with $7 million expended). However, the Department provided no documentation to support the need to contract out for the services in the other four contracts (valued at $301.1 million, with $151.7 million expended). The services in these four contracts were necessary; however, it was not clear that the Department needed to contract out for the services.

The contract whose need was supported related to the Department's Personal Income Tax Refund Program. In this contract, a bank pays out personal income tax refunds as directed by the Department. Since the funds must be kept in a bank until they are paid out, the need for the contract is clear.

The other four contracts were for front-end processing of (1) personal income taxes, (2) corporation taxes, (3) Singlefile (an on-line service for the combined filing of certain taxes on employers) and electronic payment processing, and (4) various other taxes. In these contracts, the banks receive tax returns, deposit tax payments, scan the tax returns electronically, and transmit the information to the Department. While these activities must be performed, the Department provided no documentation showing that the activities had to be performed by the banks and could not be performed in-house by Department staff instead.

Department officials noted that there are certain advantages to using banks, rather than in-house staff, for these activities, as follows:

- Front-end tax processing has periods of intense peak activity, because taxes are filed either annually, quarterly, or monthly. It could be more costly for the Department to perform front-end processing in-house, because it would have to incur certain fixed costs for the equipment and facilities that would be needed for the peak periods and would continue to bear those fixed costs during the non-peak periods.
- Banks have more flexibility than the Department, and as a result, are better able to meet tax processing deadlines when new equipment must be obtained and new staff must be hired in response to changes caused by new tax legislation.

- The banks are more likely to have the best technologies for tax processing, since they must keep up with new technologies if they are to effectively compete with one another.

However, the Department provided no documentation, such as cost-benefit analyses, to support these claims. We recommend that the Department perform such analyses, and maintain documentation of the analyses, to support the need for such contracts. In addition, as is noted later in this report, the Department has begun to perform certain front-end processing activities in-house, rather than through a bank, and is considering expanding this in-house capability because of its potential for reduced processing costs.

Reassessment of Service Contracts

The Department should perform periodic reviews of all its Service Contracts to identify what work could be deferred, eliminated, or reduced to save State funds. We found that the Department has performed such reviews for its information technology contracts, but has not performed them for its banking services contracts.

Information Technology Contracts

We found that the Department routinely takes certain actions that could reduce costs on its IT contracts. Specifically, it performs an annual review of all IT contracts to determine whether the contracts should be modified and it requires its IT contractors to train Department staff to perform the contracted tasks so that they can eventually take over those tasks.

In 2003, the Department established an Information Technology Portfolio Review Board. Both this Board and its Executive Review Board review and approve all new technology projects, evaluating the business need for the projects and the resources (in-house and contracted) to be assigned to the projects. Five of the six IT contracts in our sample (all but a contract for the purchase and maintenance of a new mainframe) were parts of projects that were reviewed and approved by these Boards.

In addition, the Department's IT contracts routinely contain clauses requiring the consultants to train Department staff to perform the tasks. As Department staff assume these responsibilities, the number of consultants required for any one contract decreases over the life of the contract, thereby reducing the annual cost of the contract. Through these efforts, along with the annual review of IT needs, the Department reports that it has reduced its annual IT consulting costs by about $13.9 million, or almost 50 percent, since the 2006-07 fiscal year.

The Department's Chief Information Officer notes that the Department's reliance on IT consultants will never cease entirely, because they help address problems caused by staff turnover. When staff retire or transfer outside the Department, it takes about six months to train their replacements, and there is an information gap during this six-month period. The consultants fill these gaps since they already possess the requisite knowledge, skills, and abilities to perform the tasks. In addition, since fiscal year 2006-07, the Department has recruited 18 consultant employees to become permanent Department employees.

Banking Services Contracts

While the Department does not perform periodic reviews of its banking services contracts, it is pursuing two major initiatives to reduce its reliance on such contracts. If fully implemented, the initiatives could result in $12.7 million in annual cost savings.

In the first initiative, the Department is shifting taxpayers from paper tax returns to electronic returns (e-filing and web-filing) and payment (e-payment). Since the 2006-07 fiscal year, the Department has developed e-filing systems for personal income taxes, corporation taxes, sales taxes, and withholding taxes. In addition, the Department has mandated e-filing/web-filing for corporation taxes, partnership returns, and high-value sales tax vendors.

Department officials state that these applications save the State money by reducing the Department's dependence on banking services contracts and by improving the accuracy and speed of tax processing activities. According to Department officials, this initiative reduced the cost of its banking services contracts by nearly $2.7 million in fiscal year 2008-09 alone. The Department plans to mandate e-filing for monthly filers, which would further reduce costs.

In the second initiative, the Department is developing an in-house processing center for tax returns. In 2007, the Department began processing highway use tax returns at this in-house processing center (the returns were previously processed through one of the banking services contracts), and later began processing returns for various new taxes at the center.

The Department spent about $1.2 million to create and staff the center. We determined that the Department has saved more than $210,000 annually (23.3 percent) by processing highway use tax returns in-house instead of through the banking services contract. As an illustration, if the

Department transferred the remainder of its tax processing activities to its in-house center, and realized the same level of savings (23.3 percent), we estimate it could save up to $10 million a year.

Department officials stated that they are analyzing the feasibility of processing additional taxes in-house rather than through banking services contracts. They are currently performing this analysis for corporation taxes, and plan to perform the analysis for personal income taxes and business taxes, as well.

Since the Department has yet to determine whether it would, in fact, be cost-effective to transfer its corporation tax processing activities to its in-house center, it had to extend the current corporation tax banking services contract beyond its December 31, 2009 expiration date, and in doing so, obtained a two-year single source contract extension with the current bank. This extension, which was not competitively bid, could cost the Department an estimated $14.4 million more than the expired contract over the two-year period.

If the Department had been performing periodic reviews of its banking services contracts, it might have completed its cost-benefit analysis before the contract expired and avoided some or all of this additional cost. We recommend the Department periodically review all its Service Contracts to determine whether any of them can be deferred, eliminated, reduced or done by Department employees. In addition, since the banking services contracts for personal income taxes and business taxes are scheduled to expire on December 31, 2011 and December 31, 2013, respectively, we recommend the Department complete its cost-benefit analyses for those tax processing activities well in advance of those dates, so there is no need to extend those contracts non-competitively.

Recommendations

1. Enlist executive management to communicate to appropriate staff the requirement to support Service Contracts with written justifications of the need for the service, the appropriate level of service, and the need to contract out.

2. Instruct managers to periodically reassess all Service Contracts to identify opportunities to suspend, eliminate, reduce, or bring them in-house.

3. Complete the cost-benefit analyses for transferring personal income tax and business tax processing activities in-house before the contracts for those activities expire, so there is no need to extend those contracts non-competitively.

Agency Comments

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

JAMIE WOODWARD
ACTING COMMISSIONER

June 17, 2010

Mr. Frank J. Houston
Audit Director
Office of the State Comptroller
Division of State Government Accountability
123 William Street, 21st floor
New York, NY 10038

Dear Mr. Houston:

Thank you for the opportunity to comment on your draft audit report (2009-S-38), "*Contracts for Personal and Miscellaneous Services.*" We are pleased that your audit found that we justify our information technology contracts and review them on a regular basis. Your draft report also recognized our cost-saving initiatives to expand electronic filing and to develop an in-house returns processing center.

Following are our specific responses to the recommendations:

Recommendation 1:
Enlist executive management to communicate to appropriate staff the requirement to support Service Contracts with written justifications of the need for the service, the appropriate level of service, and the need to contract out.

DTF Response: We have instructed staff responsible for administration of the banking service contracts to provide written justifications for future procurements of banking services.

Recommendation 2:
Instruct managers to periodically reassess all Service Contracts to identify opportunities to suspend, eliminate, reduce or bring them in-house.

DTF Response: We agree. Our long-term vision is to move our service model to a combination of web-based self-service and expanded electronic filing. Our strategy is to pilot a new service approach and then build on the pilot to expand our services. Starting as a pilot program in the 1990's, our personal income tax e-filing program has been a great success and now accounts for about 60% of returns filed. After this in-house implementation, we expanded our electronic channels to include electronic filing for corporation tax; online applications for STAR rebates and sales tax renewal; and web filing for sales tax, withholding tax and the new Metropolitan Commuter Transportation mobility tax. Implemented and maintained without entering into

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new long-term contracts for e-file services, these electronic channels have produced significant savings.

The second prong of our strategy has been to pilot and then expand the in-house processing of paper returns and checks. Building on our successful highway use tax in-sourcing, we now process sales tax renewal applications, New York City taxicab ride tax returns, and withholding tax payments associated with electronically submitted files, resulting in additional cost savings.

Our tactical plan provides for the continued evaluation of our contractual services, optimally prior to the expiration of contracts. However, given demands for services, reductions in staffing levels and required implementation of new budgetary initiatives each year, we may need to consider contract extensions as well. Our evaluation will consider the scale and scope of processing services, the revenues associated with these programs, and the complexities of transitioning these services prior to the expiration of the contracts.

Recommendation 3:
Complete the cost benefit analyses for transferring personal income tax and business tax processing activities in-house before the contracts for those activities expire, so there is no need to extend those contracts non-competitively.

DTF Response: As noted in your report, the Department is completing a cost benefit analysis for corporation tax processing.

In closing, we continue to appreciate and value OSC's input and suggestions on ways to improve our operation.

Sincerely,

Jamie Woodward

Jamie Woodward
Acting Commissioner