PERFORMANCE AUDIT

DEPARTMENT OF REVENUE

FOLLOW-UP REPORT

Report to the Arizona Legislature
By the Auditor General
September 1987
87-6

AUDITOR GENERAL REPORT SUMMARY

September 1987 Report No. 87-6

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Revenue (DOR) in response to a July 26, 1985, resolution of the Joint Legislative Oversight Committee. This performance audit was conducted as part of the Sunset Review set forth in Arizona Revised Statutes §§41-2351 through 41-2379.

The purpose of this audit is to perform a follow-up review focusing on two previous performance audit reports of the Department of Revenue. These reports, issued by the Auditor General in 1985, are: Report 85-5, Taxation Division and Hearing Office; and Report 85-9, Tax Processing Function. This audit reports the extent of the Department's compliance with the recommendations contained in the two previously issued reports.

The Department Has Made Some Changes In Audit Operations, But Additional Efforts Are Needed

The Department of Revenue has not expanded audit coverage as recommended in the 1985 performance audit. Although the report estimated that increasing audit coverage of sales/use tax accounts would produce an estimated $18 million in additional assessments, coverage remains unchanged, at approximately 1 percent for sales tax. DOR plans to increase audit coverage to 4 percent of the sales tax and corporate income tax account population, but only recently requested the additional staff needed to increase coverage. DOR did not request additional auditors until fiscal year 1988, and even though 15 new positions were authorized for fiscal year 1988, DOR officials do not plan to fill them until at least February 1988 when its new building is expected to be completed. Each month's delay in hiring the new auditors will result in the loss of an estimated $600,000 in potential assessments.

Although some progress has been made, selection systems continue to need improvement and the cyclical audit schedule of major sales taxpayers is outdated. Our analysis showed that 122 major taxpayers were not scheduled for audit, while 65 scheduled audits were for taxpayers no longer on the Department's list of large accounts. DOR staff attribute the discrepancies to changes in the population of major taxpayers. However, the schedule has not been updated, as required by a Department policy, since it was first prepared in early 1986. The Department has also been unable to complete more than one-fifth of its 1985-86 major taxpayer audits, and has not started or completed more than 80 percent of its 1986-87 audits of major taxpayers.

DOR has, however, improved some areas of its audit operations. A review of recent audit files indicates that DOR has strengthened control of the audit process by improving documentation and supervision. The Department has also established a training unit to develop a training program and improve auditor capability to audit large, complex accounts; streamlined the audit protest process; and eliminated the backlog of pending cases in the Hearing Office.

To improve audit coverage, DOR should continue its efforts to increase sales tax and corporate audit staff. To resolve existing audit selection systems weaknesses, DOR should frequently review and update its audit schedule of major sales tax accounts, and should develop an automated audit history and selection system for corporate income tax accounts similar to that currently being developed by the Sales Tax Audit unit.

The Department Of Revenue Has Largely Addressed Recommendations Made To Improve Tax Processing

The Department has improved the effectiveness of its tax processing function by virtually eliminating its use of long-term temporary workers. DOR accomplished this by converting 24 full-time positions occupied by temporary workers to permanent positions during fiscal years 1987 and 1988. Revenue officials report that the conversion has reduced turnover and increased productivity as we had predicted.

DOR has also taken steps to reduce taxpayer errors that contribute to processing problems, by increasing taxpayer education and improving tax form designs. Additionally, the Processing Section has corrected one major source of DOR caused processing errors by key verifying social security number entries.

DOR has strengthened its control over outside contractors. The 1985 audit reported that poor fiscal monitoring allowed a data entry vendor and a personnel services vendor to overcharge the Department by $447,500. Both vendors have agreed to repay the overcharges in the form of credits and discounts. To prevent future overcharges, the Department now monitors billings through a computer program that verifies data entry keystrokes.

Controls over monies have also improved. A recent audit conducted by the Financial Audit Division of our office found receipt handling procedures to be adequate. However, the Department still lacks an independent internal audit group to test adequacy of procedures and compliance with them. DOR requested funding to create such a unit in fiscal year 1987-88, but the request was denied.

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AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

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DEPUTY AUDITOR GENERAL

September 10, 1987

Members of the Arizona Legislature
The Honorable Evan Mecham, Governor
Mr. C. "Hos" Hoskins, Director
Department of Revenue

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Department of Revenue. This report is in response to a July 26, 1985, resolution of the Joint Legislative Oversight Committee.

The report is a follow up review of the Department's progress in implementing recommendations made in previous audits of the Department's tax audit function and its tax processing function. We found substantial improvement in both areas. The Department has developed badly needed training for its auditors and has improved audit supervision. However, audit coverage for sales/use and corporate income taxes has not changed significantly since our previous audit and the Department needs to continue to improve its ability to identify and select the largest, most productive accounts for audit.

In addition, the Department has improved tax processing. Tax forms have been redesigned to better assist taxpayers in avoiding common errors. Use of temporary employees to fill critical processing positions has been eliminated and the Department has taken steps to reduce employee errors that contribute to processing problems.

My staff and I will be pleased to discuss or clarify items in the report.

Respectfully submitted,

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SUMMARY

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scheduled audits were for taxpayers no longer on the Department's list of large accounts. DOR staff attribute the discrepancies to changes in the population of major taxpayers. However, the schedule has not been updated, as required by a Department policy, since it was first prepared in early 1986. The Department has also been unable to complete more than one-fifth of its 1985-86 major taxpayer audits, and has not started or completed more than 80 percent of its 1986-87 audits of major taxpayers.

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DOR has also taken steps to reduce taxpayer errors that contribute to processing problems, by increasing taxpayer education and improving tax form designs. Additionally, the Processing Section has corrected one major source of DOR caused processing errors by key verifying social security number entries.

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This report is a follow-up review which examines the steps taken by DOR to implement recommendations made in two previous performance audit reports issued by the Auditor General in 1985: Report 85-5, an audit of DOR's tax audit function; and Report 85-9, an audit of the Department's tax processing function.

The Tax Audit Function

DOR's Tax Compliance Division, formerly the Taxation Division, contains two Tax Audit Units: Sales/Use Tax, and Income Tax. An office in Tucson also performs sales/use and income tax audits. These units conduct in-house audits of taxpayer returns and field audits of taxpayer records to determine whether taxpayers are accurately reporting and paying tax liabilities. Audits generate revenue when they reveal that additional tax monies are owed to the State. DOR reported total audit collections of $55.6 million in fiscal year 1984-85, and $48.9 million in fiscal year 1985-86.

However, several deficiencies were noted in a 1985 audit issued by the Auditor General. It was reported that: 1) Audit coverage was low and DOR could collect up to $18 million annually in additional revenue by increasing its sales tax audit effort; 2) DOR could increase revenue by improving audit selection systems; 3) DOR lacks adequate controls to ensure the quality and integrity of audit assessments, modifications and amendments; and 4) Protested assessments are not processed efficiently, which increases the potential for loss of revenue.

The Tax Processing Function

Tax processing consists of several work procedures, and is performed within DOR's Data Management Division. Tax returns are received in the Document Staging area, where individual documents are briefly scanned to determine if they look processible. The returns are then sorted by tax type and fowarded to the Document Processing areas, where they are batched with like documents and prepared for NCR coding [1] or data entry. Once in the Data Entry area, document information is entered into the computer system. If a tax document contains an error, caused by either the taxpayer or DOR personnel, the computer rejects the form and the document is sent to one of the Error Resolution areas for correction.

Our 1985 audit identified several problems with tax processing. The previous report noted that the Department: 1) was excessively using temporary employees to fill full-time positions; 2) could reduce processing errors and correct errors more efficiently; 3) needed to improve its contract monitoring procedures; and 4) could improve its control over receipts.

Scope Of Audit

This audit of the Department of Revenue's tax audit and processing functions is limited to a follow-up of recommendations made in the two 1985 audits issued by the Auditor General. It examines steps taken by DOR in the following areas.

- The level of audit coverage for sales tax
- Audit selection systems
- Controls to ensure the quality and integrity of audit assessments, modifications and amendments

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(1) NCR (National Cash Register) machines are used by DOR to encode and serialize all tax documents with money attached, and all checks accompanying these documents. Tax documents received without money bypass NCR coding.

- The efficiency and timeliness of the protest process
- The utilization of temporary staff for tax processing
- Processing errors
- Contract monitoring
- Receipt handling controls

This audit was conducted in accordance with generally accepted governmental auditing standards.

The Auditor General and staff express their appreciation to the Director and staff of the Department of Revenue for their cooperation during the course of the audit.

FINDING I

THE DEPARTMENT HAS MADE SOME CHANGES IN AUDIT OPERATIONS, BUT ADDITIONAL EFFORTS ARE NEEDED

The Department of Revenue (DOR) Tax Compliance Division is taking steps to comply with recommendations made by the Auditor General in 1985, but improvements to date have been limited. The Department has not increased audit coverage for sales/use and corporate income taxes. Selection systems for each tax type require additional improvement. However, the Department has improved audit quality through stronger review and control, and has eliminated the Hearing Office's backlog of protested audit assessments.

Level Of Audit Coverage Is Low, And Unchanged Since Previous Report

Although DOR has developed a plan to increase audit coverage for both sales and corporate income tax, current levels remain low. Current coverage is low compared to DOR's goal of 4 percent for both sales/use and corporate income tax. The Department has recently received approval to hire additional auditors; however, these positions will not be filled immediately and are insufficient to meet coverage and staffing goals.

Our prior audit report determined that DOR could generate up to $18 million in additional revenue by performing more sales tax audits. To perform these audits, we recommended that DOR increase its audit staff (24 auditors at an annual cost of approximately $1 million). More audit staff would provide for a more favorable tax base coverage and, therefore, increase audit assessments. We also recommended that DOR study the feasibility of increasing corporate income tax audit staff.

Low coverage - Audit coverage levels have changed little since fiscal year 1984-85. DOR has adopted our recommendation of a 4 percent target level for both

(1) While staff size has remained static, the number of sales accounts has grown significantly. At the time of our previous report, there were approximately 95,000 total sales tax accounts. As of June 1987, the accounts had increased almost 27 percent to 120,337.

sales/use tax and corporate income tax audits. However, this goal has not been attained, and audit coverage for sales tax has, in fact, decreased. [1] The following table summarizes approximate audit coverage levels for the last three fiscal years.

TABLE I

AUDIT COVERAGE LEVELS FOR SALES/USE AND CORPORATE INCOME TAX FOR FISCAL YEARS 1984-85 THROUGH 1986-87

Tax Type	Fiscal Year		
	1984-85	1985-86	1986-87
Sales/Use	1.1%	1.05%	1.0%
Corporate Income	1.9	2.1	2.1 [a]

(a) This figure is an estimate because complete data was not available.

Source: DOR budget request for fiscal year 1987-88, and Auditor General analysis based on information provided by the Assistant Director of the Tax Compliance Division.

DOR management has determined that to reach its audit coverage goals, sizable increases in audit staff will be necessary. The Department's fiscal year 1987-88 budget request details a plan calling for 80 additional sales tax positions, based on a three year phase-in period, while the corporate income tax unit plans to add 10 positions over two years. For fiscal year 1987-88 DOR requested 36 audit positions (30 sales, six corporate). Only 15 (11 sales, four corporate) [1] were approved. A concerted effort to gain approval for these positions was not apparent

(1) These figures exclude four auditor positions approved for audit selection and audit review.

until the fiscal year 1987-88 budget request. DOR did not request any audit positions for fiscal year 1985-86, in part because the fiscal year 1985-86 request was prepared before our report was issued. However, audit positions again were not requested in fiscal year 1986-87.

Hiring delayed - Although 15 new audit positions have been approved, the Director of the Department does not intend to fill them until DOR conducts a staffing analysis, and until the completion of the new DOR building, projected for February 1988. According to the Director, this delay is necessary due to insufficient space in the existing office. The Department also plans to conduct an internal staffing analysis to identify whether any existing staff can be transferred to fill the sales/use and corporate income tax audit positions. Furthermore, Department officials indicated that before hiring more auditors, they want to complete development of the Auditor training program and improve audit selection. However, since each auditor generates approximately $40,000 in assessments per month, DOR stands to lose more than $600,000 in assessments for each month the newly approved audit positions are not filled.

Audit Selection Systems For Both Sales Tax And Corporate Income Tax Need Further Improvement

The audit selection systems used by the Sales Tax unit and the Corporate Income Tax unit still need improvement. Although the Sales Tax audit unit has placed all major taxpayers that annually remit more that $500,000 in taxes on a cyclical audit schedule, it still lacks a fully developed, automated selection system for the rest of the population. Furthermore, the Corporate Income Tax Audit unit has not been able to place high dollar taxpayers on a cyclical schedule and still relies on a cumbersome manual system for audit selection. DOR has improved auditor training to strengthen its ability to conduct complex audits.

Our previous report noted that sales tax is the State's best tax revenue producer, and that fewer than 2 percent of the sales tax accounts pay 70 percent of the total sales taxes. At the time of our last audit, a random sample of 300 of these large accounts revealed that only 20 percent had been audited between January 1981 and August 1984. Our analysis showed that up to $3.6 million could be generated yearly if DOR audited more large sales tax accounts. Greater coverage of large corporate income tax accounts was also recommended.

<u>Sales Tax schedule</u> - DOR acknowledges the need to review major taxpayers, and has placed the 360 identified sales tax accounts with an annual tax remittance of more than $500,000 on a schedule to ensure that each account is reviewed within the four year statute of limitations. However, this schedule is not kept current and timely completion of scheduled audits is not occurring.

Although a cyclical sales tax audit schedule has been developed, it contains outdated information. The sales tax audit unit developed its audit schedule for large accounts using a DOR computer report of sales tax remittance data for several recent years. To determine whether DOR has accurately identified and scheduled large accounts, we compared accounts listed on the June 1987 computer report (which contains year-to-date remittances) to those accounts scheduled for audit during fiscal years 1988 through 1991. Our analysis revealed 122 of the 360 accounts listed on the report that were not scheduled for audit, and 65 scheduled accounts that were not on the report.

Sales tax audit selection staff attribute these discrepancies to changes in the population of the major taxpayers, and the fact that the four year schedule has not been updated since it was first prepared in early 1986. DOR procedures call for an annual review and update of the four year schedule. However, the procedure does not indicate when the review should occur. As a result, the first review is tentatively scheduled in December 1987, nearly two years after the four year schedule was initially prepared.

In addition to having an outdated schedule, DOR is not able to review the accounts on the schedule in a timely manner. We reviewed the audit schedules for fiscal years 1985-86 and 1986-87 and found that as of June 1987, nearly one-fifth of the audits scheduled for 1985-86 had not been completed, and more than 80 percent of the audits scheduled for 1986-87 had not been completed or started. This low rate of completion raises concern, because only 41 audits of 31 accounts were scheduled for

1985-86, and only 43 audits of 37 accounts were scheduled for 1986-87.[1] Since DOR has not been able to complete these scheduled audits, problems in completing the 90 accounts per year scheduled for audit for the next four fiscal years seem imminent without additional audit staff.

Although DOR has a system to identify and schedule large sales tax accounts for audit, it does not have a fully developed selection system for the rest of the sales tax population. Our previous report recommended that DOR continue work on the MAASS (Marginal Analysis Audit Selection System). MAASS, first obtained by DOR in 1982, is designed to select accounts that have the highest assessment potential within each industrial classification. DOR management has determined that the problems encountered with MAASS cannot be overcome. Consequently, the decision was made to abandon this system and develop a similar, yet scaled-down model more suitable for use within the Sales Tax audit unit. However, DOR does not expect this system to be fully implemented and usable for another two years.

The new system, although not currently equipped for selecting accounts for audit from the entire sales tax population, does show the progress the unit has made in improving its audit selection system since our previous audit. The system, a computerized audit history data base, contains pertinent account information on audits and reviews completed since January 1983. The unit uses the data base for scheduling audits and various other analyses. For example, the sales tax audit unit uses the system to prepare the four year audit schedule of large sales tax accounts to identify past lucrative audits and schedule follow-up audits of these accounts, and to perform other evaluations of past audits.

Corporate selection system is still deficient - The corporate income tax audit unit is not accurately identifying some high dollar accounts for audit, and has not placed accounts on a cyclical audit schedule. This is due primarily to lack of current, automated account data, as well as continued reliance on a manual selection process.

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(1) The number of scheduled audits is greater than the number of accounts because some accounts were scheduled for both sales tax and use tax audits.

The 1987-88 budget request states that all large corporate accounts are audited every three years. Working with corporate audit staff, we attempted to verify this assertion. A DOR report showing accounts reporting more than $500,000 yearly in taxable income was compared to the unit's audit logbooks. Our analysis revealed that approximately 53 percent of these large accounts had been audited since 1983. Further analysis of a different report listing accounts with more than $500,000 in annual tax remittance showed that only 58 percent of these largest taxpayers had been audited since 1983.

Large accounts have not been identified in a timely manner, partially because the present selection system is a manual, cumbersome process, which involves the yearly examination of more than 50,000 returns. This process occupies the entire Phoenix office corporate income tax audit staff for approximately one month.

Improved training - DOR has improved auditor training in response to a need recognized in our previous report. Our previous report identified major deficiencies in the level and amount of training given sales and corporate auditors. At that time, both the sales tax and corporate income tax units had many auditors who had received little or no training, and management commented that few staff were capable of performing large, complex audits.

DOR recognized and took steps to correct this problem. Presently, three full-time training coordinators are developing such a program to meet auditor training needs. The training coordinators work with experienced auditors to develop technical curriculum. DOR estimates show that sales and corporate income tax auditors have devoted approximately 350 hours on course development from August, 1986 to August, 1987. Audit staff also contributed 120 hours as instructors during formal training sessions.

The manager feels that the program is only about one-third of what is needed, and additional courses are being planned to train auditors in techniques for handling different types of sales tax and corporate income tax audits. While many of the courses currently being taught are general in nature, future courses being developed will have a more technical emphasis. Further, a cooperative training program with the IRS has been implemented.

Sales Tax And Corporate Income Tax Audit Units Have Taken Steps To Improve Audit Quality

Our review of recent sales/use and corporate income tax audit files showed evidence of improved documentation and review. Each unit has developed and formalized its own review procedures. In addition, the Department is in the process of establishing an independent audit review unit. However, policies for auditor rotation and reporting of bribery have not yet been developed.

Our previous report identified inadequate controls for ensuring the integrity of audit decisions and guarding against abuses. Significant changes were made to audit assessments with little or no review or documentation. In one case, this lack of control resulted in DOR forgoing more than $1 million in tax assessments. In another instance, an auditor was dismissed for failing to report a possible bribery attempt. We recommended a centralized quality control unit as a means of reducing the potential for abuse.

Formalized review - Both the Sales/Use Tax and Corporate Income audit units have developed and implemented audit review procedures. [1] Each unit now requires supervisory review and sign-off on all assessment documents, as well as separate verification of all calculations. Our review of a small sample of files showed adequate review in the sales tax audit files, but corporate income tax files showed the need for more consistent evidence of review. [2]

Review unit approved - Three of the newly approved audit positions are designated for a centralized, independent quality control unit for all tax types to conduct an objective technical review of completed audits and any resulting modifications or amendments. This review group would help audit managers identify weaknesses in documentation. Furthermore, the unit should provide better quality and more consistent review because it will be independent from the audit units, with review as its only function.

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(1) Although our review was of Phoenix office files only, the Audit Administrator in the Tucson office stated that his audit staff use similar review procedures.

(2) DOR was unable to locate one of the 20 sales tax files we requested for our review. This file contained a sizable assessment modification.

No rotation or bribery policies - Tax Compliance Division management has not established formal policies for rotating auditors or reporting bribery attempts. Management felt that high turnover in recent years precluded the need for such policies. However, recent reclassification of the revenue auditor position has reduced turnover, making rotation a necessity. Regardless, to improve control over the audit function and prevent potential collusion between auditors and taxpayers, DOR should adopt policies to limit the number of consecutive audits of the same taxpayer performed by an auditor and to require the reporting of bribery attempts.

DOR Has Improved Its Ability To Process Protested Assessments

DOR has improved its ability to respond to and process assessments that are protested by taxpayers. The protest tracking system has been streamlined and simplified through automation. The Audit Management Information System (AMIS) has automated all audit assessment records. The Hearing Office has improved the timeliness of its process and has eliminated its backlog of cases.

At the time of our previous report, the protest system relied on excessive manual processing of documents, which resulted in errors and mishandling of cases. The inefficiency was demonstrated by the 59 documents, five separate card files, and eight logbooks used to process and track protests. Also, the Hearing Office had a backlog of 63 pending cases that had been backlogged an average of 16 months.

AMIS was developed with the initial intention of automating the protest process. According to Tax Compliance Division management, AMIS has eliminated the reliance on the numerous and cumbersome card files and log books formerly used to track protests.

More important, the Hearing Office now issues most decisions within 60 days. According to the hearing officer, as of May 1987 only one case was pending more than 60 days.

RECOMMENDATIONS

1. DOR should fill the newly approved auditor positions as soon as possible, renting extra office space if needed.

2. DOR should continue to request additional audit staff until it is able to achieve a coverage level of 4 percent for all sales/use and corporate income tax accounts.

3. DOR should ensure its sales/use tax major account audit schedule is updated annually for proper identification of these accounts.

4. DOR should make the resources available for the development of an automated selection system and audit history database for the corporate income tax audit unit.

5. DOR should continue to develop technical courses for its auditor training program.

6. DOR should develop a policy mandating the rotation of auditors and reporting of attempted bribery.

FINDING II

THE DEPARTMENT OF REVENUE HAS LARGELY ADDRESSED RECOMMENDATIONS MADE TO IMPROVE TAX PROCESSING

Although improvement is needed in some areas, the Department of Revenue (DOR) has largely addressed recommendations made in a prior performance audit to improve its tax processing function. The Department no longer relies on temporary employees, and has taken steps to reduce tax processing errors. DOR has upgraded its contract monitoring procedures, and has made improvements in its receipt handling controls.

In September 1985 the Auditor General issued a performance audit report on DOR's tax processing function (Report 85-9). That report contained recommendations on the following topics: the use of temporary employees and staff training; tax processing errors; fiscal monitoring of outside service contracts; and internal controls over tax revenues. This follow-up review details the actions taken by the Department to address those concerns raised in our previous report.

DOR No Longer Overutilizes Temporary Workers

DOR has improved its tax processing function by significantly reducing its reliance on temporary workers. A comprehensive training program for permanent staff, however, has yet to be developed.

At the time of the previous audit, DOR used temporary personnel to an extent that impaired the tax processing function. At least 37 and possibly as many as 60 temporary positions were continuous, year round positions. Temporary personnel comprised between 40 and 52 percent of DOR's total processing staff. Our audit work showed that temporary personnel are generally less productive than permanent workers. As a result, the Department could actually save money by converting temporary positions to permanent ones. In addition, temporary workers experienced high turnover (more than 200 percent annual turnover in some sections) and inhibited DOR's ability to maintain a trained staff.

Decrease in temporary personnel - DOR's reliance on temporary personnel has significantly decreased since 1985. DOR converted 12 full-time positions occupied by temporary workers to permanent positions in both fiscal years 1986-87 and 1987-88. These 24 positions were funded through transfers from the temporary personnel services budget. [(1)] Because of these actions, temporary personnel will no longer be employed on a continuous, year round basis, but rather during peak processing periods only. [(2)] Moreover, DOR officials report that the decision to convert temporary positions to permanent has stabilized staffing, as anticipated, and resulted in productivity gains.

Formal training for permanent staff - However, the Department has yet to develop a comprehensive training program for its permanent processing workers. During the last audit, it was reported that much of the training for processing staff was done on the job by experienced employees, using whatever work procedures generally were available. New employees are still trained by experienced coworkers without the benefit of formal training materials. According to DOR's Training Section administrator, funding for training has increased, but additional monies have largely been devoted to revenue generating areas such as the Audit Section and Collections.

The Department Has Taken Action To Reduce Processing Errors

The Department has acted to reduce tax processing errors. DOR now compiles information on common taxpayer errors and has improved its form design in an effort to minimize processing errors. However, DOR could further reduce errors by implementing quality control procedures to reduce staff errors.

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(1) As a result, according to the DOR budget officer, temporary personnel expenditures have decreased from approximately $783,300 in fiscal year 1985-86 to approximately $495,800 for fiscal year 1987-88.

(2) We projected in 1985 that DOR would need at least 30 permanent positions to eliminate the excessive reliance on temporary workers. However, our current review shows that 24 positions all but eliminate DOR's reliance on temporary workers to meet regular work loads. Apparently, productivity gains were even greater than we anticipated.

The 1985 audit reported that as a result of errors made by taxpayers and DOR processing staff, an inordinate amount of personal and business tax returns were rejected by DOR's processing system and sent to the Error Resolution groups for correction, which delays processing. For example, 43 percent of all 1984 personal income tax returns processed by DOR as of August 2, 1985, were routed to the Error Resolution group. The previous audit reported that this situation was inefficient, and that processing delays were the result of DOR's failure to identify the cause of such errors and implement procedures to reduce these errors.

Taxpayer errors - In contrast to the last audit, in which we pointed out that that DOR did not give enough consideration to recurring taxpayer errors, the Department is now taking steps to minimize these kinds of errors. For example, DOR's processing staff have compiled data on common taxpayer errors made on individual income and sales tax returns. This information is relayed to taxpayers by a representative of the DOR's Taxpayer Education Section during various speaking engagements and through a new poster campaign initiated by the Department.

Moreover, DOR has made a significant effort to improve the design of its tax forms and instructions. Our previous audit identified problems with the arrangement and format of instructions for the individual income tax form, and reported that the instructions could confuse taxpayers and lead to errors. DOR has since addressed these problems. In contrast to the 1984 tax form and instructions, the 1986 form is designed to facilitate ease of use. Improvements include more noticeable line numbers and section headings, and a more readable page format.

Quality control procedures - DOR has implemented two important quality control procedures. However, the Department has not systematically implemented quality control procedures to monitor errors made by processing staff.

DOR has corrected one major source of internal processing errors. In response to a recommendation made in our previous report, the remittance processing unit now key verifies entries of social security numbers. An analysis of returns sent to the Income Tax Error Resolution Section during our last review showed that 19 percent of all DOR caused processing errors were attributable to the Remittance Processing Unit. The majority of these errors were incorrectly keyed social security numbers. We concluded that key verification of social security numbers would minimize the need to correct miskeyed entries. Now, the NCR computer system will not process a social security entry unless it is keyed twice and the two entries match. The supervisor of Remittance Processing says this new procedure reduced these kinds of keying errors by 90 percent.

Additionally, DOR has established formal lines of communication between processing units that uncover errors and units that make them. For example, according to Processing Section administrator, monthly meetings are held among supervisors of the various processing units to discuss problems in processing. Weekly meetings are held within the Income Tax Unit during the tax season.

DOR still does not systematically monitor employee accuracy. In our last report we concluded that as a result, DOR is unable to take the corrective action necessary to prevent returns from being routed to the Error Resolution Section. The current situation is essentially the same. For example, according to processing staff and a review of production reports, errors made by Document Staging, Data Entry, the Corporate/Withholding Unit and Remittance Processing are not systematically monitored.

DOR Has Upgraded Its Fiscal Monitoring Of Outside Vendor Contracts

The 1985 audit reported that poor fiscal monitoring of outside vendors caused DOR to be overcharged $423,000 by a data entry vendor, and $24,500 by a temporary personnel services vendor. The audit recommended that DOR recover the overcharges and institute better controls to guard against overcharges for copy quality and keystrokes by data entry vendors.

Compensation for overcharges - The Department is being compensated for past overcharges. The personnel services vendor agreed on October 31, 1985, to credit the $24,500 owed to DOR to the Department's account. The data entry vendor settled with DOR for $340,000 on January 31, 1986, and agreed to pay the Department in the form of discounts for data processing services until the settlement is paid in full.

Fiscal controls - DOR has also improved its administration of data entry vendor contracts. For example, the Department now negotiates with data entry vendors in deciding the quality of documents from which data will be input. Costs for data entry differ depending on whether documents are judged good, fair or poor quality. In the past, DOR allowed the vendors to unilaterally evaluate the quality of documents, which increased the potential for overcharges.

Further, the Department has developed a computer program to monitor vendor billings. Data entry billings are based on number of keystrokes. DOR's computer program allows DOR to retabulate vendor keystrokes and ensure that it is not being overcharged.

Controls Over Receipts Have Improved

In our last audit we reported that DOR could improve control over monies to reduce the risk of theft or loss of revenue. Control procedures were weak in some areas where revenue is received and processed. DOR has apparently strengthened procedures; however, these procedures need to be formalized and periodically tested.

According to a recent review conducted by the Auditor General's Financial Audit Division, receipt handling procedures used in the material areas of the Department (Incoming Mail and Central Processing) are adequate. Additionally, tests of the procedures indicate that DOR staff have generally complied with them. [1]

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(1) Although the Financial Audit staff found that most cash handling procedures were adhered to by DOR staff, they found that some sales tax receipts were not deposited until at least six days after receipt, even though deposits are to be made within 48 hours.

Further action is required to improve controls. For example, the procedures described above still need to be written and formally adopted by the Department. More importantly, although procedures may be adequate, DOR has no independent internal audit group to periodically test staff compliance with procedures to ensure that controls are working as intended. The Department included a funding request for an internal audit group in fiscal year 1986-87, but the request was turned down by the Executive Budget Office and the Joint Legislative Budget Committee. Although DOR has allocated money for one internal audit position, an audit team with at least three positions would be more appropriate for DOR's needs. [1]

RECOMMENDATIONS

1. The Department should continue working to develop a more formal and comprehensive training program for its permanent processing staff. DOR's Training Section needs to develop standard training procedures that prepare processing staff to perform their duties.
2. DOR should develop a quality control system for monitoring errors made by processing staff. Procedures should be developed to compile information on staff errors for the overall purpose of curtailing the number of tax returns routed to the Error Resolution groups.
3. The Department should develop written cash handling procedures and establish an internal audit unit within the Director's office. The unit should report directly to the Director of DOR. The unit's functions should include: 1) reviewing the adequacy of existing controls and procedures, and 2) testing for compliance. The staff should have training and experience in accounting and internal controls.

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(1) Moreover, the prior report recommended that the internal audit unit be placed within the Director's office.

ARIZONA DEPARTMENT OF REVENUE

1700 WEST WASHINGTON • PHOENIX, ARIZONA 85007

EVAN MECHAM
Governor

C. "HOS" HOSKINS
Director

September 2, 1987

SEP 1987

Douglas R. Norton, CPA
Office of the Auditor General
State of Arizona
2700 North Central Avenue
Suite 700
Phoenix, Arizona 85004

Dear Mr. Norton:

We have reviewed the draft report 87-6 on the Department of Revenue and offer the following response to it.

Generally, we are in agreement with the Findings and Recommendations. We appreciate the recognition given to the progress made to date, particularly as related to the processing activity. We are proud of our success in improving the forms and the processing of them and are pleased with the recognition of those accomplishments.

Specific responses to each finding and recommendation are as follows:

FINDING I

ADDITIONAL EFFORT IS NEEDED IN THE AUDIT OPERATIONS.

A. Level of Audit Coverage is low. We agree with the finding and concur that the results do not indicate any improvement in the amount of audit coverage. We had delayed seeking additional staffing until we could improve the productivity of the existing audit staff through the use of lap top computers and improved training and audit controls. We also were concerned about increasing the audit staff before we had the ability to support it adequately. As a consequence, it was felt that it was more important to take the long-term approach and spend resources to improve both the productivity and quality of the audit approach rather than the short-term program to conduct more audits. The results over the next three years should determine if that was the correct decision.

   In addition, it should be noted that, at this time, very few states even approach the 4% audit coverage level. A recent Colorado survey indicates that the average coverage for western states business tax is well below 2%. The average state corporate tax coverage was 1.4, as compared to our 1.7, and the average state sales coverage was only 1.6, as compared to our 1.1%. Given the results of this recent study, the validity of the 4% target needs to be re-evaluated.

B. Audit Selection Systems for Sales and Corporate Income Tax Programs still need improvement. We agree we need to do more and are in the process of developing improved processes for sales and corporate income tax.

We believe it should be recognized that Arizona's assessments per auditor are the highest of all the western states. That would indicate that even though we believe we can do better, the current audit selection programs are effective in that they allow us to concentrate on the most productive audits.

We also must note that contrary to the report, the sales tax audit schedule was first developed in 1985, was updated in mid-1986, and is about to be updated again.

C. Improved Training. We agree that we have made substantial progress in development of an auditor training program. The completion of that program is a cornerstone of our plan for improved audit productivity.

D. DOR has taken steps to improve Audit Quality. We agree and will consider the recommendations.

FINDING II

THE DEPARTMENT HAS LARGELY ADDRESSED THE RECOMMENDATIONS MADE TO IMPROVE PROCESSING.

A. Formal Training for Permanent Staff. The Department should continue to develop a more formal and comprehensive training program for its processing staff. We agree. Our training priorities remain with the Audit and Property Tax Programs. As soon as they are completed, we plan to address these needs.

B. Quality Control Procedures. DOR needs to develop a quality control program for monitoring errors made by the Processing staff. We agree additional effort is required in this area.

C. Controls over Receipts have improved but need to be formalized. The Department should develop written cash handling procedures and establish the Internal Audit unit. We agree and are in the process of formalizing the procedures. The Internal Audit Unit has been established and is in the process of being filled.

Again, we appreciate the fact that the report recognizes the progress made to date.

Sincerely,

ARIZONA DEPARTMENT OF REVENUE

Charles B. Hoskins

C. "Hos" Hoskins
Director

CHH:RPM:ng