



A REPORT
TO THE
ARIZONA LEGISLATURE

Performance Audit Division

Performance Audit

Arizona Department of Revenue

Department Is Hindered by Ineffective Information Technology (IT)
Leadership Processes and Should Prepare for the Planned
Replacement of Its Primary IT System

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Auditor General

The **Auditor General** is appointed by the Joint Legislative Audit Committee, a bipartisan committee composed of five senators and five representatives. Her mission is to provide independent and impartial information and specific recommendations to improve the operations of state and local government entities. To this end, she provides financial audits and accounting services to the State and political subdivisions, investigates possible misuse of public monies, and conducts performance audits of school districts, state agencies, and the programs they administer.

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April 16, 2015

Members of the Arizona Legislature

The Honorable Doug Ducey, Governor

Mr. David Raber, Director
Arizona Department of Revenue

Transmitted herewith is a report of the Auditor General, *A Performance Audit of the Arizona Department of Revenue—Use of Information Technology*. This report is in response to an October 3, 2013, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq. I am also transmitting within this report a copy of the Report Highlights for this audit to provide a quick summary for your convenience.

As outlined in its response, the Department agrees with all of the findings and plans to implement all of the recommendations.

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

Sincerely,

Debbie Davenport
Auditor General

Attachment



REPORT HIGHLIGHTS
PERFORMANCE AUDIT

Department hindered by ineffective IT leadership processes

Our Conclusion

The Arizona Department of Revenue (Department) relies on its information technology (IT) to carry out its business functions, including processing tax returns, auditing taxpayers, and collecting delinquent taxes. However, the Department's use of IT is hindered by ineffective IT leadership, specifically IT governance and management processes, for making and carrying out IT decisions. This struggle to effectively implement IT systems and tools can be seen in the Department's inadequate implementation of its primary IT system, as we reported in 2005, which remains plagued by problems, and by not taking advantage of various other IT capabilities that could improve its operations. Although the Department has initiated efforts to improve its IT governance processes, it should continue these efforts and establish effective IT management processes. The Department also plans to replace its primary IT system, possibly beginning in fiscal year 2017, but it needs to do more to prepare for implementing a new system.

Department has struggled implementing IT systems and tools that would improve operations—The Department's primary IT system, called the Business Reengineering/Integrated Tax System (BRITS), was not adequately implemented and is cumbersome to use. Since the first phase of BRITS was implemented in 2004, the system has required and continues to require many improvements and remains difficult to modify. In fact, as of April 2014, nearly 1,300 improvements were needed to BRITS and other department IT systems. These needed improvements have resulted in inefficiencies and inconveniences for both the Department and taxpayers.

In addition, the Department lacks IT capabilities that other states have used to improve effectiveness and efficiency. These capabilities range from enhanced electronic filing (e-filing) of tax returns to data-driven approaches for selecting which returns to audit and the best way to collect taxes owed to the State. For example:

- **Limited e-filing and inefficient paper processing**—The Department offers e-file for individual income tax, transaction privilege tax (TPT), and withholding tax, but the Department does not offer e-file for corporate income tax or luxury tax. Additionally, the e-file rate for the TPT is far less than the rate of paper-filed returns. The Department explained that this rate is likely low because the TPT e-file process is cumbersome and inconvenient, but that the implementation of statutory TPT reform will streamline the process. Additionally, the Department has not implemented optical and/or intelligent character recognition to electronically capture handwritten or typed information on paper-filed tax returns. Instead, the Department relies on temporary employees to manually process the information from these returns.
- **Ineffective processes for selecting audits and collecting delinquent taxes**—The Department has not fully leveraged data analytics tools that would help select more effective leads for taxpayer audits and prioritizing and managing collections cases. Instead, the Department largely relies on manual or inefficient processes that could result in the State receiving less money from audits and collections.

Department's IT struggles reflect ineffective IT leadership processes—Specifically, the Department has not established effective IT governance and management processes for making and carrying out IT decisions. The Department had established an IT Steering Committee (Committee) comprising department leadership that met to review the status of IT projects and system maintenance, but had not formally established the Committee's purpose or committee members' responsibilities. In addition, although the Department had developed IT-related strategic plans, these plans lacked action steps and performance measures, and did not assign responsibility for achieving the action steps.

Without these processes, we observed that the Committee had difficulty making decisions and often made decisions in response to IT demands, crises, or challenges; and that committee members were frustrated in their decision making by limited project understanding, poor communication, and uncertainty as to who was ultimately responsible for decision making.



2015

Department should apply IT standards to establish more effective IT leadership processes—The Department should look to IT standards to improve its IT governance and management processes. During the audit, the Department adopted a charter that restructures its Committee as a governance body, establishes its purpose, and includes a decision-making policy. However, the Department had not yet developed and implemented associated policies and procedures that address its prioritization process, communication and reporting methods, and the assignment of responsibilities and authority. The Department should also train those responsible for IT governance on these policies and procedures once they are implemented, the governance charter, and their IT governance roles.

Although the Department's governance charter describes the new IT management structure it intends to implement, as of December 2014, it had yet to establish this structure or define how it would carry out the direction set by the Committee. The Department should also ensure that its IT management develops an IT strategic plan based on an assessment of the gap between its current and target IT capabilities. In creating the strategic plan, the Department should ensure that its IT management follow model planning practices, including communicating the plan to appropriate stakeholders and throughout the organization.

Recommendations

The Department should:

- Fully establish and implement its new IT governance and management structures;
- Develop and implement necessary policies and procedures;
- Train those responsible for IT governance and/or management on their roles, responsibilities, and related policies and procedures;
- Ensure that IT management creates a strategic plan that follows model planning practices; and
- Monitor and evaluate its IT governance and management structures and related policies and procedures annually and update them as needed.

Additional steps needed to prepare for planned IT system replacement

Department reported that BRITS will need to be replaced soon—According to the Department, BRITS is outdated, and further upgrades would be more expensive and less useful than a new system. In addition, the contractor that developed BRITS no longer sells the system and has discontinued its hardware and system support. A vendor that provides software used in BRITS is also reducing its level of support. As a result, and as required by statute, the Department has requested funding to begin planning for a replacement system, possibly for a phased implementation between fiscal years 2017 and 2020.

Department should address system implementation risks—As we reported in 2005, the Department did not adequately manage BRITS' implementation. For example, the Department did not adequately define or test the functions the system needed to perform. The Department's IT Division has adopted project management and system development lifecycle (SDLC) policies and procedures that are generally aligned with IT standards to manage projects and develop software. However, these policies and procedures will need to be revised so they are consistent with the Department's new IT governance, management, and strategic planning processes. To avoid the same problems encountered with BRITS' implementation, the Department should ensure that it clearly communicates these policies and procedures to applicable staff and that the staff closely follow them.

Recommendation

The Department should revise its project management and SDLC policies and procedures to be consistent with its new IT governance, management, and strategic planning processes, and ensure that it clearly communicates them to staff and that staff closely follow them.

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INTRODUCTION

Scope and Objectives

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Revenue (Department)—Use of Information Technology pursuant to an October 3, 2013, resolution of the Joint Legislative Audit Committee. This audit is the first in a series of audits conducted as part of the sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq. It examines the Department's use of information technology (IT) and its IT leadership processes, specifically addressing aspects of IT governance and management. The audit also addresses the Department's plans to replace its primary IT system.

The final audit(s) will focus on the extent to which the Department protects taxpayers' information and include an analysis of the statutory sunset factors.

Department relies on IT to administer taxes

Department administers state taxes

The Department is responsible for administering and collecting state taxes. Its mission is to serve the people of Arizona by administering tax laws with integrity, fairness, and efficiency. For fiscal year 2015, the Department had an appropriated budget of approximately \$73.7 million and 764.5 filled full-time equivalent (FTE) staff positions as of March 2015.

The Department's key functions include processing tax documents and payments, auditing taxpayers, and collecting money owed to the State. Specifically:

- **Processing tax documents and payments**—The Department processes tax documents and payments/refunds for taxes administered by the Department, including those submitted electronically or on paper.¹ The Department reported that it processed approximately 5.7 million tax documents and deposited nearly \$13.1 billion in revenues in fiscal year 2014 (see textbox, page 2, for the State's primary tax revenue sources). For fiscal year 2015, the Department allocated approximately \$8 million to this function, which had 91 filled FTE positions as of March 2015.
- **Auditing taxpayers**—The Department performs audits of selected taxpayers for most tax types to ensure that taxpayers are paying the correct amount of state tax. As a result of these audits, the Department reported that it assessed nearly \$207 million in fiscal year 2014 that taxpayers owed to the State. For fiscal year 2015, the Department allocated approximately \$13.4 million to this function, which had 190.25 filled FTE positions as of March 2015.
- **Collecting on delinquent accounts**—The Department collects taxes owed on delinquent accounts. The Department reported that it collected approximately \$232 million in fiscal year 2014 from taxpayers who owed taxes to the State. For fiscal year 2015, the Department allocated approximately \$9.7 million to this function, which had 161 filled FTE positions as of March 2015.

The Department performs other functions as well. Some of these other functions include researching tax policy, providing general oversight to county property tax assessors, providing IT support for the Department's business functions, and assisting taxpayers with questions related to their accounts. For

¹ The Department also administers some taxes for Arizona counties and most Arizona cities and towns.

Arizona's primary tax revenue sources and amounts collected¹ Fiscal year 2014

- **Transaction privilege, use, and severance taxes (approximately \$7.1 billion)**—A transaction privilege tax (TPT) is imposed on the seller for doing business in the State. Because it is usually passed on to the customer, this tax is commonly referred to as a sales tax. Use and severance taxes are similar to the TPT, but apply to out-of-state purchases and mining of certain minerals, respectively.
- **Corporate income, individual income, and withholding taxes (approximately \$5.4 billion)**—Income taxes are imposed on individuals and corporations earning income in Arizona. In addition, employers must withhold income tax from their employees' compensation and remit it to the Department.
- **Luxury tax (approximately \$400 million)**—Luxury taxes apply to liquor and tobacco products. The majority of these monies are distributed to special funds.

¹ The Department also administers many smaller taxes such as estate, bingo, and waste tire taxes; however, all of these taxes collectively totaled approximately 1 percent of the revenue the Department received in fiscal year 2014.

Source: Auditor General staff analysis of department documentation.

fiscal year 2015, the Department allocated approximately \$35.7 million to performing its other functions, which had 322.25 filled FTE positions as of March 2015.¹

IT supports Department's business processes

The Department relies on IT for its business processes. The Department's primary IT system for its tax administration and enforcement functions is the Business Reengineering/Integrated Tax System (BRITS). BRITS was developed by a contractor and implemented in phases beginning in 2002 and was paid for through the additional tax revenues and cost savings the State received as a result of its implementation. BRITS is maintained and supported by the Department's IT Division. BRITS comprises multiple applications, including both the Taxpayer Accounting System (TAS) and AZTaxes. TAS refers to the system that supports the processing of individual income, withholding, corporate income, and transaction privilege taxes. AZTaxes is the Web-based system that handles electronic filing and all of the Department's bank deposits.

The Department devotes a considerable portion of its budget, as well as state Automation Projects Fund (APF) monies, to develop and maintain its IT systems (see page 4 for additional information about the APF). In fiscal year 2015, the Department estimated it will spend approximately 24 percent, or more than \$17.4 million, of its total budget on IT-related expenses incurred by its IT Division. As shown in Table 1 (see page 3), the majority of the Department's IT expenditures are for personnel expenses and other operating costs, such as operating supplies, telecommunications, and repair and maintenance. The IT Division had 111.5 filled FTE positions as of March 2015.² The IT Division also employed 30 temporary staff positions as of March 2015 to assist with various IT projects. IT staff positions include primarily application developers, business analysts, and system/database administrators. Other positions include

¹ Department reports show that the fiscal year 2015 budget also includes an allocation of approximately \$5.8 million for shared division expenses, such as rent and postage, and approximately \$1.1 million in non-State General Fund monies dedicated to specific purposes.

² The Department reported an additional 26 FTE positions in other divisions that also carry out IT functions.

**Table 1: Schedule of IT Division revenues and expenditures¹
Fiscal years 2013 through 2015
(In thousands)
(Unaudited)**

	2013 (Actual)	2014 (Actual)	2015 (Estimate)
Revenues			
Appropriations: ²			
General Fund	\$ 13,119	\$ 13,072	\$ 12,136
Administrative Fund	4,034	4,328	5,300
Total revenues	<u>\$ 17,153</u>	<u>\$ 17,400</u>	<u>\$ 17,436</u>
Expenditures			
Personal services and related benefits	\$ 9,135	\$ 10,491	\$ 12,297
Professional and outside services	1,147	1,650	594
Travel	13	14	20
Other operating	4,214	4,539	3,800
Equipment	2,644	706	725
Total expenditures	<u>\$ 17,153</u>	<u>\$ 17,400</u>	<u>\$ 17,436</u>

¹ This table includes all IT Division financial activity except for APF-related activity. The Department received APF appropriations for fiscal years 2013 through 2015 for various IT projects. See Table 2 on page 4 for further information. In addition, the Department reported that for fiscal year 2015, it allocated approximately \$2 million for 26 IT-related FTE positions in other department divisions.

² Amounts consist of a portion of the Department's State General Fund and Administrative Fund appropriations that were spent by the IT Division for operations. Administrative Fund revenues are primarily unclaimed property monies allocated to the Department in accordance with A.R.S. §44-313.

Source: Auditor General staff analysis of department-prepared financial information for fiscal years 2013 through 2015.

project managers, service desk staff, quality assurance analysts, and information security personnel. The Department's IT Division reported that in fiscal year 2014, its IT staff worked primarily on beginning to reprogram BRITS to comply with statutory changes for TPT administration (see textbox), updating the aging hardware and software that supports BRITS, providing IT support to department staff, making IT system improvements (see Finding 1, pages 5 through 20, for additional information), providing information to department executives regarding the impact of legislation on IT, and maintaining and enhancing network security.

TPT reform—Laws 2013, Ch. 255, made several statutory changes with the intent of simplifying Arizona's TPT administration. Prior to the reform, a taxpayer may have had to pay the TPT to multiple taxing jurisdictions, such as the State and various Arizona cities and towns. However, TPT reform revised this process and instead requires the Department to administer the TPT for all Arizona cities and towns. In addition, TPT reform requires the Department to provide an online portal through which all the TPT may be paid. The Department reported that complying with the statutory changes requires significant modifications to BRITS. As a result, the Department reported that making the IT changes necessary to comply with TPT reform has been time and resource intensive.

Source: Auditor General staff review of Laws 2013, Ch. 255, and department information.

The Department also received monies from the APF for fiscal years 2013 through 2015 for various IT projects (see Table 2). The APF was created by Laws 2012, Ch. 298, and is used by state agencies to implement, upgrade, or maintain automation and IT projects. The APF is administered by the Arizona Department of Administration, and proposed projects require review by the Joint Legislative Budget Committee (JLBC). The Arizona Department of Administration must submit quarterly project reports to the JLBC that include the projects' deliverables, timeline for completion, expenditures to date, and current status.

**Table 2: Department projects approved for APF monies and total APF expenditures
From July 1, 2012 through December 31, 2014**

Department projects	Monies approved from APF	Total APF expenditures
Updating BRITS —Update and improve BRITS. This includes hardware replacements, software updates, and other improvements designed to help minimize the risk of system failure. The Department reported that it was approved to use APF monies to help pay for BRITS reprogramming needed to comply with statutory changes for TPT administration.	\$5,131,200	\$5,110,889
Network Security —Enhance encryption of department data in a phased approach.	4,900,000	4,115,386
Reporting Tax Credits —Implement the ability to gather and report information pertaining to the capital gains credit. Image additional pages of the individual income tax return, make modifications to the applicable tax systems, and key the additional data.	1,700,000	0
Tobacco Tax Processing and Revenue Accounting System —Issue a request for proposal to obtain an outside vendor to provide an electronic tobacco tax filing system.	<u>1,000,000</u>	<u>0</u>
Total	<u>\$12,731,200</u>	<u>\$9,226,275</u>

Source: Auditor General staff analysis of department information and state appropriation reports.

FINDING 1

The Arizona Department of Revenue's (Department) information technology (IT) efforts are limited by ineffective leadership processes related to IT governance and management for making and carrying out IT decisions. These limitations can be seen in the implementation of the Department's primary IT system, which was inadequately designed and remains plagued by problems years after its implementation. They are also evidenced by the Department's inability to take advantage of IT capabilities used in other states that have led to more effective and efficient tax collection in these states. Although department officials cited a lack of resources and competing priorities as reasons for being unable to implement better IT, the Department has not established effective processes for governing and managing IT. As a result of this audit, the Department began some efforts aimed at more effective IT governance and management, but it should continue these efforts by clarifying roles and responsibilities, developing a process to prioritize IT projects, assessing the Department's current and desired IT capabilities, and developing plans to address identified gaps.

Department hindered by ineffective IT leadership processes

Department has struggled to improve IT

The Department has struggled with implementing IT systems and tools that would improve its operations. For example, the Department did not adequately design and implement its primary IT system, the Business Reengineering/Integrated Tax System (BRITS), which requires many system improvements years after its implementation and is cumbersome to use. Further, the Department has been unable to incorporate various IT capabilities, such as greater use of electronic tax return filing or optical scanning equipment, to operate more effectively and efficiently. Instead, the Department often relies on manual, time-consuming processes that hinder the Department's ability to collect more revenue and better serve the public.

Primary IT system poorly implemented and cumbersome to

USE—As reported in the Office of the Auditor General's 2005 performance audit of the Department's implementation of BRITS (see Report No. 05-15), the Department had not adequately managed the implementation of BRITS. Although the system's implementation was completed in 2007, it still remains plagued by problems that are time-consuming to address. Specifically:

- **Nearly 1,300 improvements needed to BRITS and other IT systems as of April 2014**—These needed improvements generally represent either defects in system programming, erroneous data entry, or other enhancements necessary to address limited or erroneous functionality, which impact department operations or taxpayers to varying degrees (see textbox, page 6, for examples of needed improvements). According to department staff, the Department identified 900 needed improvements when the first phase of BRITS was implemented in 2004, many of which were discovered during the initial software testing period. However, the Department opted to move forward with the implementation of BRITS rather than delay it until the identified improvements could be addressed. According to department staff, the number of needed improvements increased to more than 1,500 within the first 6 months of implementation.

New IT system improvement needs are continually discovered as department staff perform their jobs. For example, in fiscal year 2014, the Department discovered 173 previously unidentified needed improvements. The Department has devoted IT staff resources to addressing needed improvements, but department staff reported that,

Examples of needed IT system improvements

Evaluation driver—A collection of defects is associated with the evaluation driver, the component that performs calculations in BRITS. These defects impact the Department's Audit and Collections Divisions as well as taxpayers. For example, BRITS sometimes shows that a taxpayer has an unsatisfied liability even if that debt has been paid. The liability is sent to the Department's Collections Division. This can inconvenience a taxpayer who is told that he/she owes a debt when he/she actually does not. When the Collections Division identifies one of these cases, it flags the account so that collectors do not attempt to collect the debt. According to the Department, 218 cases were flagged as of June 30, 2014.

Individual income audit assessments—The Audit Division would benefit from an IT system enhancement that would negate the need for a time-consuming and manual process. The Audit Division reported that it issues approximately 2,500 individual income assessment letters per week. These letters inform taxpayers that the Department has determined that the taxpayer owes a debt, how much the debt is, and how the taxpayer may proceed. Because there is no IT mechanism to send a file to a vendor to have the vendor print and mail these letters, the Department has them printed by the Arizona Department of Administration each week. Department staff then hand-stuff these letters. According to the Department, this takes 2-3 days per week and approximately 3 employees.

Source: Auditor General staff interviews with department staff and reviews of department documentation.

in April 2014, department officials decided to stop work on nonemergency improvements in order to divert resources to other IT projects, including reprogramming BRITS to comply with statutory changes for transaction privilege tax (TPT) administration (see the textbox on page 3 for additional information about the State's TPT reform). Although the Department reported that it had addressed more than 8,300 system improvements since BRITS' implementation, the Department still had nearly 1,300 improvements yet to be addressed as of April 2014.

- **Difficult to modify**—According to the Department, the complexity of BRITS' underlying design is daunting. As a result, even small programming changes that need to be made can take a long time and require significant IT staff resources and technical expertise. For example, a 2010 legislative change resulted in the Department having to create a one-time process for a business license renewal fee of \$40. According to the Department, BRITS coding is so complex that modifying BRITS to enable the Department to process the one-time fee required more than 9 months and 4,000 staff hours to complete.

Department lacks IT capabilities other states use to improve effectiveness and efficiency—The Department has not implemented various IT capabilities used by other states in the areas of tax processing, audits, and collections. These capabilities range from enhanced electronic filing of tax returns to data-driven approaches for selecting which returns to audit and how to best collect taxes owed to the State. Other states making greater use of these capabilities reported increases in both the efficiency of operations and the effectiveness of audit and collection activities. Many of these capabilities were originally intended to be used in conjunction with BRITS but were never implemented, leaving the Department to rely on manual, time-consuming processes. Specifically:

- Limited electronic tax filing**—Although electronic filing, or e-filing, is widely accepted as the optimal method to file taxes for both taxpayers and revenue agencies, the Department has not fully leveraged e-filing capabilities (see textbox for an explanation of e-filing). As shown in Figure 1, although most Arizona individual income tax returns are e-filed, most other types of taxes are not. In all, only a little more than half of Arizona tax returns were e-filed in fiscal year 2014. For two types of taxes—corporate income tax and luxury tax—the Department does not offer e-filing as an option, relying totally on manually processing paper-filed returns.

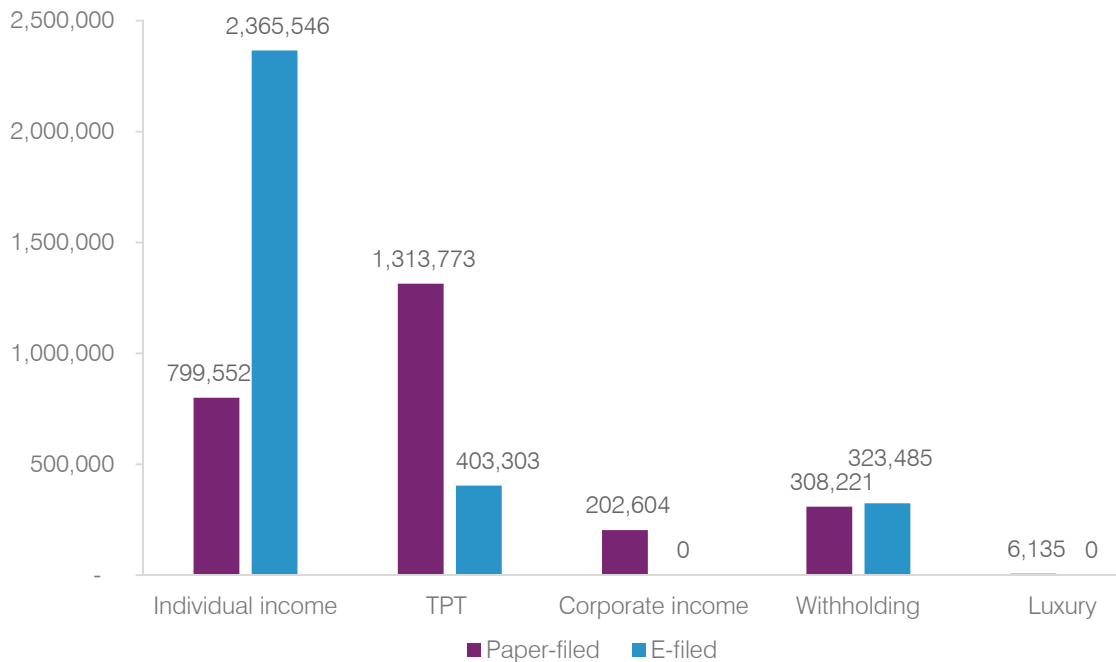
E-filing—The process of using a computer program to transmit tax information electronically to another party. E-filing offers taxpayers an easier, less-time consuming, and more secure method of filing taxes. Additionally, because e-filed returns are processed more quickly than paper-filed returns, taxpayers owed a tax refund often receive these monies more quickly than if they had filed a paper return. For tax processors, such as the Department, e-filing offers lower processing costs, faster processing, and more accurate and complete taxpayer information entering the system.

Source: Auditor General staff summary of information from the Department and the Federation of Tax Administrators.

Although Arizona's individual income tax e-file rate for fiscal year 2014 was 75 percent, e-file rates for the TPT and withholding tax were relatively low. For the TPT, the e-file rate was only 23 percent in fiscal year 2014. According to the Department, this rate is likely low because the TPT e-file process is cumbersome and inconvenient. For example, a department official reported that the system does not allow businesses to bulk e-file their returns for multiple tax licenses that may need to report locations in several jurisdictions. As a result, businesses with multiple locations that choose to e-file must manually enter tax information for each jurisdiction they report to each

jurisdiction. For example, a department official reported that the system does not allow businesses to bulk e-file their returns for multiple tax licenses that may need to report locations in several jurisdictions. As a result, businesses with multiple locations that choose to e-file must manually enter tax information for each jurisdiction they report to each

Figure 1: Total paper-filed and e-filed tax returns Fiscal year 2014



Source: Auditor General staff analysis of department information.

time they e-file. According to the Department, it is easier for a business to simply complete the forms using tax preparation software and print and submit the return, rather than enter this information into the e-file system for each month.

The State of California's Board of Equalization (Board) reported some challenges when it first implemented e-filing for sales tax, the equivalent to Arizona's TPT. The Board stated that its original e-file system in 2006 had some user difficulties and was not aggressively marketed. However, the Board indicated that in 2008, improvements were made to the e-file system and a stronger marketing campaign was introduced. In 2009, the Board was able to begin phasing out paper returns and transitioning taxpayers to e-filing. By fiscal year 2013, 98 percent of its sales tax returns were e-filed. The Board stated that e-filing led to a substantial cost savings, fewer errors, and convenience for taxpayers.

The Department reported that TPT reform (see textbox on page 3) will streamline e-filing for businesses with multiple locations and/or locations in multiple jurisdictions. Work associated with TPT reform was originally scheduled to be completed by January 2015, as required by the TPT reform legislation. However, the Department was unable to make the necessary changes to BRITS in time, and it was granted a 1-year extension to complete the work.

- **Inefficient processing of paper-filed returns**—The Department has not implemented a common technology that would allow it to more efficiently process paper-filed tax returns. This technology, called optical and/or intelligent character recognition (OCR/ICR), is used to scan paper documents and electronically capture handwritten or typed information contained in the documents. According to the Federation of Tax Administrators, OCR/ICR is a commonly used technology by tax processing organizations. Although the Department initially planned to implement OCR/ICR as part of BRITS, the Department did not implement this technology in order to stay within the target price for the BRITS contract, and it still has not acquired the technology. Instead, the Department relies on temporary employees to manually key and process the information from tax returns. For example, according to department records, the Department employed an average of approximately 80 temporary employees each week to process tax returns in fiscal year 2014, with an average of 150 temporary employees each week in the spring during the height of the tax season.¹ The cost for these temporary employees totaled more than \$1.9 million for fiscal year 2014. A department official reported that, although the need for temporary employees would not be entirely eliminated with the implementation of OCR/ICR, this technology would likely result in significant savings.

Other states that have implemented OCR/ICR have reported several benefits. For example, the Utah State Tax Commission reported that, as a result of OCR/ICR technology, its tax processing division was able to reduce the annual budget for temporary staff by more than 50 percent. Further, the Indiana Department of Revenue indicated that implementing OCR/ICR helped it to reduce the average cost of processing an individual income tax return by 57 percent per return. Moreover, the Minnesota Department of Revenue reported lower storage costs because it was able to reduce storage time, and fewer staff were required to process paper returns, since implementing OCR/ICR. The

¹ The number of temporary employees hired to process tax returns in fiscal year 2014 ranged from 29 to 207 employees per week.

Department's Process Administration Division indicated that implementing OCR/ICR technology could result in similar benefits to Arizona.

Although the Department has not implemented OCR/ICR technology, it has implemented "2D barcode" technology to add efficiency to its paper return processing. This technology, which department staff reported was implemented in 2002, allows the Department to capture individual tax information by scanning a barcode that is printed on the paper return document instead of manually entering this information. According to the Department, this cuts the time it takes to enter information from a batch of tax returns from 75 minutes to 21 minutes. However, 2D barcode is only available for individual income tax returns prepared by a tax professional or tax preparation software. The Department estimated that almost 50 percent of the paper-filed individual income tax returns submitted in calendar year 2014 had 2D barcodes, although it reported that 10 to 15 percent of these returns had barcodes that could not be scanned because of poor paper or print quality.

- **Ineffective process for selecting audits**—The Department underutilizes data analytics to select leads for taxpayer audits, which likely results in less optimal audit selection. The BRITS project originally included plans for developing an automated tool that would use data analytics to select audit leads, but the Department reported that the tool did not work properly, and it terminated this part of the project. Since that time, the Department reported that it has created tools to help select audits for some tax types. Specifically, the Department reported that it performs data analytics using federal tax information to select individual income and some corporate taxpayers for audit. However, the Department reported that it relies on manual selection processes for other tax types, especially the TPT. According to a department official, manual tools are less effective because they result in the Department's spending significant time selecting audit leads that result in no monies being owed to the State. For example, according to department reports, approximately 20 percent of TPT field audits, which are not selected using data analytics, resulted in no monies being owed to either party in fiscal year 2014. In contrast, department reports show that only 3.5 percent of individual income tax audits, which are selected using data analytics, resulted in no monies owed to either party. Additionally, department staff reported that, with the use of data analytics, they could perform more audits and make better use of available information for TPT audits. Selecting audit leads that do not result in monies being owed to the State or taxpayer is an inefficient use of department staff resources and can inconvenience taxpayers with unnecessary audits.

In contrast, some other states use a computer-based data analytics tool to select ideal audit leads based on information from various sources. For example, the New York State Department of Taxation and Finance (New York) reported that it uses an automated data analytics tool to analyze both internal data, such as tax return information, and external information, such as information from banks, retailers, or credit card merchants, in order to select audit leads for all of its major tax types. For example, New York uses data analytics to compare retail sales tax returns with information from credit card merchants. The system applies business rules to the data in order to yield optimal results and minimize the potential for selecting returns that do not need to be audited. New York reported that using data analytics has helped it select better audits and has increased voluntary taxpayer compliance.

- **Ineffective process for collecting monies owed to the State**—The Department has not implemented various technologies that could be used to more effectively collect delinquent taxes. Specifically:
 - The Department does not effectively use automated data analytics and optimization tools to prioritize collections cases.¹ Because the Department reported that it has more collections cases than it is able to work, it is important that the Department effectively prioritize collections cases. Data analytics and optimization tools would allow the collections division to use information such as taxpayer history, amount owed, and other attributes to prioritize cases that lead to higher collection amounts. Department staff reported that, instead of prioritizing cases based on multiple attributes using data analytics and optimization, individual income tax cases are prioritized for collection based on dollar amount, starting with the highest amount of debt owed. Business cases are prioritized by considering both the case's dollar amount as well as information related to the taxpayer's history. The Department reported that although it is able to use an electronic database to prioritize its business cases in this way, the database has limited functionality, is inefficient, and does not offer the Department all the functionality it would need to properly prioritize cases.

New York has implemented an automated data analytics and optimization tool for collections cases and has seen success. In 2009, New York implemented an automated data analytics tool to determine which cases to pursue, when to pursue them, and how to pursue them. The system uses a mathematical model to determine the optimal collection action for each case. From 2009 to 2010, New York increased its collections of delinquent revenue by 8 percent using this tool, despite projecting only a 3 percent increase in 2010 because of economic conditions, staffing reductions, and unusually high revenue in 2009. New York also reported that it saw an improvement in dollars collected per collections action and that using the tool reduced the average age of cases assigned to field offices.

- The Department also lacks IT tools to effectively and efficiently manage its collections cases, which totaled approximately 275,000 cases as of July 2014. In order to manage collections cases, the Department must use reports that include total collections cases, where cases are in the process, and how many cases are assigned to collectors. Department officials explained that these reports, which are run twice monthly, require an inordinate amount of department resources to produce. A department official reported that the technology used to run these reports is outdated and unsuitable for the task of running these reports. Auditors observed that technology issues with the reporting system require a staff person to actively monitor the system to ensure that reports are completed. According to the department staff person who runs the reports, this process can take up to 3 or 4 days, and once the reports are generated, she must spend additional time reformatting the report data to make them usable. According to the Department, the staff person spends approximately 20

¹ According to a department official, prior to 2008, the Department scored collections cases based on taxpayer credit scores to determine which cases to pursue collection, but department officials believed that selecting cases in this manner resulted in the collection of less revenue. Additionally, there were concerns with a pending court case examining the legality of using credit scores in this manner. The Department was also trying to identify cost savings in the BRITS implementation, and discontinuing this practice provided cost savings.

percent of her time running the queries and another 20 percent of her time formatting the reports. Once they are reformatted, department collections managers use the reports to make decisions on how to handle cases.

- Additionally, the Department has not yet implemented an automated system for the Department to obtain banking information for delinquent taxpayers whose banking information the Department does not have. Automated systems obtain this information by electronically matching bank records and collections accounts. If a match is found, the system then automatically generates a notice to the bank for a levy against the account. However, instead of using an automated system, when the Department does not know a delinquent taxpayer's banking information, the Department issues levies via paper letters to all banks in the taxpayer's specific geographic area in hopes of finding a match. The Department reported that, for fiscal years 2013 and 2014, it sent approximately 116,500 levies, and this highly manual effort resulted in only a 6 percent success rate in finding a match during that time period.¹ According to a department official, unmatched levies result in lost tax revenues for the State.

A 2005 Office of the Auditor General performance audit of the Department's Collections Division (see Report No. 05-14) recommended that the Department pursue potential statutory changes to allow for automated bank levies. The statutory changes were enacted in 2010, and the Department intended to implement an automated bank levy function in February 2011. However, according to a department official, the project was delayed due to budget constraints and staffing difficulties. Department staff reported that they were again working to implement an automated bank levy function and that it was scheduled to be completed by March 2015.

- Finally, the Department lacks an auto dialer to automatically make collections calls. An auto dialer is an electronic device or software that automatically dials telephone numbers. Once the call is answered, the auto dialer either plays a message or connects the call to a live person. This is more efficient than having a collections agent manually dial a taxpayer's phone number and wait for either a taxpayer's voicemail or a live connection. According to a department official, the Department had an auto dialer prior to implementing BRITS but it was not compatible with BRITS. As with OCR/ICR technology, the Department initially planned to implement a new auto dialer as part of BRITS, but did not implement it in order to stay within the target price for the BRITS contract. The Department reported that it has been researching adding an auto dialer as part of its current telephone service.

Department's struggles reflect ineffective IT leadership processes

Department officials indicated that their progress in addressing the issues discussed previously has been limited for three main reasons: lack of resources, challenges with adding new IT capabilities to BRITS, and the need to address higher priorities, such as improving network security and modifying BRITS to comply with statutory changes to TPT administration. However, auditors' review indicated that a key cause lies elsewhere—the Department's lack of effective IT leadership processes for

¹ The Department estimates that, for both years combined, this effort cost approximately \$76,780.

making decisions about IT efforts and carrying out these decisions (see textbox). For example, the Department has lacked an adequate IT governance structure to direct its IT and adequate IT management processes to carry out an IT direction. As a result, department leadership has struggled to make IT decisions, particularly related to prioritizing projects. Additionally, rather than reflecting a proactive approach to long-term IT solutions, auditors observed that department leadership's decisions were largely made reactively in response to IT demands, crises, or challenges. Specifically:

IT leadership processes—For the purpose of this audit, IT leadership processes are defined as processes pertaining to IT governance and IT management as defined in IT standards, including the development of organizational structures, policies, and procedures (see pages 14 through 18 for details). Specifically:

- IT governance provides direction and vision for IT in an organization. Sound IT governance structures include processes for evaluating, directing, and monitoring IT to ensure the effective and efficient use of IT in enabling the achievement of established IT goals.
- IT management carries out the direction set by governance through planning and monitoring IT activities. IT management also includes processes for building, acquiring, and implementing IT as well as delivering, servicing, and supporting IT; however, these processes are not included in the scope of this audit.

Source: ISACA. (2012). *COBIT5: Enabling processes*. Rolling Meadows, IL: Author; ISACA. (2012). *COBIT5: A Business Framework for the Governance and Management of Enterprise IT*. Rolling Meadows, IL: Author; and Gartner IT Glossary retrieved August 14, 2014, from <http://www.gartner.com/it-glossary/it-governance/>

- **Department has lacked an effective IT governance structure to ensure optimal use of IT**—Prior to this audit, the Department had not established an effective IT governance structure that was responsible for setting the Department's IT vision and direction, and for ensuring the optimal use of IT systems and tools. In 2004, the Department created a BRITS oversight team comprising department leadership to provide guidance and oversight for the BRITS project. After BRITS was implemented, this team, including the chief information officer (CIO), continued to meet as an IT Steering Committee (Committee) to review the progress of other IT projects and IT system maintenance and serves as the default planning and decision-making body for the Department's IT. However, the Department never formally established the Committee's ongoing purpose or committee members' responsibilities. When interviewed by auditors, several committee members were not clear about the Committee's purpose. Additionally, auditors attended most of the Committee's meetings between December 2013 and December 2014 and observed that the Committee never discussed the Department's long-term IT needs or direction. For example, committee members never discussed new ideas for improving the Department's IT capabilities in committee meetings, such as expanding the use of e-filing or data analytics. Instead, the Committee primarily focused on receiving project updates and responding to IT problems as they arose, which IT standards indicate is the responsibility of an IT management body rather than an IT governance body. Moreover, until December 2014, auditors observed that the Committee lacked a clearly assigned leader and a formal decision-making method. Further, auditors observed that the Committee struggled to build support, buy-in, and commitment from department leaders to formally define the Committee's purpose and committee members' responsibilities.

Department efforts to establish a better IT governance structure have begun but are not complete. According to department staff, the Department's IT Division previously proposed a charter several years ago to formally establish the Committee's scope and authority, but the Committee did not agree on the proposed charter and it was not implemented. As a result of this audit, the Department drafted and adopted a new charter in December 2014 that establishes the Committee as an IT governance body. However, it had not developed associated policies and procedures to fully implement this change (see pages 14 through 15 for additional information).

- **Department has lacked adequate IT strategic planning**—Although the Department maintains an agency strategic plan and an IT strategic plan, it has not adequately developed or followed these plans. For example, both plans contained a strategic issue to update the Department's technology, supporting software, and applications to ensure the efficiencies of its core business processes. However, staff had not created action plans or steps needed to meet that strategic issue, nor identified who would be responsible for achieving action steps within specified time frames. The Department's plans also lacked adequate performance measures to reflect its progress on achieving goals, and did not specify how these measures would be reported internally or to stakeholders. In August 2014, the Department issued an updated agency strategic plan, which contained broad goals and strategic issues similar to its prior plan. Although the plan indicated that staff would create specific objectives and action plans to accomplish strategic goals, and that each of the Department's divisions would measure and track performance, none of these activities had occurred by December 2014. Without these elements, both strategic plans fall short of providing staff with sufficient guidance to carry out the Department's IT direction.

In addition, although the Department annually shares the agency strategic plan with its staff, the Department's CIO said that the IT strategic plan had not been shared with the Committee or staff. Further, auditors did not observe committee members using either plan to make IT decisions in committee meetings.

Finally, the Department had not taken steps to ensure adequate resources would be available to accomplish the strategic plans' primary IT objective. Instead, the Department reported that, prior to the audit, its budget office determined how much of the Department's budget to allocate to the IT Division for fiscal year 2014, and that this office had not considered strategic objectives or consulted with IT management (see page 18 for the approach taken for the fiscal year 2015 budget).

Auditors observed that without an effective IT governance structure to direct IT, and without effective IT management processes to ensure adequate strategic planning, the Committee had difficulty making decisions and often made decisions in response to IT demands, crises, or challenges. For example, auditors observed that the Committee struggled to prioritize its numerous IT projects. As of February 2014, the Department reported that it had 34 IT projects—more than double the number of projects in any of the previous 3 calendar years.¹ Given the limited department resources to work on these projects, the Committee attempted to prioritize its IT projects between February and June 2014. However, the Committee lacked adequate guidance for making these decisions strategically,

¹ The Department's IT project demand is driven by changes in laws, fixes needed for system improvement, necessary maintenance, or staff requests for improved functionality or services.

and committee members typically focused their time on discussing projects that affected their specific business functions rather than planning the future IT for the entire Department. In addition, auditors observed that committee members were frustrated in their decision making by limited project understanding, poor communication, and uncertainty as to who was ultimately responsible for decision making. For example, committee members sometimes did not understand why specific projects were added to the IT project list or how IT staff were assigned to them, and were unclear or had disagreements about the scope or importance of various projects. Additionally, committee members often moved from topic to topic without making decisions on prior topics.

After months of struggling to prioritize IT projects with no success and with several projects behind schedule, the Committee asked the IT Division to make recommendations for prioritizing projects on the IT project list, and in June 2014, the Committee approved the recommendations made by the IT Division.

Department should apply IT standards to establish more effective IT leadership processes

The Department should look to IT standards to establish more effective IT leadership processes. Specifically, the Department should continue efforts it began during the audit to establish an IT governance structure for setting its IT direction, as well as IT management processes for ensuring that this direction is carried out. The Department should also improve its IT strategic planning based on an assessment of its current and target IT capabilities. State tax agencies in California and Washington provide good examples of some IT governance, management, and strategic planning practices that the Department should review and consider. Following IT standards should help the Department strengthen its IT leadership, effectively respond to IT challenges and changes, and proactively pursue IT systems and capabilities that would allow it to more efficiently and effectively operate.

Department should establish IT governance processes—IT standards emphasize the importance of a sound IT governance structure, including processes for evaluating, directing, and monitoring IT in an organization and ensuring the effective and efficient use of IT to enable an organization to achieve its goals.¹ Through these processes, an organization can develop a long-term vision for IT, as well as build support, buy-in, and commitment from department leaders. California and Washington provide examples of how two western states have established IT governance structures within their state tax agencies (see textbox, page 15).

During the audit, the Department began taking steps to establish an IT governance structure. Specifically, between July and October 2014, the Department drafted and reviewed a governance charter based on Washington's charter to restructure its Committee to become a governance body. The charter renames the Committee and establishes its purpose: to provide guidance and oversight of the Department's IT projects portfolio with the overall goal

¹ ISACA. (2012). *COBIT5: Enabling processes*. Rolling Meadows, IL: Author; and Gartner IT Glossary retrieved August 14, 2014, from <http://www.gartner.com/it-glossary/it-governance/>

Examples of IT governance structures in other state tax agencies

California—The California Franchise Tax Board has established a Governance Council (Council) to provide leadership and direction for the entire organization, including its IT. The Council adopted a charter that states a clear purpose for the Council and contains its guiding principles, goals and objectives, member responsibilities, decision-making policy, operating guidelines, strategic planning calendar, and plan to monitor the governance structure in the future. The charter outlines when and what the Council will discuss to develop the vision and set the direction for its IT, such as reviewing top IT technologies that meet long-term business needs.

Washington—The Washington Department of Revenue has established a governance committee specifically for IT called the Customer Advisory Team (CAT). The CAT adopted a charter that clearly states the purpose of the team and the responsibilities of its members, and outlines its decision-making process. The decision-making process gives CAT members a consensus approach so that priorities can be made to move the vision set by the CAT forward.

Source: Auditor General staff interviews with the chief information officers at the California Franchise Tax Board and the Washington Department of Revenue and review of documentation provided.

of ensuring that IT is working on the right things at the right time in the right way. The charter also outlines committee members' basic responsibilities, such as advising the Department's IT Division on changes in business needs, including those set by legislative or strategic directional changes. The charter also includes a decision-making policy that gives each department division a vote in decision making and indicates that the Committee will have a detailed process for prioritizing IT projects. The prioritization process will outline how IT requests are to be submitted and evaluated, define the different levels of priority for different types of projects, and detail how projects will be tracked and their status reported.

The Department's efforts are a step in the right direction, but more is needed. Although the Committee adopted a governance charter in December 2014, department leadership had not yet finalized associated procedures, including the proposed prioritization process. To fully establish an IT governance structure that is consistent with standards, the Department should:

- **Implement its governance charter and associated policies and procedures**—The Department should implement its governance charter, including developing and implementing a prioritization process and any other policies and procedures necessary to govern the Department's IT. For example, IT governance policies and procedures should ensure that communication and reporting methods provide those responsible for oversight and decision making with appropriate information. In addition, the policies and procedures should assign responsibility, authority, and accountability in line with its governance structure. The Department should train those responsible for IT governance to ensure they clearly understand the governance charter, associated policies and procedures, and their role in governance. As it implements its governance processes, the Department should ensure that the Committee's practices are revised to function as a governance body—one that sets the direction for future department-wide IT and advises on strategic direction rather than one that spends significant time receiving detailed updates on projects.
- **Monitor effectiveness of IT governance processes**—The Department should also develop and implement policies and procedures for monitoring the effectiveness of its IT governance structure and evaluate whether the IT governance structure and associated processes

provide adequate direction and oversight.¹ For example, the Department could determine whether its governance charter adequately outlines department leaders' responsibilities and whether its prioritization process effectively guides decisions. Further, the Department should evaluate its related policies and procedures annually and update them as needed to accommodate changes in operation or business environments.

Department should establish IT management processes—As the Department implements its governance processes, it will need to establish new IT management processes. According to IT standards, IT management includes the processes for carrying out the direction set by the governance body through planning, implementing, and monitoring IT activities and projects.² IT management also involves establishing the roles and responsibilities of IT personnel and setting up management structures that enable effective and efficient management decision making. For example, a management structure could entail a committee or an individual that is responsible for tracking the status of projects, resolving resource conflicts, and monitoring service levels—the role that the Committee has historically played. Again, California and Washington provide examples of IT management practices that are aligned with IT standards (see textbox).

Examples of IT management structures in other state tax agencies

California—The Governance Council charter established by the California Franchise Tax Board created action committees that prioritize and support agency-wide initiatives in alignment with the agency's strategic plan. One of the action committees was specifically established to address IT policies and practices for the entire organization, and has developed its own charter, guiding principles, and rules for operation. Additionally, IT staff are assigned specific tasks and know what is expected of them to accomplish goals. According to an agency official, specific expectations are then tied to that individual staff member's performance evaluation, thus helping California to ensure its vision is put in action through IT management.

Washington—Unlike California, which uses action committees to carry out the direction of its governance body, the Washington Department of Revenue has designated individuals called "system owners" to carry out the direction set by its governance committee. System owners manage the day-to-day maintenance and enhancement of department-wide IT functions. For example, Washington has system owners for data warehousing, internal web management, geographic information systems, and taxpayer accounting systems. By having system owners assigned to specific functions, Washington has clearly identified individuals who are accountable for each of the various areas that make up the IT infrastructure.

Source: Auditor General staff interviews with the chief information officers at the California Franchise Tax Board and the Washington Department of Revenue and review of documentation provided.

The Department's governance charter describes the new IT management structure that the Department intends to implement. According to the charter, designated system owners will be assigned responsibility for understanding, prioritizing, and communicating the needs of department staff and may create user groups to help do so. However, as of December 2014, the Department had not yet assigned system owners and had not fully defined how system owners and user groups will be expected to carry out the direction set by the Committee or report back to the Committee. To fully establish an IT management structure, the Department should:

¹ ISACA, 2012

² ISACA, 2012

- **Finalize IT management structures**—The Department should finalize and implement an IT management structure for carrying out the IT direction the governance body sets, whether through system owners or another approach. In establishing the IT management structure, the Department should develop and implement policies and procedures to define which staff will carry out IT management, what their authority and responsibilities will entail, and how they will be held accountable. The Department should also train those responsible for IT management to ensure they clearly understand the IT management structure, associated policies and procedures, and their role in IT management.
- **Monitor effectiveness of IT management processes**—As with its governance structure, the Department should develop and implement policies and procedures for monitoring the effectiveness of its IT management structure and evaluate whether the IT management structure and associated processes are adequate to carry out the IT direction that the governance body sets. For example, the Department could determine whether its policies and procedures adequately outline system owners' responsibilities and whether they effectively manage IT. Further, the Department should evaluate its related policies and procedures annually and update them as needed to accommodate changes in operation or business environments.

Department should improve IT strategic planning—The Department should ensure that, once established, its IT management follow strategic planning standards that will help it carry out the direction the Department's governing body sets. According to IT standards, organizations' IT management should assess their current IT capabilities, define optimal IT capabilities, and analyze any gaps between the two.¹ Based on the gap analysis, IT management should then develop an IT strategic plan, as well as a road map of prioritized initiatives to achieve the plan, and measures to monitor the achievement of goals. These plans should be communicated throughout an organization and to appropriate stakeholders. Finally, IT management should prepare IT budgets to reflect the investment priorities supporting their strategic objectives. California and Washington also provide examples of IT planning practices aligned with these standards (see textbox).

Examples of IT planning practices in other state tax agencies

California—According to an agency official, the California Franchise Tax Board (Board) hired a consultant to conduct an extensive analysis of the Board's IT capabilities. The official said that this analysis guided its strategic plan and road map development. Once the Board adopted its strategic plan, it created a vision document for the year 2020 and communicated that vision with staff. The vision helped explain what working at the Board would be like in the future once IT strategic goals were accomplished. The agency official reported that this document garnered support across all divisions for the IT strategic plan goals that help achieve the vision.

Washington—The Washington Department of Revenue has documented its current and desired future IT capabilities in a detailed Technology Infrastructure Plan. An agency official explained that this plan was used to help develop the tactical roadmap that contains time lines and metrics designed to measure success in accomplishing strategic initiatives. Additionally, the official said that IT staff use monthly project reports to monitor progress of their strategic initiatives, and that they intend to review the plan and prioritize strategic initiatives annually.

Source: Auditor General staff interviews with the chief information officers at the California Franchise Tax Board and the Washington Department of Revenue and review of documentation provided.

¹ ISACA, 2012

In addition to IT standards, the Governor's Office of Strategic Planning and Budgeting (OSPB) provides model planning practices.¹ For example, these practices include developing long-term goals and strategic objectives that are specific, measurable, aggressive, results-oriented, and time-bound, or SMART. In addition, these practices recommend developing action plans that identify detailed SMART action steps needed to implement the plan, who is responsible for achieving the steps, and when steps should be completed. Further, these practices recommend creating meaningful performance measures and monitoring the implementation of strategic objectives on a monthly or quarterly basis.

The Department should ensure its IT strategic planning is aligned with IT standards and the OSPB's model planning practices. Specifically, the Department should ensure that its IT management:

- **Conduct a gap analysis based on direction set by Department's IT governance**—Given the Department's lack of optimal IT discussed previously, IT management should assess the gap between its current IT capabilities and target capabilities based on IT standards and model planning practices. Then, to address the gap, IT management should create long-term goals and revise the IT strategic plan in line with the Department's strategic plan. For example, the gap analysis could help inform the Department's plans for replacing the BRITS system (see Finding 2, pages 21 through 23, for additional information).
- **Develop SMART strategic objectives, action steps, and a road map to facilitate implementation and monitoring**—IT management should ensure that its revised IT strategic plan includes prioritized, SMART strategic objectives to accomplish its goals; detailed SMART action steps needed to implement the plan; and a timetable of when specific staff will accomplish objectives and specific action steps. The IT strategic plan should also include clearly defined performance measures for each strategic objective, and a monitoring system to ensure objectives are accomplished. In addition, IT management should train those responsible for IT strategic planning to ensure they clearly understand their role and associated policies and procedures. Once the IT strategic plan is finalized, it should be communicated to appropriate stakeholders and users department-wide to garner full support of initiatives. Finally, staff should monitor progress in completing strategic initiatives and regularly report their progress to IT management.
- **Align IT budget with strategic plan**—As mentioned previously, the Department reported it had not considered strategic initiatives when it developed its IT budget for fiscal year 2014. Although department officials indicated that they based the fiscal year 2015 IT budget on resources needed to complete projects consistent with the strategic plan, the Department did not document the process it undertook in written policies and procedures. Therefore, IT management should ensure its IT budgeting practices are documented and consistent with its IT strategic initiatives.
- **Monitor effectiveness of IT strategic planning processes**—IT management should develop and implement policies and procedures for monitoring the effectiveness of its IT

¹ Governor's Office of Strategic Planning and Budgeting. (2011). *Managing for results*. Phoenix, AZ: Author.

strategic planning processes. Further, IT management should evaluate its related policies and procedures annually and update them as needed to accommodate changes in operation or business environments.

Recommendations:

1.1. To fully establish an IT governance structure, the Department should:

- a. Implement its governance charter, including developing and implementing a prioritization process and any other policies and procedures necessary to govern the Department's IT. For example, IT governance policies and procedures should ensure that communication and reporting methods provide those responsible for oversight and decision making with appropriate information. In addition, the policies and procedures should assign responsibility, authority, and accountability in line with its governance structure.
- b. Train those responsible for IT governance to ensure they clearly understand the governance charter, associated policies and procedures, and their role in governance.
- c. Ensure that the Committee's practices are revised to function as a governance body—one that sets the direction for future department-wide IT and advises on strategic direction rather than one that spends significant time receiving detailed updates on projects.
- d. Develop and implement policies and procedures for monitoring the effectiveness of its IT governance structure and evaluate whether the IT governance structure and associated processes provide adequate direction and oversight.
- e. Evaluate its related policies and procedures annually and update them as needed to accommodate changes in operation or business environments.

1.2. To fully establish an IT management structure, the Department should:

- a. Finalize and implement an IT management structure for carrying out the IT direction the governance body sets, whether through system owners or another approach.
- b. Develop and implement policies and procedures to define which staff will carry out IT management, what their authority and responsibilities will entail, and how they will be held accountable.
- c. Train those responsible for IT management to ensure they clearly understand the IT management structure, associated policies and procedures, and their role in IT management.
- d. Develop and implement policies and procedures for monitoring the effectiveness of its IT management structure and evaluate whether the IT management structure and associated processes are adequate to carry out the IT direction that the governance body sets.

- e. Evaluate its related policies and procedures annually and update them as needed to accommodate changes in operation or business environments.
- 1.3. To ensure its IT strategic planning is aligned with IT standards and the OSPB's model planning practices, the Department should ensure that its IT management:
- a. Assess the gap between its current IT capabilities and target capabilities based on IT standards and model planning practices. Then, to address the gap, IT management should create long-term goals and revise the IT strategic plan in line with the Department's strategic plan.
 - b. Ensure that its revised IT strategic plan includes prioritized, SMART strategic objectives to accomplish its goals; detailed SMART action steps needed to implement the plan; and a timetable of when specific staff will accomplish objectives and specific action steps. The IT strategic plan should also include clearly defined performance measures for each strategic objective, and a monitoring system to ensure objectives are accomplished.
 - c. Train those responsible for IT strategic planning to ensure they clearly understand their role and associated policies and procedures.
 - d. Communicate the final IT strategic plan to appropriate stakeholders and users department-wide to garner full support of initiatives.
 - e. Ensure staff monitor progress in completing strategic initiatives and regularly report their progress to IT management.
 - f. Ensure its IT budgeting practices are documented and consistent with its IT strategic initiatives.
 - g. Develop and implement policies and procedures for monitoring the effectiveness of its IT strategic planning processes.
 - h. Evaluate its related policies and procedures annually and update them as needed to accommodate changes in operation or business environments.

FINDING 2

To effectively prepare for the anticipated replacement of its primary information technology (IT) system, the Arizona Department of Revenue (Department) needs to take additional actions beyond those discussed in Finding 1 of this report (see pages 5 through 20). According to department officials, the Business Reengineering/Integrated Tax System (BRITS) is nearing the end of its useful life and will need to be replaced, possibly beginning in fiscal year 2017. The Department has adopted project management and system development policies and procedures, which could help the Department avoid repeating the problems it experienced when BRITS was developed and implemented. However, the Department will need to ensure that these procedures are aligned with needed improvements in IT governance, management, and strategic planning discussed in Finding 1, and that staff follow the procedures in conducting this expensive and important system replacement.

Additional steps needed to prepare for planned IT system replacement

Department reports that BRITS will need to be replaced soon

Despite ongoing updates and improvements to BRITS, the Department reported that the system is nearing the end of its useful life and will need to be replaced in the next few years. BRITS, which was implemented in phases beginning in 2002, is the Department's primary IT system for processing tax returns. In fiscal year 2013, the Department began a BRITS update, which the Department reported is scheduled to be completed in fiscal year 2015. This system update includes hardware replacements, software updates, and other improvements designed to help minimize the risk of system failure.

Although the BRITS update is designed to extend the supportable life of the system, the Department reported that BRITS is outdated and further upgrades would be more expensive and less useful than replacing the entire system. Specifically, the Department reported that further upgrades would require it to rewrite the entire system and that commercial tax software options that could replace BRITS are available. Further, the contractor that developed BRITS no longer sells the system and has discontinued its hardware and coding support of the system. In addition, the Department expressed concern about reduced support from one of the companies that provides software that BRITS uses. Specifically, the software vendor's Web site shows that it will reduce some software support services in October 2016 and will further reduce support services in October 2017. The Department reported that this reduced level of support after October 2017 will be inadequate because the Department will receive fewer services at a much higher price and will not receive new security updates, which could put the Department at risk for security breaches. Finally, as discussed in Finding 1 (see pages 5 through 6), the Department reported that it had identified nearly 1,300 needed improvements to BRITS and other IT systems as of April 2014 and that BRITS is difficult to modify. The Department reported that the system requires continual department resources to maintain. As a result, the Department will continue to face challenges with using BRITS until it is replaced.

The Department estimated that a new system will need to be implemented in phases during fiscal years 2017 through 2020, but indicated that a feasibility study will provide a more accurate timeline for system replacement. As required by statute, the Department has requested funding to contract for a feasibility study to begin planning for a replacement system. Effective July 2014, Arizona Revised Statutes §41-3504 requires state agencies to contract with an independent third party for review of and guidance on technology

projects with costs exceeding \$5 million.¹ Specifically, a third-party contractor is required to provide some oversight of the technology approach, scope, cost estimation, timeline for completion, and overall feasibility of the project before a request can be made for project funding. In November 2014, the Department requested funding through the state budget process to hire a contractor to lead a feasibility study in fiscal year 2016 for replacing BRITS.

Department should address risks of implementing new system

If the Department moves forward with replacing BRITS, it should ensure that it adequately addresses the project risks of implementing a new system. As reported by the Office of the Auditor General in 2005 (see Report No. 05-15), the Department did not adequately manage the implementation of the BRITS system. For example, the Department did not closely follow IT project management best practices, adequately define the functions the system needed to perform, or satisfactorily test the system's functions to determine if the system worked as planned (see textbox).

BRITS implementation problems

The Department did not:

- Closely follow IT project management best practices related to overseeing the contractor responsible for the project;
- Adequately define the functions the system needed to perform;
- Satisfactorily test the system's functions to determine if the system worked as planned;
- Adequately train users and IT staff;
- Initially involve some of its most knowledgeable IT staff who had experience with the previous computer systems; and
- Hire an oversight advisor as originally planned to audit the contractor's performance and to report on BRITS' progress, risks, and budget to department management.

Source: Office of the Auditor General, Report No. 05-15.

To avoid similar problems in implementing a new system, the Department should ensure that it follows best practices and IT standards related to project management and a system development lifecycle (SDLC) methodology (see textbox, page 23). The Department's IT Division has adopted project management and SDLC policies and procedures to help ensure a sound approach to managing projects and developing software. These policies and procedures are generally aligned with IT standards. However, these policies and procedures will need to be revised to be consistent with changes the Department makes in addressing its IT leadership process issues—including changes to IT governance, management, and strategic planning—discussed in Finding 1 (see pages 14 through 19). Improved IT governance, management, and strategic planning are necessary for addressing the full range of the Department's existing IT, but

¹ The BRITS replacement project will likely exceed the \$5 million threshold. According to the Department, BRITS cost more than \$152 million.

they will have a direct bearing on developing and implementing a new system as well. Therefore, the Department should revise its project management and SDLC policies and procedures to be consistent with its new IT governance, management, and strategic planning processes.

Once revised, the Department should ensure these policies and procedures are clearly communicated to all applicable staff and closely followed to avoid the system implementation problems it experienced when BRITS was implemented. Although evaluating the Department's compliance with these policies and procedures was not within the scope of this audit, auditors observed indications that they may not be adequately followed. For example, in meetings where the Department's IT was discussed, the department director and assistant directors expressed concerns about miscommunications regarding IT projects' scope or requirements, which resulted in projects that had been or were at risk for being delayed or over-budget.¹ In addition, auditors observed department leadership discuss problems related to testing changes made to BRITS, which, in one case, prevented staff from carrying out an accounting function in a timely manner, and, in another case, resulted in erroneous e-mails being sent out to some taxpayers. Appropriately following project management and SDLC policies and procedures can help mitigate IT project development and management risks.

SDLC—A conceptual model used in project management that describes the stages involved in an information system development project, from an initial feasibility study through maintenance of the completed system. In general, an SDLC methodology includes steps usually encompassing the planning, analysis, selection, design, testing, implementation, and maintenance of a system. An effective SDLC methodology is important to help ensure that the right people are involved in the design and selection of the system and that the system meets the business needs of the organization implementing it.

Source: Auditor General staff review of IT standards.

Recommendations:

- 2.1. The Department should revise its project management and SDLC policies and procedures to be consistent with its new IT governance, management, and strategic planning processes.
- 2.2. The Department should ensure that its project management and SDLC policies and procedures, once revised, are clearly communicated to all applicable staff and closely followed to avoid the system implementation problems it experienced when BRITS was implemented.

¹ As of February 2015, several of the Department's IT projects were behind schedule, including a large project that involves reprogramming BRITS to comply with statutory changes to the State's administration of the transaction privilege tax (see the textbox on page 3 for more information). The Department reported that this project is delayed because of schedule and resource constraints. Further information about this project will be provided in the Office of the Auditor General's Arizona Department of Revenue Sunset Factors report.

APPENDIX A

This appendix provides information on the methods auditors used to meet the audit objectives.

This performance 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.

The Auditor General and staff express appreciation to the Arizona Department of Revenue (Department) Director and staff for their cooperation and assistance throughout the audit.

Methodology

Auditors used various methods to study the issues addressed in this report. These methods included reviewing applicable state laws, department policies and procedures, and other information obtained from department staff and the Department's Web site; interviewing department officials and staff; and reviewing a previous Office of the Auditor General audit of the Department (Report No. 05-15).

In addition, auditors used the following specific methods to meet the audit objectives:

- To assess the Department's use of information technology (IT), auditors interviewed and/or observed department staff regarding IT used for processing documents, selecting taxpayers for audit, and managing collections cases; interviewed a Federation of Tax Administrators (FTA) representative; and interviewed officials and/or reviewed supporting documentation from six other states' tax agencies regarding the IT used for various tax administration functions.¹
- To evaluate the Department's IT leadership processes, including IT governance and management, auditors observed 12 of the 15 department IT Steering Committee meetings held between December 2013 and December 2014 and reviewed relevant documentation; reviewed the Department's strategic planning and budgeting processes, and evaluated the Department's strategic plans using strategic planning guidance from the Governor's Office of Strategic Planning and Budgeting.² Auditors also reviewed IT governance and management standards published by ISACA, as well as IT governance and management practices used by state tax agencies in California and Washington.³
- To review the Department's plans to replace its primary IT system, auditors reviewed vendor support levels for the current system, the Department's budget request for funding to conduct a feasibility study for a replacement system, and department policies and procedures for IT project management and IT system development.
- To obtain information used in the Introduction section of the report, auditors analyzed department-prepared financial information on IT Division revenues and expenditures for fiscal years 2013 through 2015. Auditors also reviewed department information and state appropriation

¹ The six states were California, Indiana, Minnesota, New York, Texas, and Utah. Auditors selected these states based on various factors, including input from the FTA, Department, and other stakeholders.

² Governor's Office of Strategic Planning and Budgeting. (2011). *Managing for results*. Phoenix, AZ: Author.

³ ISACA. (2012). *COBIT5: Enabling processes*. Rolling Meadows, IL: Author.

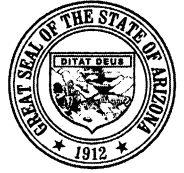
reports to document department appropriations and spending from the Automation Projects Fund between July 1, 2012 and December 31, 2014.

- Auditors' work on internal controls included observing department IT Steering Committee meetings and reviewing related documentation, reviewing the Department's strategic planning and budgeting processes, evaluating the Department's strategic plans, and reviewing department policies and procedures for IT project management and IT system development. Auditors' conclusions on internal control are reported in Findings 1 and 2 of the report.

AGENCY RESPONSE

STATE OF ARIZONA

Department of Revenue



Douglas A. Ducey
Governor

David Raber
Director

April 9, 2015

Debbie Davenport, Auditor General
Arizona Office of the Auditor General
2910 North 44th Street, Suite 410
Phoenix, AZ 85018

Dear Mrs. Davenport:

On behalf of the Arizona Department of Revenue, thank you for your performance audit report, "Use of Information Technology." We enjoyed working with your staff and commend them for their professionalism and insight.

The topic of this audit was both relevant and timely. As the state agency responsible for processing, depositing and distributing over \$13 billion per year to fund state and local government services, it is crucial that we implement and utilize the most effective technologies available to us. Arizona's taxpayers are technically sophisticated. They deserve and have come to expect e-government services, including e-services in the area of taxation. The Department desires to affirmatively respond to Governor Ducey's call for "government to operate at the speed of business." New and effective information technology systems will play a critical role in making that vision a reality.

The audit report provided two findings that we are in full agreement with. The Department intends to implement the Office of the Auditor General's recommendations with respect to these findings. Specifically, Finding 1 indicates that the Department lacks effective technology leadership and project governance processes. Finding 2 indicates that the Department must take steps necessary to effectively replace our core tax system.

Finding 1

We appreciate that your audit report discusses our current tax system (known as BRITS) in great detail. As you point out, the Department began implementing the various components of BRITS over a decade ago. While the project met many goals, including providing for a tax processing platform and certain revenue enhancements that helped to fund the system, the fact is that the project fell short in delivering what the agency required: a comprehensive, integrated tax system complete with audit and collections platforms to lead the Department into the 21st century. Since the BRITS implementation, the Department of Revenue has been forced to live with the aftermath of those serious

shortfalls in deliverables, and frankly, those deficiencies have held the Department back in many ways over the past decade.

The BRITS system was acquired as a result of a competitive procurement process. Unfortunately, BRITS was procured and implemented just a few years before the state and local taxation market was provided with some high quality, private sector-developed, commercial off-the-shelf (COTS) integrated tax system options. The urgency to replace a very old, legacy mainframe system on the brink of failure resulted in the need to procure a new system at that time, without further delay. The COTS systems were not available during the procurement process, so the Department ended up with a highly customized system, which we have since found to be inflexible and very difficult to modify. The result is a system that does not allow the Department to be adaptable and responsive to new technology priorities and tax legislation in a timely manner.

This deficiency can best be illustrated in the Department's implementation of Transaction Privilege Tax (TPT) Simplification legislation that was passed and signed into law more than two years ago. The requirement that the Department provide business/taxpayer location-based data to local governments has taken months longer to program than originally anticipated, and it has resulted in a one-year delay in implementing the single point of administration component of the new law. In implementing this legislation, it became more apparent than ever that BRITS was rigid, overly complex and highly difficult to change.

The audit report makes it clear that the Department has failed to improve its systems over the past decade such as electronic filing, OCR/ICR technology and audit selection and collections prioritization data analytics. BRITS failed to deliver that functionality upon implementation, and the complexities of BRITS logic and programming code have prohibited the Department from adding those capabilities after-the-fact. However, it is important to note that the COTS systems currently available on the market provide these forms of functionality. In fact, most of the states referenced in the audit report as "best practice examples" and jurisdictions capable of providing better technical functionality have already implemented one of the available COTS systems.

The audit report also points out the need for the Department to enhance our IT leadership and governance processes. The processes which were in place prior to the audit were carry-overs from the BRITS implementation. While those processes and systems served the agency well in the past, we agree that a fresh look at how we manage technology from a high level will be of great benefit.

As you noted in the report, we have already started down a path of improving our leadership and governance processes. We have reinvented our governance committee, and that group of agency leaders will govern initiatives requiring greater than 1,000 hours in effort. This begins with the prioritization of initiatives in the Department's annual strategic planning process. Throughout the lifecycle of initiatives, beginning with the approval of the Program Charter, the Information Technology Steering Team (IST) monitors initiative progress. As necessary, the IST reprioritizes initiatives in response to

external forces, risk or unplanned business events and uses a change management process that includes risk, resource and financial implications. Further, the IST executes quarterly strategic reviews.

The Department recently identified leadership resources and began the implementation of constituent-led Enterprise System Owner subcommittees. We are currently focused on the processes and training for the Enterprise System Owners. In February, the Department created and filled the position of Chief Architect; the Chief Architect now participates in the IT Committee and Department strategy development, serves as the IT focal point for the analysis of the BRITS system replacement and acts as a key contributor in the development of the sub-committee processes, which include application roadmaps driven by Department strategy. Also, since this audit commenced, the Department has made funds available within our existing budget to create and fill two key positions: Deputy Chief Information Officer and Program Manager over the TPT Simplification Project.

While an updated technology leadership and governance system will be of great assistance to the Department, we do not believe that those changes by themselves will solve all of our agency technology challenges. We recognize three primary reasons for a lack of progress in addressing critical technology issues in a timelier manner: (1) a lack of resources, (2) incredible challenges with modifying or improving our customized tax system, BRITS, and (3) a continuous need to address higher priorities brought about by legislative policy changes and revisions to tax laws.

Again, the best and most recent example of item (3) would be the TPT Simplification processes created by statutory changes over the past two years. While TPT Reform is a necessary, business-friendly tax policy that we are honored to implement, the legislation has consumed the agency with modifications to our brittle tax system, while sidelining other priority technology projects at the Department. Even the very best and most effective of governance and leadership processes could not have overcome or solved these challenges on their own. However, we still believe and practice continuous improvement at the Department and will implement and practice a new leadership, strategic planning and governance process in our technology.

Finding 2

We were pleased to see that your audit report addressed the replacement of the BRITS system. We fully agree and will implement your recommendations for preparing for the system replacement.

A system replacement is the highest priority of the Department in upcoming years. Much time, effort and funding has been put into modifying a system that was never designed to be changed significantly or modified from its original state. The time has come to cease making tactical, piecemeal investments in the system and instead make a strategic investment that will provide for a new integrated tax system which serves the State of Arizona and our taxpayers well in the future.

As we have pointed out, the state revenue agencies that offer the most e-services, have the best and most efficient processing, audit and collections systems and are continuously held up as examples to follow are the states that have procured and implemented one of the excellent COTS systems made available on the market within the past half-decade.

Implementing such a system at the Department is paramount. The experience of procuring and implementing the BRITS system provided valuable lessons learned that we will apply to the procurement of a new tax system. We will carefully execute this process, taking into consideration the recommendations your team has made.

The Department is an active participant in the Federation of Tax Administrators (FTA), an organization that exists to provide services to state tax administrators. These services include research and information exchange, training and intergovernmental and interstate coordination. Key representatives from our various divisions participate in FTA-sponsored conferences, training sessions, meetings and inter-departmental collaborations. One key advantage of the FTA is an opportunity to learn from state revenue departments that have recently completed, are currently implementing or are planning for a procurement of an integrated tax system. We will leverage the expertise and lessons learned of other FTA member states as we begin moving down the path of a system replacement.

Concluding Comments

The Department will take full advantage of existing resources and will allocate future resources in a manner consistent with implementing the Auditor General's recommendations. By replacing and modernizing existing systems and continuing to enhance IT's leadership and governance processes the Department will be well-positioned to operate at the "speed of business."

Again, we thank you and your staff, and look forward to working together in the future.

Sincerely,

David Raber
Director

Performance Audit Division reports issued within the last 24 months

13-02	Arizona Board of Appraisal
13-03	Arizona State Board of Physical Therapy
13-04	Registrar of Contractors
13-05	Arizona Department of Financial Institutions
13-06	Department of Environmental Quality—Underground Storage Tanks Financial Responsibility
13-07	Arizona State Board of Pharmacy
13-08	Water Infrastructure Finance Authority
13-09	Arizona State Board of Cosmetology
13-10	Department of Environmental Quality—Sunset Factors
13-11	Arizona State Board of Funeral Directors and Embalmers
13-12	Arizona State Board for Charter Schools
13-13	Arizona Historical Society
CPS-1301	Arizona Department of Economic Security—Children Support Services—Foster Home Recruitment-Related Services Contracts
13-14	Review of Selected State Practices for Information Technology Procurement
13-15	Arizona Game and Fish Commission, Department, and Director
14-101	Arizona Department of Economic Security—Children Support Services—Transportation Services
14-102	Gila County Transportation Excise Tax
14-103	Arizona State Board of Dental Examiners
14-104	Arizona Office of Administrative Hearings
14-105	Arizona Board of Executive Clemency
14-106	State of Arizona Naturopathic Physicians Medical Board
14-107	Arizona Department of Child Safety—Children Support Services—Emergency and Residential Placements
14-108	Arizona Department of Administration—Arizona State Purchasing Cooperative Program
15-101	Arizona Department of Child Safety—Compared to National Averages, Arizona’s Number of Child Abuse or Neglect Reports Has Been Similar or Higher and Its Substantiation Rate Lower, and the Office of Child Welfare Investigations Is Unique Among States
15-102	Arizona Department of Administration—Department Should Strengthen Its Management, Support, and Oversight of the State-wide Procurement System
15-103	Arizona Medical Board—Board Has Improved Its Processes, but Should Conduct a Risk-Based Review of Previously-Issued Licenses
15-104	Arizona Department of Transportation—Motor Vehicle Division—Division Should Improve Field Office Customer Service, Better Regulate the Ignition Interlock Program, and Continue to Enhance its Oversight of Third-Party Offices

Future Performance Audit Division reports

Arizona Sports and Tourism Authority