PERFORMANCE AUDIT

DEPARTMENT OF REVENUE

TAXATION DIVISION AND HEARING OFFICE

Report to the Arizona Legislature
By the Auditor General
April 1985
85-5

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STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

April 22, 1985

Members of the Arizona Legislature
The Honorable Bruce Babbitt, Governor
Mr. J. Elliott Hibbs, Director
Arizona Department of Revenue

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Arizona Department of Revenue, Taxation Division and Hearing Office. This report is in response to an April 27, 1983, resolution of the Joint Legislative Oversight Committee. The performance audit was conducted as a part of the Sunset Review set forth in A.R.S. §§41-2351 through 41-2379.

The report addresses the adequacy of the Department's sales tax audit effort, and the need to improve audit selection systems and controls over the quality and integrity of audit work. Implementation of recommendations contained in the report could generate well over $20 million annually in additional revenue.

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

Respectfully submitted,

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SUMMARY

The Office of the Auditor General has conducted a performance audit of the Department of Revenue (DOR), Taxation Division and Hearing Office in response to an April 27, 1983, resolution of the Joint Legislative Oversight Committee. This report, the first in a series on the Department of Revenue, was completed as part of the Sunset Review set forth in A.R.S. §§41-2351 through 41-2379.

The Taxation Division of DOR is responsible for administering Arizona's tax laws and regulations relating to income, sales and use, luxury, bingo, fiduciary, estate taxes, and unclaimed property. Its primary function is to conduct audits of taxpayers and assess taxpayers for amounts owed. The Department's Hearing Office is organized under the director of the Department of Revenue and is responsible for registering and monitoring all protests related to audit assessments.

The Department Of Revenue Could Collect Up To $18 Million Annually In Additional Revenue By Increasing Its Sales Tax Audit Effort (See Page 5)

Although the sales tax is the State's best revenue producer and a productive audit area, the Department maintains a relatively low coverage of the sales tax base. A national study, based on 1979 data, computed DOR's sales tax audit coverage at 2.4 percent, well below the 4 percent coverage of sales tax accounts considered near optimal by authorities.

Increasing DOR's sales tax audit coverage would substantially increase audit collections. Hiring additional auditors would be cost effective. If 24 more auditors were hired, at a cost of about $996,500, up to $18.8 million in additional revenue would be generated. Because of the inexperience of its staff and the lack of training programs, DOR may not wish to absorb 24 additional auditors at once. Instead, increases in audit staff could be phased in over 2 or 3 fiscal years.

The Department Could Significantly Increase Revenue By Improving Its Audit Selection Systems (See page 11)

The Department of Revenue needs to improve its audit selection systems. Currently, the State's major taxpayers, which generally offer the greatest potential to generate additional audit assessments and collections, are not being audited. Analysis of a random sample of the State's major sales taxpayers indicated that about 20 percent had been audited between January 1981 and August 1984. If all large accounts were audited, we estimate that an additional $1.8 million to $3.6 million in revenue could be generated yearly.

DOR has not implemented systems to identify major taxpayers for audit. It has not placed major taxpayers on a cyclical audit schedule, which is common practice in several states, nor has it implemented a computerized system to help identify major taxpayers for audit. However, even if DOR selected major taxpayers for audit, DOR auditors may not currently have sufficient experience and training to handle audits of these more complex accounts. To address this problem, DOR needs to improve both initial and in-service training programs offered to its audit staff.

In addition, many accounts DOR does select for audit are unproductive, suggesting other selection system weaknesses. A significant number of sales tax audits are terminated, some because they were not appropriately selected for audit. DOR has apparently used inaccurate or outdated records for selection purposes and has not adequately tracked audit activity. Unproductive audits also occur partly because DOR lacks clear selection criteria. DOR should develop and apply clear criteria in using various sources of information for audit selection.

The Department Of Revenue Lacks Adequate Controls To Ensure the Quality and Integrity Of Audit Assessments, Modifications, And Amendments (See Page 25)

The Audit Section of the Department of Revenue does not have adequate controls to ensure quality audit work and equitable treatment of taxpayers. Although auditors exercise considerable responsibility and authority on behalf of the State, their decisions are not adequately checked. Controls over audit decisions made by supervisory personnel are minimal, although these decisions may involve hundreds of thousands of dollars. To improve controls over audit decisions, DOR needs to strengthen its review of audit work, improve documentation in case files, and upgrade and improve training of personnel. Review of audit work could be further improved if DOR implemented a quality control review unit. Several other states have made effective use of this type of unit and consider it an integral part of their review process. We recommend that the Legislature consider appropriating $116,000 for this purpose.

Additional controls are also needed to minimize the potential for collusion, bribery and other abuses. Specific instances of abuse were uncovered by the Department in 1983, and two officials were dismissed from their positions as a result. Implementation of a centralized quality control unit would help reduce the potential for such abuses. In addition, we recommend that DOR consider implementing other controls such as routine rotation of auditors.

Finally, DOR needs to improve its review of audit working papers. A review of audit files disclosed minimal and inconsistent supervisory review. Because audit review is lax, auditor errors can go undiscovered or necessitate subsequent modifications or amendments to original audit assessments. The Department needs to develop written standards and policies governing audit work techniques and audit review.

Protested Assessments Are Not Processed Efficiently; Consequently The Potential For Loss Of Revenue Exists (See Page 37)

The Department of Revenue does not process protested assessments efficiently. As a result, the potential for loss of revenue exists. Under Arizona law, those taxpayers who are assessed additional taxes may petition for a hearing, correction or redetermination. Procedures for processing protests, however, are cumbersome and lack adequate controls. The current system relies extensively on manual operations. Our analysis of the process showed excessive transferring of documents among sections and duplication of effort. For example, 59 documents involving 14 personnel are used in the sales tax assessment and formal protest process. Each audit file is handled by at least eight different people and transferred at least 16 times between employees and eight times between sections. The number of documents involved could be reduced and efficiencies could be realized.

Excessive manual processing and duplication increases the risk of errors and mishandling. We noted several instances in which audit files were requested but could not be located. Other cases have been lost in the system and hearings have never been scheduled. DOR's ability to monitor and control the protest process is hampered by a lack of management reports, a deficiency identified in our 1981 DOR audit report. Although the Department has been working to develop a protest tracking system since at least March 1983, the system is still not operational.

In addition, the Department's Hearing Office has a backlog of cases that are not being efficiently resolved. As of October 1984, the Office had 63 pending cases for which hearings had been held but decisions had not yet been rendered. In 19 of these cases, more than a year had passed since the hearing had been held. All of these cases had been assigned to the same hearing officer. The Department needs to implement a system to ensure timely follow-up of cases awaiting decisions. In addition, the Department needs to take more timely action to resolve cases informally. Many cases are resolved informally on the day of the scheduled hearing, thus wasting the time and resources of the Hearing Office.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit of the Department of Revenue (DOR), Taxation Division and Hearing Office in response to an April 27, 1983, resolution of the Joint Legislative Oversight Committee. This report, the first in a series on the Department of Revenue, was completed as part of the Sunset Review set forth in Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

Taxation Division

The Taxation Division of DOR is responsible for administering Arizona's tax laws and regulations relating to income, sales and use, luxury, bingo, fiduciary and estate taxes, and unclaimed property. Its primary function is to conduct audits of taxpayers and assess taxpayers for amounts owed.

The Division of Taxation consists of four sections: Audit, Compliance, Estate Tax and Tax Policy. The Audit Section contains four units: Sales and Use Tax, Individual Income Tax, Corporate Income Tax, and Audit Services. The Audit Section is responsible for selecting accounts for audit and analyzing statutes applicable to the various tax types. The Compliance Section is responsible for securing compliance with State taxation laws through criminal prosecution of violators when criminal intent is found. The Estate Tax Section audits and collects State revenue from taxable estates and fiduciary returns. It is also responsible for administering the State's unclaimed property laws. The Tax Policy Section develops rules and regulations for the Taxation Division.

The Audit Section conducts in-house audits of taxpayer returns and field audits of taxpayer records to ascertain that taxpayers accurately report and pay tax liabilities. Thus, revenue is generated from additional tax assessments based on audit findings. According to Department records, auditing has resulted in the following additional assessments for fiscal years 1981-82 through 1983-84.

Year	Assessments	Collections
1981-82	$28,652,020	$12,736,226
1982-83	75,749,339*	20,659,639
1983-84	55,473,507	39,020,000

Staffing And Budget - Auditing activities consume 27 percent of the Department's resources. One hundred seventy-two of the Department's 640 authorized full-time employee positions (FTE) were allocated to auditing and compliance programs in fiscal year 1983-84. Table 1 shows actual and estimated expenditures for auditing activities in fiscal years 1982-83 through 1984-85.

TABLE 1

DOR ESTIMATED AND ACTUAL EXPENDITURES
FOR AUDITING/COMPLIANCE PROGRAMS
FISCAL YEARS 1982-83 THROUGH 1984-85

	Actual 1982-83	Actual 1983-84	Estimated FY 1984-85
FTE Positions	163	172	180
Expenditures:			
Personal Services	$3,327,000	$2,825,600	$3,306,800
Employee Related	695,300	594,200	757,900
Professional And Outside Services	2,900	5,000	14,200
Travel			
In State	80,000	41,300	69,000
Out Of State	136,600	171,000	252,100
Other Operating	56,200	44,000	74,800
Equipment	66,100	22,300	0
Total Expenditures	$4,364,100	$3,703,400	$4,474,800

Source: Department of Revenue budget requests

* Includes one large case involving more than $20 million, which is in court.

Hearing Office

The Hearing Office of the Department of Revenue is organized under the director of the Department of Revenue. It operates with one hearing officer and two clerical staff. The Office is responsible for registering and monitoring all protests related to audit assessments.

Scope Of Audit

Our audit of the Department of Revenue Taxation Division and Hearing Office was limited to the Audit Section of the Division of Taxation and the Hearing Office. The operations of the Tucson Office, except where noted, were not included in this audit. The Tucson office operates independently from the Taxation Division in Phoenix (see page 51).

Detailed work was conducted on the following issues:

- Whether sales tax audit coverage is adequate,
- Whether audit selection systems need to be improved,
- Whether review of audit work is adequate and controls sufficient to deter and prevent abuse, and
- Whether the appeals process is efficient and timely.

In addition, limited work was done to address the 12 statutory Sunset Factors. Departmentwide responses to these factors will be prepared following completion of our other Department of Revenue audits.

In some cases, work was delayed due to difficulty in obtaining accurate and reliable information. This difficulty resulted from data and systems problems and was not due to lack of cooperation by the Department.

The Auditor General and staff express appreciation to the assistant director and staff of the Taxation Division and the Hearing Office for their cooperation and assistance during the course of our audit.

FINDING I

THE DEPARTMENT OF REVENUE COULD COLLECT UP TO $18 MILLION ANNUALLY IN ADDITIONAL REVENUE BY INCREASING ITS SALES TAX AUDIT EFFORT

The Department of Revenue (DOR) does not conduct enough sales tax audits. Although sales tax is the State's highest revenue producer, audit coverage of the sales tax base is low compared with other states or standard ratios. In addition to providing for more favorable tax base coverage, assigning more audit staff to sales tax audits would significantly increase audit collections.

Current Auditor Allocation

At the time of our audit, 39.5 auditors (both Phoenix and Tucson staff) were assigned to the Sales and Use Tax Unit, and 56.5 to the Income Tax Unit. Within the Income Tax Unit, 28.5 auditors were assigned to field audits and 28 to office audits.* Income field audits are primarily corporate audits conducted at the taxpayers' place of business. These audits involve detailed review of financial records supporting the taxpayer's return. Income office audits are primarily individual income tax audits involving a desk review of tax returns and available IRS revenue agent reports.

Sales Tax Audit Coverage Is Low

Although sales tax is the State's best revenue producer and a productive audit area, the Department maintains a relatively low audit coverage of

* Total FTEs include temporary and intern (part-time) staff.

the sales tax base. This is evidenced by: 1) comparing Arizona with other states, 2) analyzing auditor allocation based on a percentage of revenue collected, and 3) examining standard ratios of auditors to numbers of accounts.

Other States - DOR does not conduct as many sales tax audits as other states. A national study based on 1979 data, which included Tucson audits and accounts, computed DOR's sales tax audit coverage at 2.4 percent, well below the 4 percent level considered near optimal by authorities.* As shown in Table 2, Arizona's audit coverage was well below coverage of five other western states considered to have reasonably adequate sales tax audit programs.**

TABLE 2

SALES AND USE TAX AUDIT COVERAGE IN ARIZONA
AND FIVE WESTERN STATES

State	Audit Coverage
ARIZONA	2.4%
California	4.1
Colorado	4.2
Nevada	4.6
Utah	8.1
Washington	3.3

Source: Due and Mikesell, op. cit., p. 238

* John F. Due and John L. Mikesell, Sales Taxation: State and Local Structure And Administration (Baltimore, The Johns Hopkins University Press, 1983).

** Other states with adequate audit coverage are Alabama, Arkansas, Mississippi, Oklahoma, Rhode Island and Tennessee.

Precise comparisons between states are not possible due to differences in state tax structures and record keeping systems. However, the differences are substantial enough to conclude that Arizona's audit coverage is relatively low.

Percentage Of Revenue Collected - DOR's sales tax audit coverage is also low when auditor allocation is compared to revenue collected. As shown in Table 3, State sales tax will generate 57 percent of total sales and use, and income tax revenue expected to be collected for fiscal year 1984-85. Yet only 41 percent of audit resources are assigned to the Sales and Use Tax Unit. If audit resources were assigned based on percentage of revenue collected, 55 auditors would be assigned to audit sales and use taxes, which is 15.5 more than are currently assigned.

TABLE 3

AUDITOR ALLOCATION AMONG TAX TYPES
SALES AND USE, AND INCOME TAXES

	Allocation Based On Percentage of 1984-85 Anticipated Revenue Collections		Current Allocation	
Tax Type	Number	% of Total(1)	Number	% of Total
Sales/Use	55	57%	39.5	41%
Income - Field	25	26	28.5	30
Income - Office	16	17	28	29
Total	96	100%	96	100%

Source: Prepared by Auditor General staff from information compiled by the assistant director of taxation

(1) Column percentages represent the proportion of revenue expected by DOR to be contributed by each tax type to total sales and use, and income tax collections for fiscal year 1984-85.

Some states have reallocated audit resources based on similar analyses. For example, the New York State Department of Taxation and Finance discovered several years ago that its corporate tax field audit program accounted for 35 percent of total field audit revenue. However, the program was allocated only 10 percent of audit staff; while the income tax program, with 22 percent of the audit staff, accounted for 8 percent of total revenue. Income tax auditors were transferred to the programs producing more revenue, such as corporate tax field audit.

Standard Ratios - Finally, DOR sales tax audit coverage is low based on the number of auditors compared to accounts. DOR has assigned 39.5 auditors to audit a sales tax base of approximately 95,000 active accounts, a ratio of one auditor per 2,400 accounts. Studies in various states indicate that one auditor per 1,000 accounts may be an adequate sales tax audit staff. Some states meeting this standard are Rhode Island, Utah, Vermont, Wisconsin and Texas. Others close to this staffing level are Connecticut, Iowa, Nevada, Oklahoma and Virginia. DOR would need to assign 95 auditors to the Sales and Use Units to meet this ratio. If only monthly sales tax accounts (63,538), which are considered by DOR to be the best audit prospects, were included in the analysis of sales tax coverage, 63.5 auditors would be needed.

Increasing Audit Staff Would Generate Substantial Additional Revenue

Increasing DOR's current sales tax audit coverage to the near optimal 4 percent level would substantially increase audit collections. Hiring additional sales tax auditors would be cost effective.

DOR could increase revenue collections substantially by hiring additional sales tax auditors. If 24 additional auditors were hired and assigned to sales tax audits, bringing the total to 63.5 positions, a total estimated increase of more than $18 million could be collected.

TABLE 4

EFFECT OF INCREASING SALES TAX AUDIT STAFF
ESTIMATED ADDITIONAL ANNUAL COLLECTIONS

Tax Type	Current Allocation		Adding Staff	
	Number of Auditors	Estimated Collections(1)	Number of Auditors	Estimated Collections
Sales/Use	39.5	$31,101,800	63.5	$49,999,074
Income - Field	28.5	14,152,200	28.5	14,152,200
Income - Office	28	9,514,000	28	9,514,000
Total	96	$54,768,000	120	$73,665,274
Increase Over Current Allocation			24	$18,897,274

Source: Auditor General analysis of information compiled by the Division of Taxation

These estimates are based on the assumption that DOR would generate the same average collections per audit as the number of sales tax audits increased. Sales taxation authorities note that if audit selection systems are working effectively, dollars generated per audit will decline as tax base audit coverage increases. This occurs because the largest and most productive accounts are audited first, leaving less productive accounts for subsequent selection. As noted in Finding II (page 11), however, DOR is not currently selecting the largest and most productive accounts for audit. Thus, improvement in audit selection may offset any expected declines in average collections per audit.

DOR could increase its sales tax audit effort by reallocating existing staff, however, this would not be desirable for two reasons. First, reduction in income field audits would not be feasible or cost effective. These audits are primarily corporate audits and are relatively productive audits based on historical data. Further audit work is needed to determine whether current corporate audit coverage is adequate. In addition, for all tax types, regardless of productivity, the Department needs to maintain adequate audit coverage for compliance purposes.

Hiring additional audit staff would be cost effective based on the expected return. DOR estimates that adding 24 auditors to the sales tax audit program would cost approximately $996,500 annually. If the full $18.8 million in additional collections could be realized, each additional dollar spent would return more than $18 in revenue. Even if only one-fourth of the expected return were generated, the cost of additional auditors would be well worth the investment.

DOR may not wish to absorb 24 additional auditors all at once. Instead, increases in audit staff could be implemented in phases over 2 or 3 fiscal years. The Department has neither adequate management, supervisory nor support staff to absorb a large staff increase, nor controls needed to minimize errors and the potential for abuse (see Finding III, page 26). Moreover, as noted in Finding II (page 16), training and experience of existing auditors needs to be improved so audit resources can be more efficiently and effectively utilized.

CONCLUSION

DOR does not conduct enough sales tax audits. Increasing coverage of the sales tax audit base could generate as much as $18 million in additional revenue.

RECOMMENDATIONS

1. The Department of Revenue should develop a comprehensive plan to increase sales tax audit coverage. This plan should address the actions that would be taken to provide training, supervision, etc. before additional audit staff were hired.

2. The Legislature should consider appropriating the necessary funds over the next 3 fiscal years for a phased increase of sales tax auditors.

3. DOR should conduct a study to determine whether corporate income tax audit coverage needs to be increased.

FINDING II

THE DEPARTMENT COULD INCREASE REVENUES BY IMPROVING ITS AUDIT SELECTION SYSTEMS

The Department of Revenue (DOR) needs to improve its audit selection systems. Most of the State's major taxpayers, some of the most productive accounts, are not being selected for audit. Estimated additional sales tax revenue of more than $1.8 million to $3.6 million could result each year if these accounts were audited. DOR has not placed these taxpayers on a cyclical audit schedule nor implemented a computerized system that would automatically identify major taxpayers. In addition, many audits DOR does perform are unproductive, suggesting other selection system weaknesses.

Taxation Division Purpose And Current Selection Systems

One purpose of the audit function is to increase tax revenue through audit assessments.* During the last few years this has been a major emphasis of the Department because of potential State budget deficits. To accomplish this, the Division of Taxation attempts to identify taxable accounts and decide which of these will be audited. Currently, selection is performed manually by staff experienced in each tax type audit unit. Both internally generated and externally derived information is used in the selection process.

The Sales and Use Tax Unit selects accounts for audit throughout the year from about 20 sources. Some sources are the McGraw Hill Dodge Reports (which provide information on current construction within the State), and outside party referrals, including complaints from concerned individuals.

* The Division of Taxation is responsible for administering sales and use, income, withholding, luxury, severance, estate, fiduciary and bingo taxes. Due to the time limitations of this audit, only sales and corporate income tax selection methods were examined. These accounted for 83 percent and 84 percent of gross revenue collected by DOR in fiscal years 1982-83 and 1983-84, respectively.

The auditors themselves identify potential audits through newspapers and periodicals, or by observing new entities or construction on the way to or during engagements.

Corporate income tax selection of reporting corporations is based on auditor experience and judgment, and prior audit information on a corporation. DOR sometimes uses a zip code report prepared by Data Processing, listing corporate name, zip code and amount of tax remitted at a particular time to aid in selection. Another source of audits is the Internal Revenue Service revenue agent reports.* Many audits are performed using these because they usually require minimal audit time to determine what State tax assessment, if any, can occur as a result of a Federal income tax assessment.

Major Taxpayer Accounts Are Not Being Audited

DOR is not selecting major taxpaying accounts for audit. Although they are among the most productive accounts, most major taxpayers have not been audited within the last 3 years. Significantly more revenue could be generated if more of these accounts were selected for audit.

Major taxpayers generally offer the greatest potential to generate additional audit assessments and collections. Various systems to select audits, such as California's cell system, place substantial emphasis on large firms because the dollar productivity of such audits is likely to be high. Several other states, including Wisconsin, Washington, Tennessee, Texas, and Nebraska emphasize audits of major taxpayers because of their revenue potential.

Arizona's actual audit experience indicates that audits of larger firms and taxpayers are more productive. According to our analysis of a random sample of 100 of the 490 sales tax audits performed by Phoenix audit staff resulting in additional tax due in fiscal year 1983-84, there is a very

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* Federal revenue agent reports contain Federal income tax adjustments to individual and corporate income tax return amounts. State auditors can often determine if additional state tax is due from the taxpayer by examining these reports.

high correlation between net taxable amount and audit assessment.* This verifies that the larger the firm, the greater the audit assessment.

Despite their potential, many major taxpayers are not being audited. Fewer than 2 percent of DOR's ongoing sales tax accounts (1,798 out of 103,913 accounts) account for 70 percent of total sales taxes paid.** Analysis of a random sample of 300 of the 1,798 large taxpaying accounts (using Phoenix Office records) revealed that only 20 percent had been audited between January 1981 and August 1984. Only 36 percent had been audited in the previous 8 years.

A similar result was found in further review of both Phoenix and Tucson audit activity for the 100 largest accounts. Ninety-seven of these 100 taxpayers remitted at least $500,000 in sales taxes in each of the last 3 fiscal years. About one-fourth (24 percent) were audited between 1981 and 1984. Because the State statute of limitations limits DOR to auditing and collecting sales accounts for the preceding 39 months, many years of potential additional tax revenue could be lost because of this failure to identify and audit potentially productive large accounts.

<u>Additional Revenue Could Be Generated</u> - DOR could generate from $1.8 million to more than $3.6 million in additional sales tax revenue yearly if the Department audited more large firms. Of the 24 largest sales tax accounts audited between 1981 and 1984, 19 owed additional taxes. The average audit assessment over this period for these major taxpayers was $126,561. If DOR audited one-third of the taxpayers remitting more than

* The actual correlation is .9407 with a significance level of .001.

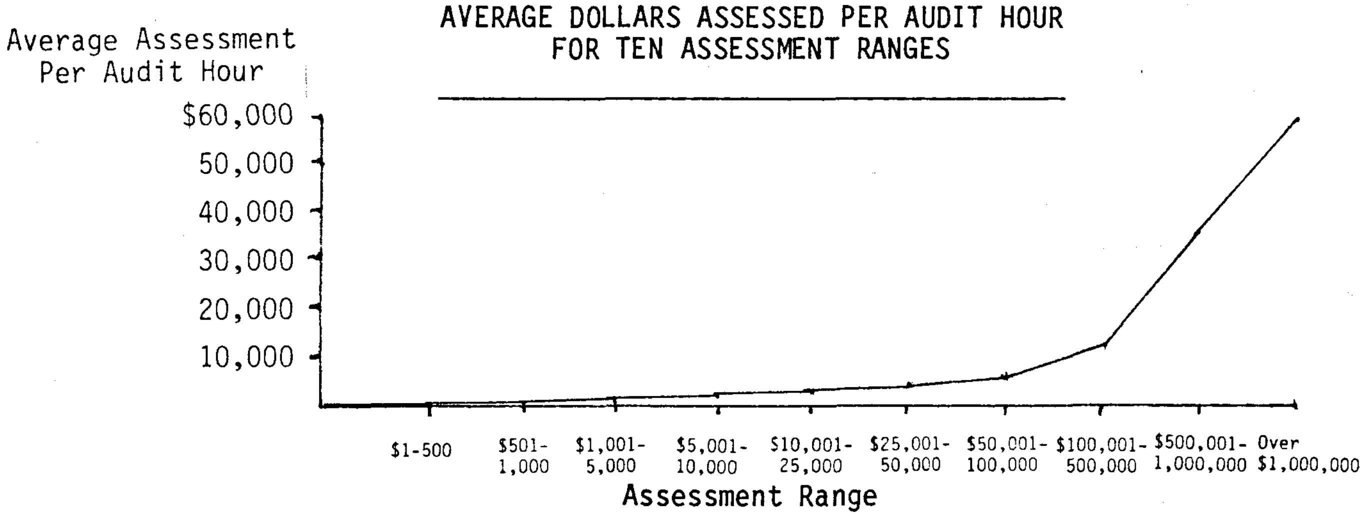
** Because sales taxes generate the most State revenue, and because of difficulty in getting accurate data, our analysis focused primarily on audit selection systems in the Sales tax unit. Three separate master sales tax file tapes, prepared by the DOR Data Processing Center, were sent to our Office. Each was different than the previous tape and each contained inaccuracies. Our comparison of the last two tapes received indicate that although certain percentages derived in our analyses may change depending on which tape is used, we can still conclude that potentially productive large tax accounts are not always audited.

$500,000 in sales tax each year (which would coincide with the 39-month statute of limitations) about $3,658,000 in additional revenue could be realized. Using the DOR 5-year audit cycle of such accounts, nearly $1,868,000 of increased collections could occur.*

In addition to generating additional revenue, audits of major taxpayers increases auditor productivity. We examined actual dollars generated per audit hour invested by DOR Phoenix Office corporate income tax auditors. Comparing audits that result in assessments of $1 to $500 with those resulting in assessments of $50,001 to $100,000, per hour average audit return is increased by more than $3,700. For assessment cases of more than $1,000,000, additional average tax due is increased by about $59,000 per average audit hour. Table 5 illustrates average audit assessment due per audit hour for ten assessment ranges.

TABLE 5

CORPORATE INCOME TAX:
AVERAGE DOLLARS ASSESSED PER AUDIT HOUR
FOR TEN ASSESSMENT RANGES



Source: Prepared by Auditor General staff using Phoenix Office Corporate Income Tax audit log for the period July 1983 through May 1984

* These estimates are based on sales tax data indicating that 221 accounts paid more than $500,000 in sales taxes in fiscal year 1983-84, and includes allowances for unproductive accounts and for productive audits currently performed. Actual collections potential may be greater. In addition, more recent sales tax data (the third sales tax tape we analyzed) showed 273 accounts paying more than $500,000 in fiscal year 1983-84, which if audited would increase collections.

Based on that analysis, if DOR performed one more audit in each of the three highest assessment ranges, estimated collections from those audit assessments would total nearly $1,750,000.*

Major Taxpayers Are Not Identified In A Systematic Way

DOR is not identifying major sales-tax payers for audit in a systematic way. Although it plans to do so, the Department has not placed major taxpayers on a cyclical audit schedule. Nor has it successfully implemented the Marginal Analysis Audit Selection System (MAASS), an automated system that is designed partly to emphasize selection of large, productive sales tax accounts. Even if large accounts were selected for audit, DOR's current capability to audit these acounts may be limited because auditors are not adequately trained to audit complex firms.

Cyclical Selection Not Performed - DOR has not placed the State's major sales-tax payers, those paying more than $500,000 in sales taxes per year, on a cyclical audit schedule. According to DOR, there were 221 accounts with a tax liability greater than $500,000 in fiscal year 1983-84. The number of such accounts has increased in each of the last 3 fiscal years. From fiscal year 1981-82 through 1983-84 these accounts have increased by about 42 percent.

The Phoenix Office plans to place all major taxpayers on a cyclical audit schedule, but its plan may not be adequate due to the statute of limitations. The Sales Tax Audit Selection Group is in the process of implementing a formal, manual, cyclical audit selection system for all accounts paying $100,000 to $500,000 yearly in taxes, and for those remitting more than $500,000 in taxes. The group expects cycles of 8-10 and 5 years respectively, for the two groups. Again, this will not allow even the highest dollar accounts to be audited within the 39 month statute of limitations. As a result, undetermined audit-related revenue will be lost.

* Estimated collections are based on fiscal year 1984-85 collection objectives.

Several states audit major taxpayers on a cyclical basis within their respective statutes of limitations. Cycles range from 3 years in Tennessee to 4 years in Washington. Texas, which has a 4-year statute of limitations, considers as its priority taxpayers those cumulatively accounting for 65 percent of the reported taxable amount (2 calendar years of reported amounts are used). Texas audit division policy stipulates that 25 percent of these accounts be examined each year, resulting in virtually 100 percent audit coverage every 4 years.

MAASS System Has Not Been Implemented - In addition, DOR has not successfully implemented an automated system to help identify major taxpayers for audit. The now defunct MAASS system was obtained by the Department in February 1982 from the City of Scottsdale. The system, similar to California's cell system, is designed to select sales tax audits to be selected based on audit assessment potential. The system groups Standard Industrial Classification* (SIC) codes into categories and assigns each sales account a number, one through 16, based on amount of tax paid each year. The cells are then grouped into three categories: most productive, productive, and least productive. The "most productive" category usually contains the largest and most complex business operations.

The MAASS system has several known program problems, which since its initial operation in June, 1982, have rendered the system unusable. First, the system is not accepting all audit maintenance input forms, and thus, all audit information does not get on the history file. For example, "last audit date" is missing from most accounts. Secondly, some SIC codes needed for account assignments are not on the system. Lastly, some "undefined" SIC codes (and accounts) show up erroneously in the listing of the "most productive accounts." These problems have not been corrected because MAASS is not a priority with the Department's Data Processing Center and the Division itself does not have the programming expertise to correct known problems.

Auditor Experience And Training Are Lacking - Even if DOR selected major

* SIC is the abbreviation for Standard Industrial Classification. These codes group businesses into industry categories.

taxpayers for audit, DOR auditors may not have sufficient experience and training to handle audits of these more complex accounts. DOR auditors lack experience due to high staff turnover. In addition, the auditors within both the Phoenix Office Sales and Corporate Income Tax Units receive little training.

Although qualified for their positions, DOR auditors lack experience at some levels.* A survey of audit staff qualifications indicated that most entry-level field auditors (81 percent) and many journey-level auditors (40 percent) had less than 1 year experience in their positions. Moreover, all but one of DOR's audit supervisors (field and office) had less than 1 year experience in their supervisory positions at the time of our audit.

DOR has experienced relatively high turnover in recent years, making it difficult for it to build more experience within its audit ranks. Field auditor turnover was 27 percent in fiscal year 1982-83, and climbed to 65 percent in fiscal year 1983-84, according to the Department. High turnover in fiscal year 1983-84 is attributable partly to the early retirement option that was offered to State employees during that year.

Turnover may decline once DOR's new auditor classification series is fully implemented. As a result of a 3-year DOA-Personnel study, most auditors will be reclassified and upgraded retroactive to January 1, 1985. DOR's audit staff salaries, although still of concern to Department management, now appear to be more competitive with salaries of comparable positions in industry and other governmental settings. Even if turnover declines, however, it will take time to develop staff experience within the audit section.

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* Audit staff come to DOR well qualified. In the Phoenix Office, of the 16 entry-level field auditors responding to our survey, all but one had a bachelor's degree, usually in accounting or business administration. Entry-level auditors have an average of more than 24 credit hours in accounting. Eleven of the 25 journey-level auditors surveyed had bachelor's degrees, and 4 had associate degrees. Journey-level auditors had an average of 25 hours in academic accounting course work. In addition, many of the auditors had related auditing and financial accounting experience before joining the DOR staff.

In addition, the sales tax auditors do not receive much formal training. The Units' trainer retired from the Department in late 1982. Because of Division reorganization and the priority given to revenue acceleration there has been little formal, structured training since that time. In late 1983 new auditors received 8 hours of training in sales and use tax problems, research materials, and the protest and appeals process. According to a supervisor, however, about half of the current staff has had no formal technical classroom training, and only about eight of the 29 auditors have enough training and experience to perform complex audits.

Auditors in the Corporate Income Tax Unit also lack structured technical training. All auditors attended a training series from October 1981 through February 1982, which ranged from basic to very technical aspects of corporate income tax auditing. Again, due to the same problems and events that occurred in the Sales and Use Tax Audit Unit, very little structured training has occurred since that time. In fiscal year 1983-84, for example, technical audit training totaled about 10 hours for new auditors. Only about half the current staff are prepared to do large, complex audits.

Supervisors in both audit Sales and Use and Corporate Income Tax Units use on-the-job auditor development programs to help train auditors. However, some supervisors in both units stated that more formal, structured, technical training would help prepare auditors to examine large, complex accounts.*

The best state tax administration agencies such as the Texas Office of the Comptroller of Public Accounts and the California Franchise Tax Board have well developed training programs. Texas states that auditor training has been the major contributing factor to job efficiency and high-quality

* The lack of training also affects even the routine audit activities. In a February 6, 1985, memo the Department's hearing officer cited several examples in which auditors and collectors lacked knowledge of fundamental policies and procedures. In his memo he stated ". . . virtually every day an auditor either calls me or comes to my office with a question(s) that reflects a basic lack of understanding of how the system works which, in my opinion, is the result of inadequate training."

audits. In the first 3 months of employment, new sales tax auditors receive up to 5 weeks (200 hours) of intensive classroom training, and on-the-job training with an office training coordinator. Subject areas covered include tax law, preaudit research, audit control, audit procedures, evidence and working paper file, and report writing. Additionally, penalty and interest procedures, and administrative procedures are taught. As auditors gain experience they attend additional classroom training for sales tax. Senior auditors receive an average of 40 hours of continuing classroom training yearly to maintain and expand their expertise.

The California Franchise Tax Board offers substantially more corporate income tax training than DOR. Its formal, classroom training plan accounts for approximately 16 percent of a new auditor's time during the first year. This training begins with 200 hours of personal income tax law and auditing techniques. The second training phase consists of about 120 hours of corporate income tax auditing methods, techniques and procedures. Thus, in the first year, California gives about 320 hours of classroom training to new corporate income tax auditors vs. 10 hours in Arizona.

Unproductive Audits Suggest Other Selection System Weaknesses

Many accounts selected by DOR for audit are unproductive, suggesting other selection system weaknesses. A number of sales tax accounts selected for audit are terminated, and about one-fourth of all corporate income tax audits performed result in no subsequent assessment or in a refund to the taxpayer. This appears to occur in part because DOR lacks clear selection criteria.

Numerous Unproductive Audits - Although even good audit selection systems produce some unproductive audit accounts, both the Sales Tax and Corporate Income Tax Units have initiated numerous unproductive audits. Sales tax audits that are started and then closed are documented on individual report forms. Individual reports are used: 1) to document that an account has been reviewed for the current audit period and no known additional tax is due or overpayments have occurred, 2) to document reasons an account was selected for audit but never audited, or 3) to provide information for potential audits that is gained while conducting other audits. According to available DOR records, which may not be complete, 450 individual reports were completed for the 2-year ending audit period of July 1982 through September 1984. Our analysis shows that during about the same period, 974 audits were completed. A comparison of individual reports and completed audits shows that slightly less than one-third of all selected accounts are terminated.*

The following case examples illustrate some of the unproductive audit activity that is documented in these reports.

- A report dated September 26, 1984, indicated that the firm selected for audit had canceled its license in February 1984 and was apparently no longer in business. The audit was canceled.

- A report dated October 1, 1984, noted that the firm selected for audit had recently been audited and no audit was necessary. The audit was canceled.

- A report dated September 11, 1984, said the firm selected for audit had been audited approximately 2 months previously for sales and use taxes. No audit was necessary and it was canceled.

- A report dated March 7, 1984, indicated that after 2 weeks' work, the auditor determined the company's sales were exempt. The audit was discontinued after 86 hours of audit time was expended.

None of the above accounts appear to have been appropriate for selection. DOR has apparently used inaccurate or outdated records for selection purposes, and has not adequately tracked audit activity. Valuable time that could have been spent on productive accounts was wasted.

* The actual percentage is 31.6 percent, which may be high because some individual reports may not record terminated audits.

Because documentation is sometimes inadequate, we were unable to determine why DOR began and then terminated some audits. For example, in February 1983, DOR started audits of several sales license accounts of a large resort. The audits were never completed, however, individual reports documenting the reasons could not be found.

The Corporate Income Tax Unit also conducts many unproductive audits. Of the 428 audits completed in fiscal year 1983-84, about 18 percent resulted in no additional tax due, and 11 percent resulted in refunds to taxpayers. Together, these audits that did not generate revenue accounted for more than one-fourth of all audits performed. For audits completed in fiscal year 1982-83, the percentages were similar, although refunds were 3 percent lower. Still, approximately 25 to 29 percent of all audits for each of those 2 years were unproductive.

Unclear Selection Criteria - Unproductive audits also occur, at least in part, because DOR lacks clear selection criteria.* Although both the Sales and Corporate Income Tax Units have identified and documented sources of potential audits, neither has well developed criteria for selecting accounts for audit from those sources.

The Sales Tax Audit Unit does not have clear, specific criteria with which to select accounts for audit within identified sources. For example, for the source "request for refund," a dollar amount of refund (or some other criteria) is not specified as an indicator for whether an account should be audited. When the Department uses the Dodge Reports, a floor amount of additional tax due (or other appropriate criteria) is not used. Another example concerns "property valuation" information. The extent of discrepancies noted as a result of certain comparisons is not specified as to when an audit should occur. In other words, there are no documented, clear-cut criteria with which to accept or reject an account for audit, again resulting in unsystematic selections.

* Implementation of the computerized MAASS system may also help reduce the number of unproductive audits.

Corporate Income Tax Audit also lacks clear criteria. Selection is performed mainly on a judgmental basis. The Department is attempting to address this deficiency. Starting in fiscal year 1984-85, tax year 1983 tax returns are being entered into the Department's computer system. Various reports will be produced from this data; some will allow selectors to request listings with certain criteria, such as all corporations with tax liability greater than X amount or all corporations with a net operating loss of X amount. These reports will be helpful but of limited use because they will originally contain data for only 1 tax year (1983). At the time of our audit report, the corporate system was not producing any reports.

CONCLUSION

Audit selection systems within the Department need to be improved. Currently, major taxpayers are not being audited. In addition, many audits performed are unproductive, indicating other selection system weaknesses.

RECOMMENDATIONS

1. DOR should implement a cyclical audit selection program for large sales and corporate income tax accounts to provide 100 percent audit coverage of major taxpayer accounts within the current statute of limitations.

2. DOR should make implementation of MAASS a priority and devote necessary data processing resources to correct program problems.

3. DOR should provide formal training to all new auditors and improve in-service training of its audit staff.

4. DOR should ensure that the Audit Section has updated and accurate audit activity and general account records for use in selecting audits.

5. DOR should improve documentation of reasons audits are terminated.

6. DOR should develop and apply clear criteria to use various sources of information for audit selection.

FINDING III

THE DEPARTMENT LACKS ADEQUATE CONTROLS TO ENSURE THE QUALITY AND INTEGRITY OF AUDIT ASSESSMENTS, MODIFICATIONS AND AMENDMENTS

The Audit Section of the Department of Revenue (DOR) does not have adequate controls to ensure quality audit work and equitable treatment of taxpayers. Technical review of decisions on audit assessments, modifications and amendments is weak, and controls are needed to prevent collusion, bribery and other abuses. In addition, supervisory review of audit working papers is minimal and needs to be improved.

Impact Of Audit Assessments, Modifications And Amendments

DOR audits in fiscal year 1983-84 generated approximately $55.5 million in additional tax revenue assessments. Many of these assessments involve substantial sums of money and can have a significant financial impact on both individual and corporate taxpayers in Arizona. Thus, it is important to ensure that audit assessments are accurately determined and fair to taxpayers.

In addition, Arizona Revised Statutes allow each taxpayer who is audited the right to protest the resulting tax liability assessment. Consequently, a significant number of assessments we reviewed were modified or amended, usually decreased, based on the outcome of protests. Many of these modifications and amendments are made informally, after contact or private meetings with the taxpayer. In the case of modifications and amendments, assurances are needed that loss of revenue is minimized and that taxpayers are treated fairly and equitably.

The reasons for changing original audit assessments are many and varied. Some reasons for changes made to corporate income tax assessments include adjustments to the apportionment factor, the Federal income tax deduction, and net operating loss carry-overs. For individual income tax assessments, changes may result from additional information supplied by the taxpayer or the taxpayer not being required to file a return. Changes in sales and use tax assessments may result from allowances for exempt purchases and sales, and from adjustments to taxable income and tax collected. Changes in assessments may also be necessary due to auditor errors.

A study done by the DOR Audit Section showed that the dollar amount of these modifications is significant. The Corporate Income Tax Unit modified eight cases for a total of $487,650 during a recent 4-month period. The Sales and Use Tax Unit modified 44 cases for a total of $394,711 during a 6-month period. The Individual Income Tax Unit modified 59 cases for a total of $48,053 during a 1-month period.

Important Controls Are Lacking

The Department currently does not have adequate controls to ensure the integrity of audit decisions. Although auditors exercise considerable responsibility and authority on behalf of the State, their decisions are not adequately checked. Unlike several other states, DOR does not have an independent quality control unit. In addition, controls necessary to reduce the risk of collusion, bribery and other abuses need to be strengthened.

Checks On Audit Decisions - Review of decisions made by audit personnel is not adequate to ensure quality, consistency, and fairness to taxpayers. A review of audit cases shows that technical review of decisions needs to be strengthened and documentation in case files needs to be improved.

Presently, controls over audit decisions made by supervisory personnel are minimal, although these decisions may involve hundreds of thousands of dollars. Audit Section procedures call for review of audit work by the auditors' immediate supervisor. The audit files may also be reviewed again at higher levels. For example, the chief auditor in the Income Tax Audit Unit attempts to review all cases involving assessments of more than $500,000. Cases including sizeable modifications to assessments may also be reviewed by the chief auditor in the Sales Tax Unit. However, files are rarely reviewed above the chief auditor level by the audit administrator, and the Department does not have an independent unit of auditors to conduct quality control reviews.*

Because checks on audit decisions are lacking, technical or judgmental errors can be made. For example, errors may be made in applying statutes, rules and Department policies. These errors may result in incorrect assessments, inconsistencies among auditors and unfairness to taxpayers. Errors could lead to taxpayers paying more or less money than legally required. In addition, Department auditors who exercise considerable authority on behalf of the State could make arbitrary or biased audit judgments.

The following case examples illustrate the need for adequate controls to minimize these problems.

Case 1

A large in-State corporation was audited for corporate income tax for fiscal years 1979, 1980 and 1981. This corporation has many out-of-State operations. The total tax liability as determined by the audit was more than $4 million. However, the corporation protested this amount on the grounds that it questioned DOR's position on its filing status. The taxpayer had been given permission by a DOR official to file a consolidated rather than a separate return. The taxpayer had suffered major financial losses and wanted to file an Arizona tax return reflecting those losses. The audit, however, had been conducted on the basis that the corporation should have filed a separate, not a consolidated return.** Four different negotiating positions were determined by DOR. These ranged in total liability from $3,081,243 down to $1,571,065 for consolidated filing. Eventually, after a lengthy negotiating process that ended at the director's office, this assessment was lowered to $550,000 - more than $1 million less than the amount of DOR's lowest negotiating position. The final settlement was based on a settlement offer made by the corporation.

* The audit administrator is responsible for managing the entire audit function, including planning, organizing and coordinating all work, and developing DOR policy on tax administration. Technical review of audit files should not be necessary at this level.

** Filing on a separate basis means that each subsidiary in a corporation files a return reflecting only its income. A consolidated return means that all tax data from each subsidiary is combined into one return. The result is one tax assessment for the corporation as a whole.

Comment

According to the Department's Attorney General representative, the DOR official may have erred in granting the company permission to file a consolidated return.* State law and Department policy on filing status are vague and allow considerable discretion in deciding such issues. Even if the manager had erred, however, the Department was not prevented from seeking the additional taxes, although its case may have been weakened.

This case illustrates the need for review of audit decisions. The case was not subjected to independent technical review, which would have served as some check on critical discretionary decisions such as the Unit manager's decision to allow a consolidated filing. Further, although meetings were held between DOR and corporation officials, neither the meetings nor the reasons and justifications supporting the final settlement agreement are documented in the case file. Department officials stated that judgmental errors and mishandling left the Department in such a weak position that it could not have acted more aggressively.

Case 2

In 1983, DOR audited three large private clubs for use tax. DOR assumed that these clubs did not sell food and liquor as part of their regular business operations. This would make them liable for use tax on these food and liquor purchases, since these clubs usually purchased this food and liquor at wholesale prices without paying sales tax.

Upon completion of these audits, these three clubs had a combined tax liability of more than $169,000. The clubs adamantly protested these assessments. They had never been audited for use tax before, and they questioned the legality of their use tax liability.

Attorneys for these clubs met with DOR officials and argued that they were not liable for the tax. The outcome of this meeting was that the additional tax liabilities for these clubs was decreased considerably to a little less than $10,000.

Comment

The documentation for these sizable modifications was inadequate. The combined modification was more than $160,000, and the only explanation in the files was a statement that the modification had resulted from a meeting between DOR officials and the attorneys for the clubs. No further details were given. A DOR official orally said that the law was somewhat vague, thus a decision was made to enforce it prospectively. However, the fact that a high level meeting resulted in a sizable modification with only minimal documentation in the audit file again demonstrates the need for review of audit decisions for consistency, fairness and compliance with law.

* This employee resigned in September 1979.

To improve controls over audit decisions, DOR needs to strengthen its review of audit work, improve documentation in case files supporting audit decisions, and upgrade and improve training of personnel (see Finding II, page 19). Better training and communication of Department policies and standards for conducting audits should improve both the quality and consistency of audit decisions.

<u>Quality Control Unit</u> - Review of audit work could be strengthened by implementing a centralized quality control review unit. Several other states have made effective use of this type of unit, and consider it an integral part of their review process.

Washington, Indiana and Connecticut are among the states that have a separate audit review unit.* In Washington, the unit is composed of highly qualified auditors with extensive experience and good performance records. Positions in this unit are highly competitive, and are viewed by the rest of the staff as a stepping stone to higher management positions. In Indiana, the unit is made up of field auditors called in to the central office for 3-month periods. This method gives the auditors exposure to reports other than their own, and allows them to judge quality by reading both good and bad reports. Finally, the Connecticut Department of Revenue has a quality control division that reviews a selected sample of reports quarterly. Any of these methods could be used by DOR to provide the independent technical review needed. Establishing a unit of three auditors and support staff would require an additional appropriation of approximately $116,000.**

DOR did attempt centralized audit review in 1982, however the effort was unsuccessful due to personality conflicts that developed among the reviewers. The reviewers interpreted statutes and the audit issues differently, which made it difficult to review the audits in a timely manner. The unit may have been further hampered by its placement in the

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* The review units in Indiana and Connecticut are described in a training manual of the National Association of Tax Administrators.

** This amount is based on salaries and employee related expenditures for two auditor IIs, an audit unit supervisor II, and a typist III.

Audit Services Section rather than the Audit Section. Eventually, such a sizable backlog of cases developed that the unit had to be disbanded.

Controls Over Abuses - Additional controls are also needed to minimize the potential for collusion, bribery and other abuses. Other states and the IRS have implemented procedures to reduce the risk of such abuses.

Controls are needed because audit personnel can potentially abuse their responsibility and authority in several ways. For example, auditors might compromise their work by knowingly issuing an incorrect audit assessment, which may require a taxpayer to pay more or less than is legally required. In the first case, the auditor may bear a personal grudge or dislike for the taxpayer, in the latter the auditor may have been improperly influenced by the taxpayer through some type of monetary or other offer. In addition, audit personnel may decide to collude in either soliciting or accepting a bribe from a taxpayer. Because audit decisions can involve hundreds of thousands of dollars, the risk and opportunity for such abuses is real.

In fact, specific instances of abuse were recently uncovered by the Department following a taxpayer complaint. In June 1983 two members of the Audit Section (a chief income tax auditor and an audit supervisor) were dismissed from State service for several violations of State Personnel Board rules and the Arizona Revised Statutes. The dismissals were appealed to the State Personnel Board and hearings were held.

According to the Personnel Board Hearing Officer's Findings of Fact, the chief income tax auditor was aware of a possible bribery attempt, but did not report it to his supervisors. In 1981, an employee in the Estate Tax Unit found a $300 check that a company had made out to her supervisor for "Director's Fees." The employee was concerned because the company, which specialized in finding heirs to unclaimed property, had submitted more than $200,000 in claims to DOR over a short period of time. She brought the matter to the attention of the chief income tax auditor and an audit supervisor. With the chief auditor's agreement, the audit supervisor conducted a withholding audit of the company and found the stub for the

$300 check. However, the chief income tax auditor did not report his knowledge of the check or anything else regarding the matter to his superiors.

After reviewing the facts surrounding this incident, the hearing officer concluded:

> "(The chief income tax auditor's) actions in authorizing a withholding audit of a company receiving money from the State from claims filed by it with the Estate Tax section where allegations of possible bribery had been made against such company upon the discovery of a $300.00 check made out (to) the section manager constitutes abuse of the audit function of the Department and as such, constitutes incompetence, neglect of duty and improper attitude.
>
> . . . (His) actions in not informing his supervisors about the $300.00 check after hearing about the check from (an employee) and after (the audit supervisor) reported that the check stub was found in a withholding audit constitutes incompetence, inefficiency, neglect of duty and improper attitude."

In the case of the audit supervisor, the hearing officer found that the supervisor had directed an arbitrary assessment of a taxpayer. The staff auditor, hand picked by the supervisor to do the audit because he considered her "aggressive" and "nit-picky," complained that she lacked sufficient information to make a proper assessment. The supervisor advised using an estimated mean average method to calculate the assessment. The taxpayer protested the assessment and appealed. After the taxpayer complained to the Governor's Office and after an investigation by the Attorney General's Office, the assessment was adjusted and the appeal hearing canceled. After reviewing the facts surrounding the matter, the hearing officer concluded:

> "(The supervisor) made fundamental errors in judgment, thereby neglecting his duties, causing distress to a taxpayer unjustifiably and demonstrated an improper attitude toward the audit powers of the State . . . In directing an arbitrary assessment of the taxpayer (the supervisor) violated fundamental responsibilities of public auditors, that is, fairness and impartiality to all members of the public. The power of the State to

> harass and demean persons through the audit power is awesome; it is only the integrity of the audit process that prevents massive disobedience of the tax laws. By violating this precept (the supervisor) jeopardized the State from collecting taxes from all of the citizens of this State."

After reviewing the facts surrounding these incidents and several other serious matters involving the chief income tax auditor and the audit supervisor, the hearing officer recommended that their appeals be denied and their dismissals be upheld. Both employees have appealed the Personnel Board decision to Superior Court.

These examples point out circumstances that can result from lack of proper control over the audit function. In our opinion, DOR still does not have adequate means of preventing future abuses of this type.

Implementation of a centralized quality control unit would help reduce the potential for abuse. Audits involving substantial amounts of money, and other audits on a sample basis, could be reviewed by an independent group of auditors not involved in the audit. The review unit could determine whether audits were conducted properly and whether audit decisions were justified and supported by adequate evidence. Any problems or abuses could be reported directly to the audit administrator or the assistant director for taxation.

In addition, some states and the U.S. Internal Revenue Service (IRS) have implemented other controls. For example, the Indiana Department of Revenue has a long-standing policy of rotating auditors. An auditor may not audit the same taxpayer consecutively. The Connecticut Department of Revenue and the IRS have similar policies. Rotating auditors minimizes the risk of collusion and abuse. The IRS has also adopted a reporting policy on bribery. This policy requires auditors to be alert to and report all instances, subtle or otherwise, that may represent an attempt to bribe an IRS official. Currently, DOR does not rotate auditors nor does it have a reporting policy on bribery.

Quality Of Audit Review Needs To Be Improved

The quality of DOR's review of staff working papers is also not adequate. A review of audit files showed minimal and inconsistent supervisory review. As a result, auditor errors that necessitate subsequent modification and amendments can occur. Unlike some other states, DOR lacks good audit review procedures and techniques.

Our review of audit files indicated that the quality of working paper review is poor. In addition to other files reviewed during the course of this audit, we judgmentally sampled ten recent sales tax audit files and eight corporate income tax files, focusing primarily on those with modifications or amendments to the initial audit assessment. The files contained minimal and inconsistent evidence of review. In most cases, there was no evidence, such as initials or sign-offs, indicating supervisory review of backup working papers. Many of those working papers were sloppy, had no headings or sources of information listed, and had not been signed or dated by the auditor. Virtually none of the files contained supervisory comments on the quality of working papers or the audit work, nor any other evidence such as point sheets of meaningful, substantive review.

Some review was evident, although its depth and scope was unclear. A few corporate income tax audit files we reviewed contained backup working papers initialed by supervisors. In addition, most files contained evidence that math calculations had been checked, although it was not always clear what specific calculations had been verified. Most files also contained assessment summary sheets or lead schedules with a supervisor's signature. It could not be determined from these sign-offs, however, whether any backup working papers were reviewed.

Errors Not Discovered - Because audit review is lax, auditor errors can go undiscovered and necessitate subsequent modifications or amendments to the original audit assessment. An internal study by DOR audit management found that some modifications were required due to auditor errors. Of the eight corporate audit cases reviewed, three involved auditor errors that necessitated amendments totaling almost $35,000.

We also found auditor errors in a separate review of sales and use tax cases involving modifications of more than $25,000. Of the 34 cases examined, eight had amended assessments as the result of auditor error. The effects of these errors may have been minimized had they been discovered during review.

Review is also needed to ensure that documentation meets miminum standards. If the Department were challenged in court, evidence in the case files would need to be adequate to support Department actions.

DOR Lacks Review Standards - The Department does not have specific working paper standards, or guidelines or policies governing supervisory review. Because DOR will be conducting more sales tax audits jointly and in coordination with municipalities, it plans to develop such standards and procedures in the future. In addition, establishment of an independent review unit would help improve the quality of audit review. Any inconsistencies, patterns of error or other problems could be reported to supervisory personnel for corrective action.

Indiana and Connecticut have strict and effective standards for working paper technique, documentation, and audit review. The Indiana Department of Revenue requires that all audit reports be checked for neatness, composition, substantiation and documentation, logical arrangement, and accounting trail. Also, the review unit that checks for compliance with these standards provides a monthly record of reporting errors so management can determine what skills the auditing staff is weak in, and what additional training they may need.

The Connecticut Department of Revenue has a standards handbook that is used by audit examiners and audit supervisors throughout the audit process. The handbook contains procedures and techniques for working paper format and referencing, for summarizing reports, and for arranging the audit package. Compliance with these standards results in a uniform audit presentation.

CONCLUSION

The Department of Revenue needs to improve controls over the audit function. Audit decisions need to be checked for quality and consistency, and controls are needed to minimize the risk of abuses. Supervisory review of audit working papers also needs to be strengthened.

RECOMMENDATIONS

1. The Legislature should consider funding an audit review unit. The Department should establish the audit review unit as an independent unit within the Taxation Division. The unit should be staffed wth a minimum of three auditors and should report directly to the audit administrator or the assistant director for taxation.

2. Reasons supporting modifications and amendments made to audit assessments should be documented in case files.

3. DOR should consider adopting a policy on rotation of auditors and on reporting of bribery.

4. The Department of Revenue should develop written standards and policies governing audit workpaper techniques and audit review.

5. Audit review should be conducted consistently and in accordance with standards and policies developed by the Department.

FINDING IV

PROTESTED ASSESSMENTS ARE NOT PROCESSED EFFICIENTLY; CONSEQUENTLY, THE POTENTIAL FOR LOSS OF REVENUE EXISTS

The Department of Revenue (DOR) does not process protested assessments efficiently; as a result the potential for loss of revenue exists. Procedures for handling protests are cumbersome and lack adequate controls. In addition, the Hearing Office has a backlog of cases awaiting decisions, and a large and increasing work load.

The Protest Process

DOR conducted more than 25,000 audits in fiscal year 1983-84, generating approximately $55.5 million in additional tax assessments. Under Arizona law, taxpayers who are assessed additional taxes may petition for a hearing, correction or redetermination. During the 2-year period that ended June 30, 1984, an indeterminable number of appeals resulted in 312 hearings.

The processing of protests involves three separate sections of the Department. These are the Audit Section, the Audit Services Section within the Taxation Division, and the Hearing Office. The Audit Section conducts audits, determines assessments, and pursues informal resolution of protests. The Audit Services Section is responsible for typing and mailing the assessments and monitoring the status of assessments and related protests. The Hearing Office is responsible for registering all protests, ensuring that action is taken on protests within reasonable time limits, and scheduling and conducting formal hearings.

Taxpayers have 30 days to protest for sales tax audits with the option to request an extension. Taxpayers have 90 days to protest for income tax audits with no extensions allowed. Taxpayers are not billed until protests are resolved. The Audit Section attempts to resolve protests informally, thus saving the time and expense of a formal hearing. If informal results are unsatisfactory, however, a formal hearing may be held at the taxpayers' request. Taxpayers may further appeal to the director of the Department of Revenue and subsequently to the Board of Tax Appeals and the courts.

Procedures Are Cumbersome And Lack Adequate Controls

Procedures for handling protests are cumbersome and lack adequate controls. The protest system relies on excessive manual processing of documents, which results in errors and mishandling of cases. In addition, lack of management information prohibits the Department from identifying and controlling problems. Implementation of an automated system would streamline processing and improve controls.

Reliance on Manual Processing - The current system relies extensively on manual operation. Our analysis of the process revealed excessive transferring of documents among sections and inefficient duplication of effort.

- Fifty-nine documents (24 originals and 35 copies) involving 14 personnel are used in the sales tax assessment and formal protest process. Each audit file is handled by at least eight different people and transferred at least 16 times between employees and eight times between sections.

- Five separate index card files are maintained on income and sales tax assessments and protests.* Four of these index files are maintained by three different employees within the Audit Services Section and one file is maintained by the Hearing Office. Each index card file contains similar information regarding protested audits.

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* During our audit, questions raised by Auditor General staff regarding the necessity of one of the card files resulted in the card file being eliminated - therefore, there are now a total of five index card files.

- Both the Hearing Office and Audit Services monitor the status of protested audit assessments, and in several cases their records do not agree on the status of a protest. Several instances were noted in which the Hearing Office had a protest registered yet Audit Services did not.

- Eight logs are maintained for the assessment and protest process indicating where audit files are and when they should be returned. However, this information is also recorded on several of the index cards.

- The Sales Tax Audit Section, in an effort to keep control over those audit files logged out to the Section, had instituted its own log book. However, personnel involved with handling the audit files were not aware of this control procedure and consequently, it was bypassed in many instances. In fact, the supervisor of the employee keeping the log was not even aware that the employee was keeping the log, and the employee did not know where the idea to keep the log had originated.

DOR could reduce the number of documents involved in the protest process. While documenting the protest process we identified some areas in which efficiencies could be realized. An analysis could be undertaken to determine other areas in which efficiencies are possible. This could also allow either a reduction in staff or assignment of staff to other functions.

Excessive manual processing and duplication of effort increases the risk of errors and mishandling. Furthermore, we observed several problems in the processing of protested assessments. In addition, the potential for loss of revenue exists, as evidenced by the following examples.

- Some audit files were missing or could not be located. In several instances audit files were requested and could not be located. In one case 45 income audit files were requested from Audit Services, and only 9 were found. Because an audit file is the only record of how an assessment was determined and what taxes are owed, it is crucial to adequately safeguard against it being lost or misplaced. In addition, the audit files and their contents are confidential, and if they are misplaced the risk of someone other than authorized personnel having access to the files is increased.

For instance, a taxpayer protested an income assessment of $52,288.72 in August 1982. A subsequent hearing was held and the taxpayer and auditor were given time to attempt resolution informally. At the time of our audit, the Hearing Office indicated that the case was still open, therefore we attempted to find the audit file to determine the status of the case. However, as of November 29, 1984, the audit file could not be found and the $52,288.72 assessment remained in limbo.*

- Auditors make amendments to protested assessments without notifying Audit Services and the Hearing Office of the protest. Auditors did not always notify the Hearing Office when they received protests. It was discovered that auditors were receiving protests and amending assessments without notifying the Hearing Office or Audit Services of the protests. Consequently, a taxpayer in protest could be billed in error. In fact, 396 income audit cases that had been protested were put on billing. This error may cause frustration on the part of the taxpayers and possibly damage the reputation and integrity of the Department among those involved.

- Failure to schedule hearings in a timely manner. Some cases have been lost in the system, and hearings have never been scheduled. The following cases illustrate a potential loss of revenue as a result of the apparent lack of a timely hearing.

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* Hearing Office records list the amount owed at more than $52,000, however, the Audit Services Unit indicates the protested amount is $24,327.00.

Case 1

A taxpayer protested tax assessments of $53,726.84 in March 1982. An informal hearing was requested for July 1982. There is no documentation in the file that a hearing, formal or informal, was held. As of November 1984, 2 1/2 years later, a formal hearing had not been held on this case.

Case 2

A taxpayer protested and a hearing was held in December 1980. The audit was subsequently amended. The taxpayer protested the amended assessment of $37,315.73 in September 1981. As of November 1984, no subsequent hearing had been held on this case.

Some of these problems occurred because DOR lacks adequate written procedures to guide staff involved in processing protested assessments. In other instances, however, Department procedures were not followed.

DOR's inefficient process results in audit files being lost or misplaced, duplication of efforts, potential frustration with the Department by the taxpayers, and potential loss of revenue as the result of delayed hearings.

Inadequate Management Information System - DOR's ability to monitor and control the protest and appeals process is inhibited by a lack of meaningful and periodic management reports. This deficiency has not been corrected since first identified in our 1981 audit report. As a result, DOR management is unsure of and cannot readily verify:

1. The identity of each outstanding audit,*
2. The age of each outstanding audit,
3. The causes for long-outstanding cases,
4. Whether assessments were amended before hearing,
5. How many assessments were corrected for mathematical or technical errors,
6. The time required to process assessments through current procedures, and
7. What stage of the protest process an account is in.

* An outstanding audit is one that has been assessed but not paid in full.

An effective monitoring system would enable the Department to identify and resolve processing errors in a more timely manner. The lack of this information currently impacts the efficiency and effectiveness of the system.

The Department of Revenue has been planning to implement an automated system to monitor assessments and protests through the process since at least March 1983. At the time of our audit the system was not yet operational. A combination of factors contributed to the delay in getting the system operational. First, DOR originally planned to use its Data Processing Section to develop a protest tracking system on the Department's main frame computer. However, this was later determined not to be feasible due to Data Processing's turnaround time for requests for service. Second, plans were made to develop the protest tracking system on a word processor. This was determined to be impractical. Third, the acquisition of a personal computer prompted the decision to develop the system on this personal computer. However, other projects took priority over the protest tracking system.

The protest tracking system is projected to be fully operational by May 1, 1985. When operational, this automated system should provide DOR with the necessary management reports needed to evaluate the assessment and protest process, providing the data input is accurate. At the time of our audit, it was impossible to determine what effect this automation will ultimately have on improving the process. The Department has planned some changes to the protest tracking system, however, they have not yet been implemented. Furthermore, the Department has 21 other areas prioritized for automation that will also impact on the efficiencies of the system.

Hearing Office Has Backlog Of Undecided Cases

The Hearing Office of the Department of Revenue has a backlog of cases that are not being efficiently processed and resolved. In some instances, the Hearing Office has not rendered timely decisions. In addition, informal resolution of protested cases has not been pursued in a timely manner by the Audit Section.

The Hearing Office has one hearing officer and two clerical staff. The Office is responsible for registering and monitoring all protests related to audit assessments. If a taxpayer wants a formal hearing to protest an assessment the Office sets the hearing date, notifies all involved parties, conducts the hearing, and renders a decision.

In the future, the Hearing Office may need additional staff to handle its growing work load. The number of hearings being scheduled has increased, and as of November 20, 1984, the Hearing Office calendar was booked into March with two hearings scheduled each day. A September 1984 internal report on the Hearing Office performed by Management Services determined that the Hearing Office's work load has increased an estimated 22 percent within the last year. This report also identified a trend showing an average increase of 19 percent each year from 1981 through mid-July 1984.*

Timely Decisions Not Rendered - The Hearing Office has a backlog of cases awaiting decisions. As of October 25, 1984, the office had 63 pending cases for which hearings had been held but decisions had not yet been rendered. The dollar amount associated with these 63 pending cases is approximately $6.7 million. 45 of those cases pending are the backlog of a hearing officer who was recently suspended and subsequently fired. In 19 of those 45 cases, more than a year has passed since the hearing was held, although hearing officers are expected to resolve cases within 60 to 90 days of a hearing.** Table 6 categorizes the cases by time between the date of the hearing and the date the protest was received.

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* The report recommended a full-time permanent position be created to assist with secretarial duties. As of December 4, 1984, this position was created and filled with a temporary employee who had been with the Hearing Office for a year.

** This is a standard on employees' Performance, Planning and Evaluation Reports.

TABLE 6

HEARING OFFICE CASES PENDING BY DATE OF HEARING AND DATE OF PROTEST

Months Since Protest Received	Pending Cases	Tax Assessment
0-3	4	$ 95,583 (1)
4-6	16	392,630 (2)
7-9	6	2,435,359
10-12	9	1,725,720
13-15	2	2,907
16-18	9	900,977
19-21	3	6,831
22-24	1	21,030
25-30	6	139,176
31-36	2	25,653
37-42	1	37,315
49-60	2	606,070
61-98	2	311,938
	63	$6,701,189

Average 16.44 months

Months Since Date of Hearing	Pending Cases	Tax Assessment
0-3	15	$ 359,372
4-6	14	3,349,140
7-9	9	1,423,815
10-12	3	444,868
13-15	8	626,022
16-18	4	29,854
19-21	2	53,088
22-24	1	1,536
25-30	2	59,359
31-48	1	116,371
49-73	1	195,566
No hearing dates set (3)	3	42,198
	63	$6,701,189

Average 9.3 months (4)

(1) Tax assessment based on three cases

(2) Tax assessment based on 15 cases

(3) Protest dates - 9-81, 9-83, 4-84

(4) Based on 60 pending cases

The following cases illustrate delays in the decision rendering process.

Case 1

A hearing was held August 30, 1978, on a taxpayer assessed $195,566. The taxpayer had failed to file tax returns for the years 1973 through 1978. The hearing officer gave the taxpayer 90 days to file these tax returns. However, no returns were subsequently filed.

Comments

It appears that a decision should have been rendered based on the information available after the extended 90 days to file returns had passed. Instead, 3 years passed with no action whatsoever taken on the case and as of the time of our audit, 6 years later, no decision had been rendered.

Case 2

A hearing was held on June 7, 1983, after the taxpayer had requested several extensions. The amount protested is $10,166. The taxpayer did not attend the hearing and the hearing officer documented in the case file that the taxpayer would be allowed 2 weeks to explain why he did not appear at the hearing.

More than a year passed with no action taken. On June 26, 1984, the hearing officer received a memo from an audit supervisor requesting a decision in favor of the Department since the taxpayer forfeited his position by not appearing at the hearing. On June 27, 1984, the hearing officer sent the taxpayer a letter giving the taxpayer 30 days to respond. The letter stated that if no response was received a decision would be rendered based on the information available.

Comments

This case has lingered for more than a year past the date of the hearing for no identifiable reason. As of October 31, 1984, the taxpayer had not responded and no decision had been rendered. In addition, administrative hearing offices in other State agencies do not contact individuals who do not appear at hearings.

Case 3

A taxpayer's protest was received on June 22, 1983, apparently 1 day past the allowed 30-day protest period. The amount in protest is $174,042. The taxpayer submitted memorandum on September 16, 1983, and the hearing was held September 27, 1983. The hearing officer requested that the taxpayer's attorney find out if the Attorney General's Office wanted to submit a response memorandum to the taxpayer's memorandum. On October 10, 1983, the hearing officer was informed that the Attorney General's Office did not intend to file a memorandum and that the matter was ready for the hearing officer to take under advisement.

Comment

From the documentation in the files it appears that this was not a valid protest because it was not submitted within the specified 30-day period. However, a hearing was held. No documentation has been added to the file since October 10, 1983, and no decision has been rendered.

All of these cases were assigned to the same hearing officer. The hearing officer attributes delays to the complexity of the cases. Some cases require more research and consequently, more time is needed to render a decision. However, there is no evidence in the files to support why no action has been taken on some cases for years. In fact, there is no documentation in the files indicating that any subsequent research has been undertaken on these cases.

An adequate system to ensure follow-up on cases awaiting decisions has not been developed. Taxpayers may be given additional time to submit supporting documents or post hearing memoranda, however, procedures have not been developed to ensure that action is taken within the extended time.*

Due Process May Be Affected - Taxpayers may be deprived of due process by unnecessary delays in the appeals procedures, and thus the whole proceeding may be void. An August 15, 1980,** Legislative Council Memorandum states:

* Since January 1984 the Hearing Office has been assigned the added responsibility of monitoring all protests in an effort to ensure that timely action is taken. As a result, its paperwork has increased tremendously. However, the Hearing Office has no direct authority or control over the process unless a formal hearing is requested or conducted.

** According to Legislative Council, this opinion is still valid as of November 1984.

> ". . . a requirement for reasonable promptness in resolving the appeal may be implied from the nature of the appeal and hearing before the department. . . . To inhibit or delay these further hearings is a denial of due process of law under the United States Constitution. Due process requires both a prompt hearing and a prompt conclusion. . . .There is little conceivable state interest in delaying the decision on an appeal of sales or use taxes. On the contrary, it would be in the interest of both the state and the taxpayer to provide for a timely and reasonably prompt resolution of the matter in order to either collect the tax or move the action on to the next forum. Moreover, if due process is not afforded by the hearing and appeal, the whole proceeding may be void." (emphasis added)

Consequently, a taxpayer could challenge a Hearing Office decision in court. In addition, the age of cases hinders the collection of revenue owed. Subsequently, cases pending for extended periods of time are difficult to collect once decisions have been rendered.

Efforts To Resolve Protests At Informal Levels Are Not Timely - Efforts to resolve protests through informal methods are not pursued in a timely manner. Many cases are resolved informally on the day of the scheduled hearing, thus wasting Hearing Office time and resources.

Protests may be resolved at an informal level eliminating the need for a formal hearing. In fact, auditors are encouraged by the Hearing Office to contact taxpayers to attempt informal resolution (even if a formal hearing is requested).

The director of the Department of Revenue supports and encourages informal resolution of protests, as evidenced by a 1981 memo.

> "When a taxpayer files a protest, it should be reviewed by members of the Taxation Division and if they feel the taxpayer is correct, they should take care of resolving the matter themselves. If it appears the taxpayer might be correct, additional information should be obtained from the taxpayer prior to the hearing to determine whether or not the hearing might be unnecessary."

Many cases are not resolved informally, however, until the day of the scheduled hearing. In an 11-month period from January 1984 through November 1984, 30 cases scheduled for hearing were resolved informally, or the taxpayer and auditor attempted to resolve the case informally immediately before the hearing. For example, a taxpayer protested an assessment of $13,436 on July 9, 1984, and requested a formal hearing. A hearing was set for September 19, 1984. However, the hearing was never held. The taxpayer brought in documents supporting his position and the assessment was amended informally. The protest was closed on September 19, 1984, the same day as the scheduled hearing.*

Scheduling a formal hearing involves considerable time and effort, as well as various personnel. Subsequently, if a hearing is canceled immediately before it is to begin, efforts involving the scheduling of the hearing become nonproductive and increase the work load unnecessarily. This problem occurs because DOR does not adequately monitor and control actions on cases in the protest process.

CONCLUSIONS

Protested assessments are not being resolved efficiently and consequently, potential revenue may be lost. Protest procedures are cumbersome and controls are inadequate. Thus, errors and inefficiencies occur in the handling of cases. In addition, the Hearing Office has a backlog of undecided cases and an increasing work load.

RECOMMENDATIONS

The Department of Revenue should:

1. Conduct a work simplification and methods improvement study of the protest process.

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* As of October 12, 1984, the Hearing Office had not been notified of the action taken by the Audit Section and consequently, still indicated the protest as open.

2. Continue to develop and implement the automated tracking system.

3. Develop and implement written procedures regarding:
   a. taxpayer no shows for hearings,
   b. appropriate and timely follow-up on hearings held,
   c. notification to the Hearing Office of attempted informal resolution, and
   d. specific and consistent deadlines for submitting post hearing memoranda.

Procedures developed should ensure consistent handling of protests, equitable treatment of taxpayers and timely resolution of pending cases.

AREAS FOR FURTHER AUDIT WORK

During the course of our audit, we identified potential areas for further audit work that we could not pursue due to time constraints. These areas include the following.

- **Should the Tucson Office continue to function as an autonomous division within the Department?**

  The Department of Revenue's Tucson Office is an organizationally autonomous division within the Department. The Tucson Office Audit Unit reports to the Tucson Office director rather than to the assistant director for taxation in the central Phoenix Office. Although the Tucson Office follows standard DOR policies and procedures, the Taxation Division has no line control over the activities of the Tucson audit unit. Further work is also needed to determine whether this organizational structure promotes the most efficient and effective Statewide administration of DOR's tax audit program.

- **Does the Department adequately serve the needs of local jurisdictions and coordinate its sales tax audit program effectively with municipalities?**

  The Department currently collects sales taxes for over 60 local jurisdictions in Arizona, and cooperates with the 11 larger municipalities that collect their own sales taxes. DOR's effort to service the needs of the local jurisdictions may not be adequate since only two employees are assigned to this function. In addition, DOR may be able to coordinate its efforts more effectively with the municipalities that collect their own sales taxes. Current coordination is primarily limited to sharing of information that could be used more effectively. A special State Commission is studying ways to better manage and administer sales tax collection Statewide, and the feasibility of implementing a centralized, State-operated program. Depending upon the outcome of the Commission's study, further work is needed to determine whether DOR needs to commit more resources to its local Sales Tax Audit Unit.

- Should Arizona's contracting law be changed?

Arizona is the only state that does not collect sales tax from contractors at their point of purchase. Instead, contractors pay sales tax when construction is complete or a sale is made. For example, when building a house contractors do not pay sales tax on the purchase of lumber and other building materials. Rather, sales tax is paid when the house is sold. According to DOR personnel, out-of-State contractors may not be aware of Arizona's law and consequently DOR conducts sales tax audits of many contractors. This law may not be providing the State with any additional revenue and furthermore, is hard to enforce. Further work is needed to verify the extent of this problem and determine whether any statutory changes are needed.

- Are auditors identifying those accounts with potential for criminal prosecution?

The Compliance Section of DOR has received no referrals from sales tax auditors since August 1983. Failure to recognize and pursue potential noncompliance may cause a loss of revenue and provides little incentive for taxpayers to comply with sales tax laws. Further audit work is needed to determine whether accounts with potential for criminal prosecution are being adequately identified and pursued.

- Should the 90-day protest period for corporate income tax audit assessments be shortened?

DOR deemphasizes corporate income tax audits, as opposed to sales tax audits, because the longer 90-day income tax protest period (vs. the

30-day period for sales tax) causes collection delays for both cases that are protested and those that are not. Further audit work is necessary to determine if the 90-day income tax protest period is too lengthy.

- <u>Are out-of-State corporations taking advantage of the Federal income tax deduction and improperly lowering their Arizona tax liability?</u>

Current statute allows both individual and corporate income-tax payers to deduct their Federal income tax paid from their State tax liability. According to a DOR official, Arizona is one of only five states that still allows this deduction. Out-of-State corporations may take advantage of this deduction and inflate their Federal tax paid to lower their State tax liability. DOR is not able to audit many of these out-of-State taxpayers to make sure they are properly using this deduction. Further work is needed to determine whether this deduction is being abused and if it should be continued.

ARIZONA DEPARTMENT OF REVENUE

J. Elliott Hibbs
Director

Bruce Babbitt
Governor

April 19, 1985

Mr. Douglas R. Norton, Auditor General
Auditor General's Office
111 W. Monroe, Suite 600
Phoenix, AZ 85003
HAND DELIVER

Dear Mr. Norton:

The Department of Revenue has completed its review of the draft report on the performance audit of the Taxation Division. I believe the following points put into perspective our performance over this audit period and are relative in this evaluation:

- We initiated aggressive audit enforcement programs thereby increasing the fairness of our tax system. This has resulted because tens of thousands of non-filers have been detected and brought into compliance. Untold others have filed back returns voluntarily as we obtained and publicized the first prosecutions of income tax non-filers and evaders. Likewise, we conducted the first amnesty program in the country which brought in millions of dollars in unpaid taxes.

- The productivity of department auditors has substantially increased the last five years. We more than doubled the $200,000 in collections per auditor recorded in 1981-82 due to such improvements as:

  1) Initiating training to improve auditor techniques. In fact, our statistical sampling course was adopted by the Internal Revenue Service.

  2) Increasing number of audits that can be done by automating some of the tasks, e.g. sales tax audit work sheets and calculating state income tax changes from federal audit report adjustments.

  3) Establishing accountability leading to higher quality audits by evaluating programs and managers based on the amount collected rather than assessed.

  4) Reorganizing audit functions to free auditors from non-audit tasks.

5) Documenting criteria and procedures to be used for manual audit selection and review to maximize return on audits conducted.

o We also devoted audit staff to assist in the development of new processing systems that prevent millions of dollars in unpaid taxes escaping detection.

We recognize there is still substantial progress that can and should be made in our audit programs. We generally concur with the findings and recommendations. Specific comments for each finding are attached for your information and inclusion in the final report.

Your staff has been very cooperative and helpful in the conduct of the performance audit. Their findings and recommendations will help us improve the administration of the audit functions.

Please contact me if you have any questions concerning our written reply.

Sincerely,

ARIZONA DEPARTMENT OF REVENUE

JEHibbs

J. Elliott Hibbs
Director

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DEPARTMENT OF REVENUE COMMENTS
PRELIMINARY REPORT OF THE AUDITOR GENERAL
PERFORMANCE AUDIT - TAXATION DIVISION

In general, we concur with the findings of the performance audit and have already adopted, are implementing or are planning implementation of most of the recommendations.

Our comments are offered in the sequence of the findings in the report.

FINDING I

The Department of Revenue could collect up to $18 million annually in additional revenue by increasing its sales tax audit coverage.

Audit Recommendation 1:

The Department of Revenue should develop a comprehensive plan to increase sales tax audit coverage. This plan should address the actions that would be taken to provide training, supervision, etc. before additional staff were hired.

DOR RESPONSE:

The division is hiring a training specialist, who will specifically address audit training needs by the end of this fiscal year. In addition, our new supervisors are scheduled to attend the state's management development program. During the upcoming budget and objective-setting processes, we will develop a plan for supplemental training of existing staff, future training for new staff and other activities that will be covered under Finding II.

Audit Recommendation 2:

The Legislature should consider appropriating the necessary funds over the next three fiscal years for a phased increase of sales tax auditors.

DOR RESPONSE:

We concur with this recommendation as the preferred method of expanding sales tax audit coverage as opposed to reassignment of auditors from other tax types. In our budget process, we will explore the optimum approach for adding staff, given our floor space limitations.

Audit Recommendation 3:

DOR should conduct a study to determine whether corporate income tax audit coverage needs to be increased.

DOR RESPONSE:

We agree. We have been increasing the corporate audit staff by reclassifying other positions because these audits generate a higher return. We plan on comparing our staff size with the staff in comparable states and the audit coverage mix in those states. Given the recent changes in corporate tax law, we feel the average audit of a multinational business will take longer due to greater complexity, and we will consider that when making corporate staff projections.

FINDING II

The Department could increase revenues by improving its audit selection systems.

Audit Recommendation 1:

DOR should implement a cyclical audit selection program for large sales and corporate income tax accounts to provide 100 percent audit coverage of major taxpayer accounts within the current statute of limitations.

DOR RESPONSE:

While improvement can always be made in any program, we have made major improvements worthy of recognition in our selection methods. For example, the report does not review dollar recovery per audit dollar spent. If it had, our achievements would have been obvious. In FY 1982-83, the recovery per dollar spent was $4.73; for FY 1983-84, it more than doubled to $10.54.

The report also does not cover revenue generated per auditor. A comparison with two major states cited in the report, Texas and California, shows the following data for FY 1983-84:

State	Sales Tax Revenue Per Auditor
Texas	$377,740
California	$379,728
Arizona	$622,449

It is obvious that, although our audit selection techniques are not perfect, they have resulted in significant revenue production.

We agree that audit selection should continue to be improved; but we see some problems in a reliance on cyclical audits to the exclusion of other methods.

Many large sales taxpayers are put on a cyclical audit schedule if audit productivity is demonstrated. While we have not covered them all, it is not necessarily true that they will all be productive. For example, we audited a large retailer with 19 separate divisions, spent over 200 hours of auditor time and produced additional tax less than $10,000.

Because of the unusual nature of Arizona's tax on contracting and a general taxpayer ignorance of use tax, we have found contracting and use tax audits to be very productive.

In corporate audit, most large taxpayers are audited on a three-year cycle. It may not be cost effective to audit all of them because some are in substantial compliance with the statutes or in a perpetual paper loss position due to the subtraction for controlled corporation dividends.

Audit Recommendation 2:

DOR should make implementation of MAASS a priority and devote necessary data processing resources to correct program problems.

DOR RESPONSE:

The Department is rewriting the sales tax processing system, which will generate reports useful for audit selection. We agree, however, that MAASS is necessary and will make it a higher priority (contingent upon the impacts of legislative changes).

Audit Recommendation 3:

DOR should provide formal training to all new auditors and improve in-service training of its audit staff.

DOR RESPONSE:

We concur and, as mentioned under Finding I, are implementing a structured training program. The need to increase revenue during the state's financial squeeze delayed the program, but we are bringing it back into priority. Because we do not have a training staff of the size of Texas and California (nor an audit staff of that size), we will be looking to other states and IRS for adaptable courses.

Audit Recommendation 4:

DOR should ensure that the Audit Section has updated and accurate audit activity and general account records for use in selecting audits.

DOR RESPONSE:

Generally, we agree with this recommendation in that our audit history records need to be both automated and readily available to both Phoenix and Tucson audit staffs. As far as questions raised about non-profitable audits, however, we want to stress that just because an audit is a refund, net operating loss adjustment or no change does not mean it was unproductive.

The purpose of an audit is to determine a taxpayer's correct tax liability. Many times, the tax impact of the audit cannot be truly gauged until the taxpayer's books are examined. A substantial adjustment of a net operating loss can result in payment of more taxes in future years. A refund caused by a certain adjustment in one year can also cause more taxes to be paid in future years.

Since audit change rates compared with coverage rates vary considerably among the states, we have not yet been able to determine the optimum change rate. For example, Illinois, with a 3.7 percent sales tax coverage rate, generates additional revenue on 66 percent of its audits. New Mexico, which has only a .9 percent coverage rate, has a 66.9 percent change rate. Even Texas, which is cited as one of the best states, considers both return on audit cost and exposure for enforcement purposes in its selection process.

Audit Recommendation 5:

DOR should improve documentation of reasons audits are terminated.

DOR RESPONSE:

We agree and will do so immediately.

Audit Recommendation 6:

DOR should develop and apply clear criteria to use various sources of information for audit selection.

DOR RESPONSE:

We concur with this recommendation, and, as mentioned in the report, are already addressing this area in the corporate income tax system. Criteria will be developed fully as the selection systems are automated.

FINDING III

The Department lacks adequate controls to ensure the quality and integrity of audit assessments, modifications and amendments.

Audit Recommendation 1:

The Legislature should consider funding an audit review unit. The Department should establish the audit review unit as an independent unit within the Taxation Division. The unit should be staffed with a minimum of three auditors and should report directly to the audit administrator or the Assistant Director for Taxation.

DOR RESPONSE:

We will create such a unit in the tax policy section, reporting to the Assistant Director. Until the unit can be fully staffed, we will tighten both technical and math review reporting, documentation and change criteria in the different sections.

Audit Recommendation 2:

Reasons supporting modifications and amendments made to audit assessments should be documented in case files.

DOR RESPONSE:

Since amendments to audits can be caused by many things other than error (such as decisions in appeals, the provision of additional information by the taxpayer, retroactive law changes, penalty abatements and settlement), we agree that better documentation of the reasons for changes is needed to protect both the department and the auditor. We already are implementing this recommendation.

Audit Recommendation 3:

DOR should consider a policy on rotation of auditors and on reporting of bribery.

DOR RESPONSE:

Given our high turnover rate, we have not felt the need for a rotation policy. We have designated audit territories for large, out-of-state audits which will be rotated every three years to minimize repetition. With the inception of a more formal cyclical audit program, however, a rotation policy will be necessary.

Audit Recommendation 4:

The Department of Revenue should develop written standards and policies governing audit workpaper techniques and audit review.

DOR RESPONSE:

With the use of portable computers, audit work papers are being standardized. We plan to present work paper training for non-computer audits.

Audit Recommendation 5:

Audit review should be conducted consistently and in accordance with standards and policies developed by the Department.

DOR RESPONSE:

As mentioned in number one above, we concur and will be establishing stricter guidelines for audit review.

FINDING IV:

Protested assessments are not processed efficiently; consequently, the potential for loss of revenue exists.

Audit Recommendation 1:

The Department of Revenue should conduct a work simplification and methods improvement study of the protest process.

DOR RESPONSE:

The division is already looking at methods to streamline the protest control process in the audit services unit in conjunction with the development of the protest tracking system. In addition to that system, we will be looking at other aspects of the process that can be automated to handle the more than 1,000 assessments generated weekly. The increase in assessment volume caused by the use of personal computers in audit necessitates elimination of as many manual control processes as possible.

Audit Recommendation 2:

The Department of Revenue should continue to develop and implement the automated tracking system.

DOR RESPONSE:

We are doing so and are on target for the May 1, 1985, implementation date.

Audit Recommendation 3:

The Department of Revenue should develop and implement written procedures regarding:

a. taxpayer no shows for hearings,
b. appropriate and timely follow-up on hearings held,
c. notification to the Hearing Office of attempted information resolutions, and
d. specific and consistent deadlines for submitting post hearing memoranda.

DOR RESPONSE:

We agree and will document the unwritten procedures as soon as possible. The procedures being utilized by the present hearing officer are:

a. If a taxpayer does not appear for a hearing, but the record shows that he or she received proper notice of the hearing and has not contacted us, the hearing proceeds as scheduled on the presumption that the taxpayer has simply chosen, for whatever reason, not to attend. If nothing more is heard from the taxpayer, a written decision will be rendered based on all of the information then available, which, of course, includes the audit section's testimony at the hearing.

   Sometimes a taxpayer will call later in the day, or within a day or two, with his reason why the hearing was missed. If the excuse is reasonable, the hearing officer will usually set the matter for hearing again, but the taxpayer is informed that the second scheduling is a firm date.

b. This is done by keeping a list of the hearings that have been held, in chronological order. That way, the hearing officer always knows where he stands regarding the 60-90 day deadline. When an old decision is rendered, that name is crossed off the list and when a new hearing is held that name is added to the list.

c. A three-copy form indicating results of informal conferences has been developed in sales tax and will be used for all tax types. One copy of the form is for the taxpayer, one for the audit file and one for the hearing officer.

d. The procedure is that the taxpayer has 30 days from the date of the hearing to submit a post hearing memorandum, the section has 30 days from the date of receipt of taxpayer's memorandum within which to file its responsive memo, and the taxpayer then has 15 days to file a reply memo, if necessary. If either party needs additional time, it is routinely granted. Those deadlines are also written down on the hearing officer's pending decision list so they can be monitored.