A REPORT
TO THE
ARIZONA LEGISLATURE

Performance Audit Division

Performance Audit

Department of Revenue—
Audit Division

AUGUST • 2005
REPORT NO. 05 – 06

Debra K. Davenport
Auditor General

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

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STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

DEBRA K. DAVENPORT, CPA
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

August 24, 2005

Members of the Arizona Legislature

The Honorable Janet Napolitano, Governor

Mr. Gale Garriott, Director
Department of Revenue

Transmitted herewith is a report of the Auditor General, a Performance Audit of the Department of Revenue, Audit Division. This report is in response to a November 20, 2002, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq. I am also transmitting with this report a copy of the Report Highlights for this audit to provide a quick summary for your convenience.

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

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

This report will be released to the public on August 25, 2005.

Sincerely,

Debbie Davenport
Auditor General

Enclosure

DD:Acm

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PROGRAM FACT SHEET

Arizona Department of Revenue

Audit Division

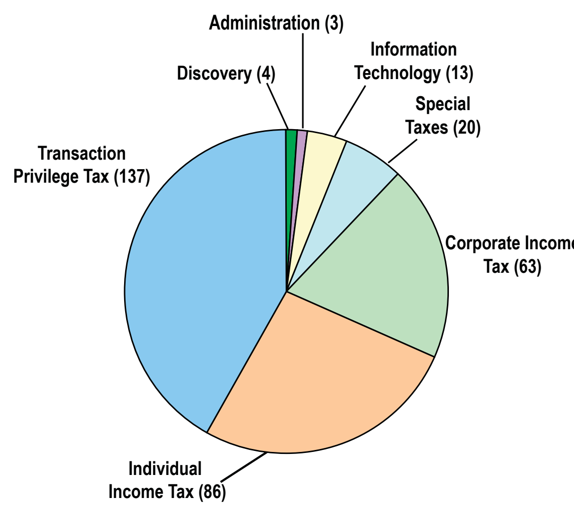
Services:

The Audit Division helps ensure that the State receives tax monies owed to it. Auditing is a critical function because the State depends on taxpayers to voluntarily report and remit taxes in a timely manner. Therefore, auditing educates taxpayers, corrects differences between taxpayers' obligations and what they report and pay, and encourages compliance with tax laws. The Audit Division is organized into sections by tax type:

- Corporate Income Tax—Performs audits of corporate income tax returns to ensure compliance with Arizona's corporate income tax laws, regulations, and policies. This includes audits of national and multinational corporations, and limited audits such as reviews of the accuracy of corporate taxpayers' specific tax credits.
- Individual Income Tax—Performs audits of individual income tax returns and identifies individuals who should have filed returns. Also performs audits of partnerships and sub-S corporations, which are organizations structured like a corporation but whose taxes are paid by individuals.
- Transaction Privilege and Use Tax—Ensures that businesses have a transaction privilege tax license and promotes education in the area of use tax, which is a tax on personal property for which a transaction privilege tax was not paid, as well as performs transaction privilege (i.e., sales) tax audits. Also administers the Cities Program, which coordinates the administration, collection, and auditing of sales tax for those cities, towns, and counties that have entered into an agreement with the Department to provide these services.
- Special Taxes—Processes licenses for and/or audits several different smaller tax revenue sources. For example, the section administers liquor and tobacco taxes, and issues licenses for tobacco wholesalers. Also investigates complaints and violations of bingo laws and conducts workshops and consultations with bingo licensees.

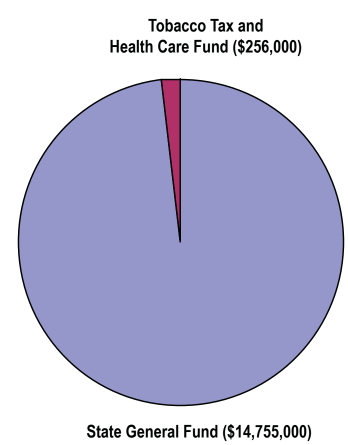
Program staffing:

326 FTE as of February 2005, which included 30 vacancies



Program revenue:

$15 million (fiscal year 2005 estimate)



Facilities:

The Division's staff are located in three offices state-wide. Specifically, division staff are located in the agency headquarters, which is a state-owned building at 1600 West Monroe in Phoenix, and in a state-owned building complex at 400 West Congress in Tucson. Finally, division staff are also located in a privately owned facility at 3191 N. Washington Street in Chandler, Arizona. The Division occupies 11,450 square feet of this 20,783-sq. ft. facility that the Department leases for $283,426 annually, plus operating costs.

Equipment:

The Division has typical office equipment, such as office furniture, computers, and printers.

Mission:

To promote voluntary compliance by auditing, identifying common areas of noncompliance, and educating taxpayers.

Program goals:

The Audit Division has adopted the Department's three goals and associated objectives. The goals are:

1. To maximize the return on investment.
2. To maximize customer and stakeholder satisfaction.
3. To maximize employee satisfaction.

Adequacy of performance measures:

The Division's 38 performance measures appear to be generally appropriate and well-aligned with the 3 department goals. Although the Division developed 4 overall performance measures, the remaining 34 performance measures are specific to division sections. The Division and each section have a variety of performance measures, including output, outcome, quality, and efficiency measures.

Source: Auditor General staff analysis of unaudited financial schedules prepared by the Department of Revenue for the years ended or ending June 30, 2003 through 2005; the Department's 2004 annual report and strategic plan; the Department's organizational chart for the Audit Division; and other information provided by the Department.

SUMMARY

The Office of the Auditor General has conducted a performance audit of the Department of Revenue (Department), Audit Division (Division) pursuant to a November 20, 2002, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the sunset review process prescribed in A.R.S. §41-2951 et seq and is the first in a series of four reports on the Department of Revenue. The subsequent reports will focus on the Department's new integrated tax system, BRITS, the Collections Division, and an analysis of the 12 statutory sunset factors.

The Audit Division helps ensure that the State receives tax monies through its auditing function. The Department reports that during fiscal year 2004, the Division conducted more than 37,000 audits, which identified more than $139 million in additional taxes owed to the State (see Table 1, page 4). In fiscal year 2003, the Department was appropriated additional full-time equivalent (FTE) positions which were assigned to the Audit and Collections Divisions with the Audit Division receiveing 81 of these positions. The Department expects that the new positions assigned to both divisions will generate an additional $53.2 million each year.[1]

Division needs to take additional steps to better manage limited resources (see pages 9 through 11)

The Division needs additional information to help it make effective resource allocation decisions. A 1995 Auditor General performance audit found that the Division needed to develop annual audit plans to proactively manage its resources. In 2004, each of the Division's sections developed an initial audit plan, which the Division refers to as business plans. However, the plans lack basic data needed to analyze how the Division uses its resources and the return on investment from its audits. For example, the plans do not indicate the number of staff hours available for auditing, the number of audits the Division plans to complete, how many dollars those audits are expected to cost, and how many additional tax revenues can be expected to be assessed. Capturing and analyzing such information can aid the Division in meeting its objectives of maximizing revenues, audit coverage, and compliance rates.

1 Laws 2003, 1st S.S., Ch. 1.

The Division is implementing a new automated audit system known as ESKORT that is targeted to be completed by August 2006. ESKORT should help gather the data necessary to conduct the analyses of available resources as well as meaningful return on investment analyses. Using ESKORT, the Division should be able to capture data that is not currently being captured. Some additional steps will also need to be taken. The Corporate Income Tax Section does not have accurate information about the numbers of audits completed or the amount of tax revenues assessed, and other sections do not capture complete information about audit costs. To use ESKORT to capture and report data that will help it better manage its resources, the Division will need to ensure that staff is trained on what data to enter, how to enter it, and why correct data is so important.

Division should further improve its audit selection processes (see pages 13 through 16)

The Division has improved some of its processes for deciding which taxpayers and businesses to audit, but should take steps to ensure continued improvements. The 1995 Auditor General performance audit found that the Division needed to develop systematic selection processes, focusing on high-liability taxpayers and noncompliant segments of the tax base. Since the 1995 audit, written processes have been developed for some types of audits, and in March 2005, the Division drafted policies for all the sections that ensure that taxpayers cannot be unfairly selected by auditors or selected for personal reasons. The Division has also taken steps to ensure that it focuses its audit selection techniques on high-liability and noncompliant taxpayers. For example, the Corporate Income Tax Audit Section has established written procedures for selecting field audits that factor in a corporation's amount of tax liability.

The Division's new automated audit system, ESKORT, should provide the Division with the opportunity to further improve its audit selection processes. ESKORT contains an audit selection component that evaluates taxpayers' tax returns on the basis of specific observations the Division defines. For example, many taxpayers who take a certain deduction on their tax return may have a tendency to make an error on their return. These patterns are entered into the system as logical "if, then" rules that ESKORT applies. The Transaction Privilege Tax Audit Section and the field audit unit of the Corporate Income Tax Audit Section have written ESKORT rules; however, the Division needs to ensure that the units in each of its sections draft rules encompassing key methods for selecting audits through ESKORT. In addition, the Division should ensure that the ESKORT audit selection rules are regularly and appropriately evaluated.

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INTRODUCTION & BACKGROUND

The Office of the Auditor General has conducted a performance audit of the Department of Revenue (Department), Audit Division (Division) pursuant to a November 20, 2002, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the sunset review process prescribed in A.R.S. §41-2951 et seq and is the first in a series of four reports on the Department of Revenue. The subsequent reports will focus on the Department's new integrated tax system, BRITS, the Collections Division, and an analysis of the 12 statutory sunset factors.

Audit division helps ensure State receives tax monies owed

The Audit Division is one of nine divisions within the Department.[1] The Department is responsible for licensing, processing, collecting, and enforcing most taxes for the State of Arizona (see text box). In fiscal year 2004, the Department reports that it collected more than $9.8 billion in state and local revenues to pay for many public services, including education, health, and welfare.

The Audit Division helps ensure that the State receives tax monies owed to it. Auditing is a critical function because the State depends on taxpayers to voluntarily report and remit taxes in a timely manner. Therefore, auditing is used to educate taxpayers and to discover and correct differences between taxpayers' obligations and what they report and pay. Auditing also serves to encourage compliance with tax laws and helps instill confidence in the fairness of state government by reassuring taxpayers who comply that those who do

Arizona's Primary Tax Revenue Sources

- **Transaction privilege, use, and severance taxes**—A *transaction privilege tax* is imposed on a seller for doing business in the State. Because it is usually passed on to the customer, this tax is commonly referred to as a sales tax. *Use tax* is imposed on the purchase of personal property for which a transaction privilege tax was not paid, and *severance tax* is imposed on the business of mining metalliferous minerals and severing timber. Some of these taxes are collected for and distributed to Arizona's cities and counties.

- **Individual income taxes**—These are taxes imposed on individuals earning income in Arizona. Additionally, businesses or individuals who hire employees must withhold income tax from their employees' compensation and remit it to the Department. Income tax revenues are shared with Arizona cities and towns.

- **Corporate income taxes**—These are taxes imposed on corporations earning income in Arizona and are shared with Arizona cities and towns.

1 The other divisions are Administrative Services, Collections, External Services and Special Projects, Information Technology, Processing Administration, Property Tax, Taxpayer Services, and Tax Policy and Research.

Auditing encourages compliance with tax laws and helps instill confidence in the fairness of state government.

not comply are at risk. The Audit Division's mission is "*to promote voluntary compliance by auditing, identifying common areas of non-compliance and educating taxpayers*."

The process of conducting an audit involves several steps. First, an individual, corporate, or business taxpayer is selected for an audit through one of several audit selection processes such as reviewing federal tax return information and taxpayers' reporting histories (see Finding 2, pages 13 through 16). Then an auditor conducts either a field or office audit (see text box).

Types of Audits

Field audit—An audit conducted on larger corporations, which may take more than a year to complete and involves traveling to a corporation's or business' headquarters, for example, to review financial and tax records.

Office (or desk) audit—Office auditors do not travel, and their work involves less-extensive audit work, such as reviewing specific items on a tax return for accuracy, such as a specific tax credit.

Both types of audits include doing such things as reviewing expense and sales records, and verifying computations and other information, including income amounts. Finally, the auditor documents the work, including one of the following three results: (1) additional tax is owed by the taxpayer, referred to as a tax assessment; (2) a refund is owed to the taxpayer; or (3) no assessment or refund is owed. The Division has up to 4 years after a tax return is filed (or required to be filed) to select and complete a taxpayer audit. A taxpayer also has the right to protest an audit assessment, which is then reviewed by division protest staff.

Section organization and responsibilities

The Division's auditing functions are divided among four major sections, as listed below. The Department reports that during fiscal year 2004, the Division conducted more than 37,000 audits resulting in a total of $139 million assessed (see Table 1, page 4).[1] As of February 1, 2005, the Division had 326 FTE positions, of which 30 were vacant.

- **Transaction Privilege Tax Audit Section (137 FTEs, 11 vacancies)**—This section is responsible for ensuring that businesses have a transaction privilege tax license and performing transaction privilege (i.e., sales) tax audits. This section also administers the Cities Program, which involves coordinating the administration, collection, and auditing of transaction privilege tax for those cities, towns, and counties that have entered into an agreement with the Department to provide these services. As of May 1, 2005, 77 cities and towns, as well as all 15 counties, were participating in the Cities Program.[2] The majority of the staff, 87 FTEs, work in the field audit units and conduct standard

1 These totals do not include the number of audits and amount of assessments for corporate office audits, or the dollars collected for transaction privilege tax licenses, or transaction privilege tax collected as a result of the licenses issued. See Table 1, page 4.

2 These services are provided to the cities, towns, and counties for free. A 1995 Auditor General Report (see Auditor General Report No. 95-16) recommended that the Legislature consider amending A.R.S. §42-1451 to allow the Department to charge an administrative fee for these services, but this recommendation has not been implemented.

compliance reviews at the business taxpayer's location to ensure they are submitting the appropriate amount of transaction privilege tax monies. The field auditors also conduct multi-jurisdictional audits for the 12 cities that do not participate in the Cities Program.[1] A multi-jurisdictional audit allows a taxpayer to be audited for state and city taxes at the same time. The remaining 50 FTEs are assigned to a licensing compliance unit, an office audit unit, a refund unit, and an administrative support unit. The licensing compliance unit consists of staff who go out into the field and find businesses that are unlicensed. For example, this unit went to the Arizona State Fair, located businesses that did not have a transaction privilege tax license, and required them to become licensed. The office audit (or desk audit) unit conducts audits by regularly sending out informational letters to different categories of businesses about specific tax requirements, reviewing information submitted by taxpayers in response to the letters, and assisting taxpayers in determining the amount of tax due. The refund unit is responsible for analyzing and processing taxpayer refund requests, and the administrative support unit provides support by performing clerical tasks such as maintaining audit files.

- **Individual Income Tax Audit Section (86 FTEs, 8 vacancies)**—This section is responsible for performing audits of individual income tax returns and identifying individuals who should have filed returns. The majority of this section's staff, 47 FTEs, work in its office audit units. These office or desk auditors perform audits of individual income tax returns and review amended returns. These audits involve reviewing information in the office and primarily contacting the taxpayer through the mail. For example, a letter sent by this unit may request clarification or documentation for expenses a taxpayer claimed as a deduction. In contrast, the eight field auditors perform audits of partnerships and sub-S corporations, which are organizations structured like a corporation, but whose taxes are paid by individuals. The remaining staff, approximately 31 FTEs, perform administrative support duties such as analyzing and researching correspondence, inputting data, and preparing audit files.

- **Corporate Income Tax Audit Section (63 FTEs, 7 vacancies)**—This section is responsible for performing audits of corporate income tax returns to ensure compliance with Arizona's corporate income tax laws, regulations, and policies. The majority of the staff, 43 FTEs, work in the section's four field units. The field units are responsible for performing field audits of large national and multinational corporations, which are conducted at the corporation's headquarters. According to the Division, the majority of its field audits are conducted on businesses whose headquarters are outside of Arizona, and these audits can sometimes take more than a year to complete. The section also has an office audit unit composed of 9 FTEs that conducts audits that are generally limited in scope and do not involve traveling to a corporation's headquarters. For example, this unit may review the accuracy of a specific tax credit taken by corporate taxpayers. The office audit unit sends information to and collects

1 The nonprogram cities are Avondale, Chandler, Flagstaff, Glendale, Mesa, Nogales, Peoria, Phoenix, Prescott, Scottsdale, Tempe, and Tucson.

information from taxpayers through the mail. The section also has a nexus unit with 5 FTEs. Nexus is a tax term used to demonstrate a minimal tax connection with a state. A multi-state corporation having nexus with Arizona must file an Arizona corporate income tax return. For example, if a corporation has property or a business location in Arizona, then the corporation is considered to have nexus. However, if a corporation only solicits sales in Arizona, but does not own property or have a place of business in the State, then there is no nexus, and the corporation does not owe taxes to Arizona. The remaining 6 FTEs work in administrative or support positions.

Table 1: Number of Audits Conducted, Net Assessments Resulting from Audits
Number of Taxpayers and Number of Auditors by Tax Type
Fiscal Years 2000 through 2004

	Fiscal Years				
	2000	2001	2002	2003	2004
Transaction Privilege and Use Tax[a]					
Number of taxpayers	167,921	175,239	168,209	172,186	171,924
Number of audits conducted[b]	1,279	1,049	870	899	1,109
Dollars assessed	$38,515,229	$26,008,472	$26,453,914	$38,309,507	$44,116,256
Number of auditors	77	65	47	75	75
Number of licenses issued	1,511	944	1,888	3,143	3,347
License dollars collected[c]	$15,868,753	$16,029,630	$14,030,610	$18,521,861	$25,996,805
Individual Income Tax					
Number of taxpayers	2,971,871	2,995,191	3,076,061	3,159,115	3,244,411
Number of audits conducted	38,553	39,681	38,341	32,376	36,729
Dollars assessed	$17,829,887	$16,771,641	$16,541,486	$20,607,390	$29,141,673
Number of auditors	33	39	40	39	49
Corporate Income Tax[d]					
Number of taxpayers	53,958	42,815	51,919	48,317	51,740
Number of audits conducted	82	62	64	66	73
Dollars assessed	$79,079,443	$21,798,200	$57,107,193	$66,711,377	$65,771,746
Number of auditors	22	21	19	22	35

[a] The number of audits, dollars assessed, taxpayers, and auditors pertain to field audit staff only. The number of licenses issued and dollars collected pertain to the office audit unit. The office audit unit also works to educate taxpayers about transaction privilege and use tax laws and requirements (see page 3).

[b] This number does not include the audits that the Division conducts for nonprogram cities (see page 3).

[c] This number includes the dollars collected for the licenses issued as well as any transaction privilege and use tax collected for an additional 12 months after the license is issued.

[d] The number of corporate office audits conducted and the amount of additional tax assessed during these fiscal years cannot be reported because the Corporate Income Tax Section's office audit unit does not have adequate controls in place to ensure that auditors are correctly recording the number of audits conducted and the amount of tax assessed.

Source: Table prepared by Auditor General staff using figures for fiscal years 2000 through 2004 obtained from the Department of Revenue Audit Division Legislative Report.

- **Special Taxes Section (20 FTEs, 4 vacancies)**—This section is responsible for the processing of licenses for and/or auditing several different smaller tax revenue sources. For example, the section administers liquor and tobacco taxes and issues licenses for tobacco wholesalers. This section also issues licenses and conducts audits of bingo operators, investigates complaints and violations of bingo laws, and conducts workshops and consultations with bingo licensees.

The Division also has the following management and administrative staff: an Administrative section with 3 FTEs, an Information Technology section with 13 FTEs, and a Discovery section with 4 FTEs. The Discovery section matches taxpayer data from different sources in order to discover taxpayers who should have filed tax returns, but did not.

Audit division undergoing changes

Several changes have taken place or are in the process of taking place within the Department's auditing function. In February 2003, the auditing function, which was previously dispersed among several different divisions, became its own division. In addition, during fiscal year 2003, the Department was appropriated additional FTEs as part of a revenue-generating program.[1] The revenue-generating program expanded the Department's enforcement function by assigning additional FTEs to the Audit and Collections Divisions, with the Audit Division receiving 81 FTEs. The Department anticipates that the new positions assigned to both divisions will generate an additional $53.2 million for the State's General Fund each year.

In addition, in February 2005, the Division began implementing a comprehensive automated audit system, known as ESKORT. The ESKORT system is being implemented as part of the Department's new integrated tax system—BRITS. According to the Department, ESKORT is targeted to be completely implemented by August 2006 and will include the following components:

- Audit Selection—This component helps the Division select audits by analyzing taxpayer information to help identify and prioritize the best candidates for audit.

- Data Warehouse—This component increases the amount of data that the Division can store and use to help identify noncompliant taxpayers or identify nonfilers, such as databases from other state agencies that can be used for comparison to department data.

- Case Management and Tracking—This component captures data on each audit selected, such as time and expense data, and allows the Division to track and monitor the progress of audit activities. It will also allow the Division to produce management and statistical reports.

- Audit Support—This component supports the day-to-day tasks associated with planning, conducting, and documenting an audit. It contains such things as templates for standardized letters; coaching tools, including a help menu for

1 Laws 2003, 1st S.S., Ch. 1.

new or inexperienced auditors; and support materials, such as checklists and tax law and policy information.

Division budget

As detailed in Table 2, during fiscal year 2004, the Department allocated to the Division approximately $14 million (or 22 percent) of its $63 million in appropriated revenues. The majority of the Division's expenditures were for personnel services and employee-related expenditures. The Division's next largest expenditure category is travel, which amounted to approximately $500,000 in fiscal year 2004. According to the Division, travel expenditures increased in fiscal year 2004 over the previous 2 fiscal years as travel budget reductions were lifted and staffing levels were increased.

Table 2: Audit Division
Schedule of Revenues and Expenditures, in Thousands
Years Ended or Ending June 30, 2003, 2004, and 2005
(Unaudited)

	2003 (Actual)	2004 (Actual)	2005 (Estimated)
Revenues:			
State General Fund	$10,832	$13,786	$14,755
Tobacco Tax and Health Care Fund [1]	200	242	256
Total revenue	$11,032	$14,028	$15,011
Expenditures:			
Personal services and employee related	$10,556	$13,275	$14,117
Professional and outside services	22	26	31
Travel	281	499	624
Other operating	149	188	221
Equipment	24	40	18
Total expenditures	$11,032	$14,028	$15,011

1 Amount is the Division's portion of Tobacco Tax Health Care Fund monies used to enforce tobacco tax collections.

Source: Auditor General staff analysis of unaudited financial schedules prepared by the Department of Revenue for the years ended or ending June 30, 2003, 2004, and 2005.

Scope and methodology

This audit followed up on the recommendations made in the 1995 performance audit of the Department's audit functions (see Auditor General Report No. 95-18). Further, auditors focused their work on the Division's audit functions related to the three primary sources of tax revenue the Department collects: corporate income, individual income, and transaction privilege tax. The audit report presents two findings and associated recommendations:

- The Division needs additional information to help it make effective resource-allocation decisions. In 2004, each of the Division's sections created audit plans to formulate and communicate ways to accomplish goals and objectives for the upcoming year. While these plans are a step in the right direction, to help ensure resource-allocation decisions are effective, the Division should include additional information in these plans, such as the number of staff hours available for audits and the costs of audits compared to the amount of additional tax revenue received.

- The Division has improved some of its audit selection processes, but more work is needed. The Division has developed systematic, written audit selection processes for two areas that focus on selecting audits of high-liability and noncompliant taxpayers. However, the Division has the opportunity to further improve its audit selection processes by developing additional audit selection rules and using its new automated audit system, known as ESKORT, to evaluate whether its audit selection criteria are effective.

During the audit work, significant limitations in one division area were identified. Because of the nature of the information collected and the need for confidentiality, these concerns will be communicated in a separate letter report to the department director.

Various methods were used to study the issues addressed in this audit. General methods included interviews with department management and staff, as well as interviews with professional organizations such the National Association of State Auditors, Comptrollers, and Treasurers, and the Federation of Tax Administrators. Auditors also reviewed Arizona Revised Statutes, the Arizona Administrative Code, the Code of Federal Regulations, and department and division policies and procedures, goals, objectives, and performance measures.

In addition, the following specific methods were used:

- To develop the report findings, auditors reviewed a previous performance audit of the Division (see Auditor General Report No. 95-18) to determine whether recommendations had been implemented. In addition, auditors reviewed performance audits of other states' tax enforcement agencies.[1] Auditors also reviewed and analyzed various internal documents, such as the Division's audit, or business plans, and observed an internal division audit selection committee meeting and supervisors' meeting. Auditors also reviewed technical literature about the Division's new automated audit system that is currently being implemented, interviewed the project manager for this system, and attended a training session on this system. In order to make general comparisons to Arizona, auditors e-mailed a questionnaire to ten states that had similar tax types as Arizona or were identified by the Federation of Tax Administrators as being best-practice states.[2] Finally, auditors reviewed academic literature on audit selection methods and best practices in tax auditing.

- To develop the Introduction and Background section, auditors conducted interviews with department management and staff, and compiled information from state laws and regulations, and unaudited information from the Department's 2004 annual report, the Department's organizational chart for the Audit Division, the Department's Web site and financial schedules, and other information provided by the Department, as well as technical literature and information from the State of Arizona Annual Financial Report.

The audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the director, division director, and staff of the Department of Revenue for their cooperation and assistance throughout the audit.

1 The state audit reports reviewed were the Utah Tax Commission; the Kansas Department of Revenue; the California State Board of Equalization; the California Franchise Tax Board; the Idaho State Tax Commission; the Wyoming Departments of Revenue; Audit and Transportation; the Florida Department of Revenue; the West Virginia Department of Tax and Revenue; the North Carolina Department of Revenue; the Colorado Department of Revenue; the Nevada Department of Taxation; the Michigan Tax Compliance Bureau; and the New Mexico Taxation and Revenue Department.

2 The states that were contacted provided information on such things as audit selection methods, number of audits conducted, and the type of information used to evaluate audit outcomes and audit selection methods. Because the information provided is of a sensitive nature, the states requested that they not be identified in this report.

FINDING 1

Division needs to take additional steps to better manage limited resources

The Division needs additional information to help it make effective resource-allocation decisions. The Division recently created audit plans to help address concerns identified in a previous performance audit about whether it was proactively managing its resources. While these plans are a step in the right direction, to help ensure resource-allocation decisions are effective, the Division should use its new automated audit system to include additional information, such as the number of staff hours available for audits and the costs of audits compared to the amount of additional tax revenue received.

Division has developed audit plans

The Division has written business plans to comply with past performance audit recommendations.

The Division has developed audit plans, which it refers to as business plans, to address concerns identified in a prior performance audit. A 1995 performance audit (see Auditor General Report No. 95-18) found that the Division needed to develop annual audit plans to proactively manage its resources. The report noted that the audit sections did not have annual plans that specified such things as the number of staff hours available for audits and the number of audits to be performed. The report recommended that audit plans be developed that detailed goals, objectives, and resource-allocation decisions. The report also noted that careful management of auditing resources was particularly important since workload and productivity could be impacted by a number of factors including changes in tax laws, the economy, and automation.

The Division has only recently developed business plans that include some of the recommended information. In 2004, each of the Division's sections (i.e., Corporate, Individual, etc.) developed an initial business plan. Each section's plan includes a data analysis section that presents information from previous years, such as the number of audits conducted by type and the tax assessment amount, and a section on ideas for accomplishing goals. According to the Division, the plans are used to formulate and communicate ways in which the sections can accomplish goals and objectives for the upcoming year.

Division can improve its business plans through better use of data

While the Division's business plans are a step in the right direction, they are missing basic information needed to analyze how audit resources are used and a cost-benefit analysis for its different types of audits. The Division should use its new automated audit system, ESKORT, to help it gather the data necessary to conduct these analyses and improve its business plans.

Business plans can be improved—The Division's business plans can be improved by including more information in the data analysis section. Specifically, adding the number of staff audit hours available and completing a return on investment (ROI) analysis, or a cost-benefit analysis, that compares the cost of audits to the amount of additional tax revenues assessed will allow the Division to determine and document its decisions on how best to allocate resources to meet its objectives of maximizing revenue, audit coverage, and compliance rates. Several of the states that auditors contacted regularly analyze the costs and profitability of audits.

The Division should conduct a cost-benefit analysis for each type of audit.

A meaningful cost-benefit or ROI analysis should be conducted for each type of audit. Currently, the Individual Income Tax Audit Section and the Corporate Income Tax Audit Section conduct a limited ROI analysis by comparing the benefits, or total assessments and collections, to the costs, or total expenditures for the sections as a whole. The Individual Income Tax Section analysis indicates that it is collecting approximately $5 for every $1 spent, and the Corporate Income Tax Audit section analysis indicates that it is collecting approximately $15 for every $1 spent. However, since it is done for the section as a whole, these analyses do not allow the sections to determine the ROI for the different types of audits that they conduct.

Improving the business plans by including the number of audit hours available and a return on investment analysis, or cost-benefit analysis for each type of audit, will allow each of the Division's sections to more clearly determine how best to use its auditing resources. In addition, taken together, the Division could use the plans to determine and document its decisions about whether resources should be moved between the sections. Further, historical return-on-investment information could help the Division determine whether it would be in the State's interest to add additional auditing resources.

New audit system will help Division improve business plans—ESKORT, the Division's new automated audit system, is designed to capture additional data that can be used to improve its business plans and enable the Division to more effectively manage its resources. According to the Division, its resource allocation decisions have been hindered by a lack of data and inaccurate data. However, using ESKORT, the Division will be able to capture data that is not currently being captured, such as the amount of hours spent on each audit. This information, coupled with the amount of additional tax owed, could then be used to determine the return on investment by categories of audits.

ESKORT will capture additional data that will enable the Division to more effectively manage its resources.

However, the Division will need to take steps to ensure that accurate data is captured. Currently, the Corporate Income Tax Section's office audit unit does not have adequate controls in place to ensure that auditors are correctly recording the number of audits conducted and the amount of tax assessed. The Division indicated that these problems stemmed in part from a lack of training. In addition, not all of the sections are capturing information on audit costs. Therefore, the Division should take steps to ensure that staff is trained on which data must be entered into ESKORT, how to enter the data, and the importance of complete and accurate data for ensuring resources are effectively managed.

Recommendations:

1. To ensure its resource-allocation decisions are based on complete and accurate information, the Division should ensure staff are trained on:

    a. what data must be entered into ESKORT,

    b. how to enter the data, and

    c. the importance of ensuring the data is complete.

2. When the Division has complete and accurate data on ESKORT, it should use the data to improve the business plans. Specifically, business plans should include:

    a. the number of staff hours available for audits,

    b. the number of audits to be performed,

    c. the analysis of audit costs compared to the additional revenue received, and

    d. the Division's resource-allocation decisions.

FINDING 2

Division should further improve its audit selection processes

The Division has improved some of its processes for deciding which taxpayers and businesses to audit, but more work is needed. The Division has developed systematic written audit selection processes for two areas, which include focusing on selecting audits of high-liability taxpayers and noncompliant taxpayers. However, the Division has the opportunity to further improve its audit selection processes by developing additional audit selection rules and using its new automated audit system, ESKORT, to evaluate whether its audit selection criteria is effective.

Division has taken some steps to address audit selection concerns

The Division has taken some steps to address audit selection concerns identified in the most recent performance audit.[1] A 1995 Auditor General performance audit (Auditor General Report No. 95-18) found that the Division needed to develop and implement systematic processes for selecting audits, increase audits of high-liability taxpayers, and focus some audit resources on noncompliant segments of the tax base. The 1995 performance audit also noted that because audit resources are limited, it is important that the Division have effective audit selection processes.

Documented selection processes—Since the 1995 audit, the most significant steps the Division has taken are developing and implementing systematic written processes for selecting audits in two areas: the Individual Income Tax Audit Section and the Corporate Income Tax Audit Section's field audit unit. Specifically, in 1999, the Corporate Income Tax Audit Section established a committee that developed and documented selection criteria for its field audit units. The criteria includes items such as a corporation's amount of tax liability and whether a corporate taxpayer has been audited before. In 2001, the Individual Income Tax Audit Section documented its

1 Similar concerns were also identified in three previous audit reports. See Auditor General Performance Audit Report Nos. 81-2, 85-5, and 87-6.

procedures for selecting audits, including criteria such as the estimated amount of additional tax owed and prior audit results. In addition, when auditors discovered during this audit that the Division did not have a policy that addressed selecting audits through auditor leads, each of the sections drafted a policy in March 2005 to ensure that taxpayers cannot be unfairly targeted by auditors or selected for personal reasons.The policies require supervisory approval of audits selected through auditor leads. Auditor leads generally refer to audits selected based on an auditor's judgment, such as information obtained during the course of an audit that results in identifying the need for additional audits. The Division has not, however, developed written processes for how it decides which taxpayers and businesses to audit for the Transaction Privilege Tax Audit Section or the Corporate Income Tax Audit Section's office audit unit.

Auditors focus their efforts on taxpayers who are likely to be out of compliance with tax laws.

Identifying noncompliant taxpayers—The Division has taken steps to develop audit selection techniques that focus on noncompliant segments of the tax base. For example, the Individual Income Tax Audit Section's written processes focus primarily on identifying noncompliant taxpayers, such as taxpayers who have an error on their federal tax return, and are therefore also likely to have an error on their Arizona tax return. The Division also identifies noncompliant taxpayer groups by participating in work groups with other states' taxing authorities, and all of the sections use auditor experience to pinpoint particular industries or groups that have tax compliance problems. For example, although the Corporate Income Tax Audit Section's office audit unit does not have current systematic, written audit selection processes, managers in this unit indicate that they have learned through experience that corporations taking certain types of tax credits are more likely to have errors on their tax returns. Therefore, the managers indicated that the office audit unit would focus some of its auditing efforts on those corporations that claim the specific tax credits because they are likely to be out of compliance.

Focusing on high tax liabilities—The Division has taken some steps to focus its audit selection on high-liability taxpayers. Although it does not appear that the Division has increased the proportion of audits of high-liability corporate taxpayers, it has taken steps to ensure that it focuses on high liability taxpayers when selecting corporate field audits. Specifically, the Corporate Income Tax Audit Section has established written selection procedures which factor in a corporation's tax liabilities. The Transaction Privilege Tax Audit Section, on the other hand, does not have documented audit selection criteria and therefore it cannot demonstrate that it is focusing on high-liability taxpayers for audit.

Division should continue to improve audit selection processes

The Division's new automated audit system, ESKORT, should provide it with the opportunity to further improve its audit selection processes. However, the Division needs to ensure that all of its audit units develop audit selection rules, and that the rules are regularly and appropriately evaluated to determine if they result in selecting the most effective audits.

Division writing rules that will help it select audits—ESKORT contains an audit selection component that evaluates taxpayers' tax returns by using division-established rules that provide a score indicating the likelihood for noncompliance (high, medium, low) and the potential amount of additional tax owed to the State. Rules are basically observations of taxpayer data. Specifically, the observations are entered into the system as logical "if, then" rules. For example, a rule may tell the system that taxpayers who take a certain deduction on their tax return may likely have an error on their return. ESKORT should also streamline the Division's audit selection processes because the system will examine and select taxpayers based on the rules, whereas currently, auditors or administrative staff have to manually review taxpayer records and search databases for specific information.

ESKORT rules—Observations of taxpayer data that ESKORT uses to select which taxpayers to audit. Rules are written in "if, then" format. For example, "if a taxpayer has taken X deduction, then there is a likelihood of error."

Some sections will need to develop rules for ESKORT. The Transaction Privilege Tax Section has written audit selection rules for ESKORT that appear to encompass its key methods for selecting audits. The Corporate Income Tax Audit Section's field audit unit has also written ESKORT rules; however, the office audit unit in this section still needs to write rules. In addition, the Division is currently working with the contractor to determine how to best use ESKORT's office audit function in the Individual Income Tax Section, and if the section decides to use the audit selection component of ESKORT, it will need to write rules that encompass current audit selection methods.

Division needs to ensure that rules are evaluated—Appropriate and regular evaluation will ensure that the rules are written to select the type of audits that will help the Division achieve its objectives of increasing tax revenues, compliance rates, and cost-effectiveness. According to division officials, the audit selection rules will be evaluated primarily through auditor feedback. However, the Division still needs to determine how and when this feedback will be obtained. For example, ESKORT comes equipped with a built-in evaluation mechanism whereby auditors can assign a score to the rules that were used to select an audit when they have completed the audit. The system is set up to score the rules on a scale from 1 to 10; however, the Division must establish the criteria for the scoring. The Division can also change the scale by using categories, such as fair, excellent, or poor. The score is intended to assist the Division in evaluating whether the audit selection rules are appropriate and effective. However, to ensure that it captures auditor feedback through this mechanism, the Division may need to require that its auditors fill in this field in order to close out their audits. Auditors spoke to one state that is using ESKORT in its audit division, and found that the division made the built-in feedback mechanism mandatory for all audits to ensure that it could gather data with which to evaluate the rules.

Division management needs to ensure that the new automated audit system is selecting audits that help meet its objectives.

Regardless of how the Division decides to gather feedback, it should assess whether the rules are selecting audits that will help meet division objectives. For example, the Division should ensure that the rules are selecting some corporations for field audit that do business only in Arizona because field audits are more thorough. Doing so would create an audit presence among Arizona corporations and could result in increased compliance, which is a division objective.

Recommendations:

1. The Division should ensure that all audit units draft rules encompassing key methods for selecting audits through ESKORT.

2. The Division should ensure that the ESKORT audit selection rules are regularly and appropriately evaluated. This evaluation should ensure that the audit selection rules are selecting audits that help meet the Division's objectives of increasing revenues, compliance rates, and cost-effectiveness.

AGENCY RESPONSE

STATE OF ARIZONA

Department of Revenue
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Janet Napolitano
Governor

Gale Garriott
Director

August 19, 2005

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

Dear Mrs. Davenport:

The Department of Revenue (Department) has reviewed the August 10, 2005 Audit Division's report of the performance audit and sunset review. The Department commends and thanks your staff for their understanding and professionalism throughout this performance audit process.

The following comments are provided as the Department's response to the findings and recommendations.

Finding 1 – Division needs to take additional steps to better manage its limited resources

Recommendation 1 – To ensure its resource allocation decisions are based on complete and accurate information, the Division should ensure staff is trained on:

a) what data must be entered into ESKORT
b) how to enter the data, and
c) the importance of ensuring the data is complete.

The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

As the ESKORT system is implemented, extensive training is being designed to ensure that all users of the system will be properly trained in a timely manner regarding the various systems. The ESKORT procedure manuals and class handouts are being designed to be very user-friendly to meet all levels of expertise regarding computer input. We are working closely with members of the ESKORT system design teams to develop in-house trainers that will be "resident experts" so the training of affected personnel and the transition to the new systems will be easy, efficient, and effective. Additional emphasis will be placed on the importance of accurate and complete data input by the ESKORT system users so meaningful management reports can be produced for analytical purposes.

Currently, the Corporate Income Tax Audit and Transaction Privilege Tax Audit field audit units have developed training plans and schedules and are awaiting final configuration of the release in order to update the plans and schedules as needed to provide accurate and timely training. The remaining training for the Audit Division will follow along with the remaining ESKORT implementation.

The Audit Division, in conjunction with the vendor, completed an ESKORT Readiness Plan in May 2005. This plan outlines the high-level timeline for the various awareness and training events that need to occur and is supplemented by a detailed report on the expected hours, broken down by employee and tax type that are expected to be needed. If requested, these documents will be provided.

Recommendation 2 – When the Division has complete and accurate data on ESKORT, it should use the data to improve the business plans. Specifically, business plans should include:

a) the number of staff hours available for audits

b) the number of audits to be performed

c) the analysis of audit costs compared to the additional revenue received, and

d) the Division's resource allocation decisions.

The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

The ESKORT system is only one part of the BRITS project, which is not due to be completed until August 2006. This will delay the Audit Division's complete use of the ESKORT case management and tracking capabilities. The Corporate Income Tax Audit and Transaction Privilege Tax Audit field audit units are scheduled to begin using ESKORT's case management and tracking in mid to late November 2005. The desk audit units in these sections, as well as Individual Income Tax Audit are not scheduled to begin using this ESKORT functionality until full BRITS implementation in August 2006. The ESKORT system will provide all the remaining data elements necessary to facilitate the business plan improvements.

Finding 2 – Division should further improve its audit selection processes

Recommendation 1 – The Division should ensure that all audit units draft rules encompassing key methods for selecting audits through ESKORT.

The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

The ESKORT audit selection system requires that rules be drafted. These rules are written and programmed into the system to electronically identify potential audit leads. These rules will select audit leads based upon their specific criteria. Value points will then be assigned to each lead and the lead will be designated as high, medium, or low for audit potential. Since the February 2005 implementation, the Transaction Privilege Tax Audit section has created 57 new rules that have been programmed into the system. Individual Income Tax Audit and the desk audit units in Corporate Income Tax and Transaction Privilege Tax Audit sections will be required to implement similar rules. However, the desk audit units will also be able to use the field audit rules for their respective audit type.

Recommendation 2 – The Division should ensure that the ESKORT audit selection rules are regularly and appropriately evaluated. This evaluation should ensure that the audit selection rules are selecting audits that help meet the Division's objectives of increasing revenues, compliance rates, and cost-effectiveness.

The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Since the implementation of the ESKORT audit selection system in February 2005, Corporate Income Tax Audit has modified 4 of its rules and Transaction Privilege Tax Audit section has modified 12. Combining this result with the additional 57 Transaction Privilege Tax Audit Section rules that have been implemented demonstrates the ongoing evaluation that is already taking place.

Additionally, within the ESKORT audit selection system, there is a "rules feedback" mechanism wherein auditors are required to provide feedback regarding the effectiveness of the rule(s) used in identifying taxpayers selected for audit (an audit can't be completed without having the auditor feedback). Training is being designed to ensure that all users of the system will be properly trained in a timely manner regarding the various systems, including the "rules feedback" mechanism. The ESKORT procedure manuals and class handouts are being designed to be very user-friendly to meet all levels of expertise regarding computer input. We are working closely with members of the ESKORT system design teams to develop in-house trainers that are "resident experts" so the training of effected personnel and the transition to the new systems will be easy, efficient, and effective. Emphasis will be placed on the importance of accurate and complete data input by the ESKORT system users, including "rules feedback" so meaningful analysis of the effectiveness of the rules can take place. This will help ensure that the rules are properly designed and functioning to identify the best possible audit leads with the greatest potential for non-compliance. This, in turn, will assist the section with meeting the division's objectives of increasing revenues, improving compliance rates, and functioning cost-effectively.

Thank you for the opportunity to respond to the report.

Sincerely,

Gale Gariott
Director

GG:VP:dbl

cc: Vince Perez
File

Performance Audit Division reports issued within the last 24 months

03-08 Arizona Department of Commerce

03-09 Department of Economic Security—Division of Children, Youth and Families, Child Protective Services—Caseloads and Training

04-L1 Letter Report—Arizona Medical Board

04-L2 Letter Report—Gila County Transportation Excise Tax

04-L3 Letter Report—Department of Economic Security—Population Estimates

04-01 Arizona Tourism and Sports Authority

04-02 Department of Economic Security—Welfare Programs

04-03 Behavioral Health Services' HB2003 Funding for Adults with Serious Mental Illness

04-04 Department of Emergency and Military Affairs and State Emergency Council

04-05 Department of Environmental Quality—Water Quality Division

04-06 Department of Environmental Quality—Waste Programs Division

04-07 Department of Environmental Quality—Air Quality Division

04-08 Department of Environmental Quality—Sunset Factors

04-09 Arizona Department of Transportation, Motor Vehicle Division— State Revenue Collection Functions

04-10 Arizona Department of Transportation, Motor Vehicle Division—Information Security and E-government Services

04-11 Arizona Department of Transportation, Motor Vehicle Division—Sunset Factors

04-12 Board of Examiners of Nursing Care Institution Administrators and Assisted Living Facility Managers

05-L1 Letter Report—Department of Health Services—Ultrasound Reviews

05-01 Department of Economic Security—Division of Employment and Rehabilitation Services—Unemployment Insurance Program

05-02 Department of Administration—Financial Services Division

05-03 Government Information Technology Agency (GITA) & Information Technology Authorization Committee (ITAC)

05-04 Department of Economic Security—Information Security

05-05 Department of Economic Security—Service Integration Initiative

Future Performance Audit Division reports

Department of Economic Security—Division of Developmental Disabilities

Arizona State Retirement System