STATE OF ARIZONA
OFFICE OF THE
AUDITOR
GENERAL

Department of Revenue
Audit Division

REPORT
HIGHLIGHTS
PERFORMANCE AUDIT

Subject

Tax audits help the State identify additional tax revenues that are owed to it. Audits also encourage compliance with tax laws, and help instill confidence in the fairness of the tax system.

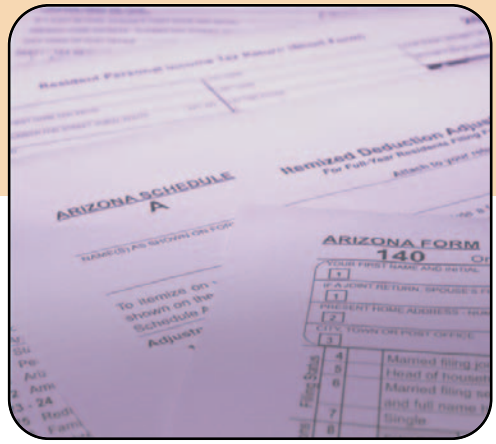
Our Conclusion

The Division lacks basic information needed to analyze how effectively it uses its audit resources, including the State's return on investment for each type of audit. The Division has improved its audit selection processes, including increasing its focus on high-liability and noncompliant taxpayers. As it prepares to use a new automated system to select audits, it needs to finish developing the criteria the system will use to select the audits.

2005

August • Report No. 05 – 06

More Steps Needed To Better Manage Limited Resources

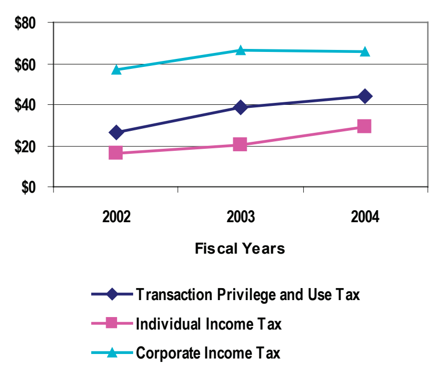


The Audit Division helps ensure that the State receives the tax money owed to it. The Department reports that in fiscal year 2004, the Division conducted more than 37,000 audits and assessed a total of $139 million in additional taxes.

The three major types of taxes that the Division audits are:

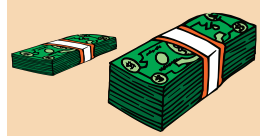
- Transaction privilege tax, commonly referred to as sales tax.
- Individual income tax.
- Corporate income tax.

Audit Assessments[1]
Fiscal Years 2002 through 2004
(Millions of Dollars)



1 The numbers for dollars assessed for Transaction Privilege and Use Tax and Corporate Income Tax pertain to field audits only.

Business plans can be improved—Audits are a cost-effective means of generating additional revenue for the State. However, audit resources are limited, and the return on investment for audits can vary by tax type and by type of audit conducted. For example, division analyses show that corporate income tax audits result in $15 in assessments for each $1 spent, while audits of individual income taxes result in $5 in assessments for each $1 spent.



For every $1 spent auditing corporate income tax returns, the Division generates $15.

The return on investment may also vary depending on the type of audit. For example, a field audit may produce a different return on investment than a desk audit.

Field audit—An audit conducted on a larger corporation that involves traveling to a corporation's or business' headquarters.

Office (or desk) audit—Office auditors do not travel, and their job involves less extensive audit work.

The Division captures some information from previous years, conducts some analysis, and develops ideas for accomplishing goals in its annual business plans. However, these plans do not include basic information that the Division would need to analyze how audit resources are used or to calculate returns on investment for all types of audits. Currently, the Division does not calculate the return on investment for audits of some tax types, such as the transaction privilege tax. The returns on investment that it does calculate—for corporate and individual income taxes—do not analyze the returns by field audit versus desk audit.

Several states we surveyed regularly analyze audit costs and profitability.

New audit system will help capture needed data—The Division's new automated audit system, ESKORT, can capture additional data that the Division can use to improve its business plans and more effectively manage its resources. However, the Division will have to train staff in order to ensure that ESKORT captures accurate data. For example, the Corporate Income Tax office audit unit does not have controls in place to ensure it is gathering accurate data on the total number of audits conducted, the amount assessed, or the cost of audits. The Division attributes this in part to a lack of training.

Recommendations

The Division should:

- Train staff on what data to enter into its new automated audit system.
- Use the new system to capture additional data to improve business plans.

Division Can Further Improve Audit Selection Processes

The Division has improved some of its processes for deciding which taxpayers and businesses to audit, but more work is needed.

Some improvements in audit selection

In a 1995 audit report, we recommended that the Division:

- Develop and implement systematic processes for selecting audits;
- Focus on some noncompliant taxpayers; and
- Increase audits of high-liability taxpayers.

The Division has made improvements in each of these areas.

Some systematic processes developed—The Division has developed systematic written processes for selecting audits in two areas: individual income tax and corporate income tax field audits.

- For individual income tax audits, the Division established criteria such as the estimated tax owed and prior audit results.
- For corporate income tax, criteria include the corporation's amount of tax liability and whether the corporate taxpayer has been audited before.

The Division has not, however, developed written processes for deciding which taxpayers and businesses to audit for transaction privilege tax or for office audits of corporate income tax.

Identifying noncompliant taxpayers—The audit selection process for individual income tax focuses on identifying noncompliant taxpayers, such as those whose state tax return does not match their federal tax return.

The Division relies extensively on auditor judgment to identify noncompliant taxpayers. For example, while the office audit unit of the Corporate Income Tax Audit Section does not have written selection processes, experience tells it that corporations taking certain kinds of tax credit, are more likely to have errors on their returns.

Targeting high tax liabilities—The Division has taken steps to ensure that its selection processes increase the proportion of high-liability corporate taxpayers. For example, the Corporate Income Tax Audit Section factors in a corporation's amount of tax liability when selecting taxpayers for audit. Audits of these taxpayers are more likely to identify large amounts owed.

Using automation to select audits

The Division's new automated audit system, ESKORT, will evaluate taxpayers' returns and compute a score indicating the likelihood for noncompliance (high, medium, low). It computes these scores using rules the Division established. For example, a rule may tell the system, "if a taxpayer has taken X deduction, then there is a likelihood of an error." The Division should ensure that all audit units draft rules for selecting audits. Rules have not been written for individual income tax and corporate income tax office audits.

After ESKORT is functioning and being used to select audits, the Division will need to periodically test how well it is performing—especially whether the rules are effective. The Division plans to evaluate the rules through auditor feedback. However, the Division has not yet determined how it will obtain this feedback. For example, ESKORT has a built-in evaluation mechanism by which auditors can assign a score to each rule that was used to select an audit. One state using ESKORT requires that auditors use the built-in feedback mechanism for all audits to evaluate the rules.

Recommendations

The Division should:

- Ensure that rules for selecting audits through ESKORT are drafted for all audit types.
- Ensure that ESKORT audit selection rules are regularly and appropriately evaluated.

TO OBTAIN MORE INFORMATION

A copy of the full report can be obtained by calling

(602) 553-0333

or by visiting our Web site at:
www.auditorgen.state.az.us

Contact person for this report:
Dot Reinhard

Department of Revenue

Audit Division

REPORT HIGHLIGHTS

PERFORMANCE AUDIT

August 2005 • Report No. 05 – 06