March 25, 1993
ILR 93-D

Representative Evan L Olsen
House of Representatives
318 State Capitol Bldg
Salt Lake City UT 84114

Subject: **Tax Commission/Administrators**

Dear Representative Olsen:

As requested, we looked at the following areas of interest in the Tax Commission: 1) the cost/effectiveness of the auditing staff, 2) the establishment of appropriate auditing practices and procedures, and 3) the ratio of Tax Commission administrators to total staff in recent years. We did not conduct an in-depth audit, but gathered information available from the Tax Commission and interviewed commission staff to try and answer your concerns. This report is organized into three sections based on the three areas of your request.

Auditing Staff Cost/effectiveness

Based on data prepared by the Tax Commission, Auditing Division staff appear to be cost/effective because the revenues returned are much greater than division costs. However, this cost/benefit ratio has decreased in recent years, and, in our opinion, is even somewhat overstated because of a lack of complete information regarding revenues and costs. In this section we address the cost/benefit ratio of the Auditing Division and discuss our concerns with how it is derived. We also discuss the cost/effectiveness of the Collections Division and attempt to identify areas of overlap between it and the Auditing Division.

According to management, the Auditing Division initially established an internal audit tracking system for the measurement of individual and group auditor performance, the dollar return by tax type, and performance of the division as a whole. Evidently, this system was never intended to track activities outside of the division's objective of auditing taxpayers and assessing tax deficiency, such as if assessments are collected, or if part of the assessment is waived by the Tax Commission. Even though the division tracks individual and group auditor performance in terms of assessments produced by the time required to produce them, and uses this information for management purposes, they do not calculate a marginal return for each new auditor in an attempt to optimize staffing levels. The revenue and cost data we reviewed was assembled on an aggregate basis to determine the return for the audit staff as a whole. We chose to analyze the aggregate data the commission uses as an acceptable way of determining audit staff cost/effectiveness rather than trying ourselves to identify the marginal return for each new auditor the division has added in recent years.

Currently, the division is asserting that over $10 of new revenue can be returned to the State for every $1 of auditing cost. This is based on the total amount of audit assessments issued by the division in a fiscal year divided by division costs. This return ratio has been decreasing in recent years as the following figure indicates.

Figure I
Auditing Division Revenues and Cost

Fiscal Year	Total Audit Assessments	Division Costs	Net Assessments	Return Per Dollar of Cost	Number of Auditing Staff *
1986	$38,300,000	$4,289,700	$34,010,300	$8.93	87
1987	58,608,593	4,707,548	53,901,045	12.45	106
1988	58,947,682	4,549,181	54,398,501	12.96	99
1989	54,519,095	4,640,463	49,878,632	11.75	101
1990	55,393,742	4,816,580	50,577,162	11.50	101
1991	59,263,527	5,340,572	53,922,955	11.10	102
1992	64,320,286	5,941,523	58,378,763	10.83	107

** Includes auditors, audit technicians, and audit supervisors.*

Management told us there are several factors which have caused costs to grow and which have contributed to the recent decline in this return ratio. Evidently, costs have increased substantially from a) growth in salaries and benefits for existing audit personnel through cost-of-living and merit increases as well as position reclassifications, b) the addition of six new audit staff in July of 1991, c) some increase in support costs, d) a one-time expense for data-processing equipment (which type of expense is normally covered by the Technology Management Division), and e) some increase in travel costs.

Management feels that some of the factors which have caused the decrease in the return ratio need some explanation in the analysis of audit staff cost/effectiveness. One factor is that the division has certain contractual obligations with the federal government and other states to conduct audits of tax types that simply do not produce much revenue. These include the motor carrier taxes such as the International Fuel Tax Agreement (IFTA), the International Registration Plan (IRP), and also "205" federal royalty contracts which pertain to oil and gas tax audits. The division reports that the 19 FTEs allocated to auditing these less profitable tax types cannot be moved to auditing other tax types because of these contractual obligations. This tends to dilute the overall return figure, but the division contends it would be very profitable to hire additional auditors to audit certain tax types that are known to produce a high return, such as corporate franchise and individual income tax. In fact, the average return over the last four years in corporate tax is $2,084 for every direct audit hour spent producing corporate tax assessments. That same average is $956 per hour when looking at individual income tax. However, the next highest average is $271 per hour for sales tax and the lowest average is $57 per hour for motor carrier tax. As a consequence, the division feels quite certain that adding new auditors to the highest revenue-generating tax types would benefit the state. The division said another factor causing the decline in the return ratio is that fiscal year 1992 audit assessments had to be reduced some 29% to $64.3 million. This reduction was partly due to a lack of resources to collect the money, and partly because some of those assessments were originally estimated too high in an attempt to induce taxpayers to file their tax returns. Retaining this reduction, which the division feels would be legitimate because the money is owed the state, would have increased total assessments which would have increased the return ratio.

In spite of the reasons for the decreasing return ratio in Figure I, net assessments, or total assessments minus division costs, have actually increased over the years, indicating that the Auditing Division has been returning more net dollars to the state. We cannot tell what the optimal staffing level should be in order to maximize audit staff cost/effectiveness, but it does appear that over the years the division has been returning much more to the state than it has been costing.

It should be noted that the audit division, besides being a revenue-generating operation, provides the dual benefit of promoting compliance with tax laws by individuals and organizations. In fact, division management pointed out that increasing compliance with tax laws due to the auditing function is another reason the return ratio has been recently declining. Though it would be extremely difficult to measure the extent to which taxes are paid because of the possibility of being audited, this compliance enhancement effect is nonetheless a very real benefit and needs to be recognized in the evaluation of audit staff cost/effectiveness.

In spite of the fact that net assessments have been increasing, we discovered some problems in the data we reviewed relative to actual revenues and costs. We were told in our initial interviews with the audit division management team that their calculations relative to auditor cost/effectiveness are based on audit *assessments, not on actual payment of assessments.* They were unable to provide us with audit payment information because, as mentioned earlier, tracking audit remittance has never been an objective of the division, nor is the division set up to do so with current internal information systems. Consequently, we took a judgmental sample of audit assessments performed in recent years to identify if the money had actually been paid as assessed. We reviewed some of the larger dollar assessments from audits of both sales tax and withholding tax because information for these taxes is readily available. The results of our sample are presented in the following figure.

Figure II
Audit Assessment Sample

Tax Type	Number in Sample	Total Assessed	Total Remitted	Percent Remitted
Sales & Use	20	$2,210,908	$2,007,591	91%
Withholding	6	329,083	299,087	91
Total	26	2,539,991	2,306,678	91

As shown in the above sample, 91% of what the division reported as being assessed was actually paid. Though 91% payment is a good rate, it illustrates that what is assessed is not necessarily the same as what the state ends up receiving. We found the 9% differential mainly due to subsequent adjustments to the original assessment not being reflected in the division's accounting system. For instance, a taxpayer may for various reasons request that the penalty or interest associated with an audit assessment be reduced or completely waived. This type of request is handled by another division and any change to an audit assessment is simply not captured by the limited capabilities of the Auditing Division's information systems. We also found that some simple errors in data entry regarding assessment amounts were responsible for the 9% differential.

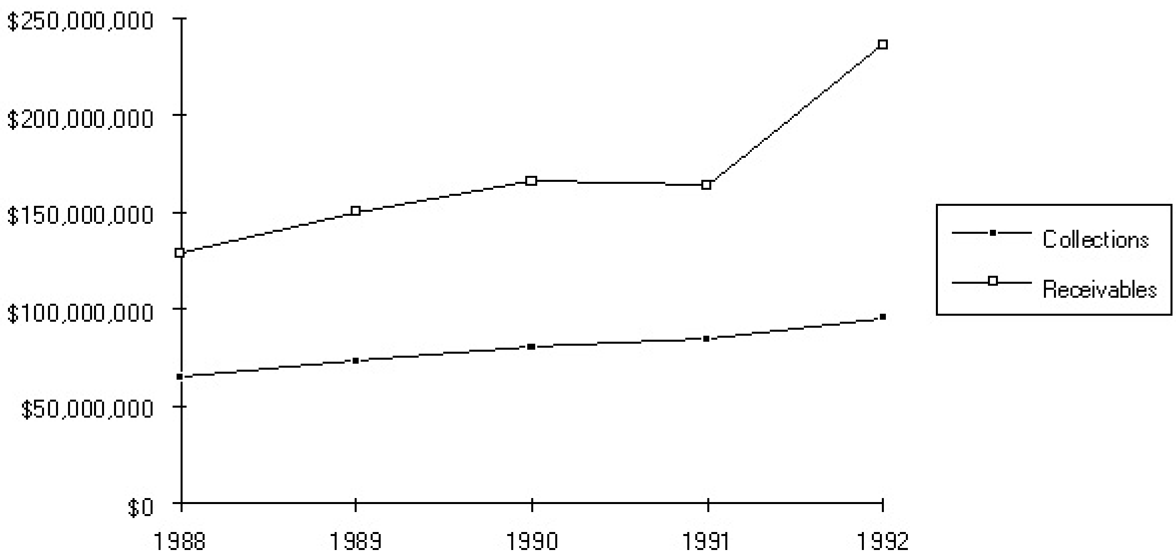
In addition to the problems noted above with assessments, we also found that not all applicable costs are included in calculating audit staff cost/effectiveness. Our discussions with division personnel as well as the budget officer for the Tax Commission indicate that essentially only direct costs of the Auditing Division are included in this ratio. There is no allocation of indirect costs such as utilities or building maintenance for the Heber Wells building, or administrative personnel (i.e., the executive director, the commissioners, the appeals unit, budget and payroll personnel, etc.). Even the direct cost of data processing hardware is not normally included in this ratio because data processing is a separate division which is responsible for its own costs.

To have a complete understanding of division cost/effectiveness, indirect costs should be allocated. However, even without this allocation, division management has developed a system that provides the information they need to evaluate staff and assess division productivity. At the division level, comparing direct costs with audit assessments is key to managing the division. Allocating indirect costs would provide an understanding of the impact that Tax Commission support systems have on the division, but it is not critical for basic management of the division. Because these systems support the entire commission, they would still have to be provided even if the Auditing Division did not exist.

Collections Division

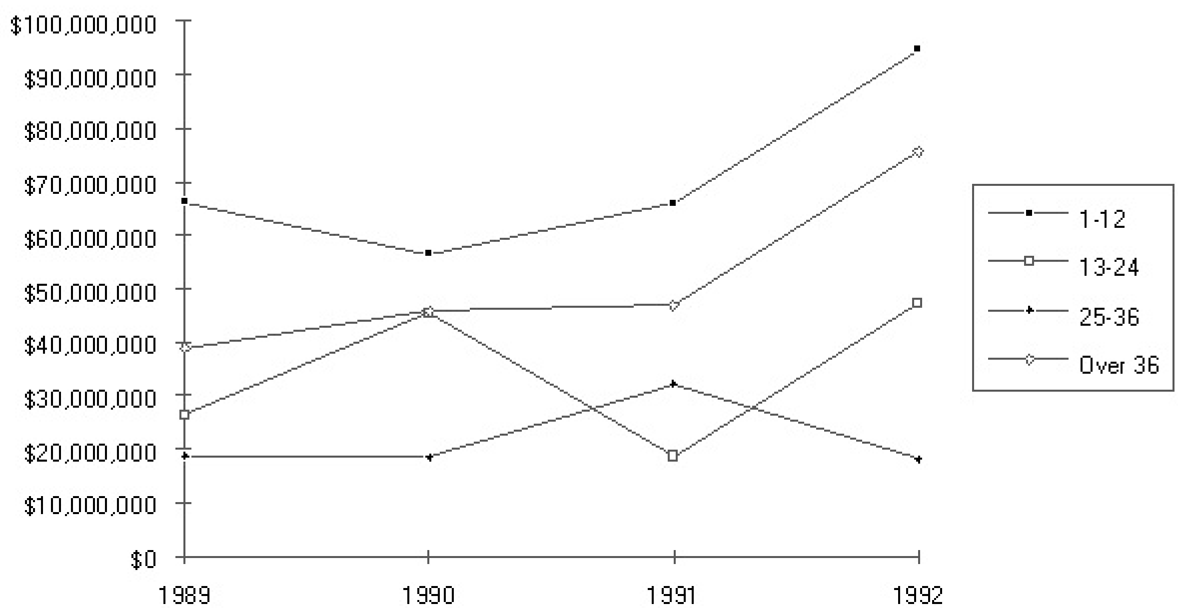
As part of our Tax Commission evaluation, we looked at the general cost/effectiveness of another division within the commission, the Collections Division. We thought it appropriate to look at the Collections Division because of some areas of overlap with the Auditing Division regarding the actual collection of assessments. The majority of the Collection division's revenue comes from taxes identified as being delinquent because of taxpayers filing a return without payment, not filing a return at all, bankruptcy cases, etc. Collections revenue is related to the size of overall accounts receivable for the Tax Commission. A "collectible" and a "receivable" are both defined as any tax owed which is beyond its due date, and as collections are made, accounts receivable amounts are reduced. Theoretically, the more accounts receivable grow, the more money there is to collect. The data we received from the commission indicate an increasing trend in the last few years in both the amount of collections revenue and the size of accounts receivable, as shown in the following figure.

Figure III
Collections and Receivable Amounts



Though both collections and receivables are on an upward trend, receivables appear to be increasing at a faster rate than collections. This was especially true between 1991 - 1992 when large increases in income and sales tax receivables caused a substantial increase in overall receivables. In fact, the amount that collections revenue reduces total accounts receivable amounts each year has been decreasing and averages about 28%. This may be because a growing portion of accounts receivable is becoming increasingly harder to collect. Some portion of accounts receivable will likely never be collected because owing taxpayers are deceased, corporations are bankrupt and without assets, etc. The older an account receivable grows, the more difficult it generally becomes to collect. In the next figure, further breakdown of the age of these receivables shows that older receivables constitute a fair portion of the total.

Figure IV
Receivables by Age
(Months Outstanding)



The "Over 36" month category represents receivables that for various reasons have been outstanding for 3 years or longer. It is the second largest category and averages about 29% of total receivables. It is also the only category that consistently increased from 1989 - 1992. It should also be noted that approximately $66 million of current receivables is in the form of audits under appeal and cannot be collected until resolved and taken off appeal. This explains in part why collections cannot keep pace with receivables as shown in Figure III, and also suggests that those receivables under appeal which are resolved in favor of the taxpayer will never be collected because they will have been judged as not being owed the state. In our opinion, any change in collections staffing levels based on the size of accounts receivable should take the age and "collectibility" of those receivables into account.

In terms of current collection staff cost/effectiveness, collection division management told us that, unlike the audit division, their revenues indeed represent dollars collected. Collection revenue is money that has actually been received. Like the audit division, however, the costs used to calculate the return ratio do not include any allocation of indirect expenses or of data processing hardware. As with the Auditing Division, allocating indirect costs would provide additional information regarding the impact of Tax Commission support systems, but it is not vital to the basic management of the Collections Division. The following figure shows the return ratio for the Collections Division as well as net collections.

Figure V
Collections Division Revenues and Costs

Fiscal Year	Total Collections	Division Costs	Net Collections	Return per Dollar of Cost	Number of Collectors*
1988	$64,764,329	$2,398,679	$62,365,650	$27.00	44
1989	73,121,531	2,708,205	70,413,326	27.00	49
1990	80,463,325	3,094,743	77,368,582	26.00	49
1991	84,588,469	3,383,539	81,204,930	25.00	49
1992	95,428,705	4,076,342	91,352,363	23.41	59

** There are additional collections personnel besides "collectors" which produce a small portion of the total collections revenue.*

As the figure shows, the division has been generating larger net collections from year to year even though the return ratio has been decreasing. According to collection division management, costs have increased because several non-"collector" positions have been added to the division in recent years. Certain functions in the Collections Division, such as the "waivers" unit and a group of compliance auditors, have been expanded and have increased division costs. However, these functions do not have much direct impact on generating revenue, and expanding them is part of the reason the division's return ratio has decreased. Division management feels the return ratio will begin to rise in the near future as the group of collectors added in 1992 gain experience and become more proficient in the collection process. Like the Auditing Division, the Collections Division is increasing its net return over time, but again it is difficult to know when staffing levels reach their optimal point relative to cost/effectiveness.

There is some overlap between the Auditing and Collections Divisions in two areas. First, audit assessments that are not remitted by the taxpayer after the Auditing Division requests payment are eventually sent to the Collections Division (unless the assessment has been appealed in which case the account is placed on hold). Consequently, this is money that is being counted twice: first, by the audit division as the original amount assessed, and second, by the Collections Division as whatever amount is ultimately collected. According to Collections Division management, about $450,000 of the $95 million collected in fiscal year 1992 - only one-half of 1% - stemmed from auditing assessments, which is not a significant amount. However, the $450,000 collected only represents a portion of all audit dollars assigned to the Collections Division that year. Because it may take more than one year to collect the full amount of an audit assessment, division management suspects this amount will rise in coming years as more and more audit dollars are collected. Therefore, the degree of overlap may become more significant in the future.

The second area of overlap concerns the costs of the collection effort. To the extent the Collections Division becomes involved in securing payment for audit assessments, the cost should be reflected in the Auditing Division's return ratio. Audit division management was not able to tell us what portion of audit assessments end up being assigned to the Collections Division. However, from a judgmental sample we pulled of 34 sales and withholding tax audit assessment accounts, 14 of the accounts (41%) were eventually assigned to the Collections Division. Though some of these accounts have been fully paid, others will require more time to resolve. Because the collection effort can take a long time in some cases, the associated costs may be of significance.

In summary, the return ratios in Figures I and V indicate the Auditing and Collections Division staff are cost/effective. However these ratios have been decreasing over the years, and to some extent are overstated, largely because they do not include any allocation of indirect costs of the commission. We cannot determine what the optimal staffing levels should be for these divisions, or the point at which adding more staff would be counterproductive. However, we feel the lack of complete information regarding the revenues and costs from which these ratios are derived needs to be considered in any proposal to increase staffing levels in the Auditing and Collections Divisions.

Audit Practices and Procedures

Because of the concerns expressed from various sources regarding audit practices and procedures, we tried to determine if the Auditing Division has a uniform set of guidelines on how audits are to be conducted in general, how frequently audits may be conducted of the same taxpayer, and how problems that arise are to be resolved. Our conclusion is that the division does have guidelines on how audits are to be conducted and how frequently they may be conducted, and that a system has been established for taxpayers to voice any concerns they may have about their audit experience which seems to be effective.

The audit division currently has a procedures analyst who is responsible for compiling a set of comprehensive guidelines on how audits should be conducted. A separate auditing manual has been written for each of the different kinds of taxes, with the exception of "miscellaneous" and "individual income" taxes, which manuals we were told are in process. From reviewing a copy of the sales and use tax auditing manual, it appears the division has a thorough set of guidelines relating to audit procedures, communication with taxpayers, and auditor/taxpayers relations in general.

According to division administration, audits may be conducted of the same taxpayer every three years, at least for sales and use tax, because that is the period of the statute of limitations. The division does not have to wait a full three years before conducting a repeat audit (a back-to-back audit so no filing periods are lost) of a taxpayer. They could audit a one-year period instead, and actually might do this in a peculiar situation such as when a company has gone bankrupt and the likelihood of collecting any delinquent tax will decrease with time. However, division management said this would be an unlikely scenario, and in almost all cases a repeat audit would not be conducted for at least three years after the previous audit was completed. Repeat audits are selected for various reasons, one of which is if the previous audit assessment exceeded $50,000. In these instances repeat audits are selected because a high tax deficiency was previously found, and therefore may be found again in the future. It also appears from division information that the annual number of sales and use tax repeat audits comprises less than 7% of the total number of sales and use tax audits.

In addition to the guidelines on conducting audits, the audit division designed and implemented over a year ago a follow-up survey which is issued to all taxpayers after a field audit has been conducted. The survey contains a set of eleven questions, plus space for additional comments, regarding the competence, fairness, courteousness, and effective use of time of the audit team. This appears to be an effective mechanism for identifying any problems or concerns taxpayers may have had with the manner in which an audit was conducted, and provides management with a tool to measure audit staff performance and productivity.

We reviewed some preliminary results of the survey which indicate that taxpayers felt they had been treated fairly and courteously by the audit staff. Out of 560 surveys filled out and returned to the division over approximately the last year, less than 1% of the questions were answered negatively. Furthermore, division management told us that all taxpayers who respond negatively to a question are subsequently contacted by the assistant audit director over the particular tax involved and asked to explain their concerns. The division told us this allows them to follow up on taxpayer concerns and modify auditing practices if valid weaknesses are identified through the negative responses.

The division does have procedures relative to how audits are to be conducted, and it appears from the limited scope of our review of this area that these procedures are being followed. It also appears that the division has a reasonable policy relative to conducting repeat audits. In our opinion, the Auditing Division has especially taken a valuable step in implementing the survey because it gives taxpayers themselves the opportunity to formally express their opinion about the audit experience.

Comparison of Tax Commission Administrators to Total Staff

We were asked to analyze the change in recent years in the number of both administrators and total staff for the Tax Commission. The data presented in this section indicate there has been a steady increase in administrative staff as a percentage of total staff in recent years, but it is difficult to draw a precise conclusion as to the meaning of these data because of the problem in defining what constitutes "administrative" personnel.

Because the definition of "administrative" personnel is subjective, we chose to look at the number of employees working specifically within the "Administrative Division" of the Tax Commission as the best way to address this question. This allowed us to be sure we were comparing the same segment of the commission over time, and prevented us from having to try to determine ourselves what constitutes "administrative" personnel. Reviewing all Tax Commission positions to decide which are administrative in nature would have required considerable time and effort, especially for past years when accurate records may not have been kept.

Personnel in the "Administrative Division" are those responsible for administrative functions which affect the commission as a whole. This division is headquartered at the Heber Wells building but some of the division employees actually work in district offices. Included in the "Administrative Division" are the Tax Commissioners and their staff, the Executive Director's office, and functions such as budgeting, accounting, human resources, payroll, etc. The "Administrative Division" does not include the support positions contained within the various divisions of the Tax Commission such as secretaries. It also does not include director and assistant director positions for the various divisions within the commission. Neither does it include the data processing function because that is a completely separate division.

The following figure presents the commission's information regarding "Administrative Division" FTEs.

Figure VI
Tax Commission FTE Figures

Fiscal Year	Total Tax Commission FTEs	Annual Percent Increase	Number of "Administrative Division" FTEs	Percent of Total
1984	540.5	-----	N/A	-----
1985	603.2	11.6%	N/A	-----
1986	656.4	8.8	N/A	-----
1987	759.1	15.7	N/A	-----
1988	759.1	0.0	N/A	-----
1989	764.1	0.7	56	7.3 %
1990	787.1	3.0	60	7.6
1991	788.1	0.1	66	8.4
1992	807.6	2.5	73	9.0
1993	824.1	2.0	81	9.9
Overall Increase	52.5%	-----	44.6%	-----

According to commission administrators, there was very little in the way of centralized administrative functions when the executive director's position was created in 1984. From that time forward, the director has been consolidating administrative positions and functions from district offices into a central administrative division. (The commission was not able to provide us with figures on administrative employees for a full ten years because of difficulty in collecting the data. However, they did come across some information suggesting the number of administrative employees in 1984 was about 25.) While it appears that administrative staff numbers have increased over the years, the commission maintains they have not changed substantially because these numbers basically represent the reshuffling and centralization of already-existing administrative positions. As an example, management said the number of payroll technicians has recently been reduced through centralizing duties which were previously being performed separately by each of the eight divisions in the commission.

This is the best information we could gather from the commission regarding administrative personnel.

We hope this letter has provided the information you need on this issue. If you have any questions or need additional information, please contact us.

Sincerely,

Wayne L Welsh
Auditor General

WLW:MDE/lm