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Franchise Tax Board:

Its Performance Measures Are Insufficient to Justify Requests for New Audit or Collection Program Staff

CALIFORNIA STATE AUDITOR
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CALIFORNIA STATE AUDITOR

ELAINE M. HOWLE
STATE AUDITOR

STEVEN M. HENDRICKSON
CHIEF DEPUTY STATE AUDITOR

May 13, 2003 2002-124

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the Bureau of State Audits presents its audit report concerning the Franchise Tax Board's (board) return on its investment in additional audit and collection program positions.

This report concludes the board's performance measures are not sufficient to justify requests for new audit or collection program staff. The board uses a variety of performance measures, with various cost components, for its audit and collection programs, potentially causing confusion about prospective and actual program results. Board documents requesting new staff for its programs typically refer to a projected return of at least $5 of benefit for each $1 of cost for these staff. In fact, between fiscal years 1998–99 and 2001–02, the board's 340 newest audit positions returned only $2.71 in assessments—potential revenue—for each $1 of cost, without adjusting for the likelihood or cost of collecting the assessed amounts. Due to various limitations in collection program data, including a change in accounting treatment, we were unable to determine the incremental revenue resulting from the newest 175 collection program positions. However, the board has allowed some approved collection program positions to go unfilled in order to achieve savings to pay for other expenses, such as merit salary adjustments.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE
State Auditor

Franchise Tax Board:

Its Performance Measures Are Insufficient to Justify Requests for New Audit or Collection Program Staff

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SUMMARY

RESULTS IN BRIEF

A primary revenue-generating agency for the State, the Franchise Tax Board (board) processes individual and corporation tax returns, audits certain tax returns for errors, and collects delinquent taxes. Between fiscal years 1990–91 and 2001–02, the board provided an average of $31 billion in annual tax revenues to the State, over 60 percent of the State's General Fund that pays for education, health, welfare, and other public services. Although many taxes are self-assessed by individuals and companies, the board's audit program reviews the accuracy of tax returns, assessing additional taxes when appropriate. In turn, the collection program pursues delinquent taxpayers identified by the board's various assessment activities.

Audit Highlights . . .

Our review of the Franchise Tax Board's (board) audit and collection activities revealed the following:

- ☑ ***The board does not always describe the differing cost components of its various performance measures, potentially leading to confusion about program results.***
- ☑ ***Between fiscal years 1998–99 and 2001–02, recently acquired audit staff returned $2.71 in assessments for each $1 of cost.***
- ☑ ***Because of limitations in board data, we could not isolate the return on 175 new collection program positions.***
- ☑ ***The board's process for assessing the incremental benefit of recently acquired audit and collection program positions is flawed.***
- ☑ ***The board allows some collection program positions to remain unfilled in order to pay for other expenses.***

The variety of performance measurements the board uses for the audit and collection programs can confuse decision makers such as the Department of Finance (Finance) and the Legislature about the programs' projected and actual results. A complete performance measure compares all the benefits of a program with all the costs of producing them. However, in budget documents describing the projected benefits that will result from new staff, the board excludes some departmental overhead costs without disclosing this exclusion. However, the board's subsequently published historical reports of program results include all costs. Further, the board's budget documents do not disclose a substantial overlap in benefits that are stated once by the audit program as assessments and again by the collection program as those same tax assessments are collected as revenue. The board believes Finance and the Legislative Analyst's Office (LAO), which advises the Legislature on budgetary matters, are aware of the overlap. Finance confirmed that it is aware of the overlap, but indicates it would support a refinement of these measurements to better capture the benefits. The LAO is also aware of this overlap and considers it when interpreting the board's data.

To increase revenues, the board received authorization for an additional 340 net audit positions between fiscal years 1992–93 and 2001–02. The board justified many of the new positions with cost-benefit ratios (CBR) that projected returns of at least $5 in audit assessments for every $1 of cost. In contrast, our review found that for every $1 of cost, the 340 audit positions returned only 79 cents in assessments over the period although the return on the additional positions improved to $2.71 for fiscal years 1998–99 through 2001–02. Changes in the economy probably affected the return on these audit positions, but a major cause of the low return is that despite having additional staff, the board did not increase the number of hours staff spent performing audits. These hours differed little in fiscal year 2001–02 from those in fiscal year 1992–93. The collection program added 175 collection program positions between fiscal years 1998–99 and 2001–02, projecting increased revenue of $179 million over that period. However, because of limitations in board data, we could not determine the return on the 175 collection program positions.

Although sufficiently demonstrating the overall cost-effectiveness of its audit and collection programs, the board's process for assessing the incremental benefit of recently acquired audit and collection program positions is flawed. The board lacks sufficient data and uses an inadequate methodology to determine whether increases in audit assessments or collection program revenues resulted from additional positions. Rather than using an incremental approach to isolate assessment or revenue pools likely to have been affected by additional audit or collection program positions, the board compares its total projected audit assessments against its total actual audit assessments and its total projected collection program revenue against its total actual collection program revenues. At the highest level of analysis, the board can demonstrate that the audit division returns about $10 in assessments, or potential revenue, for every $1 of cost, and the collection program returns around $19 in revenue for every $1 of cost. However, the board lacks a persuasive analysis to show that additional tax assessments and cash receipts to the State came from the workloads that incremental staff would likely have been assigned to work.

Recently, the board has justified collection program staffing requests based on a process that prioritizes workload according to a cost-benefit ratio. However, the board actually assigns staff based on risk and yield factors calculated by its new Accounts Receivable Collection System (ARCS). This leaves the board unable to adequately demonstrate the reliability of its cost-benefit approach. Now that the collection program has nearly two years of experience using the new system, the board is developing an alternative methodology for justifying collection program staffing needs that uses data from ARCS to better reflect the manner in which the board actually assigns collection program staff.

Finally, the board is not using all of its funding for collection program salaries to actually fill authorized positions, but is instead using some of the funding for other costs. In fiscal year 1999–2000, separate merit salary adjustment (MSA) funding for the board was ended, leaving the board to find another way to pay for its MSAs. In fiscal years 2000–01 and 2001–02, the board's savings on salaries increased by roughly 5 percent. To achieve these savings the board has left unfilled some collection program positions even though the board's budget control language requires it to fill them expeditiously.

RECOMMENDATIONS

To more completely and clearly reveal its programs' costs and benefits, the board should consider using the complete measurement of the audit program's performance that we have described in Table 3 on page 17. This measurement compares all the benefits—the total revenues that result over time from the auditors' assessments of additional taxes—with the total costs to produce them, including the costs of collection. Thus, the board would treat the collection program as another service center for audits. If it determines that its current information system cannot produce the data necessary for such a measurement, the board should consider the needs of a complete measurement when it upgrades or changes its current information system.

If the board decides not to use the complete measurement and continues to use separate performance measurements for the audit and collection programs, it should do the following:

- In budget change documents and other reports given to external decision makers, the board should explicitly disclose the elements not included in the cost components of various performance measures used to assess the audit and collection programs. The board should also disclose the effect of those excluded elements. Further, the board should disclose the overlap in benefits claimed by its audit and collection programs.

- To provide useful information to decision makers when requesting additional audit positions, the board should use a format, recommended in our prior report and shown on page 22, that details the types of activities new auditors will perform as well as the projected assessments and historical assessments resulting from these activities. Additionally, the board should revise its supporting audit workplan to include the actual returns of each of the specific workload types for the most recently completed fiscal year.

- To track the accuracy over time of its calculations of the prospective CBRs for individual audit workload types, the board should compare these prospective CBRs against actual returns annually. The board should make the results available to Finance and the LAO, and should also include them in the board's annual report to the Legislature on the results of its audit and collection activities. If the board believes this information is confidential, it can cloak the identity of the individual audit workloads in its annual report to the Legislature as we have done in Appendix C. Moreover, the board should use the results of the comparison in future calculations of prospective CBRs.

To demonstrate the effectiveness of new collection program positions, the board should develop a methodology for measuring the benefit of these positions by isolating the return resulting from the additional positions and comparing it against a base year.

To more accurately represent the process that assigns work to collection program staff, the board should continue to develop a methodology based on data from ARCS to justify new collection program staffing requests.

For the board to be consistent with the intent of budget control language and Finance, it should not as a long-term strategy leave collection program positions unfilled beyond the normal time it takes to fill a position.

AGENCY COMMENTS

The board indicates it will implement most of the recommendations made in the report. It agrees that improvements can be made to increase the usability of information it provides to Finance and the Legislature, asserting that it has already begun a project to better capture revenue and cost data. The board disagrees with the methodology we used to analyze the additional assessments generated by the new audit staff. The board contends that because our analysis fails to take into consideration tax law changes, tax regulations, case law and precedent, economic conditions, and self-compliance it does not recognize the full value of the new audit positions. We provide comments to clarify and add perspective to the board's response to the audit. ■

INTRODUCTION

BACKGROUND

The Franchise Tax Board (board) is one of the primary tax-collecting agencies in the State. For fiscal years 1990–91 through 2001–02, the board annually collected an average of $26 billion in personal income tax revenues and $5 billion in corporation tax revenues. Corporation taxes include amounts from corporations, limited liability partnerships, banks, and other business entities. The combined personal income and corporation taxes provide over 60 percent of the State's General Fund revenues, which support educational, health, welfare, and other basic services to the public. As Figure 1 on the following page indicates, the board collected $38 billion in tax revenue for fiscal year 2001–02, including taxes self-assessed by individuals and companies when they filed their tax returns, and additional taxes assessed from the board's audit and filing enforcement activities.

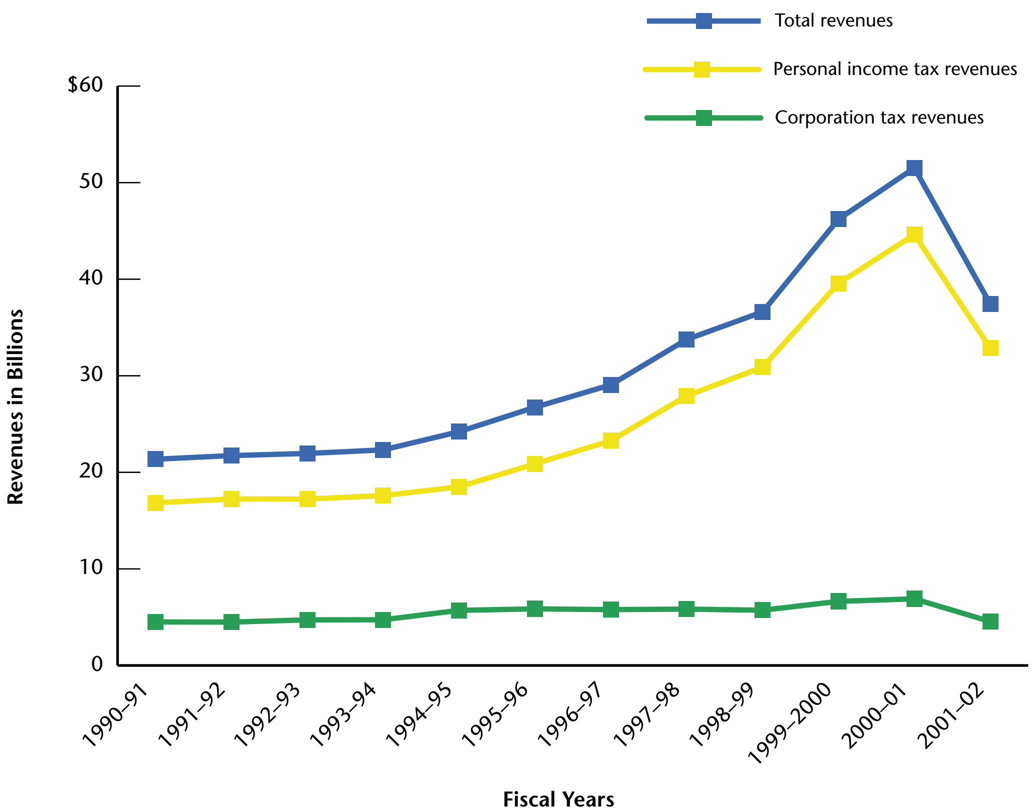
A three-member governing body composed of the state controller, the director of the Department of Finance (Finance), and the chair of the State Board of Equalization oversees the board's activities, which are under the direct administration of an executive officer. With a proposed budget of $438 million for fiscal year 2002–03, the board employs about 5,500 staff in its central office; three regional offices; 11 district offices in California; and satellite offices in Illinois, New York, and Texas. This report focuses on the board's audit and tax collection programs.

THE AUDIT PROGRAM REVIEWS TAX RETURNS TO ENSURE TAXPAYERS HAVE COMPLIED WITH THE LAW

The board's audit program examines tax returns to determine if taxpayers have accurately calculated the amounts they owe the State. When they find errors, the audit staff issue notices of corrections. The audit program examines about 400,000 tax returns each year. Between fiscal years 1998–99 and 2001–02, the audit program averaged $950 million each year in additional assessments.

FIGURE 1

**The Board's Tax Revenues
Fiscal Years 1990–91 Through 2001–02**



Source: Governor's Budget Summaries for indicated fiscal years.

To maximize audit staff's productivity, the board has developed a workplan process for identifying tax returns most likely to produce the largest additional assessments. Based on past experience, the audit branch evaluates selected returns, using certain key characteristics of tax returns as well as information from outside sources such as the Internal Revenue Service (IRS), then ranks returns based on the estimated cost of auditing them and the amount of assessments they might generate. Tax returns that could generate the most benefit relative to cost have the greatest priority for assignment. For example, audits resulting from IRS leads have historically led to very high returns, generating an average of $32 in tax assessments for every $1 of cost incurred for fiscal years 1992–93 through 2001–02. The board has also placed a high priority on certain corporation tax audits that have the potential to yield very large assessments. The board generally tries to staff all audits with projected returns of at least $5 in assessments for every $1 of cost.

In addition to identifying tax returns with higher estimated assessments, the board's workplan is designed to aid in identifying new audit issues and provide an audit presence in the taxpaying community as a means of encouraging compliance with tax laws and increasing overall self-assessed revenues. This audit presence can help instill confidence in the fairness of state government by reassuring taxpayers who have always complied with the law that those who do not comply are at risk for an audit. Although the value of this audit presence cannot be quantified, we believe it can be significant. The amount of time the board spends on these audits with lower returns varies from year to year, and according to the Legislative Analyst's Office (LAO) the board also has a certain degree of administrative flexibility to redirect staff during the year, but should notify the LAO and the Legislature when it does so. We discuss the board's audit workplan process further in Chapter 2.

For fiscal years 1992–93 through 2002–03, the board's audit program requested new positions, generally using the $5 to $1 return ratio as justification to the Legislature. As Table 1 indicates, the board received approval for 385 additional audit program positions.

TABLE 1

The Audit Program's Additional Authorized Positions
Fiscal Years 1992–93 to 2002–03

Fiscal Year	Additional Positions
1992–93	153
1993–94	52
1994–95	88
1995–96	69
1996–97	
1997–98	
1998–99	
1999–2000	-22
2000–01	
2001–02	
2002–03	45
Total Additional Positions	**385**

Sources: Governor's Budgets, budget change documents, and Final Changebooks for fiscal years 1998–99 to 2002–03; Bureau of State Audits Report 98118.2 for prior years.

THE TAX COLLECTION PROGRAM PURSUES OUTSTANDING ASSESSMENTS GENERATED THROUGH OTHER BOARD ACTIVITIES

The Accounts Receivable Management Division administers the board's tax collection program, which collects delinquent taxes established through the board's self-assessment, audit, settlement, and filing enforcement activities. Filing enforcement staff identify and issue tax assessments to individuals and business entities that have not filed a required return; settlement activities are a streamlined, alternative method of resolving tax disputes. Because collections result from accounts receivable generated by these other activities, the success of the collection program depends partly on the quality of the information these other activities provide. According to preliminary information the board compiled, in fiscal year 2001–02 collection program activities produced an additional $1.7 billion in receipts, about 4 percent of the board's total tax revenues for the year.

Collections on delinquent taxes become the collection program's responsibility roughly 120 days after they are assessed. After assessing a delinquent amount, the audit program sends the taxpayer a notice requesting payment. If the taxpayer does not remit the payment within the 120 days, the collection program then attempts to collect the outstanding amount through its automated billing and collection process. If the automated system also fails to collect, the account is generally referred to collectors who then pursue the outstanding amount, thereby attempting to ensure that nonvoluntary taxpayers also contribute the appropriate amount to the State. Collecting delinquent tax amounts can take several years, if they are collected at all.

Like the audit program, the collection program has a process for prioritizing collection workloads. Based on historical experience, the collection program estimates the probable return on account types and attempts to target its resources toward those promising the highest return and greatest likelihood of collection. It sometimes helps to justify its requests for additional staff by estimating a return of at least $5 in collectible revenue for every $1 of cost. As Table 2 indicates, the board has received 337 new collection program positions since fiscal year 1998–99.

TABLE 2

The Board's Newly Authorized Collection Program Positions Fiscal Years 1998–99 to 2002–03

Fiscal Year	Additional Positions
1998–99	42
1999–2000	7
2000–01	3
2001–02	123
2002–03	162*
Total Additional Positions	**337**

Sources: Governor's Budgets, budget change documents, and Final Changebooks for indicated fiscal years.

* Only 77 of these positions are permanent additions.

WE PREVIOUSLY REVIEWED THE BOARD'S AUDIT PROGRAM

In 1998, the Joint Legislative Audit Committee (committee) asked us to review the benefits and costs of the board's audit program. In response, we issued a report in March 1999 titled *Franchise Tax Board: Its Revenue From Audits Has Increased, but the Increase Did Not Result From Additional Time Spent Performing Audits*. In general, we concluded that overall assessments from audits had increased, but the increase did not result from the 362 additional audit positions the board received from fiscal years 1992–93 through 1995–96. In fact, we found that assessments had actually decreased from prior years in those areas where we would have expected the board to assign new staff. We concluded that one significant reason for this decrease was that the board had not assigned all the new staff to the audit program.

SCOPE AND METHODOLOGY

The committee requested that the Bureau of State Audits (bureau) review the board's audit and collection programs, identifying additional audit and collection program positions given to the board between fiscal years 1998–99 and 2001–02, assessing the board's calculation of the costs and benefits of these positions, and determining whether the board uses these positions as the Legislature intended. The committee also asked us to determine whether new audit positions given to the board between fiscal years 1992–93 and 1997–98 are used as audit personnel and to assess the board's calculation of the costs and benefits of those positions as well. Also, the committee asked us to determine whether the board has documentary evidence of the costs and benefits of its audit and collection programs and to review its methodology for calculating these costs and benefits. Finally, the committee asked us to determine whether a point of diminishing returns exists where additional audit and collection program positions do not generate a $1 to $5 cost-benefit ratio (CBR) and, if so, to determine the board's actions to shift those positions to other activities[1].

To understand the board's responsibilities related to its personal income tax and corporation tax audit and collection programs, we reviewed the relevant laws and policies and interviewed key staff. To identify additional audit and collection program positions the board received between fiscal years 1998–99 and 2001–02, we interviewed key staff and examined various budget documents finding that the board did not receive any new audit positions during this period. In assessing the board's calculation of the costs and benefits of the new collection positions, we analyzed staffing requests and other supporting documentation. We also tried to assess the incremental return on new collection program positions but were unable to do so because certain data were unavailable. To determine whether the board uses these collection program positions as the Legislature intended, we primarily compared actual hours to budgeted workload hours that included hours for the new staff and interviewed key staff about the results of our comparison.

To determine the assignment of new audit staff given to the board between fiscal years 1992–93 and 1997–98, we interviewed key staff and analyzed audit branch hours. To assess the board's calculation of the costs and benefits of audit positions for fiscal years 1992–93 through 2001–02, we analyzed changes in related assessments before and after it received funding for these additional auditors. We did not attempt to quantify how changes in the economy affected tax revenues or assessments.

The board discloses the costs and benefits of its audit and collection programs in annual operations reports, which are the source for much of the data in our various analyses. We did

[1] Our review deals with personal income and corporation taxes. The board also collects certain insurance taxes, but the amounts are very small in comparison to the board's overall revenues.

not audit the board's operations reports and did not validate the assessment amounts by examining individual tax returns or actual assessments. However, to gain some assurance that information in the operations reports is accurate and complete, we reviewed for reasonableness the board's methodology in preparing them, and we traced selected costs and revenues to accounting records and traced assessments to supporting schedules. We also compared assessment and cost data provided as estimates in our previous audit to amounts subsequently published in the operations reports and asked the board to explain significant differences. Only fiscal years 1995–96 through 1997–98 were revised from estimates included in our 1999 report. Therefore, for these three years certain amounts contained in our prior report have been updated in this report. When information we currently report is not final, we have identified it as draft information.

To determine whether a point of diminishing returns exists where additional staff do not generate a $1 to $5 CBR and, if so, to examine the board's actions to shift those staff to other activities, we interviewed key staff, reviewed work plans, and examined the nature of the CBR. This included a review of the costs and benefits incorporated in the audit and collection programs' workplans.

Finally, we reviewed budget documents supporting the board's request for additional audit program positions for fiscal year 2002–03, and we interviewed board and Finance staff to determine whether the board implemented a recommendation from our previous audit that it provide more specific information on the results of prior staff increases and on its planned use of new audit positions when requesting additional positions. ■

CHAPTER 1

The Board's Various Performance Measures May Create Confusion About the Return on Audit and Collection Activities

CHAPTER SUMMARY

The Franchise Tax Board (board) uses a variety of measurements to gauge audit and collection program performance and to assign workloads to staff. Most of these measurements take into account some of the costs and related benefits for program activities, but the various measurements may include differing calculations of costs, which the board does not always fully describe in public documents. As a result, misunderstandings of the board's performance may arise. Ideally, a performance measure should compare all the benefits of a program with all the costs of producing them. However, when the board's budget documents project a return of at least $5 in benefits, whether assessments or revenues, for each $1 of cost for new positions, the projected return does not reflect allocated costs for departmental overhead, such as rent and utilities, and the understated costs are not disclosed. Further, the audit and collection programs have some overlap in the benefits they claim. After 120 days, tax assessments the audit program claims as benefits become the collection program's accounts receivable, which, if collected, are also counted as benefits of the collection program. If the board continues to use incomplete performance measurements, decision makers should be aware of the specific benefit and cost elements that are included in the board's various audit and collection program performance measures and consider the overlap in claimed benefits.

Although the board's current resource request format for new audit positions provides decision makers with more detail regarding audit workloads than the board typically provided prior to our 1999 report, its current format is still insufficient to demonstrate both the workload types to which the board intends to assign new staff and the historical return on those workloads. In addition, historical actual returns on the specific workloads are not measured against the projections used to justify the staff increases. Without this information, decision makers are left without an accurate tool against which to measure whether the board's staffing increases return their projected assessments.

THE BEST MEASUREMENT OF PERFORMANCE COMPARES ALL BENEFITS WITH THE COSTS REQUIRED TO PRODUCE THEM

Because of how the board compiles information, its performance measurements of its audit and collection programs do not provide a full picture of either program. As explained later, the board separately measures the performance of the audit and collection programs, with some overlap of claimed benefits. Further, not all the board's various performance measurements include the full costs of those programs.

Not all of the board's various performance measurements of its audit and collection programs include the full costs of those programs.

In contrast, complete measurement of a program's performance would compare all the quantifiable benefits the program produces to all the costs required to produce those benefits. As discussed in the Introduction, the audit program produces some benefits that are difficult to quantify. For example, some audits are designed to identify new audit issues and others to provide an audit presence in the taxpaying community as a means of encouraging compliance with the laws and increasing overall self-assessed revenues. Nevertheless, a complete measurement of the performance of the board's audit program, for example, would compare the benefits—the total revenues that result over time from the auditors' assessments of additional taxes—with the total costs to produce them. Total costs would then include not only auditors' salaries and benefits, but also salaries and benefits of audit program and other staff who support the auditors' activities, as well as a proportionate share of departmental overhead costs. The costs of actually collecting assessments would then become a part of the performance measure of the audit program. The Legislative Analyst's Office (LAO), which provides the Legislature with analyses of budget issues, made a similar point in a fiscal year 1997–98 report when it stated that the full cost of collecting audit assessments should be considered as part of the overall and true cost of generating returns through audits. Similarly, other board programs, such as the self-assessment and filing enforcement activities, that require the services of the collection program to realize their full program benefits would also incorporate the costs of collection in the measures of their performance. Because the collection program serves to realize the full benefits of these other programs, it would not have a separate performance measure. Table 3 below provides a simple illustration of the complete performance measurement of the board's various programs.

TABLE 3

Composition of Complete Performance Measurements for the Board's Various Assessment Activities

Assessment Origin	Total Assessment Costs (Including Departmental Overhead)	Total Collection Costs (Including Departmental Overhead)	Total Revenues (Cash Receipts)	Total Costs to Assess and Collect (Columns 1 + 2)	Cost-Benefit Ratio (Columns 3 ÷ 4)
	Column 1	Column 2	Column 3	Column 4	Column 5
Audit					
Return Processing					
Filing Enforcement					

THE BOARD USES A VARIETY OF PERFORMANCE MEASURES AND DOES NOT ALWAYS DESCRIBE THEIR DIFFERENCES IN PUBLIC DOCUMENTS

The board uses various measurements to gauge audit and collection program performance, assign workloads to staff, and report to outside interested parties, including the Legislature and Department of Finance (Finance), for budgeting and other purposes. Although they usually account for program costs and related benefits, the various measures differ in the composition of their costs and benefits. The board does not always fully describe what is behind its various calculations, increasing the potential for misunderstanding, particularly for external users who make decisions based on budget documents. Table 4 on the following page describes measures the board commonly uses, indicates the composition of each measure, and discloses how the board uses each.

TABLE 4

Various Performance Measures the Board Uses

Source (Measure)	Use	Audit Program		Collection Program		Reference to Use in This Report
		Costs	Benefits	Costs	Benefits	
Operations Reports (annual program return)	Used for internal and external historical reporting of program results.	Total actual expenditures, including departmental overhead allocation.	Net assessments (potential revenue).	Total actual expenditures, including departmental overhead allocation.	Actual revenue.	Figure 2, p.29 Table 8, p. 38 Figure 5, p.43 App. A.1, p.57 App. B.1, p. 66
Budget Change Documents (expenditures and revenues associated with additional resources)	Prospective estimates of the effect of additional requested funding for positions or other resources. Provided to external decision makers in order to justify increased funding.	Estimated expenditures, excluding some departmental overhead.	Projected net assessments and cash receipts.	Estimated expenditures, excluding some departmental overhead.	Projected revenue.	Table 9. p.45
Workplan (cost-benefit ratio)	Prospective detailed estimate of results of specific types of workloads. Audit program uses internally to determine which projects to assign. Frequently used as support for budget change documents.	Estimated expenditures for each workload type, excluding departmental overhead.	Projected net assessments for each workload type.	Estimated expenditures for each workload type, excluding departmental overhead.	Projected revenue for each workload type.	Table 8, p.38 App. C.1, p.68
ARCS (risk-yield calculation)	Prospective measure used internally to determine nature of work for collection program staff.	N/A	N/A	Risk calculation (ARCS is not designed to quantify all costs).	Estimated yield.	Figure 7, p. 50

As the table indicates, the board includes different costs and benefits in its measures of historical and prospective performance for both its audit and collection programs. The historical measures reported in the board's annual operations reports are calculated using full costs—direct program costs such as audit and collection personnel costs, allocated indirect costs from the board's central service units, and allocated departmental overhead costs, such as rent and utilities. Prospective measures used for budget change purposes, on the other hand, include some, but not all, overhead costs. Other prospective measures, used primarily for internal prioritizing of audit program workload but also for supporting the audit and collection programs' budget change documents, do not reflect departmental overhead costs in their calculation. Although internal users may be aware of these differences, external users, such as the Legislature and Finance, may not, and the board does not always explicitly include a description in public documents of the cost elements of each measure.

Audit program benefits are assessments, or potential revenue, whereas collection program benefits consist of actual revenue collected.

Given the board's use of separate performance measures for the audit and collection programs, it is also important to distinguish between the types of benefits each program provides. In general, audit program benefits are assessments for additional taxes, representing only potential revenue. In contrast, collection program benefits are actual revenues collected, or cash receipts, which are based on the audit assessments as well as receivables other programs establish. Thus, with the board's separate reporting of audit and collection program performance, it is inaccurate to think of cash receipts as the primary benefit of both audit and collection activity.

Budget documents referring to prospective cost-benefit ratios (CBR) can be especially confusing. As Table 4 shows, the board employs a CBR analysis of its audit and certain collection program workloads. The CBR's purpose is to quantitatively compare the anticipated costs of performing audit or collection activities to their corresponding estimated benefits. Independently, each program creates a workplan ranking its projects in order of estimated return. The audit program then assigns its staff to the various workload types, generally beginning with those having the highest anticipated return. As discussed more fully in Chapter 3, the collection program does not use its workplan to assign work to staff. However, both the audit and collection programs have used the workplans to identify the need for additional staff to pursue all workload types at or above a 1:5 CBR, signifying $1 of cost for every $5 of benefit returned.

However, an estimated CBR of 1:5 does not mean a given workload will generate $5 of additional tax revenue to the State, or even $5 in additional tax assessments, for every $1 invested because neither program includes departmental overhead costs in calculating its CBRs.[2] The board uses these CBRs in its budget documents to help justify additional staff, and we do not believe this use of the CBR is appropriate without adequate disclosure of the omission of departmental overhead costs, which can be significant. For fiscal year 2000–01, such costs totaled $81 million, approximately 20 percent of the board's total costs, so including each program's proportionate share of full overhead costs would significantly reduce the projected CBR of additional requested staff positions. By not explicitly disclosing the differences in these calculations, the board risks confusing decision makers, who may then make decisions based on conflicting or incomplete information.

THE AUDIT AND COLLECTION PROGRAMS HAVE SOME OVERLAP IN CLAIMED BENEFITS

Some assessments that are counted as benefits of the audit program are also considered collection program benefits when the revenue is ultimately collected.

The board's performance measures for its audit and collection programs also suffer from a partial overlap in claimed benefits, another potential source of confusion about returns on costs. The board includes all tax deficiencies assessed through its audit program as benefits in its historical and prospective measures of audit program performance. However, taxpayers do not remit many of these assessments within 120 days, after which the assessments become the collection program's responsibility. Consequently, all audit assessments that the collection program ultimately expects to collect are also counted as benefits in the collection program's prospective performance measures—and actual receipts are similarly double-counted in its historical performance measures. For example, the board asserts that its collection program collected almost $115 million in personal income tax audit assessments in fiscal year 2001–02. However, these audit assessments were already claimed as benefits of the audit program. While acknowledging this overlap exists, the board does not discuss it in budget documents. However, the board believes that the LAO and Finance are aware of the overlap. Finance has confirmed that it is aware of the overlap, but indicates it would support a refinement of these measurements to better capture the benefits. The LAO is also aware of

[2] When the board uses the CBR as a tool to prioritize work for staff, omitting departmental overhead is not a problem as we would expect such costs to be spread proportionally among all workloads. As a result, the order of priority would not change.

this overlap and considers it when interpreting the board's data. Nevertheless, we believe it is important that the board indicate in the documents available to external decision makers that the overlap exists, thus lessening the likelihood of an expectation that the audit and collection programs will each generate actual cash receipts comparable to their performance measures.

THE BOARD'S BUDGET CHANGE DOCUMENTS DO NOT SHOW HOW NEW AUDIT POSITIONS HAVE MET PROJECTED RESULTS

When requesting audit program positions, the board uses a format that does not show projected and actual hours spent by audit staff on the various audit types, nor does it detail each type's related assessments. We believe that without the data to make these detailed comparisons, the board cannot reasonably justify its requests for additional audit staff. In our 1999 report we recommended that the board use a specific template we developed to provide decision makers with information that is relevant and specific to the additional positions requested. As illustrated in Table 5 on the following page, the template we recommended separates the audit program work by audit types, contains historical assessment returns for each of these audit types, and compares the projected assessments with and without the benefit of additional positions. Thus, the template requires information specific to those audit types to which new staff would be assigned.

However, after we released our report, the board and Finance met and agreed on the use of a different template, or "matrix." To the best of Finance's recollection, the changes made to the matrix were based on the board's concern about workload category size and possible abridgement of confidentiality of data. Finance accepted the changes proposed by the board based on the understanding that Finance could request additional information, as needed. Although the matrix includes many of the features we recommended—such as prior year actual data, current year estimated data, and projected hours and assessments with and without staffing increases—it does not detail historical and projected hours and assessments by audit type as we had recommended. Rather, the board's matrix summarizes all desk, field, and Internal Revenue Service (IRS) follow-up audit activity in a single category, "Audit Direct," which obscures the very different returns on each of the personal income tax and corporation tax audit types.

TABLE 5

Template We Recommended for the Board's Use When Requesting Additional Staff

Activity	Prior Year: Actual Hours	Prior Year: Actual Assessments	Current Year: Estimated Hours	Current Year: Estimated Assessments	Without Staffing Increase: Proposed Hours	Without Staffing Increase: Projected Assessments	With Staffing Increase: Proposed Hours	With Staffing Increase: Projected Assessments
Direct Audit Activities:								
Personal Income Tax								
Desk audits								
Field audits								
IRS follow-up audits								
Corporation Tax								
Desk audits								
Field audits								
IRS follow-up audits								

Therefore, the board's matrix does not focus on the audit types new auditors would be assigned to, the projected return of those audit types, or even their historical returns. As discussed earlier, the board generally staffs the various audit types beginning with those having the highest anticipated return. Therefore, existing staff would probably fill the high-return audits, while new positions would most likely pursue lower-return audit types such as desk and personal income tax field audits. However, how the board plans to use new auditors is not apparent in the board's matrix because it only includes very high-level information on its proposed use of new staff.

The board used its matrix to support a request for 45 additional audit positions in its 2002–03 fiscal year budget change proposal, which was approved by the Legislature. However, we continue to believe more detailed information is crucial to evaluating the need for additional staff. Also, without more detail, the board and decision makers have no relevant measure of the subsequent return on the audit types where additional staff would be assigned.

In its requests for new audit staff, the board does not provide the historical returns on the workloads to which the new staff would probably be assigned.

In addition to its matrix, the board provides Finance its audit workplan as supporting information for its budget change proposals. In fact, the board provides Finance its preliminary and revised workplans every year. The workplan includes projected returns for more specific workload types than even our template does. For example, the fiscal year 2002–03 workplan lists more than 10 separate categories and their prospective CBRs related to personal income tax desk audits and 14 for corporation tax field audits. The board uses this information to assign work to staff. However, the workplan does not contain the historical returns of the specific workload types. We believe that the workplan would be more useful in evaluating the board's need for additional staff if it contained the actual returns and full costs of each specific workload type for the most recently completed fiscal year. According to Finance and the LAO, they are not dissatisfied with what the board has been providing since they can ask for information beyond the matrix and workplan. In fact, they have historically received any information they requested. However, Finance and the LAO have no objection to having the board routinely provide, as opposed to providing in response to a special request, more detailed information as long as any confidentiality concerns the board may have are addressed.

Additionally, we believe the board should compare actual to projected CBRs for specific workload types to measure the reasonableness of its prospective CBRs. The board does not currently make this comparison, but it already collects much of the necessary information about actual results—actual assessments and staff time spent on each of the detailed audit types. Also, the board records actual costs for the broader category of audit type—personal income tax field audits, for example. Thus, the only information the board needs for a comparison of projected and actual CBRs at the workplan level of detail is the appropriate distribution of costs. Since the board also tracks salary costs associated with each individual audit workload, it can use this information to allocate audit costs proportionately. Therefore, information that the board would need to assess the reasonableness of its detailed audit CBRs is readily available. Appendix C presents a template the board could use to compare actual returns to projected CBRs for individual audit types. We believe this information should be made available to Finance and the LAO, and it should be included in the board's annual report to the Legislature that summarizes the results of its audit and collection programs. The LAO agrees with our suggestion, as does Finance, subject to any confidentiality concerns the board may have with providing this data.

If the board performed this comparison annually, it would have the necessary information to identify those prospective CBRs that are not reasonably close to actual results and revise them accordingly. As a result, it would have both a more effective tool for assigning workload to staff and a more defendable and accurate projection of the benefits that would accrue from adding new audit positions. As we discuss in Chapter 3, the collection program also has difficulty in demonstrating the effectiveness of new positions.

RECOMMENDATIONS

To more completely and clearly reveal its programs' costs and benefits, the board should consider using the complete measurement of the audit program's performance that we have described in Table 3 on page 17. This measurement compares all the benefits—the total revenues that result over time from the auditors' assessments of additional taxes—with the total costs to produce them, including the costs of collection. Thus, the board would treat the collection program as another service center for audits. If it determines that its current information system cannot produce the data necessary for such a measurement, the board should consider the needs of a complete measurement when it upgrades or changes its current information system.

If the board decides not to use the complete measurement and continues to use separate performance measurements for the audit and collection programs, it should do the following:

- In budget change documents and other reports given to external decision makers, the board should explicitly disclose the elements not included in the cost components of various performance measures used to assess the audit and collection programs. The board should also disclose the effect of those excluded elements. Further, the board should disclose the overlap in benefits claimed by its audit and collection programs.

- To provide useful information to decision makers when requesting additional audit positions, the board should use a format, recommended in our prior report and shown on page 22, that details the types of activities new auditors will perform as well as the projected assessments and historical assessments resulting from these activities. Additionally, the board should revise its supporting audit workplan to include the actual returns of each of the specific workload types for the most recently completed fiscal year.

- To track the accuracy over time of its calculations of the prospective CBRs for individual audit workload types, the board should compare these prospective CBRs against actual returns annually. The board should make the results available to Finance and the LAO and should also include them in the board's annual report to the Legislature on the results of its audit and collection activities. If the board believes this information is confidential, it can cloak the identity of the individual audit workloads in its annual report to the Legislature as we have done in Appendix C. Moreover, the board should use the results of the comparison in future calculations of prospective CBRs. ■

CHAPTER 2

The Board's Performance Measures Are Insufficient to Justify Requests for New Audit Program Staff

CHAPTER SUMMARY

The Franchise Tax Board's (board) total assessments from audits of personal income and corporation tax returns have provided the State an important source of potential revenue at relatively little cost, returning around $10 in assessments for every $1 of costs. Also, total audit program assessments of $10.4 billion for fiscal years 1992–93 through 2001–02 have exceeded budgeted amounts by almost $1.1 billion.

However, this increase is not attributable to the 340 net audit positions the board received in those years. We computed the growth in audit assessments before and after these staffing increases. Our analysis isolates the impact of these new audit positions by eliminating audit assessments the board would complete even without the additional staff, such as follow-ups of Internal Revenue Service (IRS) leads and audits with possible large-dollar assessments. When we isolated the impact of these positions from the continuing efforts of the entire audit division for fiscal years 1992–93 through 2001–02, we found that assessments increased by $101 million at a cost of $127 million, returning 79 cents in assessments for every $1 spent. More recently, return on the new positions improved to $2.71 in assessments for each $1 of cost during the last four years of the above period. However, the $101 million of assessments has not been reduced for uncollectible accounts, and the $127 million of costs has not been increased to include the cost of collecting the accounts. Thus, the amount of additional cash receipts related to the additional cash investment is unknown.

We believe economic conditions have affected the return of these positions. Another significant cause for the low return is that the board did not devote additional hours to assessment-generating audits. As we reported in a prior audit, in fiscal year 1995–96, after the board added 362 staff positions over four years, total hours for the audit division increased dramatically, but the number of hours spent on audits remained relatively unchanged. The board cannot identify where it assigned all the additional staff, but in a 1997–98 report to the Legislature the board revealed that it had redirected 30 audit positions to information technology projects, which do not directly create assessments. Since fiscal year 1999–2000, budget control language now requires the board to secure prior approval from the Department of Finance (Finance) to reassign direct audit or collection program positions to other tasks.

THE BOARD HAS HAD A POSITIVE RETURN ON ITS AUDIT PROGRAM, BUT SOME TYPES OF AUDITS HAVE HIGHER RETURNS THAN OTHERS

The board's audit program measures its performance in terms of audit assessments, which represent potential revenue. It tracks assessments for each of the primary types of audits it performs and prioritizes its workload based on potential returns. Although the amount of audit assessments fluctuated between fiscal years 1992–93 and 2001–02, on average, the board returned about $10 in assessments for every $1 of cost over the period. However, there is a wide range of returns among the various types of audits.

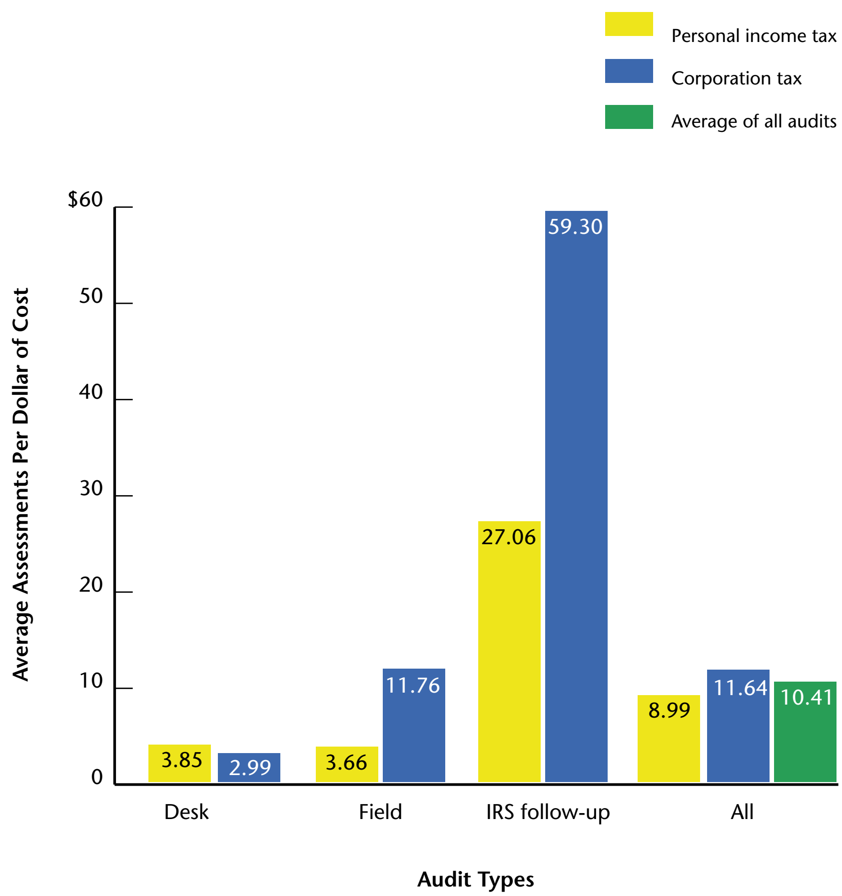
For each $1 of cost, the audits of corporation tax returns produced about $59 in assessments for IRS follow-up audits, but only $3 for desk audits.

The board conducts three primary types of audits on both personal income and corporation tax returns: field audits, desk audits, and audits that follow up on IRS leads. Desk audits are performed at the board's Sacramento central office, while field audits are conducted elsewhere—at a taxpayer's place of business, for example. Historically, the returns between audit types have differed dramatically, according to the board's calculations. For example, from fiscal years 1992–93 through 2001–02, the average return on personal income tax audits stemming from IRS leads was $27 in assessments for every $1 of cost, whereas the average return on personal income tax desk audits was only $4. The various kinds of corporation tax audits show similar differences in average returns: for each $1 of cost, IRS follow-up audits returned on average $59 in assessments, while desk audits returned only $3.

Figure 2 on the following page summarizes the board's data on the average return for each type of audit during this period, and Appendix A details the returns for individual fiscal years. As described in Chapter 1, the historical returns presented in this figure reflect all costs including departmental overhead for the audit program. In compiling these data, the board indicates it included some of the costs of auditing refund requests, but it did not include the resulting reductions in refunds. As a result, the benefits are somewhat understated.

FIGURE 2

Average Assessments Per Dollar of Cost by Primary Audit Type Fiscal Years 1992–93 Through 2001–02



Source: Franchise Tax Board's annual operations reports for fiscal years 1992–93 through 2001–02. Data for fiscal years 2000–01 and 2001–02 are draft figures.

Within each of these primary audit types, the board groups tax returns into numerous, discrete audit models with varying calculated rates of return. When selecting tax returns for audit, the board identifies audit models likely to have the highest returns and generally assigns these audits the highest priority. For example, because the returns associated with audits stemming from IRS leads have historically been very high, the board has given these audits a high staffing priority. The board has also placed a high priority on staffing those corporation tax audits that are likely to yield very large assessments. Therefore, we expect that the board generally uses its existing positions, not new positions, to ensure these high-return audits are completed.

THE BOARD BELIEVES THE AUDIT PROGRAM IS SUCCESSFUL WHEN TOTAL AUDIT ASSESSMENTS EXCEED PROJECTIONS

The board measures the performance of the audit program as a whole, blending the contributions of both existing and new staff and comparing actual to projected assessments. Using this measure of performance, the audit program as a whole has been successful. As Table 6 on the following page indicates, actual audit assessments have exceeded estimates by a total of $1.1 billion between fiscal years 1992–93 and 2001–02. According to the board, the Legislature and Finance believe that measuring the performance of the audit program as a whole is an appropriate measure of the audit program's performance, and we concur that the measure is important. However, this measure of performance fails to identify the incremental return from additional audit positions.

While Finance believes that comparing total actual assessments to projections is an appropriate measure of the audit program's overall performance, it also thinks that knowledge about marginal performance would be useful since the overall return can vary for many different reasons and can mask the marginal performance. Although it agrees that comparing total actual audit assessments to projections provides good information, the Legislative Analyst's Office also believes this may not be an adequate measure of the program's performance without additional information.

Determining the incremental contribution of new auditors is important, but the board's analysis falls short of this goal.

Although its budget change documents justify new staff based on projected increases in assessments new auditors can generate less the cost of the new auditors, the board does not separately identify the workloads, such as desk audit returns or personal income tax field audit returns, that additional staff would be assigned to, and compare the incremental return from these workloads to the incremental cost of the additional auditors.

TABLE 6

The Board's Comparison of Projected and Actual Audit Assessments Fiscal Years 1992–93 to 2001–02 (in Millions)

Fiscal Year	Projected Audit Assessments	Actual Audit Assessments*	Increase (Decrease) in Actual Over Budgeted Audit Assessments
1992–93	$ 855	$ 862	$ 7
1993–94	864	1,039	175
1994–95	806	851	45
1995–96	978	957	(21)
1996–97	1,063	1,252	189
1997–98	1,055	1,310	255
1998–99	1,034	1,207	173
1999–2000	908	1,043	135
2000–01	835	785†	(50)
2001–02	842	1,057†	215
Totals	**$9,240**	**$10,363**	**$1,123**

Source: Franchise Tax Board's summary based on its annual operations reports, production reports, and workplans for fiscal years 1992–93 through 2001–02.

* Actual assessments include reductions to claims for refund. Claims data are from the board's production reports.

† Data for fiscal years 2000–01 and 2001–02 are draft figures.

THE RETURN FROM NEW POSITIONS WAS ORIGINALLY NEGATIVE, BUT HAS INCREASED RECENTLY

Between fiscal years 1992–93 and 2001–02, the board received 340 net audit positions. Our analysis of the incremental benefit from these new positions for the entire period indicates they did not generate audit assessments that exceeded their cost, but the return has improved overall since fiscal year 1998–99.

To determine the incremental benefit of the 340 net audit positions, we isolated their budgeted costs and the actual assessments associated with the audits to which the board would have likely assigned the new staff. From fiscal years 1992–93 through 1995–96, the board received authorization for 362 additional audit positions. We reported on the incremental benefit of these positions in our prior report, discussed in the Introduction. The board did not receive any more positions during fiscal years 1996–97 through 2001–02; it lost 22 unfilled audit positions during fiscal year 1999–2000. The board received 45 audit positions in fiscal year 2002–03, but it is too early to assess the effect of those positions, so we did not include them in our analysis.

The 340 net positions the board received were intended to increase assessments through additional audits of personal income tax and corporation tax returns. However, not all of the additional positions directly generate audit assessments because only some are involved in performing audits. The additional positions also include tax technicians, legal counsel, temporary help, and support staff needed to keep up with the growth in the number of auditors. These support positions provide necessary services that enable tax auditors to work efficiently and complete more audits.

The board's policy is to first assign staff to audits with high projected returns, such as those resulting from IRS leads or corporation tax audits expected to result in large assessments, and to request new staff for lower-priority audits. Since the board's policy is to staff these high-priority audits first, without the benefit of additional positions, our analysis adjusted the total assessment figures by eliminating assessments from such high-priority audits to isolate the return applicable to the new auditors. We also included as a benefit of the audit program the amount of the program's reductions to requested refunds.

Although the new audit positions initially had a negative return for each $1 of cost, their return improved to $2.71 recently.

Table 7 compares our adjusted annual audit assessments to a base year average, which we calculated averaging adjusted audit assessments for the two years before the board received the new positions. This comparison reveals that assessments from the types of audits additional staff would likely perform have increased by $101 million since the positions were authorized beginning in fiscal year 1992–93, but that this gain was offset by costs of $127 million for the new positions, making the potential return on these positions negative, only 79 cents for every $1 of cost. It is important to note that the return on the additional positions shows improvement over the more recent fiscal years in our analysis. Between fiscal years 1998–99 and 2001–02, the new positions produced average assessments of $2.71 for every $1 of cost. However, the $101 million of assessments has not been reduced for uncollectible accounts, and the $127 million has not been increased to include the cost of collecting the accounts. Therefore, the amount of additional cash receipts related to the cash investment in the new positions is unknown. Historically, board records show that it has collected only 23 percent of personal income tax assessments

TABLE 7

Return on Audits That Additional Staff Would Likely Perform

Fiscal Year	Total Number of Positions Added	Total Personal Income Tax and Corporation Tax Audit Assessments (in Thousands)	Adjustments to Remove High Priority Audit Assessments and Add Reductions to Claims for Refunds (in Thousands)	Total Adjusted Personal Income Tax and Corporation Tax Audit Assessments (in Thousands)	Increase (Decrease) in Adjusted Audit Assessments Over Base Year Average (in Thousands)	Estimated Increase in Budgeted Expenditures (in Thousands)	Return on Investment
1990–91		$ 754,913	$ (203,817)	$ 551,096			
1991–92		990,657	(437,914)	552,743			
Base Year Average		**872,785**	**(320,866)**	**551,919**			
1992–93	153	823,582	(292,639)	530,943	$ (20,976)	$ 5,833	$ (3.60)
1993–94	52	1,006,132	(417,137)	588,995	37,076	8,001	4.63
1994–95	88	771,714	(277,160)	494,554	(57,365)	14,918	(3.85)
1995–96*	69	915,034	(630,025)	285,009	(266,910)	15,010	(17.78)
1996–97*		1,043,650	(555,407)	488,243	(63,676)	14,510	(4.39)
1997–98*		1,235,101	(358,020)	877,081	325,162	14,510	22.41
1998–99		1,103,810	(335,437)	768,373	216,454	14,510	14.92
1999–2000	(22)	967,401	(276,912)	690,489	138,570	13,300	10.42
2000–01		695,874†	(438,231)	257,643	(294,276)	13,300	(22.13)
2001–02		986,102†	(347,341)	638,761	86,842	13,300	6.53
Totals for fiscal years 1992–93 through 1997–98	362	5,795,213	(2,530,388)	3,264,825	**(46,689)**	**72,782**	**(0.64)**
Totals for fiscal years 1998–99 through 2001–02	*(22)*	*3,753,187*	*(1,397,921)*	*2,355,266*	*147,590*	*54,410*	*2.71*
Totals for fiscal years 1992–93 through 2001–02	340	$9,548,400	$(3,928,309)	$5,620,091	**$100,901**	**$127,192**	**$ .79**

Sources: Franchise Tax Board's annual operations reports for fiscal years 1992–93 through 2001–02, Bureau of State Audits Report 98118.2, budget documents, and additional data. Claims data are from the board's production reports.

* Adjusted assessments for these years differ from amounts presented in our prior audit report, 98118.2, because amounts previously provided by the board were inaccurate due to accounting system errors.

† Data for fiscal years 2000–01 and 2001–02 are draft figures.

in the first year, 50 percent by the end of three years, and 58 percent by the end of five years. The board indicates it does not have a system in place to track the collection rate of corporation tax audit assessments. However, based on a five-month study the board completed in 1998, it determined that the collection rate on these assessments was 86 percent. According to the board, it has no reason to believe that the collection rate has changed since the study was completed.

Our analysis does not account for unquantifiable benefits provided by the audit program. The overall intent of the audit program is to establish an audit presence in the taxpaying community as a means of encouraging compliance with tax laws and increasing overall self-assessed revenue. When requesting additional positions, the board provides the dual justification of projected increases to General Fund revenues, as well as increased audit presence.

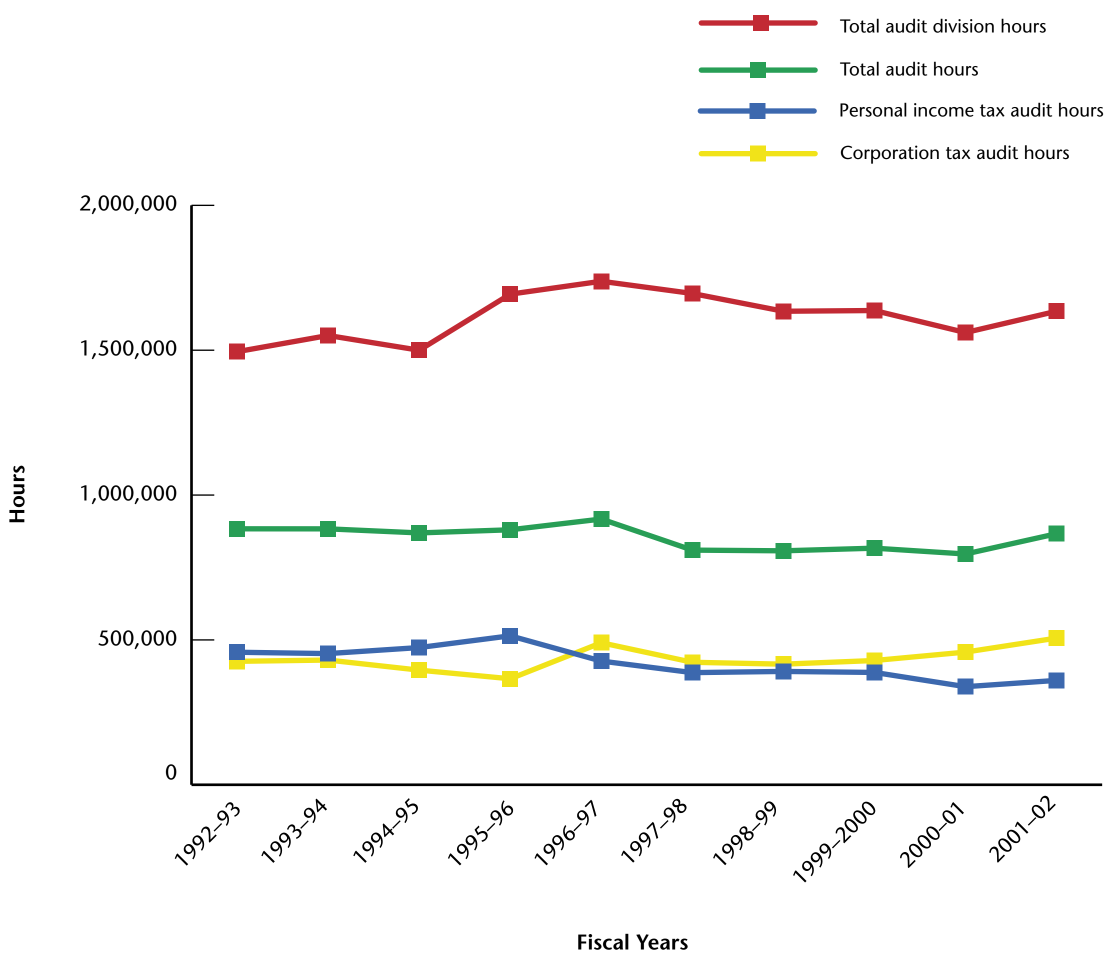
The Number of Audit Hours and Changes in the Economy Have Affected the Amount of Assessments

Several factors contributed to the low return on the new audit positions. We believe some factors not in the board's control—changes in the economy, for example—have affected the magnitude of assessments. However, as our prior audit indicated, the number of hours actually spent performing audits is a significant factor that is at least partially under the board's control. Even after allowing for delays caused by time required to hire and train the new staff, we would expect to see an increase in audit hours. From 1992–93 through 1995–96, the board received the following additional positions annually: 153, 52, 88, and 69. Yet as Figure 3 on page 35 shows, the number of personal income tax and corporation tax audit hours did not increase accordingly.

Although total hours for the entire audit division increased sufficiently to reflect a limited number of additional audit staff, the number of hours actually spent performing audits in fiscal year 2001–02 differed little from hours spent in fiscal year 1992–93. As reported in our previous audit, the board could not explain where it assigned all of the new staff, but it did give some information on the assignments in a fiscal year 1997–98 report to the Legislature. The report disclosed that the board had redirected 30 audit positions to information technology projects. While serving an important support function for audits, these positions do not directly generate assessments.

FIGURE 3

Hours Spent on Personal Income Tax and Corporation Tax Audits
Fiscal Years 1992–93 Through 2001–02

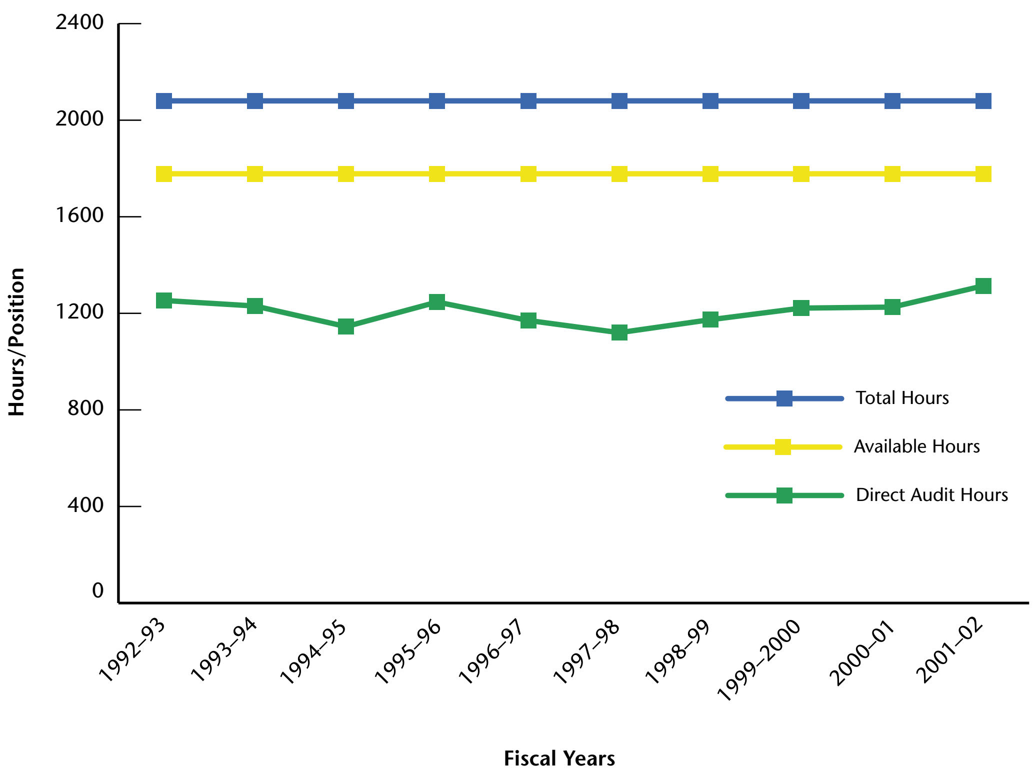


Sources: The board's summary of Audit Division hours for fiscal years 1998–99 through 2001–02; Bureau of State Audits Report 98118.2 for prior fiscal years.

Enacted in fiscal year 1999–2000 and each subsequent year, budget control language referred to as "Provision 1" requires the board to secure prior approval from Finance before transferring direct auditing or collection program positions to other areas. Since the provision's establishment, the board asserts that it has not redirected any positions out of direct audit activities. However, in the course of Finance's review of the board's budget change proposals in the fall of 2000, it found that the board had redirected five positions from auditing and collection activities in violation of Provision 1. As a result, Finance required the board to return these positions to audit and collection activity. At that time, Finance also notified the Legislature of the issue and the remedies it took. As shown in Figure 4, direct audit hours for each auditor have gradually increased since fiscal year 1997–98.

FIGURE 4

Annual Productivity Per Auditor



Source: The board's summary of Audit Division hours.

Note: According to the board, the difference between available hours and direct audit hours represents time spent on tasks such as training, supervision, audit selection, and other projects.

* After allowances for various kinds of leave.

PROSPECTIVE AUDIT PROGRAM COST-BENEFIT RATIOS DO NOT REFLECT HISTORICAL PERFORMANCE

Another potential cause for the lower than expected return from additional auditors is the different ways costs are figured in the prospective CBRs used to help justify new positions and in the historical data that report actual performance. As discussed in Chapter 1, the board's historical performance measure of returns includes the full effect of indirect costs, including departmental overhead, but

Including departmental overhead cost reduces the calculated benefit to less than $5 for each $1 of cost for certain audit types.

the prospective CBRs do not. Thus, when the full departmental overhead costs are taken into account, certain prospective CBRs drop below the anticipated return of $5 in assessments generated for every $1 of cost.

Table 8 on the following page illustrates the difference between the historical returns of general audit types reported in operations reports and their projected returns given in the board's workplans, and shows the effect of reducing the projected CBRs by the amount of departmental overhead costs. For fiscal years 1998–99 through 2001–02, the board returned $9.50 in audit assessments for every $1 of audit costs. However, over the same period, the board projected a return of almost $12 for every $1 invested, which is more than 20 percent higher. When we deflated the board's projections by actual departmental overhead costs for the four-year span, we found that had the board included full departmental overhead costs, the total actual return in assessments would closely resemble the projections. For the period, the board projected a return of $11.84 in assessments per $1 of cost; departmental overhead costs reduce this figure to $9.48, which is close to the actual return of $9.50 in assessments for each $1 of cost.

When individual audit types are examined, however, the variance is much greater, and the workplan projections fail to mirror historical return. The types of audits to which we would expect new staff to be assigned—desk audits and personal income tax field audits—do not meet the $5 or greater projected returns. For example, the average assessment per $1 invested in personal income tax desk audits over the period was $3.87, whereas the board estimated that they would return $6.36. Even after deflating the workplan projections by departmental overhead costs, actual assessments per dollar of cost were still $1.75 less than originally projected.

The board believes that these differences generally arise from adjustments the audit program makes to historical data ultimately reported in operations reports. According to the board, the adjustments are made to correct misallocated charges and miscoded revenue and to better match costs to benefits. The audit program then uses the modified data as the basis for the projections that are reflected in its workplans and in Table 8 on the following page. We find it difficult to understand the board's explanation: Why would the board publish information in its operations reports that it believes is inaccurate? Further, if the audit program corrects errors in the financial reporting system when it recalculates the basis for projections, we would expect that the board would use the corrected data in the operations reports, which it publishes after it prepares the workplans. Finally, we do not understand why the board tolerates errors in such a vital function as its financial reporting system, which is the basis for the published cost data.

TABLE 8

Comparison of Projected and Actual Returns on Audit Types Fiscal Years 1998–99 Through 2001–02

	Four-Year Average				
Description	Workplan Projected Return	Less Application of Departmental Overhead*	Adjusted Workplan Projected Return	Remaining Difference Not Explained by Departmental Overhead	Operations Report Actual Return*
Personal Income Tax					
Audit activities:					
Desk audits	$ 6.36	$0.74	$ 5.62	$ 1.75	$ 3.87
IRS follow-up audits	33.96	3.45	30.51	3.85	26.66
Field audits	5.10	0.76	4.34	0.11	4.23
Personal income tax total	**10.14**	**1.28**	**8.86**	**0.68**	**8.18**
Corporation Tax					
Audit activities:					
Desk audits	6.51	2.09	4.42	3.14	1.28
IRS follow-up audits	31.22	2.55	28.67	(40.18)	68.85
Field audits	13.01	3.32	9.69	(1.07)	10.76
Corporation tax total	**13.34**	**3.39**	**9.95**	**(0.42)**	**10.37**
Total desk audits	6.39	1.06	5.33	2.50	2.83
Total IRS follow-up audits	33.19	3.19	30.00	(4.56)	34.56
Total field audits	10.75	2.44	8.31	(0.99)	9.30
Total all audits	**$11.84**	**$2.36**	**$ 9.48**	**$ (0.02)**	**$ 9.50**

Sources: The board's annual audit workplans and operations reports for fiscal years 1998–99 through 2001–02.

* Data for fiscal years 2000–01 and 2001–02 are draft figures.

In contrast to the projections for desk audits and personal income tax field audits, the board's average four-year projected return of about $29 for IRS follow-up audits of corporation taxes was less than half the historical return of almost $69 for the same period. As Appendix A indicates, the four-year historical returns, from fiscal years 1998–99 through 2001–02, for this type of audit were approximately $69, $63, $64, and $78, and since fiscal year 1992–93 have ranged between about

$25 and $214. When we asked why it consistently established targeted returns well below the recent historical rate, the board explained that it is dependent on audits forwarded from the IRS, leaving the audit selection criteria beyond the board's control and resulting in wide fluctuations in assessments from this workload. The board notes that recently the IRS has chosen to do fewer audits with higher CBRs, but in the year prior to the period depicted in Table 8 the corporation tax IRS follow-up audits returned about $25. Given the unpredictability of IRS policies and performance, the board has chosen to be conservative in its revenue projections for this workload.

Low projections of the return on IRS follow-up audits make it more likely that the board will meet total assessment goals.

Regardless of the rationale, the effect of the low projection is to make it more likely that the board will meet or approach its overall projected assessments. Because the board measures the success of the audit program as a whole—by determining whether actual assessments exceed estimated assessments for the program as a whole—the low projection for corporation tax IRS follow-ups enables the board to exceed its projections in total, even though those audit types to which we would expect the board to assign new staff return below $5 in assessments.

In Chapter 1, we reiterated a recommendation from our prior audit about the format the board should use when requesting additional audit staff. Our suggestion was that the format should detail the types of activities new auditors will perform, as well as the projected assessments and historical assessments resulting from these activities. The analysis above of four-year projected and actual returns further underscores the value of this recommendation.

RECOMMENDATIONS

If the board believes that information it publishes in its operations reports is not accurate, even though it is based on the board's financial accounting system, the board should do the following:

- Ensure that its financial accounting system reports accurate information, and
- Correct data it believes to be inaccurate before it publishes the information in its operations reports. ■

CHAPTER 3

The Board's Performance Measures Are Insufficient to Justify Requests for New Collection Program Staff

CHAPTER SUMMARY

Despite the positive overall return of its tax collection program (collection program), the Franchise Tax Board (board) is unable to demonstrate that additional collection program positions have returned their projected revenue. Between fiscal years 1998–99 and 2001–02, the board received an additional 175 collection program positions, promising a total of $179 million in increased revenue over that period. However, the board's analysis of the return on its new positions does not demonstrate that increases in collection program revenue resulted from the additional staff because it does not isolate the workloads of the positions and compare the projected returns over a base year against actual results. Similarly, we were unable to measure the incremental benefit of the new positions because of the board's limited data on workload categories and a change in the board's accounting for revenues.

Also, although the board justified its fiscal year 2001–02 staff increase using a workplan process that prioritizes accounts based on a cost-benefit ratio (CBR), the board actually assigns work to staff according to risk and yield factors calculated by its new Accounts Receivable Collection System (ARCS). The director of the board's special programs bureau, who has broad knowledge of the collection program, indicates that the board has continued to use its workplan process for justifying staff increases because, until recently, ARCS had not amassed sufficient historical data to allow the board to use it to justify new staff. However, until the board can use the same data to both prioritize workload to assign staff and to justify new collection program positions, it cannot have reliable data to determine the effectiveness of new staff.

Finally, the board is not fully using its collection program salary funding to fill authorized positions. In fiscal year 1999–2000, separate merit salary adjustment (MSA) funding for the board was ended, leaving the board to find another way to pay for its MSAs. In fiscal years 2000–01 and 2001–02 the actual collection program hours worked decreased by 5 percent and the board applied the additional savings toward, among other expenses, MSAs. To achieve this additional savings, the board has allowed some collection program positions to remain unfilled, even some that the board's budget control language requires it to fill expeditiously.

THE FRANCHISE TAX BOARD HAS HAD A POSITIVE RETURN ON ITS COLLECTION PROGRAM

Providing about 4 percent of the board's total tax revenue, the collection program returned around $19 in actual revenue for every $1 of cost between fiscal years 1998–99 and 2001–02. The board's overall historical assessment of its collection program appears to include all appropriate costs and benefits, with the exception of certain revenues that the board claims were incorrectly counted as collection program revenue for years prior to fiscal year 2000–01.

As indicated in Chapter 1, the board measures the historical overall collection program return by comparing all collection program revenues to all related costs. Costs include all direct collection program costs, including staff salaries and benefits, and indirect support costs incurred in other areas—for example, the technology, legal, or various administrative branches. Finally, the board includes an overhead allocation for departmental costs such as rent and utilities. In its annual operations reports, the board compares the resulting cost figure to collection program revenue to determine the return on each dollar of cost.

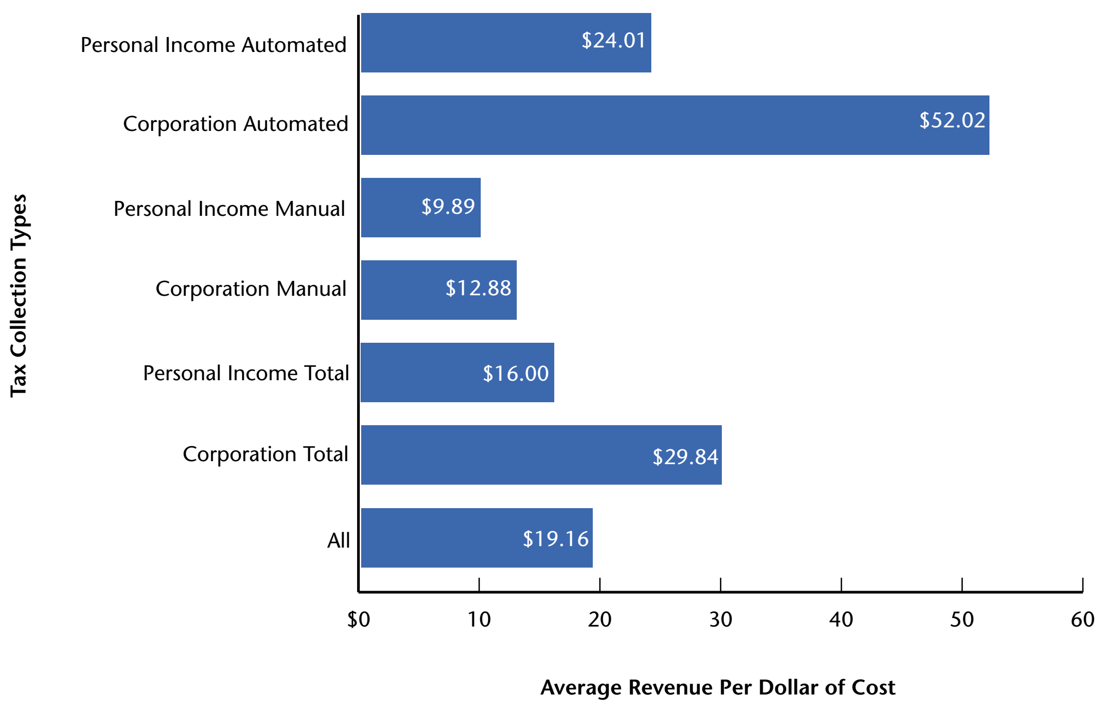
Manual collection activities involve more intensive staff intervention, such as locating the taxpayer, identifying valuable assets, and seeking to arrange payment.

At a very high level, as depicted in Appendix B, the board tracks the revenue it receives from different collection program workload types. The board records collection program revenue as either personal income tax or corporation tax and further subdivides these revenue categories by automated and manual collection activities. It classifies collection program revenue as automated when it results from computer-generated activities such as sending bills and notices, levying bank accounts, and garnishing wages, in addition to any staff interaction such as responding to phone calls or other correspondence that results from automated notices. Manual collection activities involve more intensive staff intervention, such as locating the taxpayer, identifying valuable assets, and seeking to arrange payment. According to the director of the board's special programs bureau, about 15 percent of the roughly 1 million collection program accounts processed annually require manual involvement.

Historically, returns between types of collection program activity have differed significantly. For example, between fiscal years 1998–99 and 2001–02, the average return on automated collection program activities for corporation taxes was about $52 of revenue for every $1 of cost, whereas the average return on the manual collection program activities for personal income taxes was approximately $10 for every $1 of cost. Figure 5 summarizes average returns for high-level groupings of collection program workloads during this period.

FIGURE 5

Average Return Per Dollar of Cost by Collection Program Revenue Type
Fiscal Years 1998–99 Through 2001–02



Source: Franchise Tax Board's annual operations reports for fiscal years 1998–99 through 2001–02. Data for fiscal years 2000–01 and 2001–02 are draft figures.

We were unable to calculate returns per dollar of cost for collection program workloads by their origins within the board, such as those originating from audit assessments, because the board does not track all the necessary information at this level of detail. Also, we did not adjust the data in Figure 5 or Figure 6 on page 48, for what the board states is a change in accounting treatment in fiscal year 2000–01 that is partly responsible for a drop of approximately $247 million in personal income tax revenues credited to the collection program. As discussed more fully later, the board states that collection program revenues in prior years were overstated.

MEASURING THE INCREMENTAL BENEFIT OF ADDITIONAL COLLECTION PROGRAM STAFF PROVES ELUSIVE

Because of various limitations to the board's data, we cannot determine the incremental revenue generated by new collection program staff.

Between fiscal years 1998–99 and 2001–02, the board received authorization for an additional 175 collection program positions, promising to increase collection program revenue by $179 million during the period. However, in part because the board cannot quantify the effect of a change in accounting treatment for personal income tax collection program revenues in fiscal year 2000–01, we cannot verify whether this promise was fulfilled. Moreover, in its own evaluation of the return on these additional positions, the board does not isolate revenue pools potentially affected by the new positions to compare their projected and actual return. Rather, to demonstrate the impact of additional collection program positions, the board compares total actual collection program revenue to total projected revenue for each fiscal year. Similar to our concerns with the board's measurement of audit program performance, we find this type of an analysis inconclusive because it does not measure the incremental benefit of new positions and does not establish a base year for comparison. Finally, we were unable to perform our own analysis of the incremental benefit of the new collection program positions both because of the change in accounting treatment mentioned above and because the board lacks sufficient detailed revenue and cost data for workload categories.

The Board Received Authorization for 175 Collection Program Positions for Varying Purposes in Recent Years

Job functions vary for the 175 new collection program positions authorized for the board. In fiscal year 1998–99, the board received 42 positions to continue implementing the automated ARCS system begun in fiscal year 1997–98. In fiscal years 1999–2000 and 2000–01, the board netted an additional 10 collection program positions to develop an automated system for the collection of limited liability corporation taxes. For fiscal year 2001–02, the board received

123 positions, justified by the board's analysis that account types projected to have returns at or above $5 for every $1 spent were understaffed.

Table 9 summarizes the board's total projected revenues and costs associated with these increases in staffing and other resources. For example, the board's estimated costs for the 42 positions the board received in fiscal year 1998–99 amount to $10.1 million over four years. Other related costs for fiscal years 1998–99 and 1999–2000 primarily consist of expected consulting fees through fiscal year 2001–02 for the implementation of information technology systems that are intended to assist with the collections.[3]

TABLE 9

Estimated Expenditures and Projected Revenues for 175 New Collection Program Positions and Other Resources

		1998–99 Through 2001–02		
		Estimated Expenditures		
Fiscal Year	Position Increase	Positions	Other Costs	Total Projected Revenues
1998–99*	42	$10,147,000	$18,477,389	$109,500,000
1999–2000†	7	1,063,427	171,818	
2000–01	3	260,400		16,000,000
2001–02	123	7,658,000		53,800,000
Totals	**175**	**$19,128,827**	**$18,649,207**	**$179,300,000**

Source: Franchise Tax Board's budget change documents for fiscal years 1997–98 through 2001–02.

* Estimated expenditures include significant ARCS implementation costs in fiscal years 1998–99 and 1999–2000; however, the expenditures do not include costs associated with the fiscal year 1997–98 budget change proposal for ARCS. Projected revenues are not solely the result of the 42 positions, but are the aggregate amount attributable to ARCS, for which the board had already received 39 positions in fiscal year 1997–98.

† In fiscal year 1999–2000, the board received 22 positions and $1,792,000 to develop an automated return validation, billing, and accounting system for the limited liability corporation tax program. Seven of these were collection program positions. The table proportionately reflects the estimated expenditures for the seven positions, but shows all the projected revenue, which the board considers attributable solely to collection program efforts.

[3] Table 9 does not reflect additional collection program positions received in fiscal year 2002–03 because actual data on the potential effect of these positions are not yet available. In fiscal year 2002–03, the board gained a net 77 additional permanent positions and 51 three-year, limited-term positions to pursue collection program workloads that the board determined have a 1:5 or higher CBR. The board also received 34 one-year, limited-term positions to accelerate the payment of delinquent accounts.

Limitations in the Board's Data Prevent an Analysis of the Return on Its Investment in Additional Staff

The board's analysis of its return on the additional collection program positions received between fiscal years 1998–99 and 2001–02, depicted in Table 10, does not demonstrate that any increases in collection program revenue were the result of the additional resources. For example, it does not show that the new positions in fiscal year 2001–02 actually generated the $53.8 million in projected revenues. The board evaluates the return on its new collection program positions simply by comparing total projected revenue to total actual revenue. For example, for the fiscal year 2001–02 positions, because the variance between total projected revenue and total actual revenue ($83.5 million) exceeds the board's projected increase in revenue resulting from new positions ($53.8 million), the board considers its new positions as having returned their promised benefit. We believe

TABLE 10

The Board's Analysis of the Return on Its New Collection Program Positions Fiscal Years 1998–99 Through 2001–02

		Projected Revenue	Actual Revenue	Variance	Number of Positions Added*
1998–99	Base (without new positions)	$1,687,134,677			
	Augmentation (from new positions)	16,000,000			
	Total (with new positions)	1,703,134,677	$1,893,057,216	$189,922,539	41.5
1999–2000	Base (without new positions)	1,793,745,209			
	Augmentation (from new positions)	8,000,000†			
	Total (with new positions)	1,801,745,209	1,805,963,513	4,218,304	7.0
2000–01‡	Base (without new positions)	1,602,016,316			
	Augmentation (from new positions)	8,000,000			
	Total (with new positions)	1,610,016,316	1,608,578,192	(1,438,124)	5.0
2001–02‡	Base (without new positions)	1,574,100,000			
	Augmentation (from new positions)	53,800,000			
	Total (with new positions)	$1,627,900,000	$1,711,399,022	$ 83,499,022	119.0

Source: Franchise Tax Board's analysis based on workplans and operations reports. Actual revenue for fiscal years 2000–01 and 2001–02 are draft figures.

* Number of positions differs slightly from those in our analysis because the board does not round or net positions, as we do in Table 9, and does not include four positions for fiscal year 2001–02 that were part of the same budgetary action providing the 119 positions.

† Based on our analysis of budget documents, we disagree with this $8 million increase to the board's revenue base.

‡ Revenue for these years is affected by the change in accounting for certain revenues discussed on pages 47 and 48.

a more appropriate analysis focuses on revenue pools potentially affected by the new staff. For example, if the board believes that new positions will result in additional revenue from certain manual workloads, a more effective way to demonstrate the return on the positions would be to isolate the workloads within this classification where it expects additional revenue and compare its projected increases over a base year against actual results.

Because the board does not track collection program revenues or related costs beyond high-level categories, we could not isolate to a sufficient level of detail potentially affected revenue pools. Appendix B displays the level of revenue and cost detail the board can provide. Our effort to isolate the effect attributable to the new collection program staff was further complicated by the board's change in the accounting treatment of certain personal income tax revenues, described below, and its inability to document the impact of the change. As a result, we were unable to conduct an independent analysis of the incremental return from each staffing and other resource increase for the collection program for fiscal years 1998–99 through 2001–02.

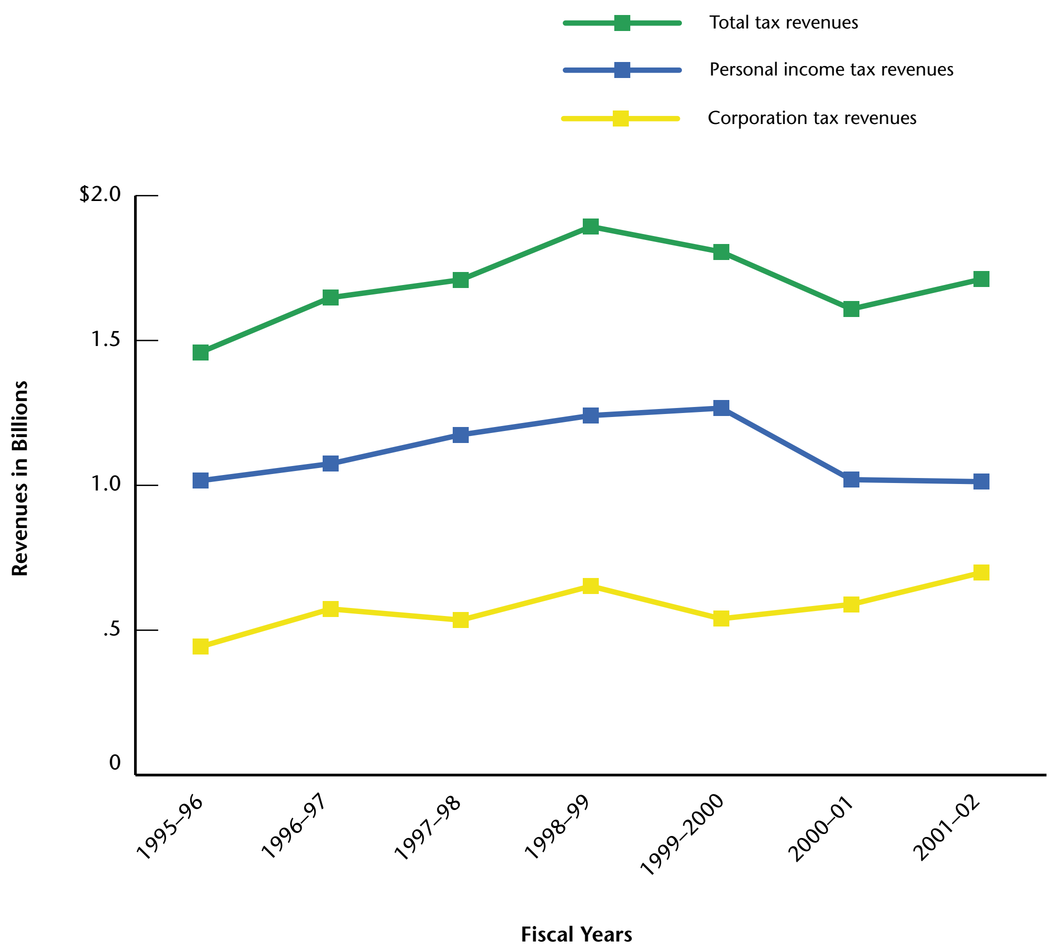
A change in the board's treatment of certain revenues complicates an analysis of the returns on new collection program positions.

Despite the increase in collection program staff and projected revenue, in fiscal year 2001–02 the board collected only $2 million more in collection program revenue than it did in fiscal year 1997–98. Again, we believe it is probable that economic factors influenced collections. Also, according to the board, this comparison does not reflect the true return of these positions because of a change in the board's method of accounting for certain collection program revenues that occurred in fiscal year 2000–01. The board explains that, in fiscal year 2000–01, it changed its accounting for certain personal income tax revenues. Under the board's prior revenue reporting system, if a taxpayer had a collection program account with an outstanding balance, any money received from that taxpayer would be credited as collection program revenue, even if the taxpayer simply remitted payment of a current-year liability. For example, prior to fiscal year 2000–01, if a taxpayer owed back taxes from a prior-year audit and remitted a payment for current-year taxes, this payment would be counted as collection program revenue rather than current-year self-assessed revenue. Using the new system, the board would appropriately identify the payment as current-year self-assessed revenue, which would not be credited to the collection program.

Although the board informed us that the subsequent reduction in reported collection program revenue from fiscal year 1999–2000 was $247 million, it was unable to tell us how much of the reduction was caused by the change in accounting. Figure 6 illustrates that a decline in personal income tax collection program revenue did occur in fiscal year 2000–01. According to the board, after the passage of time and the physical moves of personnel and files, the board cannot locate the documentation prepared during the 1998–2000 time period describing the exact components of the change.

FIGURE 6

Collection Program Revenues for Personal Income and Corporation Taxes
Fiscal Years 1995–96 Through 2001–02



Source: Franchise Tax Board's operations reports for indicated fiscal years. Data for fiscal years 2000–01 and 2001–02 are draft figures.

THE BOARD'S JUSTIFICATION FOR NEW COLLECTION PROGRAM POSITIONS DOES NOT REFLECT ITS CURRENT PROCESS FOR ASSIGNING WORK

Unlike the audit program, which both justifies new positions and assigns work based on a workplan process that prioritizes work according to a CBR, the collection program currently uses a similar workplan process only to justify its increases in collection program positions. In actually assigning work, the board relies on the recently implemented ARCS to rank accounts according to various risk and yield factors that predict the likelihood of collection as well as the ultimate amount the system expects to collect. According to the director of the board's special programs bureau, now that the collection program has nearly two years of collecting experience using ARCS, analysis is under way to use data from that system to justify future staffing needs. This goal is appropriate, but the board should also ensure that its revised process considers all the costs of collection in addition to the risk and yield components when justifying future increases in positions.

The board uses a manually prepared workplan to identify and justify collection program staffing needs, but relies on factors calculated by its automated system to actually assign work to staff.

Each year, for budgeting purposes, the board prepares a collection program resource workplan for the upcoming fiscal year. The board budgets its staff resources in terms of hours. Within the workplan the board assigns available staff hours to various direct, support, and overhead collection program activities, budgeting staff hours to required workloads first and applying the remaining staff hours to discretionary workloads. The board's final allocation is to certain accounts requiring manual intervention, which the board prioritizes according to CBRs.

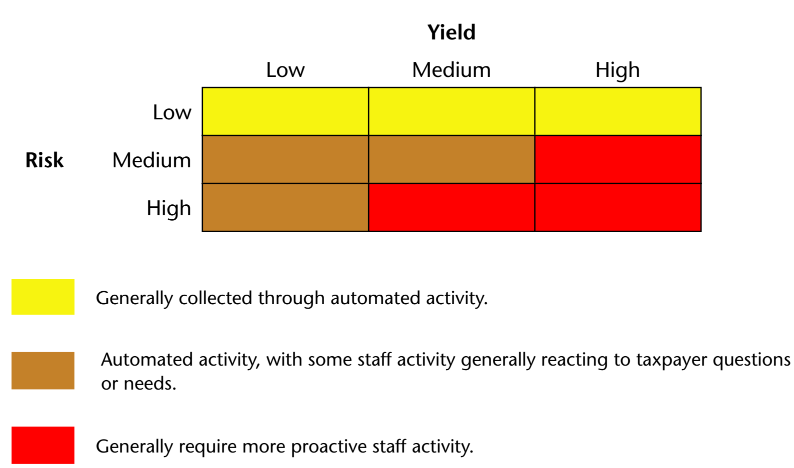
The board used the above process to justify additional collection program positions in fiscal years 2001–02 and 2002–03 based on work projected to generate at least $5 of revenue for each $1 of cost the board identified following its workplan process. While waiting for the new ARCS to amass sufficient historical data to provide more detailed and reliable revenue projections, the board continued to use the workplan process to justify additional positions, relying on actual revenue data from fiscal year 1998–99 that it adjusted each year for changes in tax law and the economy. The board completed implementation of ARCS for personal income and corporation taxes in fiscal year 2000–01.

Although it justifies additional staffing needs based on the workplan process, the board actually allocates collection program work based on automated risk-yield calculations performed by ARCS. In contrast to the workplan process that uses CBRs based on estimated costs and projected revenue, ARCS prioritizes collecting activities by likelihood of collection (risk) and the amount the system expects to collect (yield). Figure 7 provides a simple illustration of how ARCS determines collecting activities.

When an account enters ARCS for collection, the system scores its risk using a wide range of account characteristics, such as account balance, taxpayer filing history, time since the last payment, the number of payments made in recent years, the accuracy of the taxpayer's address, and other factors. Based on the risk score, ARCS classifies the account as high, moderate, or low risk. The system also computes each account's anticipated yield, which it also classifies as high, moderate, or low.

FIGURE 7

Accounts Receivable Collection System (ARCS) Determines Collection Actions Based on Risk and Yield



Using this risk and yield information, ARCS assigns accounts to the functional area best suited to the characteristics of each case. A functional area is a predefined set of actions designed to collect on accounts displaying similar characteristics. Low-risk accounts include those that will likely result in payment with minimal intervention from collection program staff. For example, a taxpayer will receive a computer-generated notice with an explanation of the debt and is expected to pay promptly. High-risk accounts require more vigorous collection activity such as staff intervention to locate the taxpayers or their assets. According to the manager of the board's program administration and analysis section, as additional information about an existing account enters ARCS, the system continuously rescores the risk and yield factors.

The board plans to refine its process for justifying new collection program staff to reflect current workflow strategies.

The director of the board's special programs bureau has indicated that, until recently, the newly implemented ARCS had not accumulated sufficient historical performance data to allow the board to refine its process for justifying additional collection program staffing requests and that, in the interim, the board has used its workplan process for budgeting purposes. According to the same director, now that the collection program has nearly two years of collecting experience using ARCS, analysis is under way to use data from that system to justify future staffing requests that reflect current workflow strategies. In fact, the board plans to use a revised process to forecast and validate collection program performance data beginning with fiscal year 2003–04.

As the board considers alternatives for justifying additional staffing requests based on ARCS data, it should ensure that its revised process includes costs as well as the risk and yield components. The board could use its risk and yield calculations to project the revenue related to staffing requests, while estimating the related costs according to a model that includes all costs, as well as an allocation for departmental overhead. Thus, the goal is to have staffing requests for the collection program reflect how the collection program staff completes its work and also to give a complete picture of the projected revenues and estimated costs against which decision makers could measure performance.

THE BOARD LEAVES SOME APPROVED COLLECTION PROGRAM POSITIONS UNFILLED

The board is not using all of its funding for collection program salaries to actually fill authorized positions, but is instead using some funding for other costs. Periodically, the board rewards employees for meritorious performance through pay increases, or MSAs, above the initial salary funding for their positions. Before fiscal year 1999–2000, the board received budget augmentations to fund its MSAs, but beginning in fiscal year 1999–2000, the board's MSA funding ended. The difference between the total hours collection program staff worked and the total budgeted hours for the collection program increased by 5 percent shortly after the board lost its separate funding for MSAs. In the same fiscal year, however, the budget control language required the board to "expeditiously fill" direct collection program positions.

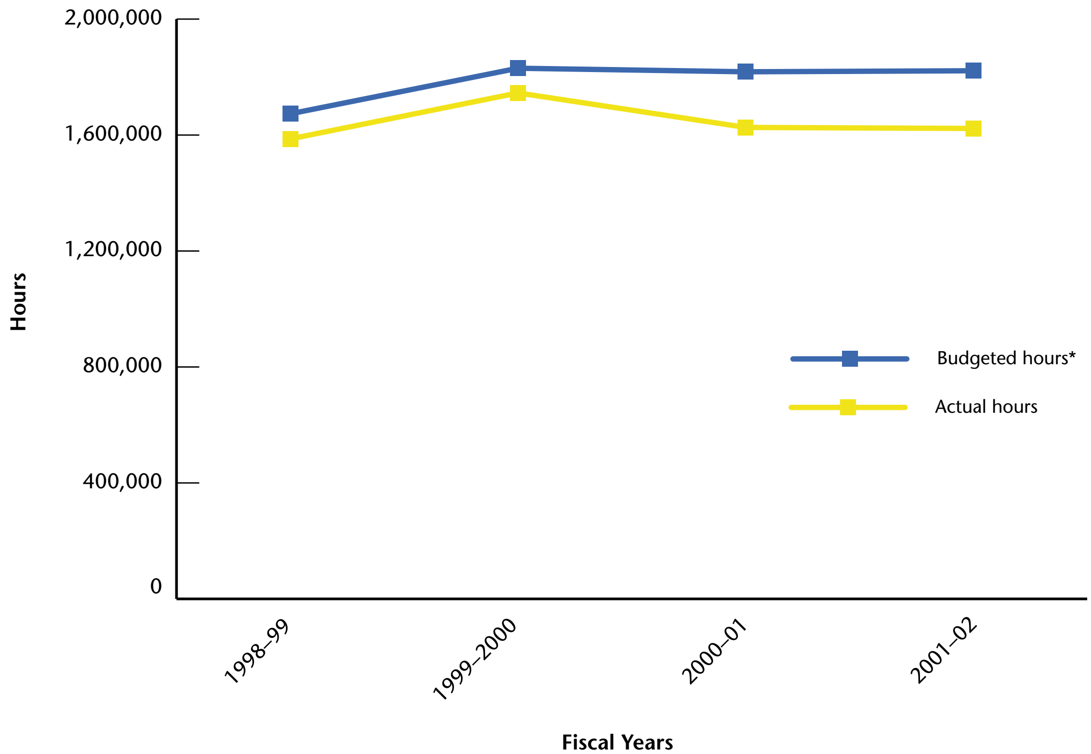
When the board requests both additional positions and the associated funding, it makes a standard state adjustment for "salary savings" that automatically reduces its funding request by 5 percent to account for funding it is unlikely to spend on the additional positions during the normal course of business because of turnover or the time it takes to fill new positions. For example, if the board requests 100 positions that cost $50,000 each, it will request funding to pay only for the equivalent of 95 positions, or $4,750,000, even though it receives authorization for the full 100 positions. Thus, budgeted hours as shown in Figure 8 already reflect this standard 5 percent reduction, and the difference between budgeted and actual hours reflects additional savings. The board indicates that expenses it finances through these savings fluctuate from year to year because of retirements, new hires, the time it takes to hire staff, MSAs, and other unfunded salary adjustments arising from upgrading and reclassifying staff.

The board believes state departments must leave positions vacant to avoid overspending salaries and wage budgets.

Since the loss of its separate MSA funding, the board requires each branch to achieve savings to pay for the branch employees' MSAs, allowing them to realize the savings from unfilled positions. The board believes state departments must leave positions vacant or they will overspend their salaries and wage budgets. However, Government Code Section 12439 requires that positions that are continuously vacant for six months be eliminated and the Department of Finance (Finance) recently began eliminating those positions in state departments. Finance believes that it is inappropriate as a long-term strategy to leave positions unfilled without addressing the underlying budget problem. However, in short-term situations, in order to not overexpend their budgets, departments may be required to hold positions open longer than normal recruitment times. In general, Finance's position is that given a stable base of positions, normal turnover means that employees who receive MSAs and are at higher salary costs in a range are eventually replaced with employees who are at the bottom step. Where this approach does not work is when a department is steadily adding employees who at the bottom step. Then, as that group of new positions "ages" in class, it has higher salary costs driven by MSAs. Finance occasionally funds MSAs when departments can demonstrate real need; however, it generally guards against funding voluntary upgrades that did not come through the budget change proposal process.

FIGURE 8

Budgeted and Actual Collection Program Workload Hours
Fiscal Years 1998–99 Through 2001–02



Source: Franchise Tax Board's summary based on workplans.

* Budgeted hours already reflect the standard state funding reduction of 5 percent.

For the board to be consistent with the intent of the budget control language and with Finance, it should not as a long-term strategy leave collection program positions unfilled beyond the normal time it takes to fill a vacant position. This should prevent an increased gap between budgeted and actual hours. Figure 8, which is based on information the board provided to us, illustrates that prior to losing its funding for MSAs, the collection program's actual hours worked were about 5 percent lower than budgeted hours, and the gap subsequently increased by an additional 5 percent. Therefore, in addition to the standard funding reduction of 5 percent, by fiscal year 2000–01 the board was applying salary and wage funding related to the 10 percent gap in hours to finance MSAs and other expenditures.

RECOMMENDATIONS

To better measure the effectiveness of its additional positions, the collection program should develop a methodology for determining the incremental return of new collection program positions received in any given year. This type of analysis should isolate changes over a base year in revenue pools that are affected by the new positions and compare the resulting revenue against all costs resulting from the new positions.

To more accurately represent how it actually allocates resources, the collection program should continue to develop a methodology based on ARCS for justifying future collection program positions. The revised process should include all relevant costs, including an allocation for departmental overhead, in addition to ARCS' risk and yield factors. The estimated expenditures and projected revenues related to each new staffing request should be easy to compare against actual results.

For the board to be consistent with the intent of budget control language and Finance, it should not as a long-term strategy leave collection program positions unfilled beyond the normal time it takes to fill a position.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE
State Auditor

Date: May 13, 2003

Staff: Lois Benson, CPA, Audit Principal
Michael Tilden, CPA
Michael K. Adjemian
Almis Udrys

APPENDIX A

Historical Returns of the Audit Program by Audit Type

This appendix provides a breakdown of the Franchise Tax Board's (board) return on its audit program for fiscal years 1992–93 through 2001–02 by audit type. The board defines its return on audit activities based on net assessments per dollar of cost. As explained in Chapter 2, the board conducts three primary types of audits for both its personal income tax and corporation tax programs: field audits, desk audits, and audits that follow up on Internal Revenue Service (IRS) leads.

As displayed in this appendix, over the last 10 years IRS follow-up audits have generated the highest returns. For example, personal income tax IRS follow-up audits have averaged $27.06 in net assessments per $1 of cost, with returns for individual fiscal years ranging from $15.97 to $44.37 in net assessments per $1 of cost. Similarly, corporation tax IRS follow-up audits averaged $59.30 in net assessments per $1 of cost, with returns ranging from $25.28 to $213.42 in net assessments per $1 of cost. The board's corporation tax field audits have also performed well, averaging $11.76 in net assessments per $1 of cost over the 10-year period. Because its best-performing types of audits receive the highest staffing priority, the board would pursue these workloads regardless of whether it received any new auditors.

Conversely, over the last 10 years, the board's lowest-performing types have been personal income tax desk and field audits and corporation tax desk audits with average returns of net assessments per $1 of cost of $3.85, $3.66, and $2.99, respectively. In fact, at times corporation tax desk audits did not generate net assessments in excess of cost. For example, in fiscal years 1995–96 and 2000–01, corporation tax desk audits only returned $0.59 and $0.81 in net assessments for every $1 of cost, respectively. Again, because the board's higher-return audit types receive staffing priority, new auditors would likely be used to pursue these lower-return audit types. Furthermore, the returns described above and presented in this appendix are averages for the various audit types, and each audit type contains numerous specific workloads. Therefore, the returns associated with the lowest performing workloads that new staff would likely be assigned to would generally be lower than the averages presented in this appendix.

Finally, it is important to note that net assessments presented in this appendix have not been reduced for uncollectible accounts, and costs have not been increased to include collection costs. Both of these adjustments would reduce the returns.

APPENDIX A.1

Historical Returns of the Audit Program by Audit Type

	Fiscal Year 1992–93			Fiscal Year 1993–94		
Description	**Net Assessments (in Thousands)**	**Costs (in Thousands)**	**Net Assessments Per Dollar of Cost**	**Net Assessments (in Thousands)**	**Costs (in Thousands)**	**Net Assessments Per Dollar of Cost**
Personal Income Tax						
Audit activities:						
Desk audits	$ 72,351	$18,016	$ 4.02	$ 72,481	$20,180	$ 3.59
IRS follow-up audits	253,183	10,691	23.68	215,103	13,465	15.97
Field audits	30,826	7,544	4.09	37,359	10,067	3.71
Personal income tax audit subtotals	**356,360**	**36,251**	**9.83**	**324,943**	**43,712**	**7.43**
Corporation Tax						
Audit activities:						
Desk audits	126,420	4,066	31.09	28,866	5,193	5.56
IRS follow-up audits	78,456	698	112.40	92,890	595	156.12
Field audits	262,346	27,260	9.62	559,433	28,136	19.88
Corporation tax audit subtotals	**467,222**	**32,024**	**14.59**	**681,189**	**33,924**	**20.08**
Total desk audits	**198,771**	**22,082**	**9.00**	**101,347**	**25,373**	**3.99**
Total IRS follow-up audits	**331,639**	**11,389**	**29.12**	**307,993**	**14,060**	**21.91**
Total field audits	**293,172**	**34,804**	**8.42**	**596,792**	**38,203**	**15.62**
Total all audits	**$823,582**	**$68,275**	**$12.06**	**$1,006,132**	**$77,636**	**$ 12.96**

continued on the next page

Description	Fiscal Year 1994–95			Fiscal Year 1995–96		
	Net Assessments (in Thousands)	Costs (in Thousands)	Net Assessments Per Dollar of Cost	Net Assessments (in Thousands)	Costs (in Thousands)	Net Assessments Per Dollar of Cost
Personal Income Tax						
Audit activities:						
Desk audits	$ 72,521	$29,197	$ 2.48	$ 75,197	$23,149	$ 3.25
IRS follow-up audits	234,243	12,591	18.60	428,869	10,482	40.91
Field audits	25,636	14,089	1.82	51,574	16,302	3.16
Personal income tax audit subtotals	**332,400**	**55,877**	**5.95**	**555,640**	**49,933**	**11.13**
Corporation Tax						
Audit activities:						
Desk audits	15,803	5,393	2.93	4,420	7,487	0.59
IRS follow-up audits	67,869	318	213.42	66,859	1,935	34.55
Field audits	355,642	29,234	12.17	288,115	29,435	9.79
Corporation tax audit subtotals	**439,314**	**34,945**	**12.57**	**359,394**	**38,857**	**9.25**
Total desk audits	**88,324**	**34,590**	**2.55**	**79,617**	**30,636**	**2.60**
Total IRS follow-up audits	**302,112**	**12,909**	**23.40**	**495,728**	**12,417**	**39.92**
Total field audits	**381,278**	**43,323**	**8.80**	**339,689**	**45,737**	**7.43**
Total all audits	**$771,714**	**$90,822**	**$8.50**	**$915,034**	**$88,790**	**$10.31**

Description	Fiscal Year 1996–97			Fiscal Year 1997–98		
	Net Assessments (in Thousands)	Costs (in Thousands)	Net Assessments Per Dollar of Cost	Net Assessments (in Thousands)	Costs (in Thousands)	Net Assessments Per Dollar of Cost
Personal Income Tax						
Audit activities:						
Desk audits	$ 125,272	$18,584	$ 6.74	$ 65,749	$16,970	$ 3.87
IRS follow-up audits	328,254	11,203	29.30	340,397	7,672	44.37
Field audits	70,784	13,644	5.19	28,710	13,544	2.12
Personal income tax audit subtotals	**524,310**	**43,431**	**12.07**	**434,856**	**38,186**	**11.39**
Corporation Tax						
Audit activities:						
Desk audits	19,487	8,524	2.29	12,184	9,842	1.24
IRS follow-up audits	68,664	1,812	37.89	89,091	3,524	25.28
Field audits	431,189	44,008	9.80	698,970	47,189	14.81
Corporation tax audit subtotals	**519,340**	**54,344**	**9.56**	**800,245**	**60,555**	**13.22**
Total desk audits	**144,759**	**27,108**	**5.34**	**77,933**	**26,813**	**2.91**
Total IRS follow-up audits	**396,918**	**13,015**	**30.50**	**429,488**	**11,195**	**38.36**
Total field audits	**501,973**	**57,652**	**8.71**	**727,680**	**60,733**	**11.98**
Total all audits	**$1,043,650**	**$97,775**	**$10.67**	**$1,235,101**	**$98,741**	**$12.51**

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	Fiscal Year 1992–93 Through 1997–98			Fiscal Year 1998–99		
Description	Average Net Assessments (in Thousands)	Average Cost (in Thousands)	Average Net Assessments Per Dollar of Cost	Net Assessments (in Thousands)	Costs (in Thousands)	Net Assessments Per Dollar of Cost
Personal Income Tax						
Audit activities:						
Desk audits	$ 80,595	$21,016	$ 3.83	$ 73,473	$ 14,403	$ 5.10
IRS follow-up audits	300,008	11,017	27.23	234,492	6,708	34.96
Field audits	40,815	12,532	3.26	47,868	14,230	3.36
Personal income tax audit subtotals	**421,418**	**44,565**	**9.46**	**355,833**	**35,341**	**10.07**
Corporation Tax						
Audit activities:						
Desk audits	34,530	6,751	5.11	17,051	7,157	2.38
IRS follow-up audits	77,305	1,480	52.23	124,690	1,815	68.70
Field audits	432,616	34,211	12.65	606,236	59,336	10.22
Corporation tax audit subtotals	**544,451**	**42,442**	**12.83**	**747,977**	**68,308**	**10.95**
Total desk audits	**115,125**	**27,767**	**4.15**	**90,524**	**21,560**	**4.20**
Total IRS follow-up audits	**377,313**	**12,497**	**30.19**	**359,182**	**8,523**	**42.14**
Total field audits	**473,431**	**46,743**	**10.13**	**654,104**	**73,566**	**8.89**
Total all audits	**$965,869**	**$87,007**	**$11.10**	**$1,103,810**	**$103,649**	**$10.65**

Description	Fiscal Year 1999–00			Fiscal Year 2000–01		
	Net Assessments (in Thousands)	Costs (in Thousands)	Net Assessments Per Dollar of Cost	Net Assessments (in Thousands)	Costs (in Thousands)	Net Assessments Per Dollar of Cost
Personal Income Tax						
Audit activities:						
Desk audits	$ 64,392	$18,085	$ 3.56	$ 59,840	$21,150	$ 2.83
IRS follow-up audits	174,507	8,876	19.66	220,614	7,342	30.05
Field audits	46,346	14,745	3.14	49,751	11,417	4.36
Personal income tax audit subtotals	**285,245**	**41,706**	**6.84**	**330,205**	**39,909**	8.27
Corporation Tax						
Audit activities:						
Desk audits	15,194	12,883	1.18	12,711	15,686	0.81
IRS follow-up audits	91,612	1,464	62.58	98,000	1,533	63.93
Field audits	575,350	40,285	14.28	254,958	40,286	6.33
Corporation tax audit subtotals	**682,156**	**54,632**	**12.49**	**365,669**	**57,505**	**6.36**
Total desk audits	**79,586**	**30,968**	**2.57**	**72,551**	**36,836**	**1.97**
Total IRS follow-up audits	**266,119**	**10,340**	**25.74**	**318,614**	**8,875**	**35.90**
Total field audits	**621,696**	**55,030**	**11.30**	**304,709**	**51,703**	**5.89**
Total all audits	**$967,401**	**$96,338**	**$10.04**	**$695,874**	**$97,414**	**$ 7.14**

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	Fiscal Year 2001–02			Fiscal Year 1998–99 through 2001–02		
Description	Net Assessments (In Thousands)	Costs (In Thousands)	Net Assessments Per Dollar of Cost	Average Net Assessments (In Thousands)	Average Cost (In Thousands)	Average Net Assessments Per Dollar of Cost
Personal Income Tax						
Audit activities:						
Desk audits	$ 91,755	$21,134	$ 4.34	$ 72,365	$18,693	$ 3.87
IRS follow-up audits	134,795	5,746	23.46	191,102	7,168	26.66
Field audits	78,962	12,266	6.44	55,732	13,165	4.23
Personal income tax audit subtotals	**305,512**	**39,146**	**7.80**	**319,199**	**39,026**	**8.18**
Corporation Tax						
Audit activities:						
Desk audits	19,559	14,608	1.34	16,128	12,583	1.28
IRS follow-up audits	140,388	1,791	78.39	113,673	1,651	68.85
Field audits	520,643	41,958	12.41	489,297	45,466	10.76
Corporation tax audit subtotals	**680,590**	**58,357**	**11.66**	**619,098**	**59,700**	**10.37**
Total desk audits	**111,314**	**35,742**	**3.11**	**88,493**	**31,276**	**2.83**
Total IRS follow-up audits	**275,183**	**7,537**	**36.51**	**304,775**	**8,819**	**34.56**
Total field audits	**599,605**	**54,224**	**11.06**	**545,029**	**58,631**	**9.30**
Total all audits	**$986,102**	**$97,503**	**$10.11**	**$938,297**	**$98,726**	**$ 9.50**

	Fiscal Year 1992–93 Through 2001–02		
Description	**Average Net Assessments (in Thousands)**	**Average Cost (in Thousands)**	**Average Net Assessments Per Dollar of Cost**
Personal Income Tax			
Audit activities:			
Desk audits	$ 77,303	$20,087	$ 3.85
IRS follow-up audits	256,446	9,477	27.06
Field audits	46,781	12,785	3.66
Personal income tax audit subtotals	**380,530**	**42,349**	**8.99**
Corporation Tax			
Audit activities:			
Desk audits	27,170	9,084	2.99
IRS follow-up audits	91,852	1,549	59.30
Field audits	455,288	38,712	11.76
Corporation tax audit subtotals	**574,310**	**49,345**	**11.64**
Total desk audits	**104,473**	**29,171**	**3.58**
Total IRS follow-up audits	**348,298**	**11,026**	**31.59**
Total field audits	**502,069**	**51,497**	**9.75**
Total all audits	**$954,840**	**$91,694**	**$10.41**

Source: The board's annual operations reports for fiscal years 1992–93 through 2001–02. Assessments and costs are related to each type of audit. Data for fiscal years 2000–01 and 2001–02 are draft figures.

Note: As explained in Chapter 1, these assessments do not represent actual state revenue. Also, the net assessments per dollar of cost reflect departmental overhead, but are not adjusted for collectibility or collection costs.

APPENDIX B

Collection Program Actual Revenue and Cost Data

As noted in Chapter 3, the Franchise Tax Board (board) generally does not track actual collection program revenues or related costs beyond high-level categories. Appendix B.1 on the following page displays the level of revenue and cost detail that the board is able to provide for fiscal year 2001–02. Although the board is able to provide revenue detail by assessment origin for total personal income taxes, it is unable to further divide these revenues into automated and manual activities, nor does it track corporation tax revenue in this detail. In addition, the board does not track any costs by origin, which prevents the calculation of a cost-benefit ratio by assessment type.

APPENDIX B.1

Collection Program Revenue and Cost Data

Tax	Revenue			Cost			Cost-Benefit Ratio		
	Automated	Manual	Total	Automated	Manual	Total	Automated	Manual	Total
Personal Income	$ 661,601,000	$351,075,000	$1,012,676,000	$27,554,000	$39,048,000	$66,602,000	$24.01	$8.99	$15.20
Return	N/A	N/A	726,173,000	N/A	N/A	N/A	—	—	—
Audit	N/A	N/A	114,857,000	N/A	N/A	N/A	—	—	—
Filing enforcement	N/A	N/A	167,274,000	N/A	N/A	N/A	—	—	—
Other	N/A	N/A	4,372,000	N/A	N/A	N/A	—	—	—
Corporation	513,338,000	185,385,000	698,723,000	10,134,000	14,362,000	24,496,000	50.66	12.91	28.52
Return	N/A	N/A	N/A	N/A	N/A	N/A	—	—	—
Audit	N/A	N/A	N/A	N/A	N/A	N/A	—	—	—
Filing enforcement	N/A	N/A	N/A	N/A	N/A	N/A	—	—	—
Other	N/A	N/A	N/A	N/A	N/A	N/A	—	—	—
Totals	**$1,174,939,000**	**$536,460,000**	**$1,711,399,000**	**$37,688,000**	**$53,410,000**	**$91,098,000**	**$31.18**	**$10.04**	**$18.79**

Sources: Franchise Tax Board's estimates and draft operations report for fiscal year 2001–02.

N/A = Data not available.

APPENDIX C

Proposed Template for a Comparison of Actual to Projected Returns for Specific Audit Workload Types

The following pages provide the template that we recommend in Chapter 1 for the Franchise Tax Board's (board) use in comparing its audit workplan's projected cost-benefit ratios (CBR) to the corresponding actual CBR, or return on investment, by individual audit workloads, an evaluation that the board does not currently make. As discussed in Chapter 1, we believe that this template would aid the board in assessing the reasonableness of its prospective audit CBRs, identifying those projections that do not reasonably match actual results, and adjusting future prospective CBRs accordingly. Using this information, the board would have a more accurate and effective tool for assigning workload to staff and estimating the additional benefits that proposed new auditors would provide.

Each of the board's audit types contains numerous specific workloads such as audits of partnerships, estates and trusts, and corporations. For this public report, we have removed the names of the specific workloads to protect the confidentiality of the board's workplans. The template includes the planned assessments and cost for the individual audit workloads from the board's 2001–02 workplan. The board already collects much of the information about actual results necessary to complete this comparison, compiling actual hours charged and assessments by individual audit workload, while accounting for actual costs at a higher level: audit type. Therefore, the board needs only a method of allocating costs to each workload. A relatively simple allocation would use information the board already has—salary costs and hours charged for each specific workload—to distribute total costs proportionately. Finally, the board could compute an actual return on investment per individual workload and compare it to the corresponding prospective CBR in order to measure the reasonableness of the projection.

APPENDIX C.1

Proposed Template for Comparison of Actual to Projected Returns for Specific Audit Workload Types

	Planned Assessments	Planned Cost	Actual Assessments	Total Actual Costs	Return on Investment	Workplan Cost-Benefit Ratio	Variance
Personal Income Tax							
Field							
Workload A	$ 10,108,800	$ 2,320,477	$ 30,148,117	—	—	4.36	—
Workload B	19,180,000	1,550,209	9,084,341	—	—	12.37	—
Workload C	17,692,500	2,636,801	6,448,915	—	—	6.71	—
Workload D	7,000	179,994	1,624	—	—	0.04	—
Workload E	69,000	819,564	465,412	—	—	0.08	—
Workload F	11,573,660	2,358,941	9,810,808	—	—	4.91	—
Workload G	15,207,500	3,093,882	9,812,355	—	—	4.92	—
Workload H	505,400	103,011	—	—	—	4.91	—
Workload I	360,336	129,768	—	—	—	2.78	—
Workload J	95,794	88,169	—	—	—	1.09	—
Totals	**74,799,990**	**13,280,816**	**65,771,572**	**$ 9,739,108**	—	**5.63**	—
Desk							
Workload A	8,983,950	1,982,247	20,526,238	—	—	4.53	—
Workload B	2,805,000	457,364	2,634,634	—	—	6.13	—
Workload C	7,582,500	1,130,057	2,763,821	—	—	6.71	—
Workload D	1,020,000	203,766	7,479,237	—	—	5.01	—
Workload E	594,000	602,352	769,410	—	—	0.99	—
Workload F	400,000	342,888	50,506	—	—	1.17	—
Workload G	3,000	77,140	696	—	—	0.04	—
Workload H	22,500,000	1,983,006	29,682,989	—	—	11.35	—
Workload I	38,026,830	3,813,710	34,650,351	—	—	9.97	—
Workload J	14,350,851	2,317,990	14,504,445	—	—	6.19	—
Workload K	815,000	38,788	3,914	—	—	21.01	—
Workload L	452,895	41,499	258,640	—	—	10.91	—
Workload M	120,000	866,799	1,751,769	—	—	0.14	—
Workload N	4,960,140	1,010,975	4,204,632	—	—	4.91	—
Workload O	6,517,500	1,325,950	4,205,295	—	—	4.92	—
Workload P	216,600	44,147	—	—	—	4.91	—
Workload Q	154,430	55,615	—	—	—	2.78	—
Workload R	41,054	37,787	—	—	—	1.09	—
Workload S			6,512,797	—	—	NP	—
Totals	**$109,543,750**	**$16,332,080**	**$129,999,374**	**$18,744,278**	—	**6.71**	—

NP = Not planned in the board's fiscal year 2001–02 workplan.

	Planned Assessments	Planned Cost	Actual Assessments	Total Actual Costs	Return on Investment	Workplan Cost Benefit Ratio	Variance
IRS							
Workload A	$ 1,860,000	$ 183,609	$ 1,336,756	—	—	10.13	—
Workload B	42,595,000	827,128	50,895,429	—	—	51.50	—
Workload C	768,000	85,578	2,649,383	—	—	8.97	—
Workload D	3,013,789	83,560	6,578,459	—	—	36.07	—
Workload E	5,850,000	388,251	7,562,332	—	—	15.07	—
Workload F	24,134,175	637,788	17,450,978	—	—	37.84	—
Workload G	2,925,000	157,735	12,257,187	—	—	18.54	—
Workload H	10,593,072	134,400	2,983,486	—	—	78.82	—
Workload I	21,659,520	296,312	17,704,022	—	—	73.10	—
Workload J	9,180,000	354,597	7,463,014	—	—	25.89	—
Totals	**122,578,556**	**3,148,958**	**126,881,046**	**$ 5,804,113**	—	**38.93**	—
Claims							
Workload A	2,364,413	301,212	2,936,528	—	—	7.85	—
Workload B	1,051,587	133,966	1,306,038	—	—	7.85	—
Workload C			296,313	—	—	NP	—
Workload D	1,781,900	244,336	132,037	—	—	7.29	—
Workload E			9,554	—	—	NP	—
Workload F	377,322	147,545	776,412	—	—	2.56	—
Workload G			—	—	—	NP	—
Totals	**5,575,222**	**827,059**	**5,456,882**	**2,387,546**	—	**6.74**	—
Corporation Tax							
Field							
Workload A	115,762,500	8,380,416	129,065,959	—	—	13.81	—
Workload B	10,800,000	1,901,788	3,600,738	—	—	5.68	—
Workload C	24,692,500	4,414,395	39,067,685	—	—	5.59	—
Workload D	62,884,000	2,963,092	42,656,688	—	—	21.22	—
Workload E	2,400,000	$208,008		—	—	11.54	—
Workload F	72,765,000	4,818,202	136,085,717	—	—	15.10	—
Workload G	7,380,000	1,217,698	12,014,262	—	—	6.06	—
Workload H	30,336,500	5,081,787	37,276,342	—	—	5.97	—
Workload I	35,820,000	1,543,815	23,638,924	—	—	23.20	—
Workload J	1,600,000	129,937	—	—	—	12.31	—
Workload K	15,000,000	1,998,418	18,051,382	—	—	7.51	—
Workload L	1,265,000	735,418	1,603	—	—	1.72	—
Workload M			(325,286)			NP	
Totals	**$380,705,500**	**$33,392,974**	**$441,134,014**	**$35,589,882**	—	**11.40**	—

NP = Not planned in the board's fiscal year 2001–02 workplan.

continued on the next page

	Planned Assessments	Planned Cost	Actual Assessments	Total Actual Costs	Return on Investment	Workplan Cost Benefit Ratio	Variance
Desk							
Workload A	$ 8,778,000	$ 1,119,077	$ 7,929,965	—	—	7.84	—
Workload B	3,049,500	200,360	1,379,441	—	—	15.22	—
Workload C	500,000	261,144	—	—	—	1.91	—
Workload D	3,575,000	469,290	2,129,317	—	—	7.62	—
Workload E			(81,670)	—	—	NP	—
Workload F			—	—	—	NP	—
Workload G			25,444	—	—	NP	—
Workload H			—	—	—	NP	—
Workload I			—	—	—	NP	—
Workload J	1,000	106,454	210,120	—	—	0.01	—
Totals	**15,903,500**	**2,156,325**	**11,592,617**	**$12,519,976**	—	**7.38**	—
IRS							
Workload A	3,840,000	$5,283	15,330,902	—	—	726.86	—
Workload B	3,072,000	3,960	51,462,887	—	—	775.76	—
Workload C	51,935,000	1,668,477	64,563,349	—	—	31.13	—
Workload D	11,490,000	640,520	18,508,807	—	—	17.94	—
Workload E	4,095,000	127,090	—	—	—	32.22	—
Workload F			869,942	—	—	NP	—
Totals	**74,432,000**	**2,445,330**	**150,735,887**	**1,585,684**	—	**30.44**	—
Claims							
Workload A	26,792,000	2,908,634	26,653,107	—	—	9.21	—
Workload B	21,867,000	2,133,373	14,161,020	—	—	10.25	—
Workload C	8,127,000	1,398,341	19,032,447	—	—	5.81	—
Workload D	1,368,000	379,049	1,324,801	—	—	3.61	—
Totals	**58,154,000**	**6,819,397**	**61,171,375**	**6,491,294**	—	**8.53**	—
Non-Planned							
Workload A			(318,209)	—	—	NP	—
Workload B			7,317	—	—	NP	—
Workload C			3,137,694	—	—	NP	—
Workload D			—	—	—	NP	—
Workload E			472,508	—	—	NP	—
Workload F			160,015	—	—	NP	—
Workload G			—	—	—	NP	—
Workload H			2,458,722	—	—	NP	—
Grand Totals	**$841,692,518**	**$78,402,939**	**$998,660,814**	**$92,861,881**	—	**10.74**	—

Sources: The board's workplan, operations report, production reports, and CALSTARS accounting records for fiscal year 2001–02. The operations report data are draft figures.

NP = Not planned in the board's fiscal year 2001–02 workplan.

M E M O R A N D U M

To: Elaine M. Howle, State Auditor*
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814 Date: May 5, 2003

From: Gerald H. Goldberg

Subject: Draft Bureau of State Audits Report

Thank you for the opportunity to review the draft audit report prepared by your staff for the Joint Legislative Audit Committee.

We appreciate your recommendations for improving the usability of information we provide to the Department of Finance and the Legislature. We concur that improvements can be made. On our own initiative we have begun a project that will use activity based accounting to better capture revenue and cost stream data. Franchise Tax Board's total assessments from audits of personal income and corporation tax returns have provided the State an important source of potential revenue at relatively little cost, returning around $10 in assessments for every $1 of cost. In addition, the collection program returns around $19 in revenue for every $1 of cost.

Following are specific comments to the report and the recommendations:

Bureau of State Audits (BSA) Recommendation: *To more completely and clearly reveal its programs' costs and benefits, the board should consider using the complete measurement of the audit program's performance that we have described in Table 3 on page 19. This measurement compares all the benefits – the total revenues that result over time from the auditors' assessments of additional taxes – with the total costs to produce them, including the costs of collection. Thus the board would treat the collection program as another service center for audits. If it determines that its current information system cannot produce the data necessary for such a measurement, the board should consider the needs of a complete measurement when it upgrades or changes its current information system.*

Franchise Tax Board (FTB) Response: While BSA's report notes that there are significant benefits of the audit program, which cannot be measured, it chooses to focus its attention primarily on recognizing additional costs. Centering attention only on costs within the CBRs tends to obscure the central purpose of the audit program, namely to ensure that taxpayers assess the correct amount of tax and to provide a level of assurance to self compliant taxpayers that non compliance is being recognized and dealt with.

* California State Auditor's comments begin on page 77.

The CBR schedule's primary purpose is to provide a format for prioritizing audit workloads and to provide management with performance measures for program decisions. A secondary role it plays is to give a sense of the relative value of audits that have been identified but that cannot be undertaken because of resource constraints. It is not meant to be a financial accounting document.

As noted previously to the BSA, the CBRs have historically excluded certain costs such as departmental overhead and costs of collection. The costs of collection have been excluded at the direction of the LAO in its 1981 study, *The Allocation of Audit Resources: An Analysis of California's Tax Audit Programs*, since to include them could well influence the choice of which audits to undertake. Audit models that have a high cost to collect, and represent the most egregious non-compliant taxpayers would have lower CBRs and could possibly fall below the CBR threshold. This would then have the impact of discouraging compliance efforts on the taxpayers who are in the most need of it, and serve to degrade the primary purpose of the audit program.

The selection of the traditional level of funding CBRs at the 5:1 threshold was proposed and accepted with these conventions in place. The threshold seeks to maintain a balance between audit intrusiveness and effective audit presence. Inclusion of additional cost factors such as departmental overhead and collection costs should cause a reevaluation of the reasonableness of that 5:1 CBR threshold, since it would impact the number of audits undertaken, and result in a change in the current program balance.

BSA Recommendation: *If the board decides not to currently use the complete measurement and continues to use separate performance measurements for the audit and collection programs, it should do the following:*

- *In budget change documents and other reports given to external decision makers, the board should explicitly disclose the elements not included in the cost components of various performance measures used to assess the audit and collection programs. The board should also disclose the effect of those excluded elements. Further, the board should disclose the overlap in benefits claimed by its audit and collection programs.*

FTB Response: We agree.

- *To provide useful information to decision makers when requesting additional audit positions, the board should use a format, recommended in our prior report, that details the types of activities new auditors will perform as well as the projected assessments and historical returns resulting from these activities. Additionally, the board should revise its supporting audit workplans to include the actual returns of each of the specific workload types for the most recently completed fiscal year.*

FTB Response: FTB considered the format recommended by BSA in the prior report and determined that the actual user of the report should be consulted on their needs. Therefore, at a meeting with Department of Finance on April 7, 1999, and under the scrutiny of a representative of the BSA we discussed options for a workplan matrix. While considering the BSA matrix, the Department of Finance desired a number of modifications, which included additional detail for indirect workloads, and a higher summary of direct audit workloads. The resulting matrix included both projected assessments and historical returns at the agreed upon levels. The representative from BSA who attended that meeting agreed with our efforts to work together on this issue. Indeed, our 60 day response letter to the 1999 BSA audit addressed to Mr. Kurt R. Sjoberg reported that the comments from the BSA representative indicated that he was satisfied with our representation of how we use our audit hours, and that our matrix provided the format to aid in the communication of resource needs between FTB, DOF, and the Legislature.

As result of this iterative process, we assumed in good faith that our workplan was appropriate on two levels. It met our customer's (DOF) stated needs, and it had the BSA's approval. It now appears that the BSA wishes for us to utilize its original format. If this is what the BSA requires, we will certainly comply.

However, we would like to clarify the workload categories that BSA suggests. Under Corporation Tax, both Field and Desk audits are broken down into large assessments and small assessment audits. Normally we do not classify our audits in this manner, and we generally do not know at the outset whether an individual audit will yield a large or small assessment. We would suggest using the alternate sub categories of non-apportioning and apportioning audits.

- *To track the accuracy over time of its calculations of the prospective CBRs for individual audit workload types, the board should compare these prospective CBRs against actual returns annually. The board should make the results available to Finance and the Legislative Analyst's Office, which advises the Legislature on budgetary matters, and should also include them in the board's annual report to the Legislature on the results of its audit and collection activities. Moreover, the board should use the results of the comparison in future calculations of prospective CBRs.*

FTB Response: We concur. We will compare projected CBRs with actual returns annually and will make them available to Finance and the Legislative Analyst's Office. Due to the confidential nature of the workplan, specific workloads will not be identified by name on the report.

BSA Recommendation: *If the board believes that information it publishes in its operations reports is not accurate, even though it is based on the board's financial accounting system, the board should do the following:*

- *Ensure that its financial accounting system reports accurate information, and*
- *Correct data it believes to be inaccurate before it publishes the information in its operations reports.*

FTB Response: The financial accounting system used by FTB is the California Statewide Accounting and Reporting System (CALSTARS), which was developed and is administered by the Department of Finance. FTB captures costs within CALSTARS in the same structure as the department's appropriation budget – by program and element. The system captures costs as assigned by the particular program areas. These costs are captured through direct charges to the program; program timesheet reporting; and overhead allocations. Together these different cost elements are combined to reflect the financial status and reports for the various programs administered by FTB (Tax, Child Support, etc.)

As such, the CALSTARS financial accounting system is sound in design, functionality and integrity. It is in full compliance with statewide directives and regulations. The reports generated from the system reflect the financial condition of FTB based on programmatic information provided through the aforementioned methods.

The financial information from CALSTARS is reported monthly and can be used by the various organizational units and program areas in various ways, such as for monitoring costs, developing workplans, and making projections. As the CALSTARS information is reviewed, it is possible that any discrepancies or adjustments could be identified. The adjustments are reviewed by the financial staff and, if appropriate, subsequent corrections are made to update the system.

The FTB Operations Report is based, only in part, on the financial reports from the CALSTARS system. In addition, other data or adjustments are included for purposes of developing the Operations Report. In response to the BSA recommendations, we are reviewing our procedures to ensure the Operations Report is accurate, timely, and verifiable with information sources and reports, such as workplans and financial statements.

The department will focus on improving its processes to better capture and validate data that goes into the automated financial reporting system. For example, the department is evaluating how indirect costs are distributed. In addition, an important tool the department will use is the recently completed Activity Based Costing (ABC) model. This model was designed to improve the reporting of cost information and its use will enable the department to more accurately identify costs to activities, processes, and programs.

BSA Recommendation: *To demonstrate the effectiveness of new collection program positions, the board should develop a methodology for measuring the benefit of these positions by isolating the return from the additional positions and comparing it against a base year*.

FTB Response: The audit is correct in stating that we do not typically report year-end results by isolating revenue from the new positions we have acquired. However, we now have the capability to present results according to this methodology, and will follow it in future annual summaries of results.

As noted in the Audit Report, we do use a cost-to-benefit ratio (CBR) process. Since the 1980s we have used CBRs to prioritize workloads and assess our future staffing needs. This process projects the total number of staff we will need annually to collect the revenue generated from accounts that meet Department of Finance's (DOF) CBR criteria. For example, for fiscal year 2001/02, we projected that we could produce $1.63 billion in revenue from cases meeting DOF CBR criteria, if we had 1,024 PYs. As we had budget authority for only 905 PYs, we submitted a justification for additional staff to produce the projected revenue. The proposal was approved.

We leveraged our new collection system (ARCS) to implement our workplan and to generate the promised revenue. ARCS is designed to implement and support our work plan process through continuously monitoring and managing collection account activities. The system's automated account selection process maximizes collections by using yield as the criterion for selecting the "next best" account to work. Drawing from this pool of "best" accounts, the system assigns individual cases to collectors, and determines the next best manual or automated action to resolve the account. ARCS' automated assignment and decision processes keep costs of collections as low as possible. Our actual results for fiscal year 2001/02 show that we produced $1.71 billion in revenue, exceeding our revenue projections for the year. We believe these results demonstrate the effectiveness of our new collection system as well as the methodology we used to estimate the benefit of new positions.

BSA Recommendation: *To more accurately represent the process that assigns work to collection program staff, the board should continue developing a methodology based on data from its Accounts Receivable Collection System to justify new collection program staffing requests.*

FTB Response: We strongly agree with this recommendation, and have been waiting for sufficient data to become available from ARCS to allow us to implement this methodology. We recently completed an extensive analysis, based on two full years experience in using the new system. We are pleased to report that this analysis now allows us to leverage ARCS data more fully, and we are using that data for our fiscal year 2003/04 work plan.

BSA Recommendation: *For the board to be consistent with the intent of budget control language and Finance, it should not leave collection program positions unfilled beyond the normal time it takes to fill a position as a long-term strategy.*

FTB Response: We agree, and strive to fill all collection positions as quickly as possible. We do, however, periodically encounter challenges that may prevent us from filling positions, such as delayed budget enactment, hiring freezes, and limited training resources, especially during years of large augmentations of new positions. We make every reasonable effort to keep all positions filled and as of March 2003, for fiscal year 2002/03, our vacancy rate for tax collection positions is consistent with our salary savings goal.

Additional FTB Comments: We would like to reiterate our concerns expressed at the time of the 1999 BSA Audit about Table 7, *Return on Audits that Additional Staff Would Be Likely to Perform*. This table is highly selective of the factors that it presents as impacting the return on audits that new staff would likely perform. It fails to take into consideration tax law changes, tax regulations, case law and precedent, economic conditions and self-compliance. By failing to modify the base years in the table to include the impact of these factors, the analysis does not recognize the full value of the new audit positions.

Again, we appreciate the opportunity to provide you with this response. If you need any further information or would like to discuss any of the issues above, please feel free to contact Philip Yu at 845-3388.

(Signed by: John W. Davis for)

Executive Officer

COMMENTS

California State Auditor's Comments on the Response From the Franchise Tax Board

To provide clarity and perspective, we are commenting on the Franchise Tax Board's (board) response to our audit report. The numbers correspond with the numbers we have placed in the board's response.

Our suggestion to show full costs associated with audit assessments does not preclude the board from auditing returns with less than $5 in anticipated benefits for each $1 of cost. Our recommendation addresses how the board describes its work, not what work it chooses to do. However, if the board has programmatic reasons for requesting new audit positions, it should disclose those reasons as the justification for new positions. For example, if the board wants new auditors to provide additional assurance to self-compliant taxpayers that noncompliance is being recognized and dealt with, the board should explicitly describe in its budget documents the goal of the new positions. Further, the board should clarify that the monetary value of this enhanced audit presence cannot be measured.

We recognize the various uses of the cost-benefit ratios (CBRs) and believe that, for purposes of allocating workload to staff, it is not essential to include departmental overhead in the board's workplan CBRs. However, a complete measurement of the audit program's performance reported to external decision makers would compare the benefits—the total revenues that result over time from the auditors' assessments of additional taxes—with the total costs to produce them, including the costs of collecting the assessments. As stated on page 16, the Legislative Analyst's Office made a similar point in a fiscal year 1997–98 report when it stated that the full cost of collecting audit assessments should be considered as part of the overall and true cost of generating returns through audits.

In its 60-day response to the recommendations made in our 1999 report, the board indicated that it modified the matrix format to provide additional detail of total hours used and additional workload breakdowns. The board also acknowledged the agreement reached in the April 7, 1999, meeting with the

Department of Finance and the Bureau of State Audits that the workload categories would be modified over time to reflect program changes. However, the board did not indicate in the 60-day response that it planned to modify the matrix to show only a higher summary of direct audit workloads.

We agree with the board that it would be difficult to anticipate at the outset the size of a future audit assessment. Accordingly, we have modified our proposed template in Table 5 to delete the subcategories for large and smaller assessment audits.

We agree with the board's comments that the California Statewide Accounting and Reporting System (CALSTARS) which many state departments use, is sound in design, functionality, and integrity. We did not intend to suggest the board should abandon its use. CALSTARS is, however, dependent on the quality of the information input into the system, and this is what we understand the board to have been commenting on when it cited miscoding and misallocation. Thus, we believe the board's proposal to focus on improving its processes to better capture and validate data that goes into the system is appropriate.

We disagree with the board's argument that, when its collections exceeded its projected revenue for fiscal year 2001–02, the board demonstrated the benefit of the new positions it received in that year. As Figure 8 indicates, the actual hours spent on collections decreased in fiscal year 2001–02, so that the board exceeded its projected revenue with less, rather than more, staff effort for the year. As a result, we question the board's premise that the funding for additional staff resulted in the increase in revenue.

We agree that Table 7 does not take into account all the possible factors that could affect audit assessments, and we discuss two additional factors in the report: the effect of the economy (page 34) and the need for maintaining an audit presence in the taxpaying community, resulting in the board's conducting audits for which it does not necessarily anticipate a $5 benefit for each $1 of cost (pages 9, 16 and 34). As we noted on page 34, our analysis does not account for such unquantifiable benefits provided by the audit program. Similarly, the effect of changes in tax law and regulations is not readily quantifiable.

cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State
Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
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