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State Board of Equalization:

Budget Increases for Additional Auditors Have Not Increased Audit Revenues as Much as Expected

March 1999

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SUMMARY

Audit Highlights . . .

The Board of Equalization's (board) audit revenues for an additional 250 auditor positions fell $123 million short of projections due to the following actions:

- ☑ ***Audit hours have returned to earlier levels despite receiving additional staff.***
- ☑ ***Half of the additional positions were deployed to support functions.***
- ☑ ***Revenue projections contain flaws.***

The board's report to the Legislature adequately responded to the request. However, the request did not require data in sufficient detail to assess the impact of the additional positions.

RESULTS IN BRIEF

Although the Board of Equalization (board) has increased its revenues from audit activities, the increases are significantly less than the board projected. Beginning in fiscal year 1992-93, the Legislature approved 250 auditing positions to supplement the board's audit staff. This was based on the board's assertion that the additional staff would return $5 for every $1 of increased funding for a total of $364.2 million by fiscal year 1997-98. The increased revenue has reached only $241.2 million, however, which is $123 million less than projected. Consequently, the rate of return on the funding is only $3 for every additional $1 spent. When we adjust this figure to consider that the new auditors are generally placed on less complicated, lower-dollar audits and to account for a sales tax increase in July 1991, the true rate of return is closer to $2 for every $1 spent.

The board does not meet its revenue projections for several reasons. Despite the added staff, annual audit hours during fiscal year 1997-98 were essentially the same as they were before the staffing increase. Audit hours directly affect revenues; therefore, lower audit hours mean lower audit revenues. Further, the board has assigned more than half of the new staff to support positions that do not directly generate audit revenues.

We also found that the board's revenue projections have some flaws. First, the board did not consider that new auditors spend less time conducting audits and produce lower-dollar assessments during their first year of employment. Additionally, experienced auditors do not produce audit revenues while training new staff. Another flaw is that the board overestimated the average amount of time auditors actually spend on audits: it used an average of 1,600 audit hours per auditor per year in its calculations, but our review found that auditors average only 1,400 hours per year. Moreover, the board did not always factor in staff vacancies.

Finally, the Legislature asked the board to report on audit program revenues, costs, and staffing. We found that the board's report is sufficiently responsive and generally accurate. However, the information requested for inclusion in the report was not specific enough to allow readers to fully assess the additional revenues resulting from the additional audit positions.

RECOMMENDATIONS

The board should use approved audit positions to conduct audits. If the board determines that the auditors are better used elsewhere, it should report staff reassignments to the Legislature. The Legislature and the board should agree on how to determine the additional revenues that new audit positions will generate. Also, the Legislature should require the board to report any reassigned audit positions.

To project audit revenues more accurately, the board must consider the reduced audit hours and added training costs of new auditors. In addition, the board should base its revenue projections on the actual time staff spend on audits and realistic staff vacancy rates.

Finally, the Legislature should tailor its future requests for information from the board to address specific concerns.

AGENCY COMMENTS

The Board of Equalization generally agrees with our findings, and provided additional perspective and clarification on its use of auditor positions to perform support functions. ■

INTRODUCTION

BACKGROUND

The Board of Equalization (board) currently administers 25 tax and fee programs that generated during fiscal year 1997-98 over $33 billion in annual revenue for local governments and the State. For the same fiscal year, the board had a budget of over $295 million, with over 4,100 staff positions in its Sacramento headquarters and 30 district offices.

The board's greatest source of tax revenue is its Sales and Use Tax (sales tax) program. During fiscal year 1997-98 alone, the sales tax generated $28.1 billion—85 percent of all revenues the board collected. Retailers doing business in the State pay a minimum 7.25 percent sales tax for all retail sales, except those specifically exempted by law. The rate is slightly higher in areas where the voters have authorized additional taxes for local governments. Most sales tax is self-assessed; that is, businesses must regularly account for and remit the sales tax they collect from their taxable business transactions. Additionally, the majority of sales tax revenue goes to the State, but a portion is also distributed to local governments. As shown in Figure 1, the amount of sales tax collected has steadily increased since fiscal year 1990-91.

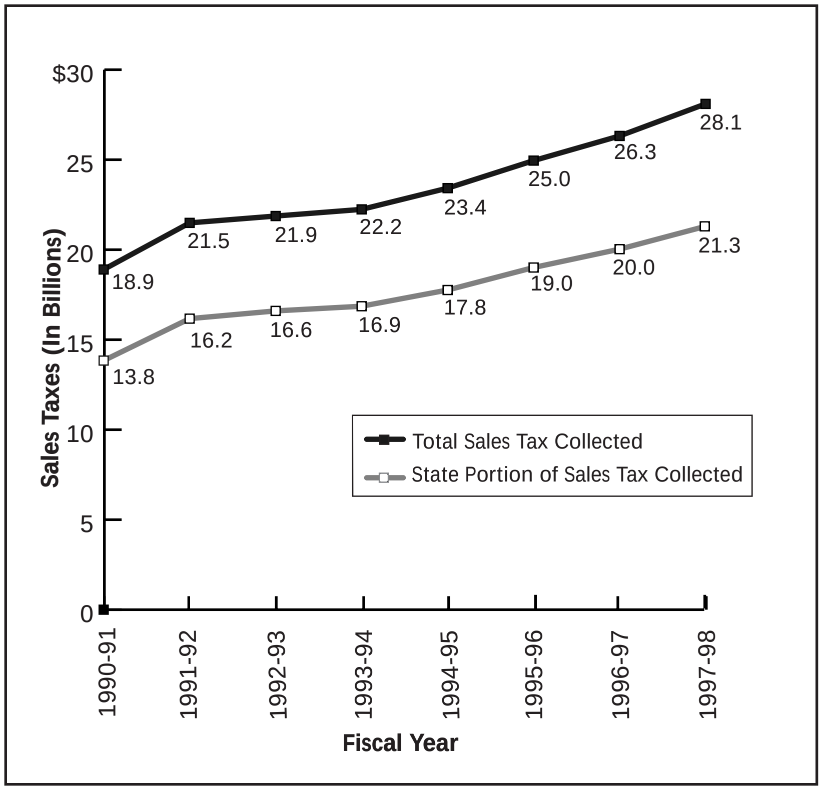
The Board Seeks to Increase Compliance With the Sales Tax Laws Through Its Audits

To ensure that businesses pay the correct amount of sales tax and further educate businesses about sales tax laws, the board maintains an audit program. In fiscal year 1997-98, the board had 913 authorized auditor positions, not including supervisors, in its 30 district offices.

Each year, the board audits approximately 3 percent of all businesses operating in the State. In selecting businesses to audit, the board considers industry types, volume of taxable sales, and the probability that the tax assessment will be greater than the audit cost. It then focuses on those businesses that are most likely to report taxes inaccurately and audits the selected businesses' tax records for a three-year period. If a business has underpaid taxes, the board issues a tax assessment. In fiscal year 1997-98, auditors identified $409.5 million of taxes owed to the State, or 1.5 percent of the total $28.1 billion of sales tax collected that year.

FIGURE 1

Sales Tax Revenues Have Grown Since Fiscal Year 1990-91



Source: Board of Equalization Annual Reports

While the audit program directly generates revenues for the State, the board also believes that auditing increases overall sales tax revenues by deterring inaccurate tax filings and educating taxpayers. Businesses may be more likely to accurately assess their sales taxes if they believe the board may audit them at some point. In addition, audits help educate businesses to better understand the sales tax law, which will likely result in them more accurately assessing their future taxes.

The Legislature Requested Information on the Board's Budget Projections

In the past, the board has justified requests for additional auditors on the basis of revenue impact. The board submits these requests to the Legislature in budget change proposals, which allow state departments to modify an existing authorized budget. When submitting a budget change proposal, the state department details the cost for the modification and the resulting benefit to the State. In the case of the board's requests for additional auditors, the budget change proposals included the projected amount of supplemental revenue the positions would generate and included data on the number of positions and support costs affected.

Since fiscal year 1992-93, the Legislature has approved the board's requests for 273 permanent auditor and supervisor positions, of which 23 positions were for new supervisors and the remaining 250 positions were for new auditors to generate revenue. The Legislature approved the additional auditor positions based on a suggested rate of return or benefit to cost ratio. The board has suggested that the rate of return would be 5-to-1—that is, it would generate $5 for each $1 spent on audit activities.

Concerns arose in both the Legislature and the Legislative Analyst's Office, however, about whether the additional resources had actually increased revenues by the amounts projected in the board's budget change proposals. Based on the Legislative Analyst's Office's recommendations, the Legislature asked the board to submit a report detailing audit costs, revenues, and staffing by November 1, 1997. Our audit examined the budget change proposals, actual revenue generated, and the board's report to the Legislature.

SCOPE AND METHODOLOGY

The Joint Legislative Audit Committee requested that we independently verify the costs and benefits of the board's audit programs to determine the impact of adding 250 new audit staff. In addition, the committee asked us to assess the accuracy and reliability of the report the board submitted to the Legislature.

To understand the board's audit duties for the sales tax program, we reviewed relevant laws and interviewed key board staff. Because we focused on the costs and benefits of the audit program, we did not assess the effects of the audit program on other areas of the board's operations, such as collecting taxes, registering new businesses, or processing tax returns. Further, we did not analyze changes in the economy or adjust for inflation because the board did not address either factor in its budget change proposals.

To assess the costs and benefits of adding the 250 positions, we analyzed revenues before and after the board received its funding. We reduced the board's actual tax assessment amounts by an estimate of canceled assessments and uncollectable amounts to determine the audit revenues the board generated. Our analysis was two-tiered: we first compared the incremental change in revenues to the board's projections in its budget change proposals and then conducted a second analysis to factor in the inexperience of new auditors, which usually places them on audits that produce lower revenues. We also factored in the sales tax increase on July 15, 1991, from 6 percent to 7.25 percent (a 21 percent increase). We then calculated the rate of return due to the additional auditors. Finally, we researched why revenues did not match projections.

To assess the accuracy and reliability of the board's report to the Legislature, we compared the board's data to its accounting reports and other supporting schedules. To determine if the report included all costs, we reviewed overall program costs and how the board allocated these costs to its programs. ■

CHAPTER 1

Audit Revenues Have Fallen Short of Projections Because of Several Actions by the Board of Equalization

CHAPTER SUMMARY

To increase revenues for the State, the Legislature funded 250 additional audit positions at the Board of Equalization (board), which cost the State over $77.6 million from fiscal year 1992-93 to fiscal year 1997-98. In its budget change proposals, the board projected that the additional staff would increase audit revenues by $364.2 million for this period. Although the board did increase audit revenues by $241.2 million for these six fiscal years, this increase fell short of the board's projections by approximately $123 million.

In a broad analysis of revenues and costs, the board received a rate of return of $3 for every $1 spent on the additional audit resources. However, considering that the new auditors do not impact the high-dollar audits that the board would perform regardless of the staff increases and larger assessments from a sales tax increase in fiscal year 1991-92, the board's rate of return was found to be just $2 for every $1 spent.

The board did not reach its projected goals because audit hours—the hours staff spend auditing businesses—were about the same in fiscal year 1997-98 as in fiscal year 1991-92. Total audit hours have remained relatively unchanged because the board has assigned over half of the approved auditor positions to support functions.

Additionally, the board's revenue projections were unrealistically high because the board failed to take into account that new auditors bring in less revenue during their first year of employment. Further, the board overestimated the time auditors actually spend conducting audits and did not consider staff turnover.

AUDIT REVENUE INCREASES WERE LESS THAN PROJECTED

In fiscal year 1992-93, the Legislature approved additional funding to expand the board's audit staff. The board received $10.4 million for 200 auditor positions, as well as supervisors and support staff. In its budget change proposal requesting these 200 auditor positions, the board predicted the additional staff would increase revenues by $40.9 million in fiscal year 1992-93. By fiscal year 1997-98, the Legislature had approved three budget change proposals totaling $13.5 million annually to fund 250 positions. The board predicted that the new staff would raise annual audit revenues $58.4 million by fiscal year 1997-98.

Three budget change proposals totaling $13.5 million funded 250 new positions.

The board did not explain in its budget change proposals how it would achieve these annual revenues. Instead, it merely stated that funding the positions would generate additional revenues. However, two budget change proposals explicitly state that the additional resources would result in revenues that would not otherwise exist, and overall audit revenues would increase by the amount the board expected the additional positions to generate.

To assess the audit revenues these budget increases actually generated, we compared the board's audit revenues before fiscal year 1992-93 to the audit revenues it received from fiscal year 1992-93 through 1997-98. Although the budget change proposals predicted audit revenues would increase by almost $364.2 million over the six fiscal years, the actual increase totaled only $241.2 million. Thus, revenues have fallen one-third short of projections, or $123 million less than anticipated.

One budget change proposal requested 50 positions to increase both sales and fuel tax revenues through audits of fuel sales fraud, but we were not able to allocate the positions between the two tax programs. The board asserted the additional positions would achieve an 11-to-1 return in fraud audits. However, in the *Analysis of the 1993-94 Budget Bill*, the Legislative Analyst's Office noted that the board was already conducting these audits and believed the actual rate of return was closer to a 5-to-1 rate of return for the additional positions. Using the 5-to-1 ratio lowers the projected increases from $364.2 million to $331.1 million and the shortfall from $123 million to $90 million.

TABLE

Audit Revenues Failed to Achieve Projected Levels

Year	Actual Revenue Increases	Projected Revenue Increases	Amount Over/(Under) Projected Revenues	Budget Increase	Audit Positions Added
1992-93	$ 4,964,000	$ 40,880,000	$ (35,916,000)	$10,421,000	200 *
1993-94	65,818,000	68,560,000	(2,742,000)	12,852,000	50
1994-95	62,037,000	68,560,000	(6,523,000)	12,852,000	
1995-96	42,413,000	69,340,000	(26,927,000)	14,390,000	25
1996-97	(5,404,000)	58,420,000	(63,824,000)	13,527,000	-25
1997-98	71,349,000	58,420,000	12,929,000	13,527,000	
Totals	**$241,177,000**	**$364,180,000**	**($123,003,000)**	**$77,569,000**	**250**

A Ratio of 3-to-1

* Note: Added positions for fiscal year 1992-93 include 75 positions added on April 1, 1992. According to board staff, these positions were not filled until fiscal year 1992-93 and had no impact on audit revenues until fiscal year 1992-93.

Although the board's budget change proposals did not always contain the rate of return, using the anticipated revenues and total costs the board included, we calculated rates of return ranging between 4-to-1 and 11-to-1. However, as shown in the table above, the revenues increased by $241.2 million, at a cost of $77.6 million, which results in a rate of return that was actually 3-to-1.

This ratio has not been adjusted for certain factors that further reduce the real return rate, including the smaller cases additional auditors would likely audit. Another factor that skews the 3-to-1 ratio is the statewide tax rate increase on July 15, 1991, from 6 percent to 7.25 percent. A higher tax rate raises revenues without additional audit effort.

Inclusion of High-Dollar Audits and a Sales Tax Increase Overstated the Rate of Return on Audits

Board staff said the board audits all businesses with the highest revenue potential (high-dollar audits), but only a portion of businesses that have a moderate or low-revenue potential (low-dollar audits). Thus, the additional auditor positions allow the board to conduct more low-dollar audits. Because high-dollar audits generate the most money, including these audits in the board's estimate overstates the rate of return additional auditors generate. For example, $14.5 million of the $241.2 million revenue increase is attributable to high-dollar audits, which would have been completed even if the board had not increased its staff.

Also lowering the rate of return is the July 15, 1991, sales tax increase from 6 percent to 7.25 percent, which accounts for $66.3 million of the $241.2 million rise and does not relate to audit effort. Because the board usually examines records from the last three tax years when it audits a business, the full effect of the raise in taxes was not evident until fiscal year 1994-95.

The additional auditor positions brought in $2 for every $1 spent, not the 5-to-1 return that the board had suggested.

The remaining $160.4 million of the $241.2 million increase is probably attributable to the additional audit staff, inflation, the economy, or other factors that we did not separately analyze. After adjusting the 3-to-1 ratio for the lower-dollar audits new auditors perform and the rise in the sales tax, we found that the board generated revenues of $160.4 million related to the $77.6 million budget augmentations, or a return of only 2-to-1 on the additional auditors it requested. This is significantly lower than the 5-to-1 ratio the board had suggested it would achieve.

THE BOARD FAILED TO REACH ITS REVENUE GOALS BECAUSE IT REASSIGNED AUDIT POSITIONS AND OVERSTATED AUDIT HOURS

A failure to increase audit effort and incomplete revenue projections contributed to audit revenues not reaching expected levels. Despite the fact that budget increases added considerable staff to the audit program, actual audit hours effectively stayed the same because the board chose to deploy over half of the additional auditors to support functions. In addition, the board's estimate of the revenue that the supplemental field auditors would generate was overly optimistic. The board neglected to consider that new auditors produce less revenue during their first year. Further, it used an inaccurate estimate of average audit hours and did not completely factor in staff turnover.

Despite Budget Augmentations, Audit Hours Have Not Increased

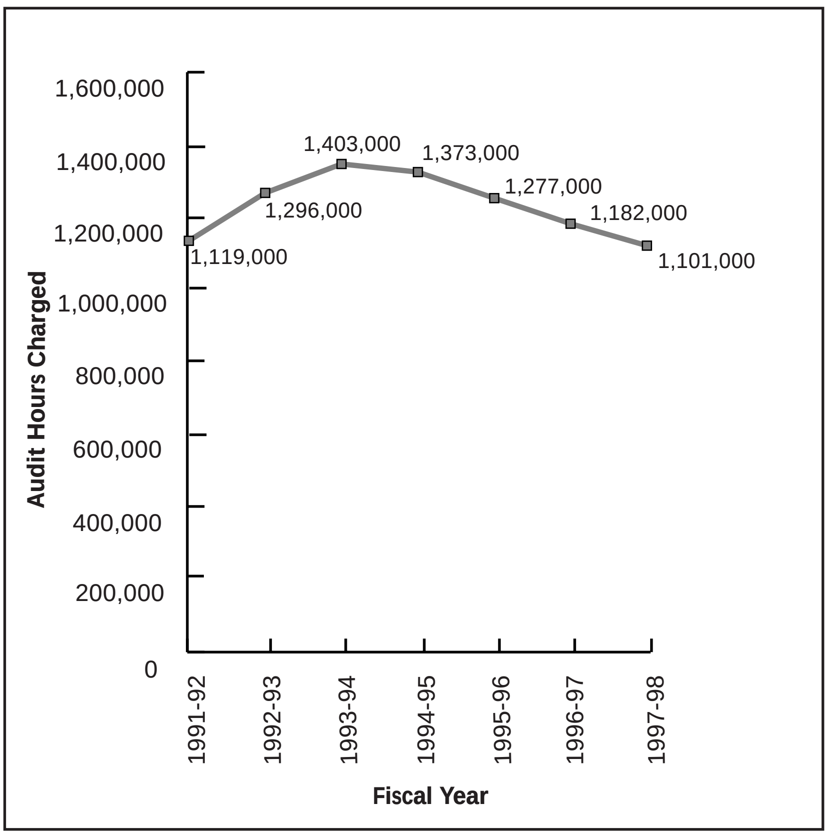
An appropriate measure of the board's audit effort is the number of hours its staff spends conducting audits. The board classifies audit hours as the time field auditors spend reviewing business records for compliance with sales tax law. Audit hours exclude time spent on supervision, selecting businesses to audit, or reviewing completed audits. Thus, audit hours represent a strictly defined measure of the board's effort to audit businesses and generate audit revenues.

Despite receiving 250 additional auditors, audit effort is the same now as it was in fiscal year 1991-92.

To determine the effect of adding more audit staff, we reviewed the time field auditors charged from fiscal years 1991-92 to 1997-98. We found that audit hours initially rose with the increase in staff, but over the last four years, they have steadily fallen. As shown in Figure 2, in fiscal year 1991-92, field auditors charged 1.1 million audit hours. By fiscal year 1993-94, audit

FIGURE 2

Audit Hours Have Fallen Since Fiscal Year 1993-94



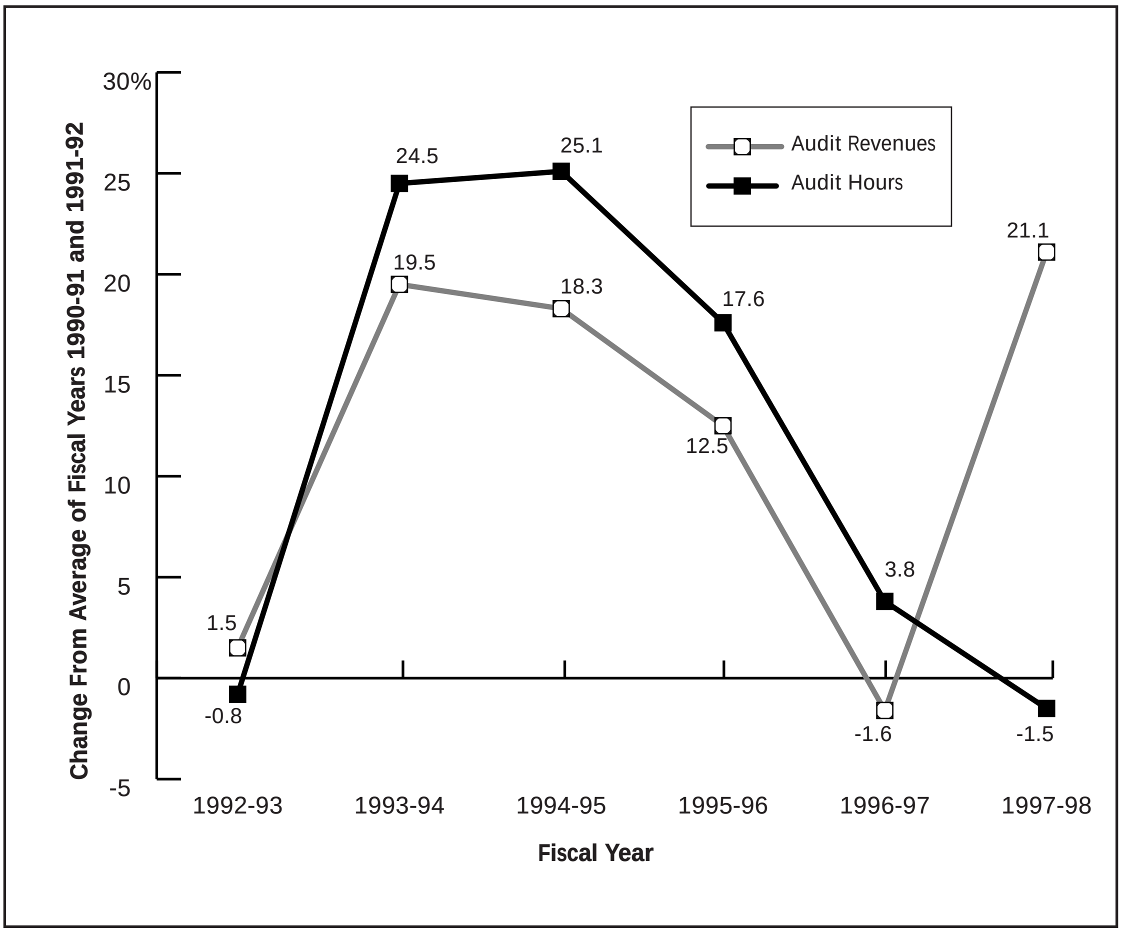
hours increased 25 percent to peak at 1.4 million. However, by fiscal year 1997-98, audit hours fell back to 1.1 million hours, which is about the same level as before the staffing increases.

Audit Hours Drive Revenues

The number of audit hours charged directly drives the amount of audit revenue generated. As Figure 3 illustrates, when the board used the supplemental positions to conduct audits, as it

FIGURE 3

Audit Hours Directly Affect Audit Revenues



Note: The comparison between audit hours and revenues for fiscal year 1997-98 did not fit well because of extraordinary audits of a single business that brought in $85.3 million. These assessments are more than twice the size of the next largest assessment recorded by the board since 1990. Because of these unique audits, fiscal year 1997-98 revenues were higher than normal.

did in fiscal years 1993-94 and 1994-95, audit hours increased and so did revenues. Conversely, when the board began using field auditors for support functions in fiscal years 1995-96 and 1996-97, audit hours and revenues decreased.

If we exclude the positions transferred to support functions, as discussed in the next section, we calculate that the additional auditors returned $4.30 for every $1 budgeted for them, or a return of 2.8-to-1, once the return is adjusted for high-dollar audits and the sales tax increase.

The Reassignment of Field Auditors to Support Positions Reduced Audit Hours

A major factor contributing to the reduction in audit hours is the board's decision to deploy over half of the supplemental audit positions to support functions. Although the board indicated in its budget change proposals that it intended to use the 250 positions to conduct sales tax audits, only 122.5 positions continue to do so. As shown in Figure 4, the board transferred the other 127.5 auditor positions to support functions because it believed that the resources were needed to perform functions other than auditing.

The board deployed over half the supplemental audit positions to support functions.

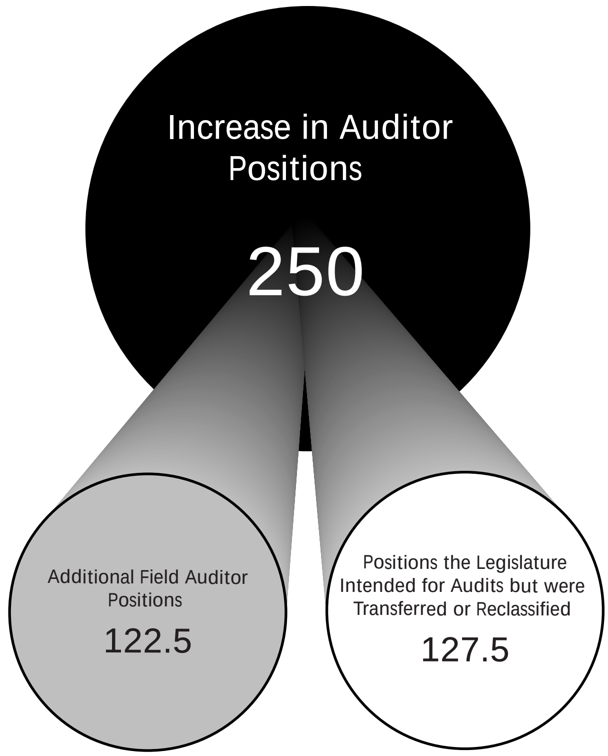
Figure 4 indicates that the board reclassified 21.5 auditor positions to other activities within the district offices. Most of these staff now perform duties related to the board's compliance program, such as collecting taxes and investigating fuel tax evasion.

The board also assigned another 49 audit staff to support functions within the Sales and Use Tax Department. Their duties include answering the public's questions, investigating fuel tax evasion, handling disputes of taxes, performing special projects, giving field auditors direct technical support, and performing central planning and evaluation for the board's compliance program. The board has indicated that eight transfers are temporary and expects to return the positions to the audit program in the future.

Another 57 audit staff assist the board in its broader mission of administering tax and fee programs by developing and maintaining computer systems, handling appeals of tax assessments and public inquiries, and assisting board members.

FIGURE 4

More Than Half of the Audit Revenue-Generating Positions Were Transferred to Support Functions



Field Auditors Reclassified Within the District Offices	**21.5**
Transfers to Support Functions Within the Sales Tax Department	**49.0**
Transfers to Support Functions Outside the Sales Tax Department	**57.0**
Total Positions	**127.5**

While district office personnel costs rose 24 percent, audit support costs rose 29 percent.

These transfers have contributed to support costs for the audit program rising at a higher rate than audit personnel costs for the district offices. While district office personnel costs for the audit program rose 24 percent from fiscal years 1991-92 to 1997-98, audit program support costs rose 29 percent. The audit program support costs include expenses for audit headquarters staff as well as administrative staff, which primarily includes personnel in the legal and technology services divisions who charge time to the audit program. We estimate that of the $13.5 million budgeted in fiscal year 1997-98 for the supplemental audit staff, only $6.6 million funds the 122.5 audit positions. The remaining $6.9 million funds the 127.5 support functions.

Further, even though the board has the discretion to deploy its budgeted resources as it deems best to administer its $28.1 billion sales tax program, using audit staff for support functions diminishes the board's ability to generate audit revenues, which was the basis for the Legislature authorizing additional staff.

The Board's Projections for Revenue Enhancements Contain Flaws

The board's revenue projections for supplemental field auditors in its budget change proposals were overly optimistic, largely because the board failed to consider new, inexperienced auditors' limited contributions during their first year. Further, the projections failed to account for training time experienced auditors must devote to new staff. Also, the projections assumed that all field auditors charge more audit hours than they actually do and did not factor in vacancies.

First-Year Field Auditors Produce Less Revenue Than Projected

The board's revenue projections significantly overstated the amount of time new field auditors would report during their first year of employment because first-year auditors charge fewer audit hours than the district office average. When projecting revenues that new auditors would generate, the board's calculations use 1,600 audit hours as the average. However, a board study of 109 field auditors hired in 1992 found that new employees averaged 800 audit hours during their first 12 months of employment. The study indicates that its estimate of audit hours attributable to the new positions was overstated because it did not consider that new auditors receive extensive training and mentoring to develop their skills, thus limiting the number of audit hours they charge during their first year.

A board study disclosed that new auditors average 800 audit hours during their first year, almost half that of experienced staff.

The study also showed that first-year field auditors produce lower tax assessments per hour than more experienced field auditors working on similar audits. In its revenue projections, the board used the amount earned per audit hour on its least productive audits. The board correctly assumed that existing audit staff would perform high-dollar audits and that new staff would cover low-dollar audits. However, while the board's projections calculate $146 in tax revenues per audit hour for the least productive audits, its own study now shows that first-year field auditors only generated $103 per hour, 29 percent less than it projected.

Moreover, providing training to the new auditors also lowers the revenues produced by experienced auditors. The study shows that the ratio of trainees to trainers is usually 2-to-1. With the addition of 200 field auditors in fiscal year 1992-93, 100 trainers would have been required. Assuming the training lasted three weeks, experienced auditors would have spent over 12,000 hours providing on-the-job training. Because trainers were not able to perform their normal assignments during training, we estimate that audit revenues would have fallen $1.8 million short of original projections during the first year.

If it had fully factored in auditor inexperience, training time, and reduced revenues for experienced auditors who conduct training in its fiscal year 1992-93 revenue projections for the 200 supplemental auditors, the board would have more accurately estimated the first-year revenues to be $14.7 million instead of $40.9 million, a reduction of $26.2 million.

Average Hours for All Field Auditors Are Lower Than Estimates

In addition to failing to consider the reduced revenues for first-year auditors in its projections, the board also overstates the number of audit hours that the average field auditor charges. We reviewed audit hours charged by field auditors from fiscal years 1991-92 to 1997-98 and found that field auditors charge an average of only 1,400 audit hours per year. When developing budget estimates, however, the board assumes that each field auditor spends 1,600 hours auditing during the year. However, other activities, such as training, recruiting, and answering the public's questions, reduce the number of audit hours actually charged. In adjusting the revenue projections for the 200 positions added in fiscal year 1992-93 by the lower average of 1,400 audit hours actually charged, we find that the ongoing revenue projections should have been $40.9 million instead of $46.7 million, a difference of $5.8 million.

The board overestimated auditors' chargeable hours by 13 percent, thus overstating related projected revenues.

Following our discussions with the board about the actual audit hours charged per auditor, board staff performed a similar analysis for fiscal year 1997-98. Although the board agreed with our average of 1,400 hours for all auditors, staff nevertheless concluded that entry-level auditors averaged 1,459 audit hours. Because all additional auditors began in entry-level positions, the board believes that the average hours for entry-level auditors better represents the increased audit effort. Using the board's figure, its projections overestimated revenues by $4.1 million, as compared to our calculation of $5.8 million. Although the board's estimate differs from ours, both calculations demonstrate that the board should not use an average of 1,600 audit hours to estimate revenues.

The Board Did Not Always Consider Vacant Positions in Its Calculations

Although the budget change proposals reduced costs of the new auditors for vacancies, the board did not factor in vacancies into its revenue projections related to the fiscal year 1992-93 budget change proposal. Because of leaves of absence, staff turnover, and recruiting delays, it is difficult for a department to keep all authorized positions filled for the entire year. The vacancy factor that the board included in the cost figures was 5 percent. Using this rate, the board's annual revenue projection should be reduced by $2.3 million. However, since fiscal year 1990-91, we determined that an average of 9.3 percent of the board's auditor positions were vacant. The additional 4.3 percent of vacancies indicate the board overstated revenues by another $2 million annually, for a total annual overstatement of $4.3 million.

Since fiscal year 1990-91, 9.3 percent of the board's auditor positions have been vacant.

In its audit report to the Legislature, the board recognized that a high number of vacancies contributed to decreased audit revenues in fiscal years 1995-96 and 1996-97. It attributed these vacancies to difficulties in recruiting and retaining staff. The board claims the public perceives that state salaries and benefits are less competitive than the private sector. However, the board did not attempt to quantify the effect of the high vacancies on revenues.

CONCLUSION AND RECOMMENDATIONS

The board needs to improve its process for estimating revenue enhancements related to increased audit staffing to ensure that it realistically projects increased revenues. Although the board received an additional 250 auditors to increase audit revenues, it only increased audit revenues by $2 for every $1 dollar spent on the additional auditors—not a 5-to-1 ratio as the board had suggested. Additionally, despite receiving additional audit staff, audit effort is basically unchanged from fiscal year 1991-92 levels.

If the board intends to request funding for auditors to generate additional revenue, it should use these resources to supplement, rather than supplant, the auditors it has in the field. However, if the board determines later that the resources can produce a greater benefit in support functions, the board should report this to the Legislature.

To project revenues more accurately, the board should revise its revenue projections as follows:

- Realistically estimate the time that auditors actually devote to audit-related activities, taking into consideration the training time needed for new auditors.

- Adjust for staff vacancies.

- Reduce the projections for those positions that it will not directly use to generate audit revenues.

Lastly, the Legislature needs to carefully consider the board's requests for additional auditors. Specifically, the Legislature should require the board to demonstrate that it has realistically projected additional revenue that these auditors will generate. The Legislature should also agree with the board on the appropriate method for determining the growth in revenue attributable to these additional positions. Further, if it does approve funding for additional auditors, the Legislature should require the board to fill these positions as intended, or report staff reassignments. ■

CHAPTER 2

The Board of Equalization's Audit Report Was Responsive, but It Was Not Required to Provide All Key Data

CHAPTER SUMMARY

The Board of Equalization's (board) audit report adequately responded to the Legislature's request for information about the audit program. Except for the omission of the program's share of costs for computer system development, which did not materially affect the overall costs, we found that the audit report data was generally accurate.

Although the board's report responded to the Legislature's concerns about the revenue impact of the additional audit positions, the Legislature's request did not solicit key information that would allow it to adequately assess the revenues the 250 audit positions generated or address other specific concerns.

THE BOARD'S REPORT ACCURATELY RESPONDED TO THE LEGISLATURE'S REQUEST FOR INFORMATION

The board's audit report appropriately addressed each of the six areas that the Legislature requested it cover. The Legislature included its request for information on the audit program in the *Supplemental Report of the 1997-98 Budget Act* to help it and the Legislative Analyst's Office better understand how the additional audit positions impacted revenue.

We reviewed the board's response and found that it contained the appropriate level of information to satisfy the request. We also found that the information in the report was generally accurate, even though the board did not include development costs for the Integrated Revenue Information System. Because this system integrates various applications in many of the board's programs, some of the $16.7 million in development costs should have been allocated to the audit program. The contract to develop the system specifically allocates $645,000 to the audit program. However, compared to the fiscal year

1996-97 audit program costs of $112.7 million, omitting these costs is immaterial. We found no material errors in our sample of other costs and data contained in the audit report or in the board's estimate of collection costs related to the sales tax program.

ALTHOUGH USEFUL, THE LEGISLATURE'S REQUEST TO THE BOARD COULD HAVE BEEN MORE FOCUSED

The Legislature's request for the report elicited useful information from the board, but it did not require all information needed to answer specific concerns. When requesting this report in the *Supplemental Report of the 1997-98 Budget Act*, the Legislature wanted to determine the validity of the board's revenue projections for the added audit staff. However, the information it required was too general to clearly demonstrate the impact of the supplementary staff.

INFORMATION REQUIRED ON THE AUDIT PROGRAM, AS STIPULATED IN THE *SUPPLEMENTAL REPORT OF THE 1997-98 BUDGET ACT*

"The report shall, at a minimum, identify by fiscal year since 1992-93 (a) authorized, filled, and vacant auditor positions, (b) the classification of all authorized, filled, and vacant auditor positions, (c) the number of supervisory auditor positions, (d) the approved and filled program assignment of all authorized auditor positions, (e) the revenue identified and collected through the audit activities of the filled auditor positions by types of audit, and (f) the total costs—direct and indirect—of identifying and collecting these revenues through audit."

In making this request, the Legislature needed to consider the board's ability to quickly gather the information. However, other data exists that would have made the board's report more valuable to the Legislature and other interested parties. Specifically, the request did not solicit the amount of audit revenue generated before the board received the 250 additional auditor positions. The revenue prior to the augmentations would enable a comparison of the incremental change in audit revenues. The request could have further required the board to support the 5-to-1 ratio it suggested that audits can generate. If the report contained this information, it would better illustrate the true rate of return on audit activities. Further, the request could have asked the board to first calculate an overall rate of return and then calculate the rate of return for only the 250 new audit positions.

Lastly, the request did not ask the board to state how it had used the audit positions. As noted previously, we determined that only 122.5 of the 250 positions are auditing businesses while the remaining 127.5 positions serve in various support functions. This information would tell the Legislature and other interested parties that many supplemental audit positions are not currently generating audit revenues, contrary to the original intent in the budget change proposals.

RECOMMENDATION

In any future request for program information from the board, the Legislature should tailor the request to more specifically address its concerns. By doing so, the Legislature can gather relevant information that is more valuable to it and other interested parties.

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 governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

KURT R. SJOBERG
State Auditor

Date: March 10, 1999

Staff: John Baier, CPA
Michael Tilden, CPA
Nathan Checketts
Tone Staten, CPA

Agency's response provided as text only:

State Board of Equalization
450 N Street
Sacramento, CA 95814

Mr. Kurt R. Sjoberg
State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814

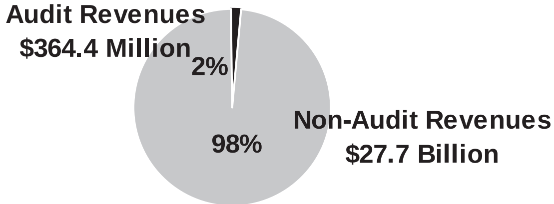
Dear Mr. Sjoberg:

Thank you for the opportunity to review and comment on the Bureau of State Audits' (BSA) draft audit report entitled "Board of Equalization: Budget Increases for Additional Auditors Have Not Increased Audit Revenues as Much as Expected."

The State Board of Equalization (BOE) has completed its review of the BSA's February 26, 1999 draft report and has no conceptual disagreement with your findings concerning the utilization of positions approved to conduct audits and the need to revise and update the method used to project audit generated revenues. We appreciate your acknowledgement that the Audit Program Report submitted by the BOE to the Legislature in compliance with Item 0860-001-0001 of the Supplemental Report of the Budget Act of 1997 was accurate and responsive. Regarding general comments, following is additional information that is intended to provide clarification and perspective to items discussed in the draft report.

While the Audit Program is an important function within the BOE's sales and use tax program, the chart on the following page portrays graphically the relatively small proportion of total (direct) revenue it accounts for. It was responsible for only 2% of the $28.1 billion in revenue collected in fiscal year 1997-98. The difference, $27.7 billion (98%) was self-assessed by the nearly one million taxpayers who voluntarily remitted taxes with either monthly, quarterly or annual tax returns. Audits have an impact on these revenues as well, but so do many other important taxpayer support activities that rely on new technology and more modern practices to improve voluntary compliance, so that the taxpayer's compliance burden is minimized as much as possible. This is not to excuse our not having reported the redirections, but to put the Audit Program in perspective and to explain our overall agency focus on total revenues. The BOE processes and verifies taxpayers' remittances and in addition performs audits on approximately three percent of the one million taxpayers annually to ensure compliance with the State's sales and use tax laws. The BOE's audit program complements the return processing program to facilitate the remittance and collection of tax revenues and increases overall sales tax revenues through better taxpayer compliance and education.

Actual 1997-98 Sales and Use Tax Revenues



We would like to make two comments on technical points contained within the report. First, the BOE did not initiate budget change proposals requesting the 250 audit positions that are the focus of the report summary and the first chapter. During the development of the State's budget, the BOE responded to requests initiated by the Administration and the Legislature to develop plans for accommodating additional positions for the purpose of increasing General Fund revenues. This was to help offset major budget shortfalls during a severe recessionary period in California. Upon completion of budget deliberations regarding the respective plans, the BOE received 200 audit positions during the 1992-93 budget process and 50 more in 1995-96. For the period of 1992-93 through 1997-98, the revenue estimates and costs reflected in these plans translated into an anticipated benefit to cost ratio of $4.20 for every $1 spent.

The second comment relates to the revenue estimates reflected in these plans. Based on an earlier study, it was determined that each new field audit positions received would spend 1,600 hours in direct auditing per year. The revenue estimates relied on the findings of this study. Following discussions with the BSA on a study they conducted using time reporting information unavailable at the time of the original estimates, BOE staff performed a similar study. The BOE study validated the BSA's results showing an average of 1,400 hours for all auditors. However, our study indicated the average number of hours worked by entry-level auditors averaged 1,459 hours of direct auditing per year.

The change from 1,600 hours to 1,459 hours per year is the result of the field audit program's evolution into a multi-faceted function, directly impacting the field staff and the hours devoted to direct field audit activities. The audit program now encompasses other growing critical needs and mandated requirements beyond direct audit activity, such as outreach programs, customer service activities, and taxpayer education. These efforts increase overall sales tax revenues by improving voluntary compliance through less intrusive, though more difficult to measure, methods. Examples are described on the following pages.

The BSA report also discusses the redirection of audit positions from field audit functions to other functions within the BOE. As the BOE was confronted with constantly changing demands and operational needs, between fiscal year 1992-93 to the present, the BOE found it necessary to redirect 127.5 positions. We also believe that it is important to articulate the actual benefit of the 122.5 audit positions that remain in the field dedicated to direct field audit activities. Based on data included in the BSA draft report, at a cost of $6.6 million, the audits conducted by the 122.5 positions will generate $18.5 million in sales tax revenue annually. The BOE determined that the redirections were necessary to effectively and efficiently generate sales and use tax revenues. These other functions include, but are not limited to:

- Collection of Audit Assessments
- Adjudication of Audit Appeals
- Taxpayer Assistance with Inquiries
- Technology Support for Audit Tasks
- Technical Planning and Program Evaluation for Audit and Collection Activities

The benefits derived from the redirected positions are described in the following:

Computer Audit Specialists — The Technical Support and Analysis Section, which is located in Headquarters, includes a group of auditors who are physically located in district offices. These auditors are Computer Audit Specialists (CAS), and they form the core of the Computer Audit Program. This program was developed in response to the need to audit through sophisticated taxpayer computer systems. The CAS receive in-depth training in computer programming and auditing techniques. They provide direct, technical support to auditors who are reviewing complex accounting records maintained on computer. Test samples that once took weeks or months to develop can now be obtained electronically in a matter of hours. Assisted audit staff make better testing decisions, which results in a more accurate work product and fewer contested audits.

Legal —The Legal Division furnishes services with respect to the full scope of the BOE's activities under the law. This includes handling the taxpayer audit appeals and legal counsel on complex sales and use tax audit issues.
Taxpayers most often file appeals as the result of a BOE audit. Although most appeals are resolved at the district level, the Appeals Section represents the next level of appeal for those that are not. The appeals operation is a separate and distinct section staffed by appeals attorneys and appeals auditors who have had no prior involvement with the case. The section directly supports the audit program by conducting administrative conferences on petitions for redetermination, claims for refund, jeopardy determinations, and successor's liability on behalf of both the petitioner and the audit staff.
The Sales and Use Tax Section of the Legal Division directly supports both the Sales and Use Tax Program as a whole and the audit function individually. It does so by rendering written legal opinions and giving legal advice to program staff on all segments of the program, furnishing interpretations to the public on the application of the sales and use tax law, and meeting with taxpayers to discuss and consider their specific tax situation. The complexity of audit issues has continued to rise as we see advances in technology, changes in business practices, increased passage of new legislation, and ongoing regulatory amendments, to list a few of the variables.

Customer and Taxpayer Services —Annually, several thousand telephone calls are received from taxpayers inquiring about the taxability of their sales and services. District office staff previously handled these telephone inquiries and if the question related to the tax law or audit procedures/policies, the inquiry was generally referred to a tax auditor. The volume of such inquiries required the district offices to have tax auditors available in the office rather than in the field performing actual audits. In an effort to improve customer service, the BOE established an 800 line to centrally respond to the calls.

The centralization of this customer information function achieved through redirection of the field staff ensures that information provided to taxpayers and their representatives, legislators, other state agencies, the news media and interested parties throughout the nation, is uniform and correct. This in turn promotes improved compliance with sales and use tax laws. A better informed and more compliant customer base will result in a decreased need for field auditors to educate the taxpayers they audit, and a reduction in audit hours. Thus, the redirection of field audit positions to the Customer and Taxpayer Services Division has had a beneficial impact on the department's audit program, as well as on the sales and use tax program as a whole, while helping to achieve an important aspect of the BOE's mission. In fact, the success of the BOE's customer service efforts were recently recognized in a survey by the Wall Street Journal.

<u>Revenue Opportunity Positions</u> —Redirections of field staff positions to the Technical Support and Analysis Section were used in their Revenue Opportunity Team. This two-person team identifies sources of state revenue that might otherwise go uncollected develops programs to discover non-filers and improve voluntary compliance, and researches ways to identify and correct pockets of noncompliance.

One such revenue opportunity project involves retailers located outside California who may be required to collect and report California use tax on sales of tangible personal property that is used, stored, or otherwise consumed in this state. Under this program, retailers and/or their representatives contact the Revenue Opportunity Team to submit voluntary registration agreements. In 1997, the Revenue Opportunity Team received approximately $700,000 in tax from out-of-state retailers with their initial applications. In 1998, approximately $2 million was received. These amounts represent the out of state retailers' back tax liability, and do not include taxes that these entities currently report now that they have been brought into compliance.

In another project, the team obtained a list of use tax leads on purchases of farm and construction equipment made by California residents from out of state equipment dealers. In most cases, the dealers who sold the equipment are not engaged in business in California and the tax was most likely not to be reported by purchasers. Consequently, the leads are being sent out to the district offices to investigate to ensure that the use tax due is paid. The Revenue Opportunity Team is distributing approximately 12,000 leads with a total estimated taxable measure of $100 million.

<u>Audit Evaluation & Planning</u> —Redirections provide direct field audit support in a number of critical areas, including, but not limited to:

- Establishing procedures to improve use of computer technology in performing field audits;
- Reviewing and providing recommendations on requests from the field dealing with newly enact procedures such as those related to the use of prior audit percentages, and the reliance on written advice (Regulation 1705).
- Updating field audit procedure manuals to ensure consistent audit approaches and adherence to work paper standards; and
- Responding to management and Board Member information requests to provide analyses of proposals which directly affect the audit program.

Automated Compliance Management System (ACMS)—From June 30, 1992 to June 30, 1996, the BOE's accounts receivable increased from $343 million to $456 million (an 8% yearly increase). This increase was due primarily to the increase in audit assessments during that period. The Board-assessed portion of accounts receivable (of which audits are the predominant component) increased from $215 million to $303 million over this four-year period. In order to stem this increase in accounts receivable without requesting a large number of new positions, it was necessary to automate certain portions of our compliance activity. This automation was realized when the ACMS was implemented in August of 1996.

ACMS has increased collector productivity significantly. Over the first two years of operation, the ACMS resulted in the collection of an additional $106 million in revenue. While some support positions were included with the BCP that funded the ACMS project, experience operating the system showed that additional support was needed to further refine and improve the system.

Technology Services– The BOE's automated systems have been key in allowing staff to handle the volume of work that passes through the agency. But because these systems were established in a piecemeal fashion, information sharing became difficult. As a result, the many stand-alone systems no longer adequately provided for the BOE's information needs. To meet the demands of BOE's ever-changing business, the BOE chose to move, or migrate, its computer programs from the aging in-house Unisys mainframe computer to an IBM mainframe at the Teale Data Center. This migration provided the opportunity to integrate various data bases into the Integrated Revenue Information System (IRIS).

The redirections made it possible to establish the "Audit Subsytem," a major part of IRIS, which will maintain audit information about a taxpayer within a tax program. This application will provide district offices with information such as assignment control, case management, and statistical reports. Audit areas affected include selection, control, review, and billing.

With additional software enhancements, the BOE will be able to obtain reporting and audit information from other tax agencies such as the IRS and FTB, incorporate the data into our audit selection model, and more easily identify under-reporters for selection purposes. These future needs would not have been met had it not been for the audit staff working on IRIS recognizing these needs and ensuring that the data in the prescribed format would be available.

Currently, the Audit Control Unit processes approximately 20,000 assignments per year. The file must be pulled on each one, the returns must be compiled and data entered into a spreadsheet, and the resultant spreadsheet must be mailed to each district performing the audit. Often the district is required to update the spreadsheet because the audit assignment could not be started for several months after the spreadsheet has been sent by Audit Control. IRIS will provide the capability to more expeditiously accomplish this with much less manual effort.

Finally, over the past six years, the BOE has made a concerted effort to prudently manage the resources available to carry out the mandated responsibilities of administering the sales and use tax program. Some of the ongoing BOE operational efficiencies and economies achieved over this period of time follow:

- Reduced the number of sales and use tax field offices from approximately 60 to 30.

- Consolidated the Bakersfield, Stockton and Ventura offices into joint Taxpayer Service Centers that include the BOE, EDD and FTB. The joint Taxpayer Service Centers enable taxpayers to obtain assistance at one location.

- Implemented an Automated Compliance Management System (ACMS) to enhance accounts receivable collections and productivity. Routine manual collection processes have been automated to secure payment and/or establish accounts receivable by establishing prompt communications on delinquent accounts.

- Voluntarily identified and sustained ongoing budget reductions totaling $7.6 million and 113.4 positions in program support savings. For 1997-98, this included a reduction of $1.6 million and 32 positions as a result of increasing the BOE's average staff to supervisor ratio from 7.5:1 to 8.0:1. Overall, the BOE's cost of doing business is expected to be less than 1% of the revenue collected on behalf of the State and local jurisdictions.

- Piloted the use of Local Area Network technology in two of the SUTD district and branch offices (San Jose/Salinas and Ventura/Bakersfield) to improve field office staff efficiency and effectiveness. It is anticipated that this project will be used to formally establish the costs and benefits of installing LANs in the field, and to demonstrate the audit and compliance productivity gains and benefits. It is anticipated that results will support expansion to the BOE's other field offices.

- Implemented electronic fund transfers and credit card payments for Sales and Use Tax permit holders.

- Introduced new printer technology and modern mail inserting equipment that has increased productivity and greatly improved internal and external customer services.

- Established a new Customer and Taxpayer Services Division to assist the public through taxpayer education and services (e.g., informational publications and document translations). The BOE introduced and has been enhancing Information Center/Toll Free 800 Telephone and Internet access for taxpayers.

- Promoted Taxpayers Bill of Rights hearings to provide a forum for taxpayers to present suggestions for improving agency services and administrative procedures and for modifying the tax laws.

Please note that upon the release of the report, we will be providing our Board Members with a copy along with staff comments. If you have any questions or need additional information, you may wish to have your staff contact Ms. Sally Lee (Deputy Director, Administration) at (916) 445-4274 or Mr. Ed Steele (Chief, Financial Management Division) at (916) 445-3811.

Sincerely,

(Signedby: E.L.Sorensen,Jr.)

E. L. Sorensen, Jr.
Executive Director