FRANCHISE TAX BOARD

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

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.***

REPORT NUMBER 2002-124, MAY 2003

Franchise Tax Board response from the State and Consumer Services Agency as of May 2004

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. 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 through the board's various assessment activities.

The Joint Legislative Audit Committee requested that we review the board's audit and collection programs, identifying recently acquired audit and collection program positions, 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. We were also asked to review the board's methodology for calculating the costs and benefits of its audit and collection programs. Finally, we were asked 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. We found that:

Finding #1: The board uses a variety of performance measures and does not always describe their differences in public documents.

The 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. In contrast, the historical measures reported in the board's annual operations reports are calculated using full costs.

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. 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.

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 our report. 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. 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, in budget change documents and other reports given to external decision makers, it should:

- Explicitly disclose the elements not included in the cost components of various performance measures used to assess the audit and collection programs and the effect of their absence.

- Disclose the overlap in benefits claimed by its audit and collection programs.

Board Action: Partial corrective action taken.

The board reports that it has developed and deployed an enterprise Activity Based Costing (ABC) tool, which provides information on the costs to perform various processes and business activities. The ABC model includes both direct and indirect processes and activities, which contribute toward the board's programs, including programs that provide revenue to the state. The ABC model enables the board to calculate the "cost" element of the CBR. The board states that it is using the foundation of this model to link the cost of work to the revenue generated. With newly added "revenue streams," the board reports that it will be able to more completely measure program performance—that is, the total cost and total revenue by programs such as the audit and the filing enforcement programs.

The board states that to add revenue to the ABC model, it is initially using revenue stream data from existing fiscal year 2002–03 data sources in order to produce test performance measures. These test performance measures will be evaluated, and recommendations for improvements for fiscal year 2003–04 data collection will be developed. Furthermore, the board is analyzing changes required for existing information systems to produce the data required for a complete measurement for use in the ABC model, and will make recommendations for future changes. Long term, the board expects to use the ABC model to produce meaningful return-on-investment data that, along with other enterprise performance measures, can facilitate decisions about the best use of available resources.

Finally, the board reports that it has begun to provide clarification to performance measures reported to external decision makers. The board plans to continue this practice in future communications.

Finding #2: Prospective cost-benefit ratios for individual audit types do not reflect historical performance.

The board's historical performance measure of returns on its audit program includes the full effect of indirect costs, including departmental overhead, but the prospective CBRs for individual audit types do not. Thus, when 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.

When we deflated the board's projected returns by actual departmental overhead costs, we found that had the board included full departmental overhead costs, the total actual return in assessments would closely resemble the board's projections. However, when we examined individual audit types, the variance was much greater, and the workplan projections failed to mirror historical 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. 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.

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:

- 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.

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. Moreover, the board should use the results of the comparison in future calculations of prospective CBRs.

Board Action: Corrective action taken.

The board states that it is continuing to review the methods of gathering data for its operations reports. It reports that it is currently examining revenue as reported by one of its major taxpayer information systems. The board is working with system staff to more accurately capture the revenue from audit and filing enforcement activities. The board states that this has included rewriting system design documents as they relate to revenue, and working with staff to ensure the accuracy of the reporting of revenue. With respect to cost issues, the board reports that it is looking to use ABC to better link the costs and the activities.

The board further reports that it has compiled initial costs and benefit information for its current workplan process and has made this preliminary information available to both Finance and the LAO. The board states that it is continuing its analysis to perfect these initial computations to ensure that the cost components within the CBRs are accurate and attributed to the correct workloads. The board plans to use this information as one of several factors in its calculations of projected CBRs.

Finding #3: The board's budget change documents do not show how new audit positions have met projected results.

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 titled *Franchise Tax Board: Its Revenue From Audits Has Increased, but the Increase Did Not Result From Additional Time Spent Performing Audits,* 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.

While the board's resource request format does include many of the features we previously recommended, it does not detail historical and projected hours and assessments by audit type as we had suggested. Rather, the board summarizes all desk, field, and Internal Revenue Service follow-up audit activity into a single category, which obscures the very different returns on each of the personal income tax and corporation tax audit types. 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.

To provide useful information to decision makers when requesting additional audit positions, the board should use a format, shown in our 2003 report, 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.

Board Action: Corrective action taken.

The board reports that if it requests additional audit positions it will continue to adhere to the specific budget instructions provided by Finance for the establishment of new positions. This would include any information Finance may require in its review of any audit position request including an analysis of the work to be performed by the new auditors and the associated assessments to be derived. In addition, the board reports that it has modified its supporting audit workplans for both the current and budget year to include the actual returns of each of the specific workload types that are currently being performed. The board states that the confidential backup detail to the summary workload matrix is available to Finance or the LAO upon request and will include historical CBR information for each workload type. Finally, the board reports that in November 2003 it met with Finance staff and they accepted these changes to the CBR matrix.

Finding #4: The incremental benefit of new audit positions was originally negative but has increased recently and measuring the incremental benefit of additional collection program staff proves elusive.

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 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 revenue.

To determine the incremental benefit of the 340 net new audit positions between fiscal years 1992–93 and 2001–02, we isolated their budgeted costs and the actual assessments associated with the audits to which the board would have likely assigned the new staff. We found that the new audit positions generated average assessments of only $0.79 for every $1 of cost. It is important to note that the return on the additional positions shows improvement over more recent fiscal years. Between fiscal years 1998–99 and 2001–02, the new positions produced average assessments of $2.71 for every $1 of cost. Changes in the economy probably affected the return on these audit positions, but a significant cause of the low return is that despite having additional staff, the board did not increase the number of hours staff spent performing audits. The collection program received 175 positions between fiscal years 1998–99 and 2001–02, promising increased revenue of $179 million over that period. However, because of limitations in board data, we could not determine the return on the collection program positions.

See the recommendation under finding #3 above for addressing the measurement of the effectiveness of additional audit positions. To better measure the effectiveness of its additional collection positions, the board 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.

Board Action: Corrective action taken.

The board reports that it has tested and evaluated a refined methodology for measuring the effectiveness of manual collection efforts. Specifically, the board created a conceptual framework for measuring inputs in terms of time expended by direct collection staff and support staff, and matching the results in terms of dollars collected. The board states that it has populated this model, conducted testing, and implemented it within its manual collection process. The board states that the model allows it to establish a base year for comparison with subsequent year's results. The board reports that it has validated the accuracy of the data gathered to date. However, the board states that because of the three-year duration of the collection lifecycle, the revenue stream will not be fully populated until this period has elapsed for accounts paid incrementally.

Finding #5: 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 Accounts Receivable Collection System (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 the system to justify future staffing needs.

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 the 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.

Board Action: Partial corrective action taken.

The board reports that the workload tracking and revenue assignment methodology discussed above will complement the process used to project potential revenue from new collection positions that may be added in the future. Furthermore, the board states that the new reporting methodology was implemented on a limited basis in January 2004, and will continue to be implemented throughout the collection program in a phased approach over the next 12 to 18 months.

Finding #6: 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 merit salary adjustments (MSA), 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.

Since the loss of separate MSA funding, the board has required 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 Finance recently began eliminating those positions in state departments.

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.

Board Action: Corrective action taken.

The board reports that it conducted a department-wide redeployment process to meet mandated budget cuts. As a result, the board contends that the vacancy rate for the collections program is at a historic low—less than 4 percent. The board also states that it is determined to fill vacancies as quickly as possible, but is sometimes prevented from achieving this goal by constraints that include meeting mandated salary savings, and because budget authority for new positions is often delayed due to the legislative cycle and budget constraints. To counteract these constraints in future hirings, the board plans to request position effective dates that more accurately reflect new hire start dates.