REPORT OF

THE

STATE AUDITOR

Department of Revenue
Business Tax Audits

Performance Audit
January 2003

LEGISLATIVE AUDIT COMMITTEE
2003 MEMBERS

Senator Ron Tupa
Chairman

Representative Tambor Williams
Vice-Chairman

Senator Norma Anderson
Representative Fran Coleman
Representative Pamela Rhodes
Senator Stephanie Takis
Senator Jack Taylor
Representative Val Vigil

Office of the State Auditor Staff

Joanne Hill
State Auditor

Sally W. Symanski
Deputy State Auditor

Brenda Berlin
Greg Fugate
Eric Johnson
Legislative Auditors

STATE OF COLORADO

JOANNE HILL, CPA
State Auditor

OFFICE OF THE STATE AUDITOR
(303) 869-2800
FAX(303) 869-3060

Legislative Services Building
200 East 14th Avenue
Denver, Colorado 80203-2211

January 17, 2003

Members of the Legislative Audit Committee:

This report contains the results of a performance audit of the Department of Revenue's Field Audit Section. The audit was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. The report presents our findings, conclusions, and recommendations, and the responses of the Department of Revenue.

TABLE OF CONTENTS

JOANNE HILL, CPA
State Auditor

Department of Revenue
Business Tax Audits Performance Audit
January 2003

Authority, Purpose, and Scope

This performance audit of the Department of Revenue's Field Audit Section was conducted under the authority of Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of state government. The audit was conducted in accordance with generally accepted government auditing standards. Audit work was performed from March through August 2002. We gratefully acknowledge the assistance and cooperation of staff at the Department of Revenue in completing this audit. The following summary provides highlights of some of the comments and recommendations contained in the report.

Overview

The Field Audit Section (Field Audits), which is located in the Tax Auditing and Compliance Division within the Department of Revenue, is responsible for conducting audits of Colorado businesses in order to determine the correct state and local tax liabilities owed to the State. As of September 2002, there were approximately 446,000 corporations, sole proprietorships, and partnerships registered in the State, all of which are potentially subject to audit by the Field Audit Section. There are more than 50 different tax liabilities that Field Audits is responsible for auditing; however, the primary taxes that the Field Audit Section audits include corporate income, sales, and use.

In Fiscal Year 2002 the total amount of state and local taxes collected by the Department and subject to audit by Field Audits was about $3.8 billion. Of this amount, about $3 billion was state revenue, while the remaining $0.8 billion represents taxes collected by the State on behalf of certain local governments.

Audit Selection

As part of our audit, we reviewed the Field Audit Section's processes related to selecting and scheduling businesses for audit. We found the following areas for improvement:

- **A systematic method for tracking local government audit requests is needed.** The Field Audit Section receives audit requests from the cities and counties that have designated the State as their agent to collect business-related taxes. Audits are usually requested because a local government has identified a problem with a business's tax payments. Field Audits reports that the local government requests are high-priority audits. In order to determine whether Field Audits completed audit requests in a timely manner, we requested a list of requests received by Field Audits during Fiscal Year 2002. We found that staff could not systematically identify all of the local government audit requests received but not yet completed during Fiscal Year 2002. Although staff did provide us with a list of six audit requests that were completed in Fiscal Year 2002, we noted that the date of receipt for three requests was not adequately documented. Also, the Field Audit Section has not established time frames for initiating and completing audit requests or procedures for formally communicating audit results to the requesting entity and maintaining a copy of such correspondence.

- **The Department's focus on auditing small businesses is inequitable and may result in lost revenue.** The Field Audit Section currently devotes a significant percentage of resources toward auditing small businesses (e.g., about 39 percent of audit hours in Fiscal Year 2002). Field Audits needs to prioritize its resources to auditing businesses that represent the highest risk to the State in terms of lost tax revenue. In Fiscal Year 2002, 90 percent of Field Audits' dollar production (i.e., the sum of tax assessments and refunds identified during audits) resulted from audits of large businesses. In contrast, audits of small businesses generated only 6 percent of Field Audits' total dollar production for the same year. Additionally, in Fiscal Year 2002 audits of large businesses yielded about $1,000 in dollar production for every hour spent auditing, while audits of small businesses averaged about $96 per audit hour.

- **The Department's process for reviewing business tax data used for audit selection could be improved.** Currently the Field Audit Section performs a manual review of the Department of Revenue's listings of business tax information in order to ensure that all businesses remitting significant tax revenues are assessed for audit potential. In addition, staff review sources such as Forbes 500 business listings, *Denver Business Journal* listings, and other information including referrals from other sections in the Department. Field Audits could streamline its review of data and selection of businesses by using automated methods to perform its review of Department tax data. This could be done using audit software already used by staff during audits to analyze data from businesses. By using this software on electronic downloads of data from the Department's records, Field Audits could perform greater analysis on the data in a more efficient manner and potentially further refine its selection process. Additionally, Field Audits could incorporate an element of random selection in its process for selecting businesses for audit, which would ensure that each business in the State over a certain size has an opportunity of being chosen for audit.

Audit Quality

We examined a sample of audit files as part of our review and found the following:

- **Audit procedures were not always adhered to.** In our review of audit files, we found that Field Audits did not always follow established audit procedures and that management's review of the audits was not always adequate. We found that required forms were missing in 4 of 26 files and that a refund due to a taxpayer was not processed. Although the refund was small ($66), it is important that the Department have adequate controls over the billing and refund process to reduce the risk of errors and irregularities. Additionally, we found that managers do not always perform adequate review of audit files to identify errors. In our examination of 34 audit files where taxpayers had filed a protest, we found 2 instances in which the manager's initial review of the completed audit did not identify and correct errors made by the Field Audit Section auditor.

- **Additional analysis of audits where taxpayers filed a protest is needed.** Under Section 39-21-103, C.R.S., all businesses audited by the Field Audit Section have the right to protest the outcomes of their audits. We found that original tax assessments for protested audits were reduced between 13 and 43 percent for Fiscal Years 1999 through 2002. We believe that analyzing the cases that were subsequently reversed could help the Field Audit Section improve the quality of its audits. For example, in our review of 34 protested audit files, we identified 2 instances in which errors made by the auditor contributed to the change in tax assessment.

- **Audit assessment collection rates appear low.** We found that the Department collected between 22 and 51 percent of the net tax assessments made by the Field Audit Section from Fiscal Years 1999 through 2002. Since the effectiveness of Field Audits is, in part, dependent on how well the Department collects audit assessments, the Department needs to examine the underlying causes of low collection rates and identify ways to improve these rates.

Our recommendations and the responses of the Department of Revenue can be found in the Recommendation Locator.

RECOMMENDATION LOCATOR

All recommendations are addressed to the Department of Revenue.

Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
1	17	Establish a systematic method for tracking local government audit requests, and ensure audits are completed in a timely manner.	Agree	March 2003
2	21	Reevaluate audit selection methodology to achieve a more reasonable balance between identifying tax revenues owed to the State and promoting voluntary tax compliance.	Agree	January 2004
3	21	Improve adherence to established audit cycles.	Agree	Ongoing
4	23	Incorporate automated methods and random selection in process for identifying potential audit candidates.	Partially Agree	October 2003
5	25	Implement formal procedures for prioritizing the assignment of small business audits.	Agree	April 2004
6	26	Improve the process for compiling master lists for large, in-state businesses.	Agree	April 2004

RECOMMENDATION LOCATOR

All recommendations are addressed to the Department of Revenue.

Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
7	28	Improve the review process for Out-of-State businesses by standardizing review procedures and documenting reasons for deviations from review cycles.	Agree	October 2004
8	31	Improve audit procedures by (a) ensuring assessment amounts in audit files and in tracking and billing systems agree and (b) developing an internal peer review process for completed audits.	Agree	a. Implemented b. None provided; dependent on funding
9	34	Improve tracking and analysis of information on protested audits.	Partially Agree	October 2003
10	37	Investigate ways to improve collections.	Agree	December 2003
11	39	Ensure management reports are accurate and reliable.	Agree	October 2003

Overview

Background

The Colorado Department of Revenue (Department) is responsible for the administration and enforcement of the State's tax laws. As part of this responsibility, the Department collects various taxes owed to the State and enforces compliance with the laws by conducting audits of the State's taxpayers.

The Field Audit Section (Field Audits), within the Department's Tax Auditing and Compliance Division, is responsible for conducting audits of Colorado businesses in order to determine the correct state and local tax liabilities owed to the State. As of September 2002, there were approximately 446,000 corporations, sole proprietorships, and partnerships registered in the State, all of which are potentially subject to audit by the Field Audit Section. Although the number of tax liabilities varies between businesses, overall there are more than 50 different types of tax that Field Audits is responsible for auditing, including corporate income, sales (state, county, and city), consumer use, RTD sales, Football District Stadium sales, Scientific/Cultural Facilities District sales, cigarette, and wage withholding.

In Fiscal Year 2002 the total amount of state and local taxes collected by the Department and subject to audit by Field Audits was about $3.8 billion. Of this amount, around $3 billion was state revenue; the remaining $0.8 billion represents taxes collected by the State on behalf of certain local governments. In Fiscal Year 2002, Field Audits estimates that it audited about 3 percent of the total tax dollars remitted by businesses.

One way the Field Audit Section measures its performance is the sum of tax assessments and refunds identified during its audits (i.e., total dollar production). In Fiscal Year 2002, Field Audits produced over $58 million in assessments and refunds that resulted from audits of about 7,100 tax liabilities. Field Audits counts each liability audited as a single audit. Although Field Audits does not track the number of businesses it audits each year, on average, a typical business is audited for about eight different tax liabilities. On this basis, the 7,100 tax liability audits in Fiscal Year 2002 equate to about 890 businesses. Historical production and number of audits for the Field Audit Section are shown in Table 1 below.

Table 1: Department of Revenue Field Audit Section Audit Production Fiscal Years 1999 Through 2002 (Dollars in Millions)

	Fiscal Year			
	1999	**2000**	**2001**	**2002**
Assessments[1]	$60.6	$48.4	$76.6	$55.5
Refunds[2]	$4.7	$2.4	$13.3	$2.6
Total Dollar Production[3]	$65.3	$50.8	$89.9	$58.1
Number of Audits[4]	7,100	7,150	6,780	7,110

Source: Department of Revenue Field Audit Section.
[1] Includes tax, interest, penalty, and penalty interest assessments.
[2] Includes refunds and interest.
[3] Includes amounts for atypical audits, which are audits that result in unusually large assessments or refunds. For example, in Fiscal Year 2001 atypical audits resulted in dollar production of about $35 million.
[4] Equals the number of tax liabilities audited, not individual businesses. On average, a typical business is audited for about eight different tax liabilities; therefore, 7,100 tax liability audits in Fiscal Year 2002 equate to approximately 890 businesses that were audited.

In terms of revenues realized from audits, the State does not collect all taxes that Field Audits assesses. According to Section 39-21-103, C.R.S., businesses may protest any assessment made by Field Audits; therefore, tax assessments may be reduced as a result of valid protests. As indicated in Table 2, audit assessments from Fiscal Years 1999 through 2002 have been reduced by between 7 and 43 percent due to protested audit settlements. This means, for example, that the maximum amount of revenue that the State can currently collect from Fiscal Year 2002 audit assessments is about $47 million. It should be noted, however, that the assessment figures for any of the fiscal years could be reduced further by additional protests settled in favor of taxpayers. This is because, although taxpayers have 30 days to protest an audit, it could take up to several years to settle a protest if the protest is regarding a question of tax law.

Table 2: Department of Revenue Field Audit Section Assessments, Cancellations, and Collections Fiscal Years 1999 Through 2002 (Dollars in Millions)

	Fiscal Year			
	1999	**2000**	**2001**	**2002**
Total Assessments[1]	$60.6	$48.4	$76.6	$55.5
Total Cancellations[2]	$26.2	$8.2	$5.1	$8.4
% of Total Assessments Cancelled	43%[3]	17%	7%	15%
Net Assessments	$34.4	$40.2	$71.5	$47.1
Total Collections[4]	$12.5	$20.7	$23.4	$10.4
% of Net Assessments Collected	36%	51%	33%	22%

Source: Office of the State Auditor analysis of data provided by the Field Audit Section.
1 Includes tax, interest, penalty, and penalty interest assessments.
2 Represents reductions in assessments due to protested audits that have been settled.
3 Although this percentage significantly exceeds the percentage of assessments cancelled for Fiscal Years 2000 through 2002, 43 percent is not unusual compared with the percentage of assessments cancelled in years prior to Fiscal Year 1999. Field Audits indicates that during Fiscal Years 1993 through 1998 the percentage of assessments cancelled ranged from about 27 to 74 percent. The percentages for Fiscal Years 2000 through 2002 will most likely increase as additional tax assessments are cancelled as a result of protests settled in favor of taxpayers.
4 Collection of tax assessments is the shared responsibility of the Field Audit Section, Office Collections Section, and Field Compliance and Criminal Tax Enforcement Section.

The table above also indicates that the Department has collected between 22 and 51 percent of the net assessments made by the Field Audit Section from Fiscal Years 1999 through 2002. The Department utilizes a variety of methods for collecting assessments owed by businesses including filing bankruptcy claims, recording tax liens and judgments, garnishing bank accounts, seizing property, and using private collection agencies. While the Field Audit Section sends initial bills to businesses for tax assessments determined as a result of its audits, collection of tax assessments from delinquent taxpayers is the responsibility of the Office Collections Section and the Field Compliance and Criminal Tax Enforcement Section within the Department's Tax Auditing and Compliance Division. Collection amounts related to assessments could increase due to future receipts.

In addition to the audits of tax liabilities described above, the Field Audit Section is responsible for the following audit programs:

Multistate Tax Commission Joint Audit Program (MTC): The MTC is an organization of 44 state governments and the District of Columbia that works with taxpayers to administer tax laws which apply to businesses operating in multiple states. On the basis of input from all state representatives, the MTC conducts audits of specific businesses across multiple states on sales, use, and corporate income taxes. The Field Audit Section oversees Colorado's participation in this program by recommending and voting on proposed audits and by participating in audits deemed to be of benefit to the State. Colorado's participation in multistate audits is authorized by state law (Section 24-60-1306, C.R.S.). MTC audits represented about 3 percent of the Field Audit Section's total dollar production in Fiscal Year 2002, or about $1.7 million.

Mineral Audit Program: This program provides assurance that mineral revenues generated from state and federal lands in Colorado are properly reported and paid to the State and to the federal government. Field Audit Section staff conduct audits of mineral royalties generated from federal lands within Colorado for the U.S. Department of Interior, mineral royalties generated from state lands for the State Land Board Commission, Conservation and Environmental Recovery Fund levies on oil and gas production for the Colorado Oil and Gas Conservation Commission, and severance taxes on oil and gas for the Colorado Department of Revenue. The mineral audit program was established in accordance with Section 24-35-115, C.R.S. Field Audits receives federal funds and some funding from other state agencies in support of resources spent on determining compliance with state and federal mineral tax laws. Severance tax audits conducted on behalf of the Colorado Department of Revenue represented less than 1 percent of the Field Audit Section's total dollar production in Fiscal Year 2002. Mineral Audit Program staff estimated that adjustments resulting from audits conducted on behalf of the federal government, State Land Board Commission, and Colorado Oil and Gas Conservation Commission totaled about $2.2 million in Fiscal Year 2002. It should be noted that this amount is not included in the Field Audit Section's Fiscal Year 2002 dollar production because the revenue is remitted to the entities for which the audits were conducted.

International Fuel Tax Agreement (IFTA)/International Registration Plan (IRP) audits: These two cooperative agreements promote uniform administration of motor fuels use tax and vehicle registration laws among states. Field Audits staff are responsible for auditing motor carrier businesses that have established Colorado as their "base jurisdiction" (i.e., Colorado is where the motor carrier is legally domiciled or where the motor carrier's vehicles are most frequently dispatched, garaged, or serviced). When performing IFTA audits, Field Audits staff are responsible for determining whether the business appropriately allocated fuel consumption and resulting tax obligations among states. International Registration Plan audits ensure proportional registration of commercial vehicles among states on the basis of the number of miles driven within each state. Section 39-27-302, C.R.S., grants the State authority to enter into these multi-jurisdictional fuel tax agreements. Less than 1 percent of the Field Audit Section's total dollar production in Fiscal Year 2002 was generated from these audits.

Special projects: The Field Audit Section has designated certain types of audits as ongoing priorities. These include audits of liquor distributors, businesses in the process of filing for bankruptcy, and requests from cities and counties to audit certain businesses.

Fiscal Overview

As indicated in Table 3, expenditures for the Field Audit Section have grown from about $7.1 million to $7.7 million over the past four years, while full-time equivalents, or FTE, has remained relatively unchanged during the same period.

Table 3: Department of Revenue Field Audit Section Expenditures and FTE Fiscal Years 1999 Through 2002 (Dollars in Millions)

	Fiscal Year			
	1999	**2000**	**2001**	**2002**
Expenditures	$7.1	$7.3	$8.2	$7.7
FTE[1,2]	83.5	81.6	84.6	83.9

Source: COFRS and Department of Revenue Budget Office.
[1] Represents actual FTE, not appropriated.
[2] The Department does not separately track actual FTE for non-revenue agent (i.e., support staff) positions within the Field Audit Section. On the basis of our review of employment history records provided by Field Audits, FTE numbers include an estimate of nine FTE for program support staff such as administrative assistants, tax examiners, and general professionals.

Of the total expenditures for Field Audits in Fiscal Year 2002, 86 percent was for personal services, 11 percent for operating costs (e.g., office supplies, freight, postage, and utilities), and 3 percent for travel. Approximately 88 percent of Fiscal Year 2002 expenditures were funded with general funds.

Audit Scope

We reviewed documentation and interviewed personnel from the Field Audit Section in areas related to selecting and scheduling businesses for audit (Chapter 1) and audit quality (Chapter 2). Our review concentrated on the Field Audit Section's audits of corporate income, sales, and use taxes, which are the primary taxes that Field Audits is responsible for auditing. In Fiscal Year 2002, audits of these taxes accounted for about 97 percent of Field Audits' total dollar production. We did not review audits conducted for the Mineral Audit program.

Our audit work also included a survey of seven states to determine other methods of selecting and conducting audits. The states we surveyed included Kansas, Kentucky, Nebraska, New Jersey, Oregon, and Utah. We chose to survey these states because they had audit approaches similar to Colorado. We also surveyed California because this state was testing a new method for identifying audit candidates.

Audit Selection

Chapter 1

Introduction

One of the most important tasks performed by the Field Audit Section (Field Audits) is its process for selecting which businesses it will audit during a given year. According to records from the Department of Revenue and the Secretary of State's Office, the number of companies conducting business in the State as of September 2002 was around 446,000, all of which are potentially subject to audit by the Field Audit Section. The total amount of taxes remitted to the State by businesses in Fiscal Year 2002 and subject to audit by Field Audits was approximately $3.8 billion.

The Department of Revenue's audit philosophy affects the Field Audit Section's operations and audit selection process. In the early 1990s the Department of Revenue adopted the "Statement of Colorado Taxpayer Rights." This statement outlines the steps that the Department will take to ensure that taxpayers' rights are protected during the audit and collections processes. Most notably, the Statement of Taxpayer Rights states that the Department will not evaluate its employees on the basis of meeting tax assessment quotas or goals. Field Audits' staff indicated that in practice this means the Department has determined that the overall goal of the audit program is to promote voluntary compliance with the tax law, as opposed to maximizing tax recovery. Field Audits has interpreted this to mean that a significant portion of its resources should be used to audit relatively small businesses in order to increase the number of businesses audited and thus increase the "visibility" of enforcement efforts.

Audit Selection and Tracking (AST), a working group within the Field Audit Section comprising seven FTE, is responsible for selecting and scheduling specific businesses for audit. AST is responsible for pre-audit research and analysis of businesses, audit selection, and file setup. Audit Selection and Tracking staff, in conjunction with Field Audit Section managers, are responsible for developing an annual audit plan that specifies how Field Audits will use its resources in order to meet program goals for the coming year.

The audit mix for the Field Audit Section is composed of several different audit programs, which include the following:

- *Local 1 and Local 2:* These audit programs encompass audits of large and medium-size Colorado businesses whose records are located within the State. AST uses specific thresholds, such as sales tax remittances over a set dollar amount, as well as more general criteria, such as appearances on the Forbes 500 or on the *Denver Business Journal's* lists of largest Denver-area companies, to identify Local 1 and Local 2 businesses. The Local 1 businesses typically take more than 300 hours to audit and the Local 2 businesses typically take between 80 and 300 hours to audit. Companies in these programs are audited every three, four, or five years based on their audit history. For example, businesses with higher dollar adjustments (i.e., the assessment or refund resulting from an audit) and smaller decreases in their adjustments over time are considered to be higher-risk, or less compliant, and are classified on a three-year audit cycle. Businesses with lower dollar adjustments and greater decreases in their adjustments over time are considered to be lower-risk, or more compliant, and are classified on four- and five-year audit cycles. In Fiscal Year 2002 the Local 1 and Local 2 audits produced about $23 million of Field Audits' total dollar production, or about 43 percent.

- *Out-of-State:* This program includes audits of corporations doing business within Colorado but whose records are located outside the State. AST selects out-of-state businesses for audit after detailed review of state and federal tax returns, SEC filings, and other taxpayer documentation. Businesses are reviewed every four years to determine whether an audit is necessary. The Out-of-State audit program provides a significant percentage of the Field Audit Section's annual dollar production. Specifically, in Fiscal Year 2002, audits of businesses in this category generated about $25 million, or around 47 percent of Field Audits' total dollar production.

- *Routine Metro and In-State:* Businesses that are not already included in one of the other audit programs make up this group. These taxpayers are generally smaller businesses that maintain their records in the State, and the audits typically take less than 80 hours to complete. Most of these audits do not result in large assessments, but they are selected to establish audit presence in an area and help Field Audits achieve its goal of promoting voluntary tax compliance. Audits of businesses in this category are rarely repeated. The Routine Metro and In-State audit programs together produced about 6 percent of Field Audits' total dollar production in Fiscal Year 2002, or about $3 million.

The remainder of the Field Audit Section's audit mix is composed of audits performed through the Multistate Tax Commission, Mineral Audit Program, IFTA/IRP agreements, and other special projects such as bankruptcies and audit requests from cities and counties. See the Overview for discussion on these types of audits.

In addition to the size and complexity of the audit, another factor that AST must consider when scheduling businesses for audit in the Local 1, Local 2, and Out-of-State programs is the statute of limitations on taxes. This is important because Field Audits can only audit taxes within the time frame allowed by the State's statute of limitations laws. According to Section 39-21-113(3), C.R.S., the statute of limitations is four years for income tax and three years for all remaining taxes. Once the statute of limitations has expired, Field Audits no longer has the authority to audit businesses' records. Therefore, AST must select and schedule audits for businesses within the Local 1, Local 2, and Out-of-State audit programs in a manner that minimizes the loss of opportunity to audit particular months because the statute of limitations has expired. These scheduling considerations are particularly important in cases where a business has a history of significant assessments resulting from audits by Field Audits.

Local Government Audit Requests

Each year the Field Audit Section receives audit requests from the cities and counties that have designated the State as their agent to collect business-related taxes such as sales tax. The audit requests, known as 1141 requests, are among Field Audits' highest-priority audits because of the importance of the potential additional tax revenues to local governments. According to the Department, as of the end of Fiscal Year 2002, there were about 200 cities and counties for which it collected approximately $500 million in sales tax.

Audits are usually requested because the local government has identified a problem with a business. For example, the city or county may have reason to believe that a business has not remitted taxes owed or is remitting incorrect tax amounts. Audit Selection and Tracking staff review audit requests, determine if an audit is appropriate and, if so, schedule the business for audit.

In our July 1999 Sales Tax Performance Audit, we noted problems with the Department's customer service provided to local governments. Specifically, we found that the Department had not addressed county and city concerns satisfactorily and that communications between local governments and the Department needed to be improved. As discussed in more detail below, we continue to find problems with the manner in which audit requests from local governments are handled.

In order to assess whether Field Audits completes local government audit requests in a timely manner, we requested a list of all such requests received by Field Audits during Fiscal Year 2002. We found the following:

- **AST does not have a systematic tracking method to identify all the local government audit requests received.** The audit tracking system used to monitor the status of all audits does not track incomplete audits by category or type. Therefore, staff could not systematically identify the local government audit requests received but not yet completed during the year except by manually reviewing the entire list of audits in progress and recalling by memory which audits were local government requests. Staff were able to provide us with a list of six local government requests completed in Fiscal Year 2002. Without a tracking system, however, we could not determine whether these six requests were all of the requests received during the fiscal year.

- **Time frames for initiating and completing local government audit requests are needed.** Although the Field Audit Section's audit procedures manual states that auditors are responsible for auditing requests "in a timely manner," Field Audits has not further defined a required time frame for completion of the audits. Using the Field Audit Section's audit tracking system, we determined that the length of time from the audit's assignment date to its completion date varied from 9 to 219 days for five of the six audit requests completed in Fiscal Year 2002. We could not determine this information for the sixth item based on the information in the Field Audit Section's audit tracking system.

- **AST did not adequately document the date of receipt for three of the six completed local government audit requests.** The audit procedures manual requires staff to stamp all incoming audit request letters with a date of receipt, and staff stated that they place all request letters in the audit file. However, in two cases we found that the request letters were not in the audit file, and in the third case the audit request letter was not stamped with a date of receipt. We were unable to determine the receipt date of the remaining three audits because the hard copy documentation within the files had been discarded in accordance with Field Audits' records retention procedures. These procedures require that Field Audits maintain only electronically created documentation.

- **Procedures for communicating audit results to the requesting entity would improve customer service.** Although staff indicated that auditors notify city or county officials when a request has been completed, we could not determine how or when audit information was communicated to local government staff for the three audit request files we reviewed. In order to ensure that local government officials are informed of audit results, Field Audits should require that auditors provide such information through formal correspondence and that a record of the correspondence be maintained.

To ensure that auditors are working to complete audits, staff stated that they monitor a report of all incomplete audits. However, the current system's inability to specifically identify all local government audit requests increases the risk that Field Audit Section staff may overlook one of these high-priority audits.

Recommendation No. 1:

The Department of Revenue should establish a systematic method for tracking local government audit requests and ensuring these audits are completed in a timely manner by:

a. Developing a log of requests that identifies the city or county submitting the request and the date the request was received.

b. For those requests which lead to an audit, documenting within the log the date the audit is assigned and completed. In those instances in which no audit is performed, the Department should document the basis for this determination.

c. Maintaining audit request letters.

d. Establishing time frames for completing the audits and periodically evaluating whether time frames are being met and reasons for exceptions.

e. Reporting outcomes of all audit requests to the requesting entity through formal correspondence and maintaining a record of such correspondence.

Department of Revenue Response:

Agree.

a. The list of requests for audits of taxpayers in 1141 cities has been re-instated. Audit Selection currently maintains an electronic spreadsheet documenting 100 percent of all 1141 city/county audit referrals submitted, who submitted the referral, date request received, employee working the case (date assigned already captured on the mainframe) case status and completed information. Implemented September 1, 2002.

b. When the list was re-instated it included this requirement. Implemented September 1, 2002.

c. The letter will be maintained in a file in AST. Implementation by February 3, 2003.

d. The time frames for the completion of the audits are usually defined by assignments in the in-state travel program. Standards for completion and a tracking system will be established and deviations from the standards will be explained. Implementation by March 31, 2003.

e. An electronic copy of the correspondence will be maintained. Implementation by February 3, 2003.

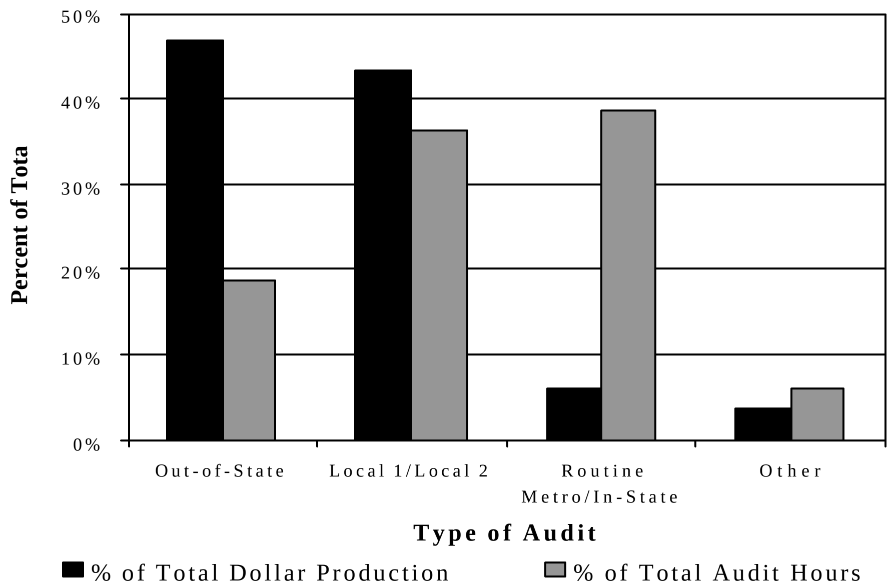
Audit Focus

As mentioned earlier, the Department of Revenue's present audit philosophy emphasizes promoting compliance with the tax laws rather than identifying the maximum amount of taxes owed to the State. To achieve this tax compliance goal, the Field Audit Section devotes a significant percentage of resources to auditing small businesses (i.e., businesses classified in the Routine Metro and In-State audit programs). In Fiscal Year 2002 about 39 percent of the Field Audit Section's audit hours were used to audit Routine Metro and In-State businesses; this is reasonably consistent with Field Audits' budget of about 34 percent of hours to be used for auditing businesses within these audit programs. Staff indicated that auditing a large number of small businesses helps Field Audits achieve broad audit coverage in terms of the number of businesses audited and, therefore, achieve audit presence in a geographic area or specific industry. Department staff believe that audit presence promotes voluntary compliance with the tax law. We are concerned, however, that the current practice (1) is not equitable, in terms of allocating resources toward businesses with the potential for the largest assessments and therefore representing the greatest risk, and (2) results in lost revenue to the State.

As mentioned above, Field Audits currently focuses about 39 percent of its resources on Routine Metro and In-State businesses. On the basis of our review, however, large (i.e., Out-of-State, Local 1, and Local 2) noncompliant businesses represent a greater risk to the State in terms of lost tax revenue than do noncompliant businesses within the Routine Metro and In-State audit programs. Table 4 shows that, in Fiscal Year 2002, 90 percent of Field Audits' total dollar production was generated from audits of businesses within the

Out-of-State, Local 1, and Local 2 audit programs (i.e., from audits of large businesses). In contrast, the Routine Metro and In-State audit programs, which cover small businesses, generated only 6 percent of Field Audits' total dollar production for the same year.

Table 4: Department of Revenue Field Audit Section Dollar Production vs. Audit Hours by Type of Audit
Fiscal Year 2002



Total Dollar Production = $52,125,200 Total Audit Hours = 84,100

Source: Office of the State Auditor analysis of Department of Revenue Field Audit Section data.

Notes: Statistics do not include atypical audits, which are audits that result in unusually large assessments or refunds (e.g., atypical audits adjustments totaled about $6 million for Fiscal Year 2002). "Other" audit types include severance tax audits, audits conducted by the Multistate Tax Commission on behalf of the State, and multi-jurisdiction fuel tax audits.

The chart above also demonstrates that the Out-of-State, Local 1, and Local 2 audits produce more dollars per audit hour than do the Routine Metro and In-State audits. For example, in Fiscal Year 2002 the Out-of-State, Local 1, and Local 2 audits yielded about $1,000 in dollar production for every hour spent auditing. We calculated that over the last four fiscal years, the dollar production for these audits averaged over $900 per audit hour. By contrast, the dollar production for both Routine Metro and In-State audits averaged about $189 per audit hour for the same time period. From the revenue generating and tax compliance perspectives, Field Audits' resources would be more effectively used to identify tax dollars owed to the State by concentrating additional audit hours on large businesses.

The Field Audit Section's current policy to concentrate resources on auditing the State's small businesses also results in underutilization of some of Field Audits' most senior auditors. We analyzed data from auditors' time records for Fiscal Year 2000 through May 31, 2002, and found that the senior auditors spend a significant percentage of their time, or approximately 22 percent of their total audit hours, on Routine Metro and In-State audits. Senior auditors are highly trained staff that are responsible for leading Field Audits' most complicated audits. Therefore, maximizing the time these staff spend on higher-risk businesses would be a more effective use of Field Audit Section personnel.

Effective Utilization of Resources

To ensure that the Field Audit Section utilizes its resources in the most effective manner, we believe it should audit more businesses within the Out-of-State, Local 1, and Local 2 audit programs. By shifting its efforts to auditing more of the State's larger businesses, Field Audits would be able to audit a greater percentage of the total tax dollars paid to the State. As mentioned earlier, the Field Audit Section estimates that it audited about 3 percent of the total tax dollars paid in Fiscal Year 2002.

More emphasis on audits of Out-of-State, Local 1, and Local 2 businesses in its annual audit mix would also help Field Audits to audit businesses within their assigned audit cycles. AST schedules Local 1 and Local 2 businesses for re-audit every three, four, or five years based on the results of prior audits. In particular, the highest-risk businesses are audited every three years in order to ensure that Field Audits does not lose the opportunity to audit particular months because the statute of limitations has expired. However, in our review of 20 Local 1 and Local 2 businesses' (i.e., large, in-state businesses) audit schedules, we found 10 businesses in which AST staff scheduled the business's next audit one fiscal year later than we determined on the basis of the Field Audit Section's audit cycle criteria. In other words, in many instances businesses that should be audited on a three-year cycle are audited on a four-year cycle. This is a concern because Field Audits loses the opportunity to audit particular months, since the statute of limitations has expired as a result of its method for scheduling audits for those businesses in the highest-risk category (i.e., businesses within the three-year audit cycle). AST staff indicated that adherence to audit cycles is difficult due to limitations in resources, as well as the complexities involved in staffing and scheduling with respect to meeting specific audit cycles for a variety of businesses. While these are legitimate concerns, Field Audits should be able to improve its adherence to these audit cycles by targeting more resources to the higher-risk audits.

The Field Audit Section needs to reevaluate the current mix of audits. Specifically, Field Audits could limit the number of small business compliance audits to ensure that its resources are used more effectively. Kansas, for example, reserves 20 to 30 percent of its audits for compliance and uses the remaining audits to pursue tax revenue. Kentucky expects to limit audits of small businesses to less than 10 percent of its total audit mix for Fiscal Year 2003. This compares with Colorado's 39 percent of resources spent on smaller audits in Fiscal Year 2002 noted earlier.

Recommendation No. 2:

The Department of Revenue should reevaluate its audit selection methodology to achieve a more reasonable balance between identifying tax revenues owed to the State and promoting voluntary tax compliance.

Department of Revenue Response:

Agree. The Section has been focusing on increasing revenue through increased compliance by increasing its level of audits. This was done in accord with several studies, including one from the Internal Revenue Service that supports the concept of the ripple effect of auditing. The indirect effect of audits is, on the average, about eleven times as large as their direct effect on revenue. The Section has been attempting to allocate resources optimally across its various audit activities.

The Section will re-evaluate its selection methodology to increase revenue through the audits of large case Local 1 and 2 taxpayers and out-of-state travel. The implementation of this recommendation is limited by the availability of Local 1 and 2 audits and funding for Out-of-State Travel. Re-evaluation will begin immediately; methodology will be redrafted by January 1, 2004.

Recommendation No. 3:

The Department of Revenue should improve its adherence to established audit cycles for businesses, especially with respect to higher-risk entities.

Department of Revenue Response:

Agree. The Field Audit Section believes it is doing a good job with the available resources. The Section will continue to monitor statute of limitations and scheduling of appointments, but believes that foregoing a few months of audit period is preferable to auditing less than a full 36-month audit period. Time to capture exactly 36 months for all of the large audits assigned to an agent during a year is impractical. If the Section is given additional resources this recommendation can be implemented. Implementation would probably require continuing or increasing the amount of small audits assigned to senior as "fillers" to work around large case appointments, a practice criticized in other parts of this report. Implementation is ongoing.

Review of Business Data

To select businesses for audit, staff review various sources such as Forbes 500 business listings, *Denver Business Journal* listings of top businesses in the State, and referrals from the Field Audit Section's field auditors. From these sources, staff judgmentally select certain businesses that should be reviewed to determine if the business has audit potential. Staff generally select businesses for review on the basis of information such as industry type or how much revenue the business appears to generate in the State. The review process includes compiling and analyzing information such as state and federal tax returns, Department of Revenue tax liability account detail, outstanding tax assessments, business location, and industry type, and then determining audit potential. Additionally, staff manually examine listings of business tax information maintained by the Department to ensure that larger businesses are identified for review and assessed for audit potential.

In addition to the sources discussed above, staff also receive audit suggestions from other sections within the Department such as the Taxpayer Services Section and the Fair Share Section. For example, AST receives referrals regarding businesses with sales or use tax account problems, including not filing taxes or filing the incorrect amount of tax, and businesses claiming large income tax refunds. AST reviews these businesses for audit potential and, if warranted, schedules the business for audit.

Although Field Audits' approach for audit selection identifies businesses with audit potential, we believe that Field Audits could streamline its review and selection of businesses by using automated methods to perform aspects of this process. For example, staff currently use audit software that allows them to manipulate and analyze businesses' electronic data. Field Audits could use this same software to analyze the business tax account records maintained by the Department. The use of automated tools, rather than a manual process, to review Department records would enable Field Audits to perform greater analysis on the data in a more efficient manner and potentially further refine its selection process.

In addition, Field Audits should incorporate an element of random selection of businesses for audit. This could also be done using the audit software that staff now utilize. Under this approach, each business in the State has an opportunity of being selected for audit. Field Audits could take different approaches in selecting the sample such as stratifying the accounts between businesses whose sales tax remittances meet or exceed a certain threshold and those that remit less than this amount. As indicated previously, businesses that remit larger amounts of taxes are generally higher-risk in terms of potential revenue lost to the State. Therefore, sorting the businesses in this fashion would help staff prioritize their research efforts. Additionally, staff could stratify the listings of businesses by location or industry type, should Field Audits decide to concentrate its audit efforts on businesses in certain geographic areas or industries.

Recommendation No. 4:

The Department of Revenue should incorporate automated methods and random selection in processes for identifying potential audit candidates.

Department of Revenue Response:

Partially Agree. The Department of Revenue should develop automated systems to select businesses for review and audit, but not to make selections on a <u>random</u> basis. One of the business objectives of the Field Audit Section is to pursue alternative methods for selecting entities for review and audit. The development of an automated system to select businesses for review and audit is the goal that the Department has favored in an ideal world. The inquiries that have been made this year have left no doubt that with the application of enough money and manpower a sophisticated automated system could be developed.

Within established audit selection categories the Section will pilot some basic random selection to allow the assignment and audit of a percentage of files on a random basis. Implementation for October 30, 2003, with the implementation of improvements in the Out-of-State review process discussed in Recommendation No. 7.

Risk-Based Audit Assignment

As previously mentioned, before conducting an audit, staff review each business to determine its audit potential. Once staff determine that an audit of a business is warranted, the business is added to the appropriate audit program inventory. Field Audits currently has a process in place to help ensure that larger businesses (i.e., Out-of-State, Local 1, and Local 2 audit programs) are audited according to risk; however, we found that Field Audits has not developed similar risk-based procedures for prioritizing which smaller businesses (i.e., Routine Metro and In-State audit programs) are assigned for audit. Prioritizing audit assignments according to risk is important because, in any given fiscal year, field auditors may not audit all of the businesses that were identified as having audit potential.

Once a small business has been reviewed and assigned to the Routine Metro or In-State audit programs for audit, staff create an audit file, place the file in a drawer, and create a new audit on the Field Audit Section's audit tracking system. Auditors then request one of these files when ready to start a new audit. Audits that have been in inventory the longest generally have priority over more recently created audits. Staff reported that current events, changes in industry statistics, or special audit requests may increase a small business's potential to be audited sooner. However, audit assignment for this group is not formalized and is generally handled on a case-by-case basis.

Developing priorities for small taxpayer audits would result in a more effective use of Field Audits' limited resources. We contacted other states to identify approaches that AST might consider to better target audits of smaller businesses. We found the following:

- Kentucky targets one specific at-risk industry for 18 months before moving on to another industry for the next 18 months.

- California, Kentucky, and Nebraska use information available in their Departments of Revenue (or equivalent) to assign point values and rank businesses' audit potential.

As mentioned earlier, Field Audits staff already compile and review detailed data on businesses and industries as part of the current review process. We believe Field Audits could utilize this existing information to develop and implement a formal approach for prioritizing audit assignments similar to those used in other states. In this manner, the Field Audit Section would better direct the Routine Metro and In-State audit programs to target potentially higher-risk businesses.

Recommendation No. 5:

The Department of Revenue should implement formal procedures for prioritizing the assignment of small business audits.

Department of Revenue Response:

Agree. Procedures will be developed that formalize the analysis that the auditor who receives an audit assignment must follow before a decision to complete the audit is made. The procedure will include a report to AST concerning the decision. The implementation will be complete by April 30, 2004.

Accuracy of Audit Selection Information

Audit Selection and Tracking staff track and maintain large, in-state businesses within the Local 1 and Local 2 audit programs on two "master lists" that contain information such as business name and address, audit cycle classification, next scheduled audit, account numbers, and most recent audit statistics, including the net assessment or refund and hours expended. The information on the master lists is used to determine businesses' audit cycles. As mentioned previously, Field Audits' goal is to audit more compliant businesses every four to five years and less compliant businesses every three years.

As part of our audit, we reviewed a sample of 20 businesses from the Local 1 and Local 2 master lists to determine accuracy and completeness of these lists. We identified three ways in which these master lists could be improved.

Accuracy and efficiency of compilation process. In 2 out of 20 instances, audit adjustments from businesses' branch accounts were not included on the master lists. These missed adjustments totaled $37,500. Further, we noted that AST's current process for compiling audit adjustment information for the master lists duplicates efforts already made by the Field Audit Section's field auditors. As part of the audit process, auditors must compile and summarize audit results, including adjustments and refunds. Therefore, instead of AST staff recompiling audit results for audit selection and tracking purposes, field auditors should forward audit results along with audit cycle recommendations to AST staff at the completion of each audit. Because the auditors are more familiar with the businesses, this would help ensure that accurate information is reflected on AST master lists and that adjustments, such as those for branch accounts, are not inadvertently excluded from these lists. Although the missed adjustments we identified were not large enough to affect the audit cycle classification for the businesses reviewed, there is a risk that staff may incorrectly determine a business's audit cycle based on erroneous information on the master lists.

Completeness of information. Another problem we found with the master lists is that they do not always contain the most complete and accurate information regarding a business's audit results. Specifically, AST does not include the results of protested audit settlements in the figures used to determine audit cycles. Businesses may protest any assessment made by the Field Audit Section, and if the protest is determined valid, the original tax assessment may be reduced. By excluding changes made as a result of valid protests, AST in these cases is basing businesses' audit cycles on incomplete information. To ensure that the master lists reflect final assessment and refund data for all businesses, Field Audits' Protest Resolution staff should forward information regarding the results of all protested audit settlements to Audit Selection and Tracking staff.

Documentation of deviations. The third problem we found is that AST did not adequately document reasons for deviations from audit cycles for 4 out of the 20 businesses we sampled. Issues may arise that warrant deviating from the established audit cycles. In order to ensure that deviations are based on objective information, staff should clearly document these deviations on the master list at the time the decision is made.

Audit Selection and Tracking staff use data from the Local 1 and Local 2 master lists to track and determine audit cycle classifications for some of Colorado's largest companies. Without complete and accurate data on these lists, Field Audits cannot ensure that it is classifying these businesses on the appropriate audit cycle. Therefore, the risk is increased that a noncompliant business may be placed on a less frequent audit cycle than necessary or a more compliant business may be audited more frequently than necessary. As a result, Field Audits may not identify potential tax revenue owed to the State or may be ineffectively using its resources.

Recommendation No. 6:

The Department of Revenue should improve the process for compiling Local 1 and Local 2 master lists by requiring that:

a. Field auditors compile audit results, make recommendations regarding audit cycles per Audit Selection and Tracking (AST) criteria, and forward this information to AST staff at the completion of each audit.

b. Protest Resolution staff communicate to AST staff all changes in tax assessments and refunds resulting from the protest process.

c. Reasons for deviations from businesses' assigned audit cycles are clearly documented.

Department of Revenue Response:

a. Agree. Implementation complete by April 30, 2004.

b. Agree. Protest Resolution is currently providing Audit Selection with such reports. Implemented August 1, 2002.

c. Agree. Documentation was provided in 100 percent of the test cases the State Auditor questioned. Although deviations do occur, i.e., an auditor could not get an appointment, field resources were not available, etc., and these deviations are not mentioned on the master list. Audit Selection and Tracking retains the information supporting any deviations. This information is available to the Chief Auditor and staff upon request. Already implemented.

Out-of-State Taxpayer Reviews

As mentioned earlier, Audit Selection and Tracking reviews Out-of-State businesses every four years to determine audit potential. As part of this process, AST staff first conduct a preliminary review to screen out cases where lack of audit potential is relatively easy to determine. The remaining taxpayers undergo a "full review" before staff make a recommendation to Field Audit Section management that the business be considered for audit. This full review consists of examining information such as the business's state and federal tax returns and Securities and Exchange Commission filings, and using this information to calculate various financial ratios and perform other analyses. An Out-of-State "master list" is used to track the businesses within this audit program.

We reviewed a sample of 25 taxpayers from the Out-of-State master list. We found that in 4 instances staff did not consistently document their conclusions, comments, and the disposition of the preliminary reviews. Audit Selection and Tracking's account of the preliminary reviews ranged from no documentation at all to minimal comments in the audit tracking system or on the Out-of-State master list. Although staff use a checklist to document the results of full reviews, AST has not developed standardized procedures for documenting the results of preliminary reviews. Such procedures would help ensure that AST does not overlook potential audit suggestions and would reduce the risk of errors and irregularities.

We also found that staff did not adequately document reasons for conducting a full review of a business earlier than the standard four-year review cycle. Staff reported that a business's review cycle may change if information presented to AST staff warrants such a change. However, specific comments indicating why this business's file was reviewed early were not documented. Again, to ensure the objectivity of the review process, staff should clearly document any deviations at the time the decision is made.

Recommendation No. 7:

The Department of Revenue should improve the review process for Out-of-State businesses by:

a. Developing standardized procedures for conducting and documenting preliminary reviews of Out-of-State businesses for audit potential.

b. Ensuring that reasons for deviations from review cycles are clearly documented.

Department of Revenue Response:

Agree.

a. Implementation complete by October 30, 2004

b. Implementation complete by October 30, 2004.

Audit Quality

Chapter 2

Introduction

The Field Audit Section audited over 7,100 tax liabilities in Fiscal Year 2002. As a result of these audits, Field Audits identified about $58 million in tax assessments and refunds. Field Audits conducts most audits out of its main office in Denver, where approximately 60 auditors work. Field Audits also maintains four district offices in the State to audit businesses outside of the Denver metro area. There are three auditors in Fort Collins, three in Colorado Springs, two in Grand Junction, and one in Pueblo. Finally, a total of four staff are located in other states (California, Texas, New York, and New Jersey) to audit companies that do business in Colorado but maintain their records in locations outside of the State.

In addition to those staff who conduct audits, four members of the Field Audit Section are responsible for resolving protested audits. This group, known as Protest Resolution, is responsible for determining whether a business's protest is valid and, if so, adjusting the auditor's original tax assessment or refund as appropriate. If Protest Resolution cannot resolve the protest or if the protest involves interpretation of tax law, it will refer the protest to the Department's Tax Conferee Section for further review.

We reviewed a sample of completed and protested audit files and found that Field Audits could make some improvements to its processes, which we discuss below.

Reviews of Audit Workpapers

As part of our audit, we reviewed a sample of completed audits in order to determine if staff followed Field Audits' standard audit procedures and whether management's review of completed audits was adequate. We found the following:

- **In 4 of 26 files, required forms were missing.** The missing forms included checklists to document that the agent followed all required audit steps and a form to document taxpayer acknowledgment of sampling techniques. Without these checklists and forms, Field Audits cannot easily ensure that its agents are completing audits in compliance with guidelines.

- **In 1 of 36 audit files**, **the assessment amounts from the audit billing system, tracking system, and workpapers did not agree.** In this case, the audit workpapers indicated that tax refunds were due to the business; however, the refunds were not on the billing system or audit tracking system. As a result, the business did not receive a refund totaling $66. After bringing this issue to their attention, Field Audits management indicated that a refund would be issued to this business. Although the amount in this case was relatively small and this appeared to be an isolated instance, it is important that Field Audits have adequate controls over the billing and refund process to reduce the risk of errors and irregularities.

During our review, we found evidence that managers do not always perform adequate review of audit files to identify errors made by audit staff. In addition to the problems noted above, our review of protested audit files identified two instances in which errors were made by auditors that affected the business's tax assessment. Both errors should have been identified by Field Audits' managers during their review of the completed audits.

Currently Field Audits does not have a system for reviewing completed audits to ensure that they are conducted correctly and consistently among the Field Audit Section's auditors and that review procedures are adequate. Peer reviews are a generally accepted method used by audit organizations to ensure that audits are conducted appropriately. For example, organizations that perform audits of governments must follow the United States General Accounting Office's *Government Auditing Standards*. These standards require that audit organizations have internal quality control systems in place and undergo periodic external quality control reviews by a peer organization. Field Audits' Mineral Audits and IFTA/IRP audits undergo external peer reviews in accordance with federal requirements and interstate agreement guidelines. Developing a peer review process for Field Audits' other audit programs will help improve audit quality by reducing errors and ensuring consistency across audits. Consistency among auditors will help ensure that businesses are treated equitably during the audit process and that errors and irregularities are minimized.

Recommendation No. 8:

The Department of Revenue should improve audit procedures by:

a. Ensuring that assessment amounts recorded in the audit file, audit tracking system, and billing system agree, and that all required forms are completed for each audit.

b. Developing and implementing an internal peer review process of completed audits to ensure that appropriate and sufficient audit procedures and reviews are performed. The Department should conduct a peer review on a sample of audits annually and follow up on all exceptions identified.

Department of Revenue Response:

Agree.

a. The Section had two vacant manager positions at the time of these errors. We now have sufficient managers due to filling those positions. The procedures that are in place are adequate to have reasonable assurance that the information in the reports is accurate. In addition, the Protest Resolution function corrects any minor errors that escape the standard screening by our managers, as evidenced by the identification and correction of the two errors reported above. Already implemented.

b. The Section previously used peer reviews. They were discontinued because the level of error detected was marginal and the cost of resources to carry on the review outweighed the benefit. In order for a peer review procedure to be practical and the information to be meaningful, the review must be timely.

   The diversion of audit resources from the audit function may not be wise at this time due to the current budget shortfall. The need to focus resources in the conduct of field audits must take precedence. When the current fiscal difficulties have passed the Section will evaluate ways to rapidly review current work without interfering with auditing, billing and the protest resolution processes.

Analysis of Protested Audits

Under Section 39-21-103, C.R.S., all businesses audited by the Field Audit Section have the right to protest the outcomes of their audits. Field Audits' Protest Resolution group receives these protests and determines if they have been filed within the statutory time limit of 30 days. For all protests filed timely, Protest Resolution then researches the protested issues, which may include contacting the business, discussing the issues with the auditor, and reviewing the audit workpapers. If the protest is determined to be valid, Protest Resolution staff make the appropriate adjustments to the original tax assessment or refund amounts. Protest Resolution may also refer the protest to the Department's Tax Conferee Section if it cannot resolve the protest or if the protest involves interpretation of tax laws. Generally, Protest Resolution staff resolve protested audits within 30 days of receiving the business's protest or refer the protested audit to the Tax Conferee Section.

During our audit we found that the Field Audit Section does not routinely conduct a formal analysis of data on protested audits. Although Field Audits collects information on each protest received, it does not systematically compile the data for analysis in determining whether audit quality is a factor affecting why audits are protested. We identified two areas where we believe analysis could help Field Audits monitor and potentially improve the quality of its audits.

First, the Field Audit Section should monitor the amount of original tax assessments that are adjusted as a result of resolving protested audits. As stated previously, Protest Resolution may reduce a business's tax assessment for valid protests. Because Protest Resolution reduces these assessments only when its interpretation of the facts about a particular audit differs from the auditors or when the taxpayer provides additional relevant information, Field Audits should track and analyze the trends in this area to monitor the soundness of the original findings.

Analyzing the amount of tax assessments that are adjusted due to protested audits is also important because some substantial reductions can occur. As indicated in Table 5, original tax assessments for protested audits were reduced between 13 and 43 percent for Fiscal Years 1999 through 2002.

Table 5: Department of Revenue Field Audit Section
Adjustments to Protested Audits
Fiscal Years 1999 Through 2002

	Fiscal Year			
	1999	**2000**	**2001**	**2002**
Original Tax Assessed (Protested Audits Only)	$5.6	$10.7	$13.0	$10.9
Net Tax Reductions due to Protests[1, 2]	$2.4	$2.7	$1.7	$3.7
Adjusted Tax Assessments (Protested Audits Only)	**$3.2**	**$8.0**	**$11.3**	**$7.2**
% of Tax Reduced	**43%**	**25%**	**13%**	**34%**

Source: Office of the State Auditor analysis of data provided by the Field Audit Section.

[1] Includes adjustments made by the Field Audit Section's Protest Resolution group only and not adjustments made by the Tax Conferee Section due to data limitations. Specifically, adjustments to tax assessments for protests settled by the Tax Conferee are not tracked separately; Tax Conferee tracks only total adjustments to tax assessments, interest, penalty, and penalty interest. During Fiscal Year 2002, protested audits referred to Tax Conferee totaled about $18.8 million, which includes original tax, interest, penalty, and penalty interest assessed. This amount was reduced by about $224,000 due to settlements as of June 30, 2002.

[2] Amounts are net of increases to tax assessments as a result of settled protests. Further reductions could occur in the future due to additional protests settled in favor of taxpayers.

Table 5 also indicates that although the amount of original tax assessments protested for the four-year period was highest in Fiscal Year 2001, the Protest Resolution group made significantly fewer reductions to the tax assessments in that year compared with the percentage of tax assessments reduced in the other fiscal years. This could suggest that the quality of the Field Audit Section's audits may have been better in Fiscal Year 2001 because the field auditors' original assessments were not reduced as much as in the other years. Routinely compiling and tracking these types of data could help Field Audits identify trends and issues in protests that may allow it to improve the quality of its audits and reduce the time spent in resolving protests.

The second way in which the Field Audit Section could monitor the quality of its audits is to conduct more detailed analysis of how protested audits are resolved. This analysis could help Field Audits determine possible reasons for variances in the amounts of adjustments that resulted from settled protests. Currently Protest Resolution enters a comment for each resolved protest in its protest tracking database to describe its resolution. For most audits, Field Audits uses only two categories to describe how it settles protests: (1) the taxpayer provided additional information that resulted in a change in the original tax assessment or refund, or (2) Protest Resolution adjusted only the penalty and/or penalty interest assessments.

During our review we noted a problem with the categories used to track how protested audits are resolved. Specifically, the category "taxpayer provided additional information" is vague and should be further defined for two reasons. First, this category obscures those protests in which the auditor has made an error. Field Audit Section staff indicated that this category is always used to describe the resolution of protests where assessments or refunds are changed, even if the change was attributable in whole or in part to auditor error. We reviewed a sample of 34 protested audits and identified 2 instances in which errors made by the auditor contributed to the change in assessed tax for the audit. Although staff indicate that managers are notified of errors made by their auditors and are responsible for discussing the errors with auditors, Field Audits does not systematically collect or analyze data on the number or types of errors made by the Field Audits Section's auditors. As a result, Field Audits loses the opportunity to systematically identify areas where review procedures should be enhanced and additional training may be needed to prevent other auditors from making similar mistakes.

Second, the category "taxpayer provided additional information" does not describe what type of information the business provided or why the business did not provide the information until after the audit's completion. As a result, Field Audits misses opportunities to systematically identify and reduce these types of protests. For example, Protest Resolution staff report that some audits are protested because the auditor did not give the business enough time to provide all requested information. By capturing additional detail regarding the resolution of protests, Field Audits can identify specific problems and work to prevent similar protests in the future.

Recommendation No. 9:

The Department of Revenue should work to reduce the number of protested audits by improving its analysis of information regarding protested audits, including:

a. Tracking the percentage of the original tax assessments reduced as a result of resolving protested audits.

b. Analyzing the reasons for reductions in assessments, which should include further defining the category "taxpayer provided additional information" in order to systematically track auditor errors.

c. Utilizing its analysis to identify opportunities for improving audit quality, limiting the number of protests received, and decreasing the amount of tax adjustments.

Department of Revenue Response:

a. Agree. This information is already provided to the management of the Field Audit Section on a monthly basis on the "Protest Received and Settled Report." The report includes the percentage of tax, interest, penalty interest and penalty collected. We will prepare an annual report from the monthly report summary. The report will be prepared at the end of the current fiscal year. Implementation by July 31, 2003.

b. Partially Agree. The reports where the language "taxpayer provided additional information" appears are widely distributed throughout the audit and tax determination staff at the Department. The reports identify specific auditors and audits and are an inappropriate forum for the presentation of specific auditor errors. Currently, the Protest Resolution group sends a copy of the correspondence with the taxpayer and supporting schedules to the auditor's manager who will communicate the information to the auditor. In addition the Protest Resolution group communicates via a "DR 87" form to the Chief Auditor and the manager on any material issues. When issues are noticed that effect multiple audits the manager of the Protest Resolution group brings the issue before regular meetings of the Field Audit Section Group Managers for discussion. The Section will explore better ways to communicate. Implementation by July 31, 2003.

c. Agree. Each audit is based on a taxpayer's returns that are characteristic of that taxpayer's policy and staffing, and each audit has separate and distinctive adjustments and areas of dispute. Very seldom is an issue common to more than one audit. The information contained in unique letters to taxpayers does not readily lend itself to meaningful generalization and subsequent analysis of general classifications. The Section will evaluate possible error tracking and reporting. Implementation by October 31, 2003.

Collection Efforts

As a result of its audits, the Field Audit Section may determine that a business owes additional tax to the Department. Field Audits is responsible for billing businesses for the tax due in these circumstances. A business has 30 days from the date of the notice to pay the amount or protest the assessment. If Field Audits has not received timely payment or notice of protest from the business, the account is referred to the Department's Office Collections Section and/or the Field Compliance and Criminal Tax Enforcement Section for additional collection efforts. Staff from these Sections utilize a variety of methods for collecting assessments including filing bankruptcy claims, recording tax liens and judgments, garnishing bank accounts, seizing property, and using private collection agencies.

During our audit we found that the percentage of Field Audits' assessments that the Department has collected appears low. Table 6 below indicates that the Department collected between 22 and 51 percent of the net assessments made by Field Audits from Fiscal Years 1999 through 2002. There are numerous factors that could affect low collection rates, including timeliness of collection efforts, bankruptcies, liens, and outstanding protested audits within the Tax Conferee Section, among others.

Table 6: Department of Revenue Field Audit Section
Net Assessments and Collections of Settled Audits
Fiscal Years 1999 Through 2002
(Dollars in Millions)

	Fiscal Year			
	1999	**2000**	**2001**	**2002**
Net Assessments[1]	$34.4	$40.2	$71.5	$47.1
Total Collections[2]	$12.5	$20.7	$23.4	$10.4
% of Net Assessments Collected	**36%**	**51%**	**33%**	**22%**

Source: Office of the State Auditor analysis of data provided by the Field Audit Section.
[1] Amounts are net of reductions to assessments due to protested audits that have been settled.
[2] Collection amounts related to assessments could increase as a result of future receipts.

Since the effectiveness of the Field Audit Section is, in part, dependent on how well the Department collects audit assessments, the Department needs to examine the underlying causes of low collection rates and identify ways to improve these rates.

Recommendation No. 10:

The Department of Revenue should investigate ways to improve its collections process.

Department of Revenue Response:

Agree. The Section will benchmark with other states to evaluate their collection percentage and will look for additional ways to improve the collection of our audits. Implementation by December 31, 2003.

Field Audit Section Reporting

As part of our audit, we reviewed various reports prepared by the Field Audit Section. Specifically, we reviewed the Collections report, Director's report, Quarterly Audit Plan report, and the Monthly Group Comparison report to verify accuracy and reliability of the data. We found instances where these reports either did not reconcile to each other or had classification or calculation errors. The Field Audit Section and Department management use these reports to manage resources and track progress toward performance objectives. The reports, therefore, should be accurate and reliable.

Collections Report

The Collections report is produced monthly and provides information regarding the amount of assessments collected and the amount of adjustments made by the Protest Resolution group and Tax Conferee Section for the current fiscal year and the previous nine fiscal years. Although the Field Audit Section is not primarily responsible for the collections function, Field Audits prepares this report for its management. We found two problems with the reports:

- **Staff in some instances did not accurately account for total assessments and for adjustments made to assessments.** For Fiscal Years 1997 and 2001, we found that the assessments amounts on the Collections report were approximately $429,000 and $48,000 less, respectively, than the assessment amounts on the Director's report. The assessment amount on the Director's report was about $80.6 million for Fiscal Year 1997 and about $76.6 million for Fiscal Year 2001. According to staff, the assessment figures on the Collections report are obtained from the Director's report; therefore, these figures should agree. In addition, the amount of cancelled assessments on the collections report was understated by $501,000 (about 6 percent of total cancellations) for Fiscal Year 2000 and by $666,000 (approximately 13 percent of total cancellations) for Fiscal Year 2001. A cancelled assessment occurs when either Field Audits' Protest Resolution group or Tax Conferee staff adjust a business's original tax assessment or refund as a result of a protest. This is a highly sensitive area. Therefore, reconciliations between key reports are important to ensure that information is accurate and that errors and irregularities are minimized.

- **Staff incorrectly calculate certain ratios on the report.** The report tracks two ratios.

  Collections ratio: This is calculated by dividing the amount of assessments collected by total tax assessments. This ratio shows how well the Department is collecting assessments.

  Cancellation ratio: This is calculated by dividing the amount of reductions to the original assessments by total tax assessments. This ratio shows the extent to which assessments are reduced as a result of protested audits that have been settled.

We found that staff had incorrectly calculated the ratios because while taxpayer refunds are included in the numerators of both ratios, refunds are excluded from both denominators. In other words, the numbers used to calculate the ratios are not consistent, and therefore the ratios do not yield accurate results.

When we recalculated these ratios by including refunds in both denominators and correcting for the other errors noted, the collection ratios increased about 1 percent for Fiscal Year 1997 and between 1 and 6 percent for Fiscal Years 2000 through 2002. In other words, the percentage of audit assessments collected by the Department was actually more than the amount reported on the Collections report. In addition, the cancellation ratios increased about 1 percent for Fiscal Year 1997 and between 1 and 2 percent for Fiscal Years 2000 through 2002. This means that the Department reduced more assessments as a result of protested audit settlements than the amount reported on the Collections report.

Although staff indicated that completed Collections reports are reviewed for accuracy by Field Audit Section management, the errors noted above were not identified as part of this review process.

Director's, Quarterly Audit Plan, and Monthly Group Comparison Reports

The Director's, Quarterly Audit Plan, and Monthly Group Comparison reports track the number of audits, total audit hours, and total dollar production from audits. These reports are all generated from the Field Audit Section's audit tracking system; therefore, information within the reports should agree. We compared Director's reports with Quarterly Audit Plan and Monthly Group Comparison reports for Fiscal Years 1997 through 2002 and found the following discrepancies:

- Total audit hours and total dollar production did not agree between the Director's and Quarterly Audit Plan reports. Hours disagreed in three of the six fiscal years with differences ranging from 14 to 2,923 hours, while dollar production disagreed in two fiscal years with differences of about $400 and $159,800.

- The number of audits and total audit hours did not agree between the Director's and Monthly Group Comparison reports. Both the number of audits and total audit hours disagreed in two of the six fiscal years. The number of audits differed by two and six audits, while the total audit hours differed by 23 and 101 hours.

Field Audit Section staff indicated that they were aware that some differences between these reports existed, but they had not determined the reason for the discrepancies.

Finally, Field Audits staff identified several businesses that were incorrectly classified in the Fiscal Year 2002 Quarterly Audit Plan report. These misclassifications totaled 8,000 hours and about $2.7 million in dollar production. The Quarterly Audit Plan report needs to be accurate because it is the only management report used by Field Audits that tracks actual hours and dollar production against budgeted amounts. It is particularly important that Field Audits have an accurate tool to monitor how resources are being used if audit resources are to be shifted toward larger, more high-risk audits. Implementing a review process would help ensure that the all reports are complete and accurate.

Recommendation No. 11:

The Department of Revenue should ensure that Field Audits management reports are accurate and reliable by:

a. Implementing effective review procedures for all management reports to identify and correct errors and discrepancies.

b. Establishing a threshold regarding acceptable difference amounts.

c. Investigating discrepancies that rise above established thresholds.

Department of Revenue Response:

Agree.

a. The Section will continue to monitor and evaluate the cost effectiveness of correcting computer programs. Management reports have never had unlimited resources and it can become too expensive in research cost and/or programming cost to fix the minor discrepancies now occurring. A procedure to monitor will be implemented by October 1, 2003.

b. The Section will evaluate threshold numbers and assess resources for identifying differences and establish the unacceptable variances by October 1, 2003. (The report and the system in question are now in the test phase of a recently completed software program improvement. This will delay beginning an evaluation.)

c. Once thresholds are set, the Section will implement investigation of discrepancies that go over the thresholds when they occur. Procedure will be implemented by October 1, 2003.

The electronic version of this report is available on the Web site of the
Office of the State Auditor
www.state.co.us/auditor

A bound report may be obtained by calling the
Office of the State Auditor
303-869-2800

Please refer to the Report Control Number below when requesting this report.

Report Control Number 1476