PERFORMANCE AUDIT

DEPARTMENT OF TRANSPORTATION

MOTOR VEHICLE DIVISION – REVENUE GROUP

Report to the Arizona Legislature
By the Auditor General
August 1986
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STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

August 18, 1986

Members of the Arizona Legislature
The Honorable Bruce Babbitt, Governor
Charles L. Miller, Director
Department of Transportation

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Department of Transportation Motor Vehicle Division - Revenue Group. This report is in response to the July 26, 1985 resolution of the Joint Legislative Oversight Committee.

The report addresses audit coverage, audit selection and auditor productivity. We found the Revenue Group Audit Section conducts too few audits of commercial carriers, resulting in potential lost assessments of up to $10.9 million per year. The Section's procedures for selecting accounts to audit have caused many accounts to be excluded from audit, and this may reduce taxpayer incentive to report taxes properly. We also discuss the potential loss of more than $1.4 million in revenue resulting from assigning auditors to duties other than auditing, and we recommend ways to maximize auditor productivity through automation.

My staff and I will be pleased to discuss or clarify items in the report.

Respectfully submitted,

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SUMMARY

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Transportation (ADOT) Motor Vehicle Division's Revenue Group, in response to a July 26, 1985 resolution of the Joint Legislative Oversight Committee. This performance audit is one in a series of audits on ADOT and was conducted as part of the Sunset Review set forth in Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

The Revenue Group serves as the revenue processing arm of the Motor Vehicle Division (MVD). The Revenue Group handles all revenues resulting from A.R.S. Title 28 (transportation code): approximately $424 million annually. The major duties of the Revenue Group are to: 1) set up and monitor commercial carrier accounts to ensure compliance with Title 28 and other requirements; 2) receive, process and distribute all Title 28 tax and license revenues; and 3) audit commercial vehicle and distributor tax accounts to ensure proper tax reporting.

Additional Audit Staff Could Generate Millions of Dollars in Revenue For the Highway User Revenue Fund (see pages 5 through 12)

The Revenue Group Audit Section does not conduct enough audits of commercial carriers. Currently the Section audits only about 2 percent of its accounts annually, resulting in potential lost assessments of as much as $10.9 million per year. While audit coverage varies from state to state, Arizona's falls below that of several other states in at least two tax types.

Expanded audit coverage would substantially increase audit collections and improve compliance with Arizona tax laws. Increasing the Section's current coverage to 3.1 percent would produce approximately $1.5 million in additional assessments, and could be accomplished with current staffing levels by implementing the productivity improvements recommended in Finding III (page 17). Increasing coverage to the 10 percent level would require 38 additional auditors, but could result in an additional $10.9

million in assessments. The Audit Section should develop a plan to increase audit coverage and use the plan to request funding for needed staff.

Current Audit Selection Procedures
Are Not Effective (see pages 13 through 18)

The Audit Section's effectiveness is reduced by poor audit selection procedures. Currently, audits are selected based on individual, often arbitrary judgment and are not selected randomly. As a result, the Audit Section has audited 57 percent of the largest accounts we analyzed at least once in the past three years. Many of the largest accounts were audited repeatedly. The other 43 percent of large accounts and 96 percent of the remaining accounts we analyzed have not been audited. Because the Section focuses its efforts on a limited number of large accounts, most other taxpayers have little incentive to report their taxes properly. For example, one carrier who was reporting a zero monthly tax liability was assessed more than $37,000 as the result of an audit. Such underreporting could be causing the State to lose substantial tax revenue.

To improve the effectiveness of its audit coverage, the Audit Section needs to develop selection criteria that ensure random coverage of accounts. Management should also review accounts to determine factors upon which selection could be based, including account size, to further maximize revenue recovery.

The Revenue Group Could Generate
Additional Revenue By Increasing The
Productivity Of Its Audit Section (see pages 19 through 27)

The Audit Section could increase revenue recovered through audit assessments by approximately $1.8 million to $2.8 million annually by limiting special project assignments and automating auditor duties. Currently, auditors spend approximately 35 percent of their time on nonaudit duties. Using auditors for special projects has cost the State approximately $4.3 million in the past three years, because the auditors were not using their time to generate audit assessments. MVD should limit use of audit staff for special projects.

The Audit Section could further increase productivity and generate more revenue by automating several audit processes. The experience of other audit organizations shows that the use of personal computers by auditors can decrease the time needed to complete each audit by 10 to 30 percent. This translates into additional audits with an estimated $351,000 to $1.3 million in potential audit assessments. The Legislature should consider funding the Audit Section's 1987-88 budget request for eight microcomputers and software. Based on MVD's progress in implementing a computerized audit program, the Legislature should consider funding additional requests for computers in subsequent years.

The Audit Section Lacks Adequate Controls To Ensure Quality And Integrity Of Audit Modifications And Taxpayer Billings (see pages 29 through 33)

The Audit Section does not have adequate controls to ensure accurate, justifiable audit assessment modifications and billings. Documentation to support audit assessment modifications reviewed by our staff was either weak or not available, even though the modifications resulted in reductions of the original assessment amount and ranged from approximately $500 to $368,000. Further, MVD audit supervisors did not sign-off on most of the modifications after the completion of each audit. The Audit Section also lacks adequate controls over assessment notifications, since individual auditors have control over both the audit and the taxpayer billing.

The Audit Section needs to enforce existing standards and policies governing assessment modifications and taxpayer notifications to ensure that all modifications are adequately documented and reviewed. ADOT's Internal Audit Section should periodically review the MVD Audit Section's internal controls over modifications and taxpayer notifications to ensure that they are adequate and are working as intended.

MVD Could Reduce Growth In The Number Of Uncollectible Accounts (see pages 35 through 37)

The Revenue Group has difficulty collecting monies owed from commercial carrier accounts after all allowable collections procedures have been

attempted. In order to prevent an increase in the number of such outstanding accounts, the Revenue Group could implement various monitoring procedures. For example, MVD could use a local publication to track in-State accounts entering bankruptcy proceedings so the State can file as a creditor before bankruptcy proceedings are final. MVD could also improve its ability to identify out-of-State accounts that may go bankrupt by monitoring the financial reporting of all carriers in and out of the State. It could also use an outside collection agency to track bankrupt out-of-State carriers.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit of the Arizona Department of Transportation (ADOT) Motor Vehicle Division's Revenue Group in response to a July 26, 1985, resolution of the Joint Legislative Oversight Committee. This performance audit is one in a series of audits on ADOT, and was conducted as part of the Sunset Review set forth in Arizona Revised Statutes (A.R.S.) §§41-2351 through 41-2379.

The Revenue Group serves primarily as the revenue processing arm of the Motor Vehicle Division (MVD). The Revenue Group monitors and collects all revenues resulting from A.R.S. Title 28 (transportation code), averaging approximately $424 million annually over the past two years. Title 28 revenues include gas and other fuel taxes, commercial carrier taxes, drivers' license fees, and vehicle license plate, title and registration fees.

The Revenue Group has three major functions carried out by its three sections as described below.

- Compliance Control: Responsible for setting up and monitoring accounts to ensure that all commercial vehicle operators are in compliance with Title 28 requirements, and rules and regulations governing registration and taxation. This includes opening accounts and determining the appropriate registration fees and tax and bond amounts.

- Receivables Control: Responsible for receiving and processing all Title 28 tax and fee payments, accounting for, reporting and distributing these revenues, and collecting delinquent payments.

- Audit: Responsible for enforcing commercial vehicle and distributor tax laws by auditing accounts to ensure proper tax reporting.

The three sections conduct various activities to ensure commercial carrier compliance and remittance of monies owed to the State. For example, the Compliance Control Section reviews potential new applicants and renewals to ensure proper licensure and appropriate bonding levels. This can include a yearly review of carriers' bonding levels based on the dollar amount of business to verify if the bonds are correct. The Receivables

Control Section processes and accounts for all Revenue Group monies. This section monitors each motor carrier use fuel tax report which is filed to ensure that a specified ratio exists between the motor carrier tax and use fuel tax. If, for any reason, this ratio does not exist, it signals a potential noncomplier and the report is forwarded to the Revenue Group collection unit for follow-up. The Audit Section provides the final check. An audit is the most comprehensive and effective of all the processes performed.

Staffing And Budget - The Revenue Group's budget is not separate from the the budget for the Motor Vehicle Division of ADOT. However, staffing figures for the three sections plus the Revenue Group's administration are presented in Table 1.

TABLE 1

PERSONNEL ASSIGNED TO MVD REVENUE GROUP AS OF JUNE 1986

	Budgeted FTEs	Budgeted Positions Filled	Temporary/Seasonal Clerical Pool Employees
Compliance Control	39	31	
Receivables Control	37	29	3
Audit	22 (1)	19	1
Administration	2	2	1
TOTALS	100	81	5

(1) This figure includes 17 auditors, one manager, two supervisors and two support staff.

Source: MVD Revenue Group data.

Scope Of Audit

Our audit of the MVD Revenue Group focused primarily on the effectiveness and efficiency of the Revenue Group's Audit Section. We focused on the Audit Section because the Revenue Group is in the process of designing and implementing an automated system that will affect most operations in the Compliance Control and Receivables Central Sections. The audit addressed the following specific issues.

- Whether current audit coverage is sufficient;
- The effectiveness of current audit selection procedures;
- Ways to maximize auditor productivity;
- The adequacy of audit modification documentation and supervisory review, and of certain procedures governing taxpayer billings; and
- Whether MVD can reduce the growth in the number of uncollectible accounts.

The report section titled Other Pertinent Information addresses the productivity of the Revenue Group's collection activities and problems concerning the abatement of uncollectible liabilities.

The Auditor General and staff express appreciation to the Director of the Department of Transportation and his staff, and specifically to MVD's Revenue Group, for their cooperation and assistance during the course of the audit.

FINDING I

ADDITIONAL AUDIT STAFF COULD GENERATE MILLIONS OF DOLLARS IN REVENUE FOR THE HIGHWAY USER REVENUE FUND

The Revenue Group Audit Section does not conduct enough audits of commercial carriers. Currently the Audit Section audits only about two percent of its accounts annually, resulting in a backlog of approximately 3,100 unaudited accounts per year. While audit coverage varies among states and among different types of taxes, Arizona's coverage of at least two tax types is less than the average of other states. Assigning more audit staff to commercial carrier audits would increase audit coverage and could result in up to $10.9 million per year in additional audit assessments.

The Audit Section is charged with auditing accounts for several different taxes paid by commercial motor carriers, fuel vendors and distributors.* Taxpayers may be required by law to pay several types of commercial vehicle taxes. All taxes paid are deposited in the Highway User Revenue Fund. A taxpayer's account may consist of more than one tax type. Each tax type on a taxpayer's account is referred to as an account type. As of June 1986, 22,000 taxpayers paid taxes in more than 39,000 account types. Also as of June 1986, the Audit Section employed 17 full-time auditors.

Low Audit Coverage Could Mean Sizable Revenue Loss

The level of audit coverage achieved by the Audit Section appears to be inadequate. The Section audits only a small portion of its accounts each

* The Audit Section is responsible for ten different tax and revenue types: 1) use fuel user, 2) use fuel vendor, 3) use fuel restricted vendor, 4) weight distance, 5) gross receipts, 6) motor vehicle fuel distributor, 7) motor vehicle fuel restricted distributor, 8) international fuel tax agreement, 9) international registration plan, 10) prorate. According to an MVD supervisor, two types - use fuel user and weight/distance (motor carrier) - account for 82 percent of the accounts and 52 percent of the assessments.

year and has a substantial backlog of unaudited accounts. Arizona's percentage of accounts audited is low compared with other states.

Low audit coverage - The Audit Section audits only about 2 percent of the total number of account types each year. The Section has completed an average of only 802 audits of account types per year over the last three years, while the total tax load continues to grow and is now more than 39,000 account types. The 802 audits translate into approximately 500 taxpayer accounts audited per year out of a total population of 22,000 taxpayers.

The low audit coverage means that the Motor Vehicle Division (MVD) may be losing potential revenues because so few accounts are audited each year. More than 14,000 taxpayer accounts have not been audited within the last 30 months, which translates into more than 24,700* separate audits of account types. Based on our suggestions regarding a more appropriate level of audit coverage, MVD's backlog could be as much as 3,100 accounts per year. This results in a loss of up to $10.9 million annually in potential assessments (see page 10).

The backlog also means that many otherwise collectible funds must go uncollected, because taxpayers are required in most cases to maintain records for only three years. Thus, failure to audit in three years results in potential revenue that may never be collected.

Coverage is higher in other states - While audit coverage varies from state to state and among the various tax types, Arizona's performance falls below that of several other states' actual performance for two major Arizona tax types.

* Although MVD currently has more than 39,000 account types, the 24,700 unaudited in the last 30 months include only accounts that are over 30 months old and have not been scheduled for audit. The remaining 14,300 accounts include accounts established within the previous 30 months, the approximately 2,400 accounts audited during the past 30 months, and accounts scheduled for audit that have not yet been audited.

At least 13 other states are auditing a greater percentage of fuel usage tax account types. Table 2 shows Arizona in comparison to the six highest states and the 35 state average. At least four states audit a significantly greater percentage of weight or mileage account types, as shown in Table 3, page 6.

TABLE 2

FUEL USE TAX AUDIT COVERAGE COMPARISON
JULY 1, 1983 THROUGH JUNE 30, 1984

Rank	State (1)	Carriers Registered For Fuel Use Tax	Field Audits	Percentage
1	Maryland	33,116	3,180	9.6
2	Kentucky	29,240	1,808	6.2
3	S. Dakota	9,624	480	4.9
4	Texas	20,100	754	3.8
5	Washington	13,588	461	3.4
6	Iowa	24,700	812	3.3
	.	.	.	.
	.	.	.	.
	.	.	.	.
14	Arizona	17,938 (2)	239	1.3 (3)
		Average for 35 States Surveyed		1.9

(1) Colorado was eliminated from the ranking because of its manner of counting audits. Audits covering more than one year are multiple counted.

(2) This number was obtained from MVD and not the NGA study, since MVD had originally supplied incorrect data to the NGA.

(3) Maine also had 1.3 percent coverage.

Source: Compiled by Auditor General staff from "State Audit and Enforcement Practices," Report No. 9 of the National Governors' Association Project on Uniform State Procedures for Interstate Motor Carrier Taxation and Regulation.

TABLE 3

OTHER TAXES (1) AUDIT COVERAGE FOR SELECTED STATES
JULY 1, 1983 THROUGH JUNE 30, 1984

State	Carriers Registered For Other Taxes	Field Audits	Percentage
Oregon	34,729	4,883	14.1
Nevada	11,408	1,371	12.0
Kentucky	29,240	1,808	6.2
Idaho	15,075	646	4.3
Arizona	17,812	327	1.8
	Average for 11 states surveyed		4.1

(1) Other taxes are imposed based on weight and mileage, gross receipts and mileage, mileage alone, or the number of axles on the vehicle.

Source: Compiled by Auditor General staff from "State Audit and Enforcement Practices," Report No. 9 of the National Governors' Association Project on Uniform State Procedures for Interstate Motor Carrier Taxation and Regulation.

According to Table 2, the state of Maryland's fuel use audit coverage is more than seven times as high as Arizona's. Kentucky's coverage is almost five times as high, and at least 12 other states exceed Arizona's use fuel tax audit coverage rate. Table 3 shows more rate variances, with Oregon's weight or mileage tax audit coverage more than seven times and Nevada's more than six times higher than Arizona's.

Although there is no recognized standard that specifies an adequate level of audit coverage, MVD has not established its own goals for both coverage level and revenue recovery. For these reasons, the Audit Section needs to establish an audit plan that sets coverage and recovery goals. For example, the Section may want to consider the 10 percent level suggested by a National Governor's Association (NGA) study for home-based interstate accounts in the International Registration Plan (IRP). Although this level is intended only for IRP accounts, Arizona's low overall coverage combined with the potential high dollar amounts that could be recovered may make 10 percent a worthwhile goal to attain.

Increasing Audit Coverage Would Generate Substantial Additional Revenue

Increasing the Audit Section's coverage would substantially increase audit collections. However, the Audit Section needs to develop a plan for increased coverage before any staff are added.

Additional collections - If the Audit Section were to increase its current audit coverage, it could recover substantial additional revenue. The Section could increase its coverage to 3.1 percent without adding staff. Increasing beyond 3.1 percent would require additional staff but would be cost effective.

Improving Audit Section productivity could increase audit coverage without additional personnel. According to ADOT productivity figures, each auditor has 1,598 hours of available time each year.* However, this level is seldom attained because auditors are frequently assigned to special projects. The special projects take away from direct audit time and audit coverage suffers as a result. Eliminating special project assignments and automating several auditor functions (see Finding III, page 17) could increase coverage to 3.1 percent without adding staff, as shown in Table 4 (page 10).

Audit staff are cost effective because each auditor produces more revenue than is expended on salary and related expenses. At maximum productivity, the average Audit Section auditor could produce more than $249,000 in audit assessments per year.** The average auditor's salary and related expenses are $28,429. Thus, each additional auditor could result in a net

* There are 1,776 direct hours available, but MVD excluded travel time when calculating assessments per hour. Our analysis indicates that travel time is approximately 10 percent. Thus, we used 1,598 hours to calculate potential audit assessments.

** Annual assessments are based on the average of $3,408 per audit. This figure is based on current figures of $142/hour times 24/hour audit = $3,408. New figures based on improved productivity are $3,408 divided by (24 times 0.9) = $156/hour. The 90 percent figure is used because it takes only 90 percent as long to do an audit with automation. The dollars per hour increase as hours per audit decrease.

increase of more than $220,000 in potential assessments. Even at the Audit Section's current average level of 60 percent direct audit time, an additional auditor would produce a net increase of $132,000 in assessments.

Expanding MVD's audit staff is, therefore, a cost effective means of producing revenue for Arizona's transportation programs. Table 4 also shows several possibilities for increased staff and audit assessments.

TABLE 4

POTENTIAL ANNUAL ASSESSMENTS FROM INCREASED COVERAGE

	Number of Auditors	Coverage	Assessments	Amount of Increase
Present	17 (1)	2.0%	$ 2,733,216	
Proposed (2)	17	3.1	4,208,880	$ 1,475,664
	28	5.0	6,965,952	4,232,736
	55	10.0	13,683,120	10,949,904

(1) This is the current level of staffing as of June 1986.
(2) These alternatives assume 1,598 hours of direct audit time and a 10 percent increase in productivity through automation. (See Finding III, pages 19 through 27 for an explanation of possible increases in Audit Section efficiency.)

Source: Compiled by Auditor General staff from Audit Section data and National Governor's Association data.

Our estimates of potential additional revenue recovery are based on the assumption that the Audit Section would generate the same average revenue per audit hour as in the past three years even as the number of audits increased. Authorities note that if audit selection systems are working effectively, dollars generated per audit will decline as tax base audit coverage increases. This occurs because the largest and most productive accounts are audited first, leaving less productive accounts for subsequent selection. However, as noted in Finding II (page 11), the Audit Section is not currently selecting the most productive accounts for audit. Thus, improvement in audit selection may offset any expected declines in average collections per audit, at least during the first few years. The eventual lower assessments would still result in a revenue gain because more taxpayers would pay their true liability.

Audit plan needed - The Audit Section needs to develop a plan for increasing audit coverage. The plan should focus on the best means for reducing the backlog through increased productivity and additional staff.

Any kind of expanded coverage beyond that gained through enforcing 100 percent direct audit time for all auditors and automating audit tasks would require more audit staff, and these staff need to be carefully phased into the operation. Audit Section management feel that they could handle up to 20 new staff at a time as long as there was one supervisor for every five to seven auditors. However, given the current state of change within the Section, this may not be possible. Eight to ten new auditors a year for several years is perhaps a more appropriate estimate. MVD is receiving more auditors, but on a limited basis.

ADOT has requested some additional auditor positions. The MVD Revenue Group submitted a request for 18 auditors in the fiscal year 1986-87 budget. Five of these positions were submitted by ADOT for legislative approval. All five positions were funded. ADOT's five year strategic budget plan has a request for three additional auditors in fiscal year 1988-89. ADOT is also planning to contract some audits. The 1986-87 budget includes $39,000 to fund a pilot project that would involve contracting with a public accounting firm in Los Angeles. The accounting firm would perform revenue audits of Arizona tax accounts domiciled in Los Angeles and the surrounding area.

CONCLUSION

The level of audit coverage achieved by the Audit Section is low. This low coverage could be costing the State millions of dollars in lost revenue, and does not ensure compliance by the carriers. The Audit Section needs to develop goals for increasing coverage and compliance, and outline a plan for staff and resources necessary for attaining these goals.

RECOMMENDATIONS

1. The Audit Section needs to develop a plan to increase audit coverage. Specific objectives should be developed to establish the level of coverage and the number of audits that need to be done to meet these goals. This plan should outline the additional staff and resources needed, how they are to be phased into this increased effort, and the time table for implementation. An estimate should be made of the anticipated additional revenue the effort will bring.

2. ADOT should use this plan in formulating its budget and request funding for the auditor positions to carry out the plan.

3. The Legislature should consider funding additional auditing positions for MVD in accordance with the plan developed by the Audit Section.

FINDING II

CURRENT AUDIT SELECTION PROCEDURES ARE NOT EFFECTIVE

In addition to the problem of low audit coverage described in Finding I, poor audit selection further reduces the Audit Section's effectiveness. The Section has chosen to repeatedly audit a portion of the largest taxpayers and has ignored most of the remaining taxpayers. This practice reduces the incentive for many taxpayers to accurately report their taxes and has resulted in the loss of potential revenue through underreporting. To improve its effectiveness, the Audit Section should develop a more systematic selection process.

Audit Selection Criteria Are Poor

Current audit selection criteria limit the Motor Vehicle Division's (MVD) ability to maximize compliance and revenue recovery. These criteria are highly judgmental, arbitrary and lack randomness. As a result, certain accounts are audited on a regular basis while other accounts are virtually ignored.

Current selection procedures allow Audit Section personnel considerable subjectivity in selecting accounts for audit. Although MVD's primary goal is to audit larger accounts, the audit staff also use other criteria which include past audit results, reporting problems and the account holder's geographic location. While some of these criteria may have objective merit, the lack of any formal system or guidelines means that the chance of being selected for audit varies widely from one account to another. This is due in part to the fact that individual auditors, in effect, select many of the accounts to be audited. Although the ultimate authority for deciding which accounts will be audited lies with the audit manager, he usually assigns audit selection responsibility to an audit supervisor who in turn assigns it to a staff auditor.

As a result, the MVD Audit Section has emphasized certain large accounts in the selection process. These accounts are audited regularly, primarily

because audit resources are limited and previous audits have resulted in large assessments. Overall, 57 percent of the largest* accounts we analyzed** have been audited at least once and, according to Audit Section management, many have been audited repeatedly. The other 43 percent of large accounts and 96 percent of the remaining accounts we analyzed were not audited in at least the last 30 months.***

Unaudited Accounts Are Not Encouraged To Report Correctly

The Audit Section's poor selection procedures appear to have resulted in underreporting among some taxpayers. Because the Audit Section focuses its efforts on a limited number of large accounts, most taxpayers have little incentive to report their taxes properly. In fact, several instances have surfaced in which taxpayers were underreporting their actual liabilities. Underreporting may cause the State to lose substantial highway revenue and also results in inaccurate management information regarding actual account size.

Little incentive to report properly - Through its poor selection procedures, the Audit Section is, in effect, providing unaudited account holders with little incentive to properly report taxes owed. Some trucking companies may decide to underreport (and save money) because they know the risk of being audited is low. Therefore, the Audit Section's selection policies may actually encourage taxpayers to underreport.

Analysis of MVD audit results by Auditor General staff suggests that some carriers do underreport. We analyzed a random sample of audited accounts by correlating account size and assessment amount for each account in the

* Largest accounts are defined as those with an average monthly liability of more than $5,000.

** Our analysis included all active accounts that have at least one of the vendor, fuel use, or motor carrier tax types. We therefore analyzed more than 17,000 accounts, or more than 77 percent of MVD's total active accounts as of 12-13-85.

*** The Audit Section's records only cover the past 30 months. Thus, we were unable to determine how often the audited accounts had been audited or how long unaudited accounts had existed without an audit.

sample.* The results of this correlation clearly show that there is a very weak relationship between account size and assessment amount.** In short, large assessments could result from smaller accounts in the population as well as from the larger accounts.*** The reason for this relationship may be that some smaller accounts are, in fact, small only because the taxpayer underreports actual tax liabilities.

Specific instances of underreporting - Although complete data is not available, several accounts in the population clearly indicate that "small" accounts may in fact be larger than reported to be. The following are examples of substantial audit assessments resulting from reportedly smaller accounts.

- One carrier who was reporting a monthly liability of zero was assessed more than $37,000 as the result of an audit.
- A carrier who reported $1,400 in monthly liabilities was assessed $19,400 during an audit.
- A carrier whose reported monthly liabilities were just under $2,500 was assessed $31,200 after an audit.

These examples were discovered by the MVD Revenue Group and clearly illustrate the potential for underreporting. Our correlation analysis also indicates the possibility that such underreporting is taking place because the larger assessments were found in the smaller accounts.

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* The sample consisted of 169 audited accounts of the total of 759 active audited accounts as of December 13, 1985, that had at least one of the vendor, fuel use or motor carrier tax types. The sample of 169 yielded a 95 percent confidence level with a reliability of ± 3 percent.

** The correlation derived was .1991 at the .01 level of significance, therefore indicating a very weak relationship.

*** The weak correlation also suggests that those large accounts that have been audited repeatedly may be improving their tax reporting. The closer a taxpayer comes to reaching full compliance (i.e., accurate tax reporting), the lower the audit assessment.

Improper reporting means reduced revenue - Underreporting could be causing the State to lose substantial tax revenue. Although it was not possible to precisely estimate the amount of lost revenue, our correlation suggests that unaudited accounts have the potential for sizeable assessments.

In addition, improper reporting reduces the Audit Section's attempts to maximize revenue recovery. The Section's assumption that large liabilities would lead to large assessments seemed logical because big companies do more business and incur larger liabilities which usually result in larger assessments. However, such an assumption depends upon accurate identification of companies with large liabilities. Accurate identification of all such companies is unlikely without proper reporting of tax liabilities.

Audit Selection Procedures Need To Be Improved

The Audit Section needs to develop procedures for selecting audits that will improve taxpayer reporting. These procedures should include oversampling of large accounts that have not been previously audited and random sampling of small accounts. Once this has been accomplished other potentially productive accounts should be oversampled. The Tax and Revenue Group Automated Tracking System (TARGATS) is intended to facilitate many of these improved procedures, but an interim system is needed.

To improve the effectiveness of the expanded audit coverage recommended in Finding I (page 5), the Audit Section needs to develop selection criteria that ensures greater coverage of unaudited large accounts and random coverage of all accounts. With improved selection techniques, audits of large accounts that have not previously been audited are likely to produce large assessments and help ensure future compliance by major taxpayers. At the same time, however, the Audit Section needs to ensure that all other taxpayers comply with commercial carrier tax laws through proper reporting of liabilities. Random sampling of accounts is particularly important because of the underreporting identified by previous MVD audits of reportedly smaller accounts that were actually larger than expected.

While these procedures are being implemented, management should concurrently focus on other potentially productive accounts to further maximize revenue recovery. Management may wish to examine accounts based on secondary criteria to determine which accounts should be targeted to increase the Audit Section's ability to ensure proper reporting and maximize revenue recovery. Possible criteria could be those accounts with a history of reporting problems (i.e. reporting zero liability, failure to report at all, major record keeping errors uncovered on previous audits), and accounts that are facing bankruptcy. Other factors to consider could be changes in company personnel (i.e. new bookkeeper) and statutory changes.

The Revenue Group's plans to improve its audit selection criteria appear adequate but will not be implemented for approximately one year. The criteria planned for the TARGATS system appear to take into consideration both accurate reporting (random selection) and revenue recovery (oversampling of large and other potentially productive accounts). However, the Audit Section does not plan to implement the TARGATS selection criteria until September 1987. In the meantime, MVD will continue to lose potential revenue. The Audit Section should, therefore, implement these criteria before TARGATS is brought on line.

CONCLUSION

Audit Section selection procedures may not effectively ensure compliance with Arizona tax laws. Consequently, the State could be losing revenue needed for highway construction and maintenance. Improved selection procedures are needed to improve compliance and maximize revenue recovery.

RECOMMENDATIONS

1. The Audit Section should improve audit selection by:

    a. Selecting audits randomly from the entire population of taxpayers. The Section should implement random selection before TARGATS is brought on line.

b. Once random selection is achieved, management should evaluate various characteristics of its accounts to determine which accounts would likely result in the greatest potential revenue recovery. Such characteristics may include account size, reporting problems, organizational changes within the company, account age, and period of time since the account was last audited. If account size is considered, the Audit Section should identify large accounts that have not been audited and designate a portion of its audit resources to ensure that these accounts are audited in a timely manner.

FINDING III

THE MOTOR VEHICLE DIVISION REVENUE GROUP COULD GENERATE ADDITIONAL REVENUE BY INCREASING THE PRODUCTIVITY OF ITS AUDIT SECTION

The Motor Vehicle Division (MVD) Revenue Group Audit Section could increase audit assessments by approximately $1.8 million to $2.8 million annually through improved Audit Section productivity. Reducing the amount of time auditors currently devote to nonaudit activities would enable MVD to increase audit assessments by more than $1.4 million annually. Use of microcomputers for field audits would also improve individual auditor productivity, and could result in additional assessments of $351,210 to more than $1.3 million annually.

Special Projects Reduce Potential Audit Revenue

Use of audit staff for special projects limits the audit assessments generated by the MVD Audit Section. Time spent on nonaudit projects during the past three fiscal years cost the State more than $4.3 million in lost assessments. MVD could take several steps to reduce these losses.

The major duty of the Audit Section is to ensure proper payment of taxes and fees incurred by commercial carriers. Auditors conduct examinations of taxpayer/corporate accounts and records. Other activities are considered special projects. Serving in acting management or supervisory capacities, special task force assignments, compiling audit production reports, and performing clerical functions such as preparing mailouts or purging files are several examples of activities MVD defines as special projects.

Loss of revenue - The State is losing a great deal of money because auditors are taken away from direct audit assignments and placed on special projects. Further, because special projects require experienced audit staff, the more complex accounts remain unaudited. Special project assignments have increased over the last three fiscal years.

Special projects cost the State more than $4.3 million in potential revenue over the past three fiscal years, and have contributed to a substantial backlog of unaudited accounts. Since special projects limit the time spent on audits, MVD must forgo potential assessments that auditors would otherwise produce. Table 5 shows the potential revenue losses based on the average assessment per hour from fiscal years 1983 through 1985. In addition, over the past three years the Audit Section completed an average of only 802 audits per year out of a total of approximately 39,000 account types.*

TABLE 5

PERCENTAGE OF AUDITOR TIME ASSIGNED AND POTENTIAL REVENUE LOST DUE TO SPECIAL PROJECT ASSIGNMENTS FOR FISCAL YEARS 1982-83 THROUGH 1984-85

Fiscal Year	Special Project Hours (1)	Percentage of Total Audit Hours	Average Assessment Per Audit Hour	Potential Revenue Lost
1982-83	8,933	31	$125.49	$1,121,002
1983-84	9,385	33	151.16	1,418,637
1984-85	11,985 (2)	40	149.41	1,790,679
TOTAL				$4,330,318
Annual Average	10,101	35	$142.02	$1,443,439

(1) Figures exclude all project time charged by the acting audit manager.
(2) Special project time increased in fiscal year 1984-85 because two Audit Section staff were assigned full-time to the TARGATS project. TARGATS is the Tax and Revenue Group Automated Tracking System which will attempt to address MVD system deficiencies through automation.

Source: Compiled by Auditor General staff from MVD Audit Section data and the Field Audit Production Report covering fiscal years 1982-83 through 1984-85.

* A carrier account consists of different account types (e.g., fuel use, motor carrier, etc.). All account types are subject to audit.

Special project assignments also reduce the experience level available to the Audit Section. For example, two special projects* outside the Audit Section are currently using four of the most experienced auditors with 28 combined years of audit experience. This loss of experience to the Audit Section reduces its ability to complete the more complex audits and eliminates the assessments that would have resulted from those audits.

Special project assignments account for a growing proportion of auditor time. During the three-year period from fiscal year 1982-83 through 1984-85, special project assignments have increased from approximately 31 percent to 40 percent of all auditor time, for an average of 35 percent, as shown in Table 5.

Minimize auditor time spent on special projects - Because of the impact of special project assignments on audit assessments, MVD should limit the use of audit staff for these assignments. Management or clerical personnel could be assigned to most special projects within the Audit Section. When audit staff must be used for extended assignments outside the Audit Section, they should be replaced to ensure full audit coverage.

Use of audit staff for many special projects within the Audit Section appears to be unnecessary and poorly managed. These projects are usually of short duration and seldom require auditor expertise. Instead, these projects could be more appropriately assigned to an audit supervisor, the audit group manager or to clerical staff. Examples of special projects include: development of future audit schedules, pending closure account review,** and proofreading a proposed audit procedures manual. MVD is presently reviewing all project assignments within the Audit Section. Corrections will be made so future projects will not interfere with regular auditor responsibilities.

* Projects include TARGATS automation and MVD assuming vehicle county title and registration responsibilities for several counties.

** Pending closure account review was defined by Audit Section management as a clerical function.

MVD uses audit staff on long-term special projects because these projects require specific expertise not otherwise available in the Division. Examples of long-term special projects include the following.

- TARGATS Project - The Revenue Group is developing an automated system (Tax and Revenue Group Automated Tracking System) to correct systematic deficiencies in the Group's operations. A task force was created and recommendations were made to improve operations. The TARGATS project task force included an outside CPA firm and employees of the Motor Vehicle Division. Also, an audit manager and an auditor were selected to serve on this project full-time. The project assignments are for five years. The auditors were not replaced.

- Other Long-Term Projects - MVD Revenue Group auditors often provide professional assistance in other areas. In the past, MVD has assigned Revenue Group auditors to provide technical expertise to the Office of Audit Analysis and MVD's Pima County Title and Registration Office. The auditors have also done limited follow-up for county title and registration takeovers after ADOT's Office of Audit Analysis identified problems. An MVD auditor was also assigned, along with other ADOT staff, to help resolve possible problems with Highway User Revenue Fund monies in Pima County. The MVD auditor remained on the Pima County project approximately a year and one-half.

MVD does not replace auditors assigned to long-term projects and this could cause substantial revenue losses. According to the MVD Assistant Director, the Department agreed to absorb personnel costs on the TARGATS project. As a result, when auditors were assigned they were not replaced. Therefore, MVD was willing to forgo the potential assessment revenue in exchange for TARGATS, because the Director felt that the long-term revenue gain from TARGATS would be greater than the potential revenue lost. However, the assignment of an audit manager and an auditor to TARGATS for five years reduces potential audit assessments by more than

$477,500* annually. Projected over the five-year period, replacing auditors could pay for almost one-half of TARGATS' estimated cost.**

In the future, the MVD Director plans to assign management analysis section personnel to special projects. However, this section is currently staffed with mostly clerical personnel and lacks the expertise to meet many MVD needs. Future budget requests will seek positions for qualified technical personnel to staff difficult and complex projects.

Until the Department has an adequate management analysis capability and for extended projects where audit staff is absolutely necessary, MVD should replace any audit staff who are reassigned, to maintain adequate audit coverage. Use of replacement staff would not only maintain the Audit Section's ability to ensure compliance and generate audit revenue, but would also provide for skilled staff in the future.

Automation Could Increase Productivity And Produce More Revenue

The Revenue Group Audit Section could increase productivity and generate more revenue by automating audit processess. MVD auditors are spending an excessive amount of time performing processes that could be completed in less time by computer. Automation reduces time consuming activity.

Manual processes hamper potential productivity - Lack of automation is causing MVD auditors to be less productive, and a backlog of unaudited accounts continues to grow. Auditors are spending a great deal of time repeating manual processes. Auditors expend considerable time examining and computing all necessary audit information. Records are examined for validation of reported information using source documents and sufficiency of bond coverage. At the conclusion of the examination process,

* Amount based on average audit assessment per hour of $149.41 (fiscal year 1984-85 figure) multiplied by the standard available yearly hours (3,196) for two auditor positions. Although one of the transferred positions was a manager, the net result is two vacant auditor positions in the Audit Section.

** Estimated cost of TARGATS implementation is $5.5 million.

the auditor must organize the information gathered on various work sheets. The auditors use this information to compute the tax assessment and any penalty and interest charges. A calculator is the only aid used to complete any computations and to verify formulas that determine the final assessment. An auditor places all the information gathered from each audit on three separate work sheets. A personal computer would allow an automated program to complete the process more quickly. Standardized work sheets and formulas could be stored on the computer and would not need to be recreated for each audit. The computer would recreate the schedules and perform computations automatically, thus reducing the amount of time it takes to audit an account.

The Audit Section's lack of automation results in limited audit coverage. Completing audits manually reduces the number of accounts that can be audited. Conducting fewer audits results in fewer assessments and increases the backlog of unaudited accounts.

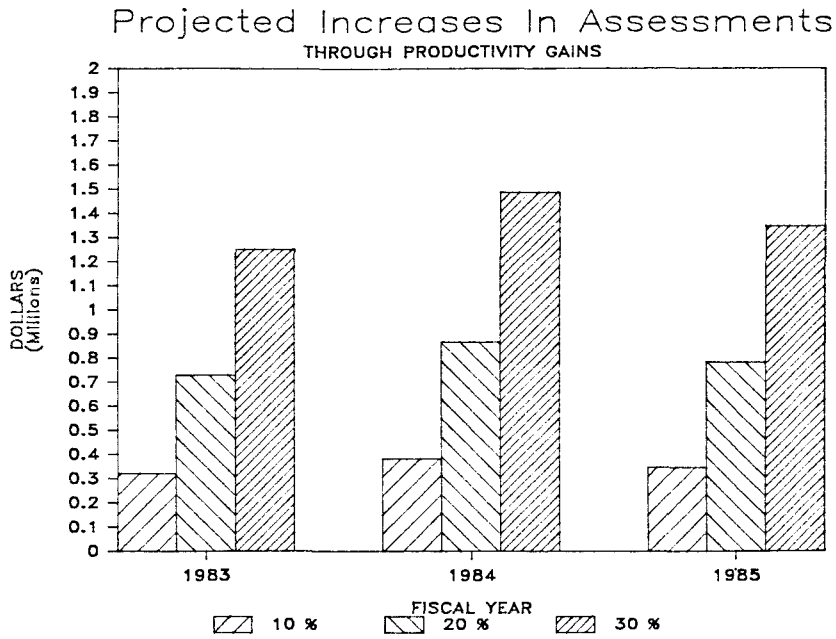
Automation reduces time consuming activity - The use of personal computers would reduce the time necessary to complete an audit. The use of personal computers in other audit organizations has increased productivity. The Motor Vehicle Division has plans to purchase personal computers during fiscal year 1987-88.

Financial audit entities with duties similar to the MVD Audit Section have experienced productivity* gains of 10 percent to 30 percent using microcomputers. For example, Wisconsin's MVD Audit Section is responsible for collecting and auditing motor carrier taxes. Since the auditors began using computers productivity has increased by 20 percent or more. The auditors use personal computers to collect specified data. Once the data is collected the computer disk with the information is mailed to the central office. The field auditors do not make the assessment. This

* Productivity is defined as the number of audits completed during a given period.

procedure is completed by clerical and management staff in the central office. Since computer implementation, the amount of auditor time required in the office to compile audit results has been reduced. Based on Arizona's audit experience for fiscal years 1983 through 1985, similar productivity gains would yield additional assessments between $322,322 and more than $1.2 million for 1982-83; and between $347,612 and $1.3 million for 1984-85, as shown in Figure 1.*

FIGURE 1



Source: Compiled by Auditor General staff from MVD Audit Section data and the Field Audit Production Report covering fiscal years 1982-83 through 1984-85.

* Based on a projected gains in audits completed, an overall productivity gain of 10 percent could have generated an average of $351,210; 20 percent could have generated an average of $793,500; and 30 percent an average of $1,361,272.

The Arizona Banking Department also reports a favorable experience with automation. Use of personal computers has increased productivity from 10 to 20 percent. However, productivity gains require training and occur only after a phase-in period.

The Motor Vehicle Division plans to purchase personal microcomputers. The budget request for fiscal year 1987-88 includes funds for eight portable computers with modem capabilities. The eight computers requested are similar to the ones used by the state of Wisconsin. The estimated cost of eight computers is approximately $18,500. This estimate does not include any software. It would cost the Audit Section approximately $53,500 to provide computers and software for all Audit Section staff.*

CONCLUSION

The use of auditors for special projects should be limited. The State potentially lost approximately $4.3 million over the last three years because of lost audit hours. Further, manual audit processes cost the State between $351,210 to more than $1.3 million in potential assessments due to unaudited accounts.

RECOMMENDATIONS

1. MVD should limit use of audit staff for special projects by:

    a. using personnel from other sections and ADOT divisions;
    b. replacing auditors on extended special projects with temporary auditors to provide continued full audit coverage; and
    c. scheduling and managing special projects within the Audit Section so they do not interfere with regular audit assignments.

* The cost includes 20 computers with modems and LOTUS software at $2,671. This cost does not include any formal software training. The price includes computers for 17 auditors and three supervisory staff.

2. The Legislature should consider funding microcomputers and software for the MVD Audit Section. The Legislature should consider providing MVD with the funds requested in the fiscal year 1987-88 budget for the initial purchase of eight microcomputers. Based on MVD's progress in utilizing its computers, the Legislature should consider funding additional requests for computers in future years.

3. The Audit Section should develop procedures to implement the use of personal computers. The procedures should include obtaining correct software and developing templates and formulas to assist in calculations. Auditors should be provided with formal and on-the-job training so the computers can receive maximum usage and accounts will continue to be audited during phase-in.

FINDING IV

THE AUDIT SECTION LACKS ADEQUATE CONTROLS TO ENSURE THE QUALITY AND INTEGRITY OF AUDIT MODIFICATIONS AND TAXPAYER BILLINGS

The Audit Section of the Motor Vehicle Division (MVD) does not have adequate controls to ensure accurate, justifiable audit assessment modifications and billings. Technical review and documentation of assessment modifications is weak. Also, procedures for billing taxpayers lack sufficient separation of duties.

Audit Section Needs To Strengthen Controls Over Modified Assessments

Presently, control over assessment modifications made by MVD auditors is minimal, although such decisions may involve hundreds of thousands of dollars. Documentation of audit assessment modifications was either weak or not available. Also, evidence of supervisory review was not apparent. Supervisory review and internal controls are needed to reduce the risk of collusion, bribery or other illegal acts.

Audit assessments are additional tax amounts owed to the State by commercial carriers. Audit assessments can occur after an auditor conducts an examination of a commercial carrier's records. In addition, if a taxpayer disagrees with the original assessment, a modification can be requested. Modifications are changes based on new information presented or clarifications made by the auditee. Modified assessments can increase or reduce a taxpayer's liability. Audit section procedures call for approval of all modifications by the auditor's immediate supervisor.

Documentation and review of modified assessments is limited - The Audit Section has weak documentation and limited review of modifications. A review of modified assessments* by Auditor General staff found weak documentation for the changes made. Modifications ranged from

* A random sample of 169 carrier accounts disclosed 17 cases with modified assessments. All assessment modifications resulted in lower liability for the carrier.

approximately $500 to $368,143, and all modifications resulted in reductions of the original assessment amount. Often documentation was little more than a cryptic note. In one case, reasons for a reduction of almost $54,000 consisted of a few words scribbled on scratch paper. In many cases modifications were based on information that had not been available at the time of the original audit assessment, yet even when records needed to document the modifications became available, the auditors did not obtain them. In other instances, supporting documentation was in the auditor's possession rather than in the audit file as required by MVD procedures.

MVD audit supervisors had not reviewed most of the modifications in the sample. Audit Section procedures require supervisory sign-off at the completion of all audits. Although the final audit results were confirmed by the supervisor, no documentation of supervisor agreement with the modification was available in many of the files.

Controls and documentation are needed - Controls and documentation are needed to reduce the risk of audit personnel abusing their responsibility and authority. While MVD has agreed to implement controls, the Arizona Department of Transportation (ADOT) should take steps to ensure that these controls are appropriate and in force.

Lack of documentation presents the opportunity for auditor abuse. For example, auditors might compromise their work by knowingly issuing an incorrect assessment modification in response to improper influence by the taxpayer. Because audit modifications often involve thousands of dollars, the risk and opportunity for such abuses are real.

Because documentation of audit assessment changes is limited, technical or judgmental errors can also be made. For example, errors can be made in applying statutes, rules and Department policies. These errors may result in incorrect assessments, inconsistencies among auditors and unfairness to taxpayers.

The Audit Section has indicated that it will act to enforce existing policy to reduce possible abuses. For example, all original and amended audit documents will be retained in the audit master file. Also, any documents relating to an assessment will be included in the file. The audit supervisor and manager will review and approve any modified audit assessments. In addition, the new audit manual will provide specific procedures and guidelines to help auditors determine what information will be considered in order to modify an original assessment.

Although the Audit Section has agreed to make needed improvements, ADOT internal audit personnel should periodically review modification procedures to ensure their appropriateness. Follow-up by ADOT internal audit personnel will enable an outside source to review these controls. Also, ADOT's Internal Audit Group can advise the MVD Audit Section on how to strengthen other existing controls.

Controls Are Needed Over Taxpayer Notifications

The Audit Section should strengthen controls over billings that notify a taxpayer of the assessment owed. Current Audit Section procedures lack separation of duties over taxpayer notifications.

Audit Section procedures give an auditor sole responsibility to complete and send out a billing. Although an audit supervisor reviews the audit file for completeness before the billing is sent out, the file is then given back to the auditor. The auditor has the responsibility to ensure that the billing is made out to the taxpayer, along with a "letter of audit finding." A clerk then types the billing but does not necessarily verify if the amount is correct or accurate. No supervisor reviews the typed billing before it is sent to the taxpayer, nor does anyone compare payments with the audit assessment in the file. Thus, the auditor has an opportunity to change the billing without detection.

Current Audit Section procedures lack adequate separation of duties as an internal control. The principle of separation of duties* requires that an individual responsible for an audit cannot simultaneously be responsible for making the assessment and preparing the billing without a third party sign-off or verification. An auditor who performs an audit should not have sole responsibility for preparing and mailing the billing without a check-off system.

With limited final review and inadequate separation of duties, a potential for auditor abuse exists. The auditor could possibly reduce the amount of the assessment or never mail the billing due to the lack of third party verification. The lack of separation of duties increases the chances of employee error, theft or falsification of records.

CONCLUSION

The Motor Vehicle Division Audit Section should improve controls over assessment modifications and taxpayer notifications. Modifications and billings need to be checked for quality, and controls are needed to minimize the risk of abuses. Supervisory review of modified assessments and taxpayer notifications needs to be strengthened.

RECOMMENDATIONS

1. The MVD Audit Section should require that all auditors comply with existing standards and policies governing assessment modifications and taxpayer notifications. All reasons supporting modified assessments should be documented in audit files.

2. The MVD Audit Section should require supervisory review and sign-off of modified assessments.

* The Codification of Statements on Auditing Standards, an authoritative guide published by the American Institute of Certified Public Accountants, includes separation of duties as a basic internal control requirement.

3. The MVD Audit Section should implement procedures to ensure separation of duties over all taxpayer notifications. The procedures should require sign-off or verification by a third party.

4. ADOT internal audit personnel should periodically review MVD Audit Section internal controls over modifications and taxpayer notifications to ensure that they are working as intended. The review should include testing the adequacy of the controls, and suggestions for strengthening controls if they are inadequate.

FINDING V

THE MOTOR VEHICLE DIVISION COULD REDUCE GROWTH IN THE NUMBER OF UNCOLLECTIBLE ACCOUNTS

The Motor Vehicle Division (MVD) Revenue Group has difficulty collecting some accounts. MVD could minimize the growth in the number of uncollectible accounts through various monitoring procedures. Once accounts become uncollectible, the cost of collection is frequently prohibitive.

An uncollectible account is defined by the Revenue Group as an outstanding liability of a commercial carrier account after all allowable in-house collections procedures have been attempted.* The Revenue Group estimates that the current balance of uncollectible accounts exceeds $3 million. According to Revenue Group officials, a large proportion of the accounts represent monies owed by bankrupt commercial carriers.

MVD Could Minimize The Growth Of Uncollectible Accounts Through Monitoring

The Revenue Group could implement monitoring procedures to reduce the number of uncollectible accounts in the future. A major factor in the growth of these accounts is MVD's inability to identify troubled carriers prior to bankruptcy. The inability to determine if a carrier is in bankruptcy court means the State cannot be considered a creditor and is not allowed to collect on that liability once the bankruptcy is final.

MVD could track in-State accounts entering bankruptcy proceedings by monitoring a monthly publication, the Arizona Court Reporter, which details bankruptcy information about Arizona based businesses. Collectors could research the document to ascertain if any of the businesses listed have outstanding unsecured accounts with MVD. The State would then be able to establish itself as a creditor before bankruptcy proceedings are final. The Arizona Department of Revenue uses this report and states it is very successful.

* The Revenue Group refers to uncollectible accounts as "unsecured liabilities."

MVD could also improve its ability to identify out-of-State accounts that may go bankrupt. The state of Washington monitors the financial reporting of all carriers in and out of the state. If a carrier's tax reports are more than 60 days late or the carrier does not submit proper payment, the carrier will be contacted to determine its financial status. If problems continue, the state monitors the account closely to ascertain if bankruptcy is pending. If bankruptcy appears likely the agency will request the Attorney General to file a lien against the carrier so the state will be able to receive all or a portion of the monies due.

The Revenue Group could also use an outside collection agency to track bankrupt out-of-State carriers. This agency could track outstanding accounts nationwide. The state of Oregon uses an outside collection agency for this purpose and has found it to be successful.

Control of uncollectible accounts will also be improved by the implementation of an automated tracking system. This system will enable the Revenue Group to better track and identify outstanding billings before they become uncollectible. Presently, MVD is unable to monitor carrier accounts on a daily basis. Such monitoring will be possible with the Tax and Revenue Group Automated Tracking System (TARGATS) currently being developed.

MVD Has Difficulty Collecting Money Owed For Certain Accounts

The Revenue Group has difficulty collecting uncollectible accounts because some account balances are too small for collection by the Attorney General.* MVD can request the Attorney General's Office to collect on these accounts, but because MVD is charged an administrative fee and a percentage of the amount collected, collection by the Attorney General's office is not cost effective for most accounts. Even some accounts with larger balances may not be cost effective for collection by the Attorney General's Office. Unsecured accounts with balances of $100 or more are

* The Revenue Group can submit accounts with balances of $100 or more to the Attorney General's Office for collection. This procedure is used after all in-house Revenue Group collection attempts are exhausted.

reviewed by the Attorney General's Office to determine the likelihood of collection. After review, if the Attorney General's Office decides the account may not be cost effective to collect or the carrier is bankrupt, the account is not pursued.

The Revenue Group is considering using a private collection agency to ensure payment of uncollectible accounts. The state of Oregon has had success in using an independent agency to collect out-of-state accounts. While the agency would receive a percentage of the amount it collects as its fee, the State would be receiving at least some remuneration.

CONCLUSION

The Revenue Group has difficulty collecting accounts identified as uncollectible. MVD could reduce the growth of these accounts through several different monitoring procedures. Collectors could use an outside agency to ensure payment of uncollectible accounts.

RECOMMENDATIONS

1. MVD Revenue Group should attempt to identify uncollectible accounts as early as possible. This could be achieved through:

    a. consistent monitoring of the commercial carriers' financial condition;
    b. using the Arizona Court Reporter to identify bankrupt carriers, so the State can establish itself as a creditor in order to receive any liabilities due; and
    c. employing an outside collection agency to track and collect accounts nationwide after all standard collection procedures are exhausted.

OTHER PERTINENT INFORMATION

During the audit we developed pertinent information in the following two areas: 1) the Motor Vehicle Division's (MVD) collection of outstanding liabilities, and 2) the abatement of uncollectable liabilities due the MVD.

MVD collections unit has increased collection of past due accounts

Due to improved collection procedures, MVD revenue collection has increased. MVD collectors are responsible for tracking and collecting delinquent amounts due MVD. This includes money from audit assessments, dishonored checks, and all other outstanding liabilities. If a liability remains unpaid after a certain period of time, collectors have legal alternatives available to assist them in collecting the delinquent amount.

The amount of revenue collected has almost doubled since fiscal year 1983-84. The unit collected over $4.9 million in 1984-85, up from approximately $2.7 million in 1983-84. As of February 1986 the unit has already collected over $5 million for the 1985-86 fiscal year.

Auditor General staff found overall collector productivity to be greatly improved. We reviewed a sample of delinquent accounts and determined that either the accounts had been closed, or of those accounts assigned to a collector some type of payment was currently being received. Improved productivity is due in part to standards* developed in the Productivity Resource Management System (PRMS) Group report. In 1983 the PRMS Group determined that certain standards were needed for the unit to become more productive. From that PRMS study, present collection practices evolved.

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* Standards included better tracking of aged accounts and development of productivity measures for all collection personnel. Personnel are tracked by the number of accounts closed, the length of time taken to close an account and the percentage of the amount owed that was collected on an account.

Abatement Of Uncollectable Accounts

Presently, uncollectable revenue from closed commercial carrier accounts and unsecured liabilities owed to MVD cannot be written off. This is because MVD has no specific statutory abatement policy. However, Arizona constitutional law questions may have to be addressed before such abatement can occur.

As noted in Finding IV (see pages 9 through 33) a number of account balances exist that are uncollectable for several reasons: Many accounts have small balances; it may not cost effective to pursue collection; and the carrier is bankrupt or has filed for bankruptcy protection.

Since many of the accounts are uncollectable the Revenue Group is considering seeking legislation to give it clear authority to abate those accounts. Although A.R.S. §41-192.B.4 gives authority to any state agency and the Attorney General's Office to "compromise or settle" a claim owed the State, this authority may not apply to trust fund monies. According to a Tax Division Attorney General representative, because the liabilities are specifically earmarked for the highway trust fund and not the general fund, there is a question as to whether ADOT can write off the liabilities without specific legislation. Such legislation would be similar to a statute which allows the Department of Revenue (DOR) to write off an account as a bad debt if the cost to collect the account exceeds the amount outstanding.

AREAS FOR FURTHER AUDIT WORK

During the course of our audit we identified two potential issues that we could not pursue due to time constraints.

- Are statutory changes needed in procedures for paying taxes on commercial fuel purchases?

The Motor Vehicle Division (MVD) has difficulty determining whether certain fuel taxes have been paid. Motor carriers may pay taxes at the time of purchase and claim a credit for any overpayment, or they may pay the tax along with other taxes at the close of their normal reporting period. When the deferral procedure was originally established, carriers had to obtain MVD approval to defer the taxes. However, the growth in the number of carriers and vendors made it difficult for MVD to enforce the deferral agreement. Since November 1981 vendors have been allowed to sell fuel to any carrier and need only note on the invoice whether the tax was paid or not. However, this does not always occur. The documentation needed to monitor the differing payment procedures is sometimes lacking. MVD records indicate that some carriers pay no tax at the pump but actually claim credit for paying those taxes. These commercial carriers may be receiving erroneous tax credits. Further audit work is needed to determine how much revenue is being lost by the State because of erroneous credits, and to evaluate the impact and effectiveness of alternatives for collecting the taxes.

- Does MVD adequately track commercial carrier bonding levels?

MVD requires all commercial carriers to maintain a financial bond. The bond is used as insurance against tax liabilities incurred by the carrier, and provides MVD with some type of payment in case of carrier insolvency or bankruptcy. However, we found that some bonds are insufficient to cover potential liabilities. According to an MVD collections official, of 3,000 bond claims made from April 1985 through March 1986, 35 percent of the carriers examined were undersecured. For example, one carrier had a bond of only $12,000 when it should have been $55,000. Moreover, a Revenue

Group official stated that MVD does not systematically review bonds to ensure their adequacy. Further audit work is needed to determine the extent to which MVD tracks commercial carrier bonding levels.

ARIZONA DEPARTMENT OF TRANSPORTATION

206 South Seventeenth Avenue Phoenix, Arizona 85007

BRUCE BABBITT
Governor

CHARLES L. MILLER
Director

August 14, 1986

AUG 1986
RECEIVED
AUDITOR
GENERAL

Douglas R. Norton
Auditor General
Office of the Auditor General
2700 North Central Avenue
Suite 700
Phoenix, Arizona 85004

Dear Mr. Norton:

My staff and I have reviewed the preliminary Auditor General's Performance Audit of the Arizona Department of Transportation, Motor Vehicle Division, Revenue Group. Because of the ongoing changes within the Revenue Group and the general upgrading of the Motor Vehicle Divison's revenue collection systems, the Auditor General's Performance Audit of the Revenue Group has concentrated on the Revenue Group Audit Section.

After careful review, I am in basic agreement with the findings and recommendations of the Performance Audit Report. Only in minor areas dealing with inferred supportive data associated with certain findings do we disagree. These areas are included with the attached detailed discussion.

The majority of the recommendations are consistent with currently ongoing management programs to enhance the revenue collection, accounting and distribution systems within the Motor Vehicle Division. A major enhancement program that will have a tremendous impact on the audit function is the Tax and Revenue Group Automated Tracking System (TARGATS) program. TARGATS will provide for better tracking of carrier mileage, tax assessment based on that mileage, random selection of accounts to be audited, and computerized programs to facilitate the actual audit.

The Department has assigned two audit positions to the TARGATS project during the design and development stages of approximately three years. The resulting revenue benefit to the state in enhanced revenue collections are projected at three million dollars per year. The projected increased revenue collections were the basis of the decision to use audit expertise. The

Department will replace the auditors assigned to the project for the duration of the project.

I am in general agreement with Finding #3, "The Motor Vehicle Division Revenue Group Could Generate Additional Revenue By Increasing the Productivity of Its Audit Section." We are in agreement that the audit staff not be utilized on special projects not related to the collection, accounting or distribution of Highway User Revenue Funds. Steps are being taken to assure that 80%-90% of the audit staff is utilized auditing revenue yielding accounts. However, Department of Transportation management has determined that the audit section will conduct non-revenue yielding audits such as restricted distributor accounts. These audits are absolutely necessary to insure that gasoline tax revenues are properly reported and distributed to the respective accounts of the state, counties and cities. It is estimated that approximately 10% of the current audit staff is required to address this audit responsibility. In addition, there are many other related functions that require audit expertise attention to insure the integrity of the Department's trusteeship of the Highway User Revenue Funds.

Attached for your review are specific comments relative to each of the findings and recommendations presented in the Performance Audit Report. I want to thank you and your staff for the cooperation, assistance and consideration given to our observations and comments during the audit process.

Sincerely,

Charles L. Miller

CHARLES L. MILLER
Director
Department of Transportation

FINDING I

Additional Audit Staff Could Generate Millions of Dollars in Revenue for the Highway User Revenue Fund

The Department of Transportation agrees with the proposition that more auditors will generate more assessments for the Highway User Revenue Fund. The Department however, does not agree with the supporting statistical data that would indicate a low audit coverage implied by Table 2 and Table 3 of the report, since the organization of audit sections vary from state to state and the data was never verified.

The Department agrees with the recommendations and has requested and been appropriated additional audit positions. The Motor Vehicle Division has included requests for additional auditors in the Division's five year operating budget plan. The basis for the past and current requests is to allow the audit function to grow consistently with the growth in total HURF revenues. The additional amount of assessments the additional auditors will generate will almost certainly exceed, by significant margin, the additional audit costs. A more exact estimate of revenue yield from additional auditors is not possible to predict and such a forecast is highly speculative. Whether additional staff will yield revenues at the same recovery rate as existing staff is not possible to predict.

FINDING II

Current Audit Selection Procedures Are Not Effective

The Department agrees with this finding, however, not with the supporting data. The report presents instances of underreporting by small accounts implying that this may be a population trend. Yet, the report itself states, "...complete data is not available,..." If complete data is not available inferences should not be made.

The Department agrees with the intent of the recommendations that an improved audit selection process is needed. As mentioned in the report, the Revenue Group will improve its audit selection process through the Tax and Revenue Group Automated Tracking System (TARGATS). In the interim, the Audit Section is developing manual selection criteria that will parallel the TARGATS process.

FINDING III

The Motor Vehicle Division Revenue Group Could Generate Additional Revenue By Increasing the Productivity of Its Audit Section

The Department agrees with this finding but with reservation. It is the opinion of the Department that the function of the MVD Audit Section include, necessary but limited, activities not related to direct tax audit assessments.

The Department agrees that audit staff productivity can be increased through the use of personal computers and has included a budget issue for FY 87/88 requesting them.

FINDING IV

The Audit Section Lacks Adequate Controls to Ensure The Quality & Integrity of Audit Modifications & Taxpayer Billings

The Department of Transportation agrees with this finding. The recommendations are being implemented to insure existing standards and policies governing assessment notification and taxpayer notifications are complied with. The Audit Section will require supervisory review and sign-off of all modified assessments.

FINDING V

The Motor Vehicle Division Could Reduce Growth In The Number of Uncollectable Accounts

The Department agrees with this finding. The Department agrees with the recommendations and has established close coordination with Arizona Attorney General's Office to identify bankrupt motor carriers so as to establish the State as a creditor. The Motor Vehicle Division will investigate the legality and effectiveness of an outside collection agency to track and collect accounts nationwide.