PERFORMANCE AUDIT

NORTH CAROLINA DEPARTMENT OF REVENUE

October 2000

AUDITOR'S TRANSMITTAL

October 27, 2000

The Honorable James B. Hunt, Jr., Governor
Secretary Muriel Offerman, Department of Revenue
Members of the North Carolina General Assembly

Ladies and Gentlemen:

We are pleased to submit this performance audit of the *Department of Revenue* conducted pursuant to House Bill 1476 as enacted by the 1999 Session of the General Assembly. The objectives of the audit were to review 1) tax collection and tax auditing activity, with particular attention to the cost, efficiency, and effectiveness of the Integrated Tax Administration System (ITAS) and subsequent automation projects; 2) current methods of processing tax returns and payments and the ability to employ the latest technology in this processing; 3) internal organization and management structure; 4) budgeting and fiscal management; and 5) such other issues as may be deemed necessary or desirable by the State Auditor.

This report consists of an executive summary, findings and recommendations, and background sections. The Secretary of the Department of Revenue has reviewed a draft copy of this report. Her written comments are included as Appendix D.

We wish to express our appreciation to Secretary Offerman and her staff for the courtesy, cooperation, and assistance provided us during this effort.

Respectfully submitted,

Ralph Campbell, Jr.

Ralph Campbell, Jr.
State Auditor

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EXECUTIVE SUMMARY

Program Description

The North Carolina Department of Revenue (DOR) was created in 1921, with 16 employees, when the General Assembly instituted the State's first net income tax. The Department is authorized by GS §143B-217. In fiscal year 2000-01, as a result of increases in North Carolina's population, industry, and the increased complexity of the modern taxation system, DOR now employs 1,265 full-time staff, as well as numerous temporary employees during the "tax season." DOR has staff located in the central office in Raleigh, 37 field offices throughout the State, and 38 interstate auditors who examine records of North Carolina taxpayers who live in states outside North Carolina. DOR collects property tax, inheritance and gift tax, beverage and cigarette taxes, corporate income and franchise tax, gasoline tax, individual income tax, sales and use tax, and administers privilege licenses. For fiscal year 1999-00, DOR collected $17.6 billion in tax revenue and had an agency budget of approximately $102 million.

Audit Scope and Methodology

This performance audit of the North Carolina Department of Revenue was mandated in the 1999 House Bill 1476, Section 4(b). The scope of the audit included all areas of operation within the department. Special emphasis was placed on DOR's use of technology to assist in the performance of the many functions and duties assigned to the department.

Audit Objectives

As outlined in House Bill 1476, Section 4.b, we had five major audit objectives.

1. Review the tax collection and tax auditing activity, with particular attention to the cost, efficiency, and effectiveness of the Integrated Tax Administration System (ITAS) and subsequent automation projects.
2. Review current methods of processing tax returns and payments and the ability to employ the latest technology in this processing.
3. Review the internal organization and management structure, and current and future staffing requirements.
4. Review budgeting and the fiscal management aspects of DOR.
5. Review any other issues as may be deemed necessary or desirable by the State Auditor.

Conclusions in Brief

North Carolina's Department of Revenue is recognized as a national leader in many of the tax administration functions it performs for the State. Senior management has worked hard in the last few years to create an organizational culture that is willing to internally review its operations for the purpose of continuous improvement. To this end, DOR established total quality management teams about six years ago which involve employees in identifying changes needed to work processes. We observed evidence throughout the audit of the positive effects of this philosophy. Management and staff were already working on, or during the audit took, steps to address a number of the issues identified in the report. A number of areas we have identified, however, will require additional resources, which could result in significant increases in the State's revenues. To effectively address the major concerns discussed below, DOR will need additional funding for increased personnel and technology resources. It is our firm belief that such funding is an investment in the future financial health of the State of North Carolina. Below we summarize our conclusions for each audit objective.

EXECUTIVE SUMMARY

OBJECTIVE 1: TAX COLLECTION AND AUDITING ACTIVITY

Overall, DOR performs the tax assessment and collection functions assigned to it under GS §105 in an effective manner given current resource limitations. However, there are areas where we believe increased resources and operational changes would serve to improve the effectiveness and efficiency of DOR.

Collection Activity

The withholding process within ITAS is ineffective, requiring increased manual intervention. As a result, the State may not be collecting tax revenue as timely as possible. Limited resources restrict DOR's ability to focus efforts on certain areas that could increase the State's revenue collections. Based on our analysis, revenues in the following areas could be increased as much as \$24.5 million, as follows: IRS Revenue Agent Reports[1]--\$13.5 million, collection of Motor Fuels accounts receivable--\$3.4 million, and bankruptcy cases--\$7.6 million. Additionally, the taxpayer assistance function could be more responsive if additional technological methods were employed.

Information Security and Business Continuity Planning

Security practices and programs are not fully developed, diminishing DOR's ability to provide a secure technology infrastructure for its non-mainframe platforms. Recovery of supporting processes and technology for key elements of tax data processing are at risk in the event of a long-term recovery requirement. DOR's disaster recovery planning efforts to date have been limited to processing by the ITAS application and do not cover critical processes and subsystems in place to capture and process taxpayer data.

Costs of ITAS and Other Automation Projects

Since fiscal year 1987-88, DOR has spent approximately \$60 million to improve its technology. The largest portion of these funds, \$46.6 million, was used to purchase, modify, and implement ITAS and Data Capture. Approximately 19%, \$15.8 million, of DOR's total operating budget is spent for information technology costs. For fiscal year 1999-00, the ITAS portion of the IT budget was \$8.25 million. DOR has a separate line item for the Data Capture Project that includes purchase of equipment and operational costs. While we were unable to isolate the benefits the State has derived from ITAS, we were able to determine that after adjustment for the increase in the number of returns filed, gross collections have increased by 4.8% or \$726 million per year since 1995. Much of this increase can be attributed to automation. To continue to derive benefits from technology, the State will need to maintain a high level of technology funding for DOR to implement and support initiatives using newer technology, while at the same time maintaining and improving existing technology.

Efficiency and Effectiveness of ITAS and Other Automation Projects

ITAS provides adequate functionality but lacks some functional requirements desired by departmental users. The ITAS planning team has taken steps towards addressing ITAS functionality deficiencies. The size and complexity of ITAS require additional supporting processes and resources to increase the effectiveness of employees using the system. While DOR has made strides in improving its change management function for automated systems, most of its efforts have been directed to ITAS and its mainframe applications.

Auditing Activity

The process of identifying prioritizing and tracking audit efforts using ITAS functionality has not been fully developed. Use of this functionality could result in significant increases to the State's revenues as the most promising candidates for audit are identified.

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[1] Revenue agent reports are notices from the IRS of a change on a federal tax return that would likely change the state tax return.

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OBJECTIVE 2:
TECHNOLOGY AND PROCESSING METHODS

North Carolina is a national leader in the use of imaging to capture paper tax returns. The Data Capture project was well planned and included a cross section of system users, strong executive involvement, and effective vendor management. We noted concern regarding implementation timing and the processes for handling future changes to the system. DOR is working on these concerns.

Best Practices

DOR has made strides in the use of enabling technology for its various tax functions and compares well with other states in use of electronic filing for individual income taxes. However, DOR has additional opportunities to improve support of its business mission and expand its use of E-commerce methods. North Carolina's DOR should continue to actively promote electronic filing and adopt a goal of seven days turnaround for individual income tax refunds.

Operational Issues

From an operational standpoint, DOR needs to concentrate efforts on taxpayer assistance, establish a taxpayer assistance call center and toll free telephone numbers, and develop system and processing measures to more closely monitor operations. Our analysis shows that utilizing a private collection firm to pursue past due accounts could result in as much as $47.1 million in increased tax revenues based on the experience of other states.

Tax Refund Issues

DOR records show that the total number of returns processed has continued to increase. On average, approximately 27% of the total returns filed result in a refund to the taxpayer. Total refunds averaged $1.46 billion per year for fiscal years 1994-95 through 1999-00. Individual taxpayer refunds account for 66% of that amount. For fiscal year 1999-00, DOR experienced a number of processing problems that resulted in late refunds to approximately 6% of taxpayers. However, DOR had to pay **less interest** for late refunds to **individual taxpayers** this year than it did for the past two fiscal years. In examining the events surrounding this "tax season," we found that a number of the causes of late refunds, such as taxpayer errors, were outside DOR's control. Others resulted from lack of adequate staff, both full-time and temporary, to handle the volume of on-going work and process individual tax returns in a timely manner. One procedural change that could get refunds to taxpayers sooner, and result in potential savings to the State, is implementation of a direct deposit option for taxpayers. Based on our estimates, savings could range from $3.7 million if 100% of refunds were direct deposited to $1.1 million if only 30% of refunds were direct deposited.

OBJECTIVE 3:
ORGANIZATION, STAFFING AND MANAGEMENT

Lack of sufficient staff and lack of training for staff inhibits DOR productivity. We documented various problem areas throughout the report that can be directly traced to lack of staff or lack of training. We noted concerns regarding the recruiting, hiring, and retention of information technology staff. DOR is competing for technical staff in an area of the State where private industry salary ranges are significantly higher than those DOR can offer. Additionally, due to workloads, training needs of DOR staff are not being met. Lastly, we note that there is a potential to increase tax revenues to the State by increasing the number of interstate audit positions. These auditors average increasing the State's tax assessments by $2.2 million each.

Overall, we have identified 74 positions throughout the department, at an approximate cost of $4.4 million including benefits, that we believe are needed to adequately staff the functions and duties discussed in this report. (We should note that DOR management has identified additional positions that it feels are needed which we did not address in the report.)

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OBJECTIVE 4: BUDGETING AND FISCAL MANAGEMENT	DOR's accounts receivable balance has increased 28% during the last three fiscal years. Management has not had sufficient staff resources to be able to actively work the receivables and is in the process of contracting with a private collection firm to address this problem. DOR's cash management plan has not been updated since 1987. Additionally, areas within DOR are not in compliance with the State's Daily Deposit Act, resulting in lost interest to the State. Lastly, we noted that the Motor Fuels division is not properly computing interest on Motor Fuels taxes and refunds due.
OBJECTIVE 5: OTHER ISSUES	DOR should request a review of the interstate audit positions by the Office of State Personnel, specifically to address issues surrounding "locality pay."

Specific Findings

EXECUTIVE SUMMARY

Specific Findings (continued)

EXECUTIVE SUMMARY

Specific Findings (continued)

North Carolina General Statutes (GS) §147-64 empowers the State Auditor with authority to conduct performance audits of any State agency or program, as well as local entities receiving State and federal funds. Performance audits are reviews of activities and operations to determine whether resources are being used economically, efficiently, and effectively.

This performance audit of the North Carolina Department of Revenue (DOR) was mandated in the 1999 House Bill 1476, Section 4.b. Specific objectives of the audit were identified in the legislation, with additional objectives being identified during the survey phase of the audit. The audit objectives were to:

- Review the tax collection and tax auditing activity, with particular attention to the cost, efficiency, and effectiveness of the Integrated Tax Administration System (ITAS) and subsequent automation projects.
- Review current methods of processing tax returns and payments and the ability to employ the latest technology in this processing.
- Review the internal organization and management structure, and current and future staffing requirements.
- Review budgeting and fiscal management aspects of DOR.
- Review any other issues as may be deemed necessary or desirable by the State Auditor.

During the period November 15, 1999 through September 1, 2000, we conducted the on-site fieldwork for the audit. Due to the specialized nature of the automation systems used by DOR, we employed an outside consulting firm (KPMG LLP) to assist us with that portion of the audit. KPMG's findings and recommendations are incorporated throughout this report.

To achieve the performance objectives, we employed various auditing techniques which adhere to the generally accepted auditing standards as promulgated in *Government Auditing Standards* issued by the Comptroller General of the United States. These techniques included:

- Review of existing General Statutes, federal laws, and North Carolina Administrative Codes as they relate to DOR;
- Review of DOR internal polices and procedures;
- Site visits to the DOR field offices and surveys of a sample of DOR employees;
- Review of existing audits and reports conducted on DOR, with particular emphasis on documentation for the automated systems at DOR;
- Examination of organizational charts, job descriptions, payroll, and personnel data;

- Analyses of financial statements;
- Examination of a sample of Motor Fuel audits, Bankruptcy cases, Revenue Officer daily reports, IRS Revenue Agent reports, and Offer and Compromise files;
- Interviews with key personnel within DOR, as well as with persons external to DOR;
- Observation of processing procedures for tax returns; and
- Comparison of information obtained from other states' revenue departments.

This report contains the results of the audit including conclusions and recommendations. Specific recommendations aimed at improving the operations of DOR in terms of economy, efficiency, and effectiveness are reported. Because of the test nature and other inherent limitations of an audit, together with the limitations of any system of internal and management controls, this audit would not necessarily disclose all weaknesses in the system or lack of compliance. Also, projection of any of the results contained in this report to future periods is subject to the risk that procedures may become inadequate due to changes in conditions and/or personnel, or that the effectiveness of the design and operation of the procedures may deteriorate.

FINDINGS AND RECOMMENDATIONS

This section of the report details the individual findings and recommendations for each of the five major objectives of the audit. We should note that the North Carolina Department of Revenue (DOR) is considered one of the most effective in the nation. In many areas, such as use of automation for tax functions, North Carolina's DOR is looked to by other states as one of the leaders. However, performance audits, by nature, focus on areas where improvements can be made to increase the effectiveness and efficiency of the operation under audit. The following findings and recommendations should be considered in this light.

> **Objective 1: *Review the tax collection and tax auditing activity, with particular attention to the cost, efficiency, and effectiveness of the Integrated Tax Administration System (ITAS) and subsequent automation projects.***

This objective encompassed a large part of the audit effort. To accomplish this objective, we reviewed all relevant documentation for the various automated systems used by DOR, with particular attention to the Integrated Tax Administration System (ITAS). To assist the reader, we have categorized findings and recommendations under: "1A – Collection Activity," "1B – Information Security and Business Continuity," "1C – Costs of ITAS and Other Automation Projects," "1D – Efficiency and Effectiveness of ITAS and Other Automation Projects," and "1E – Auditing Activity."

1A -- Collection Activity: Office of the State Auditor (OSA) and KPMG staff examined the processes used to identify, prioritize, and track the various automated collection functions of DOR. We reviewed and assessed the mechanisms DOR utilizes to communicate internally with users of ITAS and externally with taxpayers.

1B – Information Security and Business Continuity: KPMG gained an overall understanding of the security requirements of various inputs, subsystems, core applications, outputs, and network infrastructure that support ITAS. KPMG performed a review of DOR's Disaster Recovery Plan as it relates to both the mainframe and non-mainframe environment to determine DOR's overall readiness and ability to recover and restore operations in the event of a disaster.

1C -- Costs of ITAS and Other Automation Projects: OSA and KPMG reviewed cost documentation on DOR automation projects, including initial cost reports and staffing projections, current budget and resource projections, and compared them to other states of similar size and automation capability.

1D -- Efficiency and Effectiveness of ITAS and Other Automation Projects: We evaluated the efficiency and effectiveness of ITAS in performing the functions it was intended to perform. KPMG reviewed the functionality gaps within ITAS and compared these gaps to the release schedule of upcoming software changes. KPMG performed a review of DOR's policies and procedures as they relate to technology changes both with ITAS on the mainframe and with other supporting systems within the client/server environment. Additionally, we focused on determining how the IT (information technology) organization measures its efficiency and effectiveness.

1E -- Auditing Activity: KPMG evaluated the methods used to identify, prioritize, and track the audit process within DOR.

Conclusions: North Carolina's Department of Revenue is a national leader in the many tax administration functions it performs for the State. Overall, DOR performs the tax assessment and collection functions assigned to it under GS §105 in an effective manner given current resource limitations. However, there are areas where we believe operational changes, as well as increased resources, would serve to improve the effectiveness and efficiency of DOR.

Collection Activity: The withholding process within ITAS is ineffective, requiring increased manual intervention. As a result, the State may not be collecting tax revenue as timely as possible. Limited resources restrict DOR's ability to focus efforts on certain areas that could increase the State's revenue collections, such as IRS Revenue Agent Reports, collection of accounts receivable, and bankruptcy cases. Additionally, the taxpayer assistance function is not as responsive as it could be if more technological methods were employed.

Information Security and Business Continuity Planning: Security practices and programs are not fully developed, diminishing DOR's ability to provide a secure technology infrastructure for its non-mainframe platforms. Recovery of supporting processes and technology for key elements of tax data processing are at risk in the event of a long-term recovery requirement. DOR's disaster recovery planning efforts to date have been limited to processing by the ITAS application and do not cover critical processes and subsystems in place to capture and process taxpayer data.

Costs of ITAS and Other Automation Projects: **Approximately 19%, $15.8 million, of DOR's total budget is spent for information technology costs. For fiscal year 1999-00, the ITAS portion of the IT budget was $8.25 million. DOR has a separate line item for the Data Capture Project for purchase of equipment and operations of $17.5 million. While we were unable to isolate the benefits the State has derived from ITAS, we were able to determine that after adjustment for the increase in the number of returns filed, gross collections have increased by 4.8% or $726 million per year since 1995. Much of this increase can be attributed to automation. To continue to derive benefits from technology, the State will need to continue a high level of technology funding for DOR to implement and support initiatives using newer technology, while at the same time maintaining and improving existing technology.**

Efficiency and Effectiveness of ITAS and Other Automation Projects: **ITAS provides adequate functionality but lacks some functional requirements desired by departmental users. The ITAS planning team has made steps towards addressing ITAS functionality deficiencies. The size and complexity of ITAS require additional supporting processes and resources to increase effectiveness of employees. While DOR has made strides in improving its change management function for automated systems, most of its efforts have been directed to ITAS and its mainframe applications.**

Auditing Activity: **The process of identifying, prioritizing, and tracking audit efforts using ITAS functionality has not been fully developed. Use of this functionality could result in significant increases to the State's revenues.**

1A -- Collection Activity

Overview One of DOR's main functions is the collection of tax revenues due the State from its individual and corporate citizens. DOR management has long-standing procedures in place to prioritize the processing of receipts to deposit the funds into the State's coffers at the earliest possible time after re-

ceipt. For fiscal year 1999-00, DOR collected $17,648,583,683 in gross revenues for the State. Exhibit 1 shows the trend in gross revenue collection (from all sources) for the past 6 years. While certain of the collections are distributed by DOR as directed in General Statutes, the majority remain at the State level to fund the many programs and services offered by the State to its

EXHIBIT 1
Gross Revenues for FY94-95 to 99-00

FISCAL YEAR	IN BILLIONS
94-95	$12.8
95-96	$13.5
96-97	$14.6
97-98	$15.7
98-99	$16.8
99-00	$17.6

Source: NC Department of Revenue

citizens. This section of the report looks at various collection activities carried out by DOR and identifies areas where we believe changes in procedures and/or additional resources could result in increased collections for the State.
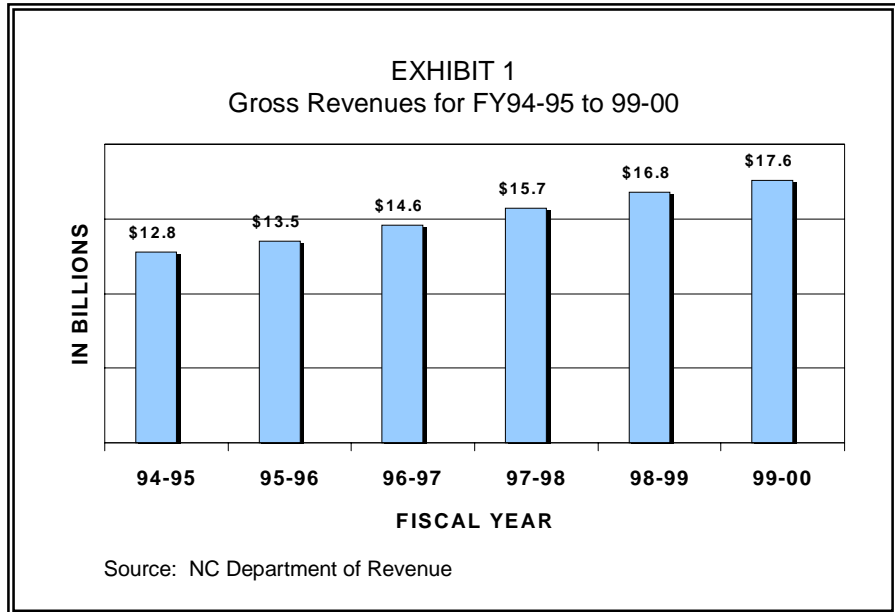
ITAS DOES NOT EFFECTIVELY SUPPORT THE WITHHOLDING PROCESSES.

ITAS was originally implemented as an individual tax system and was designed to accept only one original return per period. The withholding process was implemented on ITAS in 1995. The nature of the withholding process is such that some corporations may submit multiple original returns per period. Since only one original return was accepted by ITAS, other valid returns filed were suspended, resulting in a backlog. By 1999, the backlog of work had reached a level that could not be accomplished given the limited staff assigned to the function and other higher departmental priority responsibilities. As a result, significant portions of the 1995, 1996, and 1997 withholdings information were not reconciled due to a large number of related suspense items in ITAS. After a 1999 internal review, DOR management decided that the work backlog from 1995 through 1997 would be permanently filed since the statute of limitations had expired on these

returns. As of the end of our fieldwork, the 1998 withholdings were almost completed, with plans to begin work on 1999.

Over the last few years, the number of employers that must file accelerated returns[2] has increased, resulting in an increased withholdings workload. In the past, a large number of reconciliation issues stemmed from withholdings posting to the incorrect period, causing the withholdings form to be out of balance with the withholding payments made. Therefore, a large number of reconciliation transactions were required to move revenue received from one period to another. Current functionality in ITAS does not allow an efficient transfer of withholding payments from one period to another.

DOR management is aware of these processing problems and the 1999 internal analysis identified a number of needed changes to manual procedures and technical changes needed to ITAS. However, this analysis was high level, and it did not cover a detailed impact analysis to ITAS or DOR; nor did it include staffing, technical resources needed, and changes required in ITAS. At the time of the audit, the implementation status of these recommendations was not clear. Based on our review, we believe there is potential to use electronic means, including data capture, to electronically record and compare W2 information submitted by the employer and the individual.

RECOMMENDATION

DOR management should continue analysis of possible technical and functional improvements needed to support an efficient and effective withholding process.

FILING STATUS REVIEW IS NOT PERFORMED CONSISTENTLY TO ENSURE TAXPAYERS ARE FILING AT THE APPROPRIATE FREQUENCY.

As a corporation grows in size, the withholding filing frequency will move from quarterly to monthly and ultimately to an accelerated filing. As the corporation increases its frequency of filing withholdings, DOR will receive the revenue sooner and will have the opportunity to invest this money for the State, increasing the revenue stream via interest or other investment vehicles. We learned during the audit that, due to limited staff, DOR does not consistently review the filing frequency status to ensure that all companies are following the legislative requirements for timely filings. As a result, the State may not be receiving revenue as quickly as it should.

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[2] "Accelerated filing" is required for companies having greater than $2,000 withholdings per month.

RECOMMENDATION

DOR management should focus efforts on reconciling the withholding filing status of employers to ensure that the State receives all revenue due in a timely manner.

DOR PLACES A LOW PRIORITY ON PROCESSING IRS REVENUE AGENT REPORTS DUE TO LIMITED RESOURCES.

Revenue Agent Reports (RARs) are notices received from the IRS reporting a change to a taxpayer's federal tax return. Since the taxable income amount on the federal return is carried forward and becomes the taxable income amount on the North Carolina state tax return, RARs represent potential changes to the State's revenues. RARs must be reviewed by DOR auditors to determine whether a tax adjustment needs to be made to the taxpayer's state return. As shown in Table 1, DOR records revealed that as of June 27, 2000, North

TABLE 1 Inventory of RARs Not Processed as of June 27, 2000			
Type	**Number of RARs**	**Average Assess-ment**	**Total Potential Assessments**
INDIVIDUALS			
• Listed RAR (Taxpayer has filed a return)	342	$1,710	$ 584,820
• Non-listed RAR (Taxpayer has <u>not</u> filed a return)	6,532	$1,710	$11,169,720
Subtotal	**6,874**		**$11,754,540**
CORPORATIONS	49	$35,019	$ 1,715,931
TOTALS	**6,923**		**$13,470,471**
Source: DOR Records			

Carolina has the potential of collecting $11.8 million from individuals and $1.7 million from corporations in additional taxes resulting from the RARs. We learned that DOR places a low priority on working the RARs for individual income taxes due to limited staff and other departmental responsibilities. Currently, only 2 of the 40 revenue auditors are assigned to incorporate RARs into their work schedules.

We judgmentally sampled both the individual and corporate RARs. We examined 100% (49) of the corporate RARs and a total of 80 of the individual RARs. The test results were as follows:

- Of the 49 corporate RARs we examined, none had been reviewed or processed.
- Of the 342 listed RARs (those where the taxpayer had previously filed a tax return), we judgmentally sampled 50 items. Of the 50 tested items, 15 returns (30%) had not been reviewed or processed by an auditor. The *NC DOR Individual Income Tax Rules and Bulletin* states that a taxpayer should file a return reflecting the federal changes or determination within two years after receipt of the Internal Revenue Agent Report. DOR can make an assessment within three years from the date of receipt.

- Of the 6,532 non-listed RARs (those for taxpayers who have not previously filed returns), we judgmentally sampled 30 items. Of the 30 sampled returns, 19 returns (63%) had not been reviewed or processed by an auditor. There are no statutory provisions prohibiting an assessment at any given time for any tax year for non-listed RARs.

Not reviewing and processing RARs results in the loss of potential revenue to the State. Additionally, DOR runs the risk of not locating the taxpayers and/or misplacing the RARs. DOR does maintain a log reflecting the name of the taxpayer, date the return was received, and the date the return was destroyed (after the statute of limitations runs out). DOR has taken steps to reduce the RARs by sending 2,000 individual income tax RARs out to field auditors on May 31, 2000. Additionally, the corporate tax section has concentrated on reducing its inventory by dedicating 2 employees full-time to adjusting and reviewing RARs. As of July 6, 2000, there were 22 corporate tax RARs still to be worked.

RECOMMENDATION

DOR management should devote more auditors to reviewing and processing RARs on a full-time basis to reduce the RAR inventory for individual income taxes. Management should also implement a tracking tool to indicate who the RAR was assigned to, when it was assigned, dollar amount assessed, date return was received, date of assessment, and length of time it takes to process RARs to improve management control of this process. See finding on page 68.

THE MOTOR FUELS DIVISION IS NOT ACTIVELY COLLECTING ITS ACCOUNTS RECEIVABLE.

The Motor Fuels division is responsible for collection and distribution of motor fuels tax as a part of the International Fuel Tax Agreement. As such, it collects accounts receivable independently from the rest of DOR. The division does not have a system in place to ensure that accounts are reviewed in a timely or systematic manner. Three of the division's field auditors are assigned to collect past due accounts for one week each month. However, at the time of our review, we found no evidence that collection attempts had been made from April to June 2000. Auditors assigned to collect past due accounts are often pulled to work on special projects and, therefore, have not had time to work on past due receivables.

We chose a random sample of 30 accounts for review. The average account in the sample had been past due for 3 years. The average time since the last attempt to collect on those accounts was 1.7 years. Three accounts (10% of the sample) have been on the

books since 1991.   As of June 2000, there are 2,145 past due accounts totaling $3,376,566 owed to the Motor Fuels division.

RECOMMENDATION

DOR should implement an automated case management tool to more effectively track and work accounts receivable. A computerized tracking spreadsheet/software should be used to track accounts, flagging them when they become overdue. A list of flagged accounts should be printed and distributed to the auditors assigned to collections.   Division management should more closely monitor collection efforts.   Lastly, management should assign additional auditors from existing staff to work the backlog of past due accounts.

Auditor's Note: After discussing this issue with division management during the audit fieldwork, Motor Fuels auditors began actively working the collections backlog.

BANKRUPTCY CASE FILES ARE NOT BEING MAINTAINED OR MONITORED ON A TIMELY BASIS.

If a taxpayer filing for bankruptcy owes the State back taxes, DOR, as the State's representative, has the opportunity to file a claim with the Federal Bankruptcy Court. Failure to file appropriately[3] will result in the State being excluded from the payment plan approved by the Bankruptcy Court.   If that happens, then the State will not be allowed to collect the taxes owed for the period covered during the bankruptcy.   The bankruptcy payment plan may take as long as six years to run its course.

We selected a random sample of 30 bankruptcy files from the complete listing of 38,774 cases, representing $47,368,736 in back taxes owed to the State. Of the 30 files tested, 5 claims (16%) were either not filed or filed after the time limit had expired. As a result, DOR significantly diminished its opportunity to collect $497,327 for the cases. Since each case is different, it is difficult to estimate potential revenues. However, based on the

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[3] Federal Code states: "… A claim of interest, proof of which is filed under section <u>501</u> of this title, is deemed allowed, unless … proof of claim is not timely filed … except that a claim of a government unit shall be timely filed if it is filed before 180 days after the date of the order for relief". Federal Bankruptcy Code, Title 11 U.S.C., Section 502, (a) (b) (9)

sample, we estimate that the State could potentially increase its collections by approximately $7,579,179[4] if the bankruptcy cases were actively worked.

Further analysis of bankruptcy files revealed that 13,554 cases had been discharged or dismissed by the bankruptcy courts between September 1988 and April 2000. These cases required additional action by DOR to determine collection possibilities. A random sample of 30 dismissed files revealed that DOR had not taken further action even though some of the cases dated back to 1988. Because of the many scenarios of bankruptcy cases, DOR was unable to estimate the amount of potential revenue that could be collected from these cases.

RECOMMENDATION

> **DOR management should more closely monitor bankruptcy cases to assure the timely processing of Bankruptcy Proof of Claim Forms. DOR should implement a bankruptcy status report detailing the payment and closeout status of both individual and corporate cases. Lastly, all personnel should be cross-trained to assure timely processing of case files.**

THE LACK OF FORMAL POLICIES AND PROCEDURES ALLOWS INCONSISTENT DECISIONS TO OFFER AND COMPROMISE REQUESTS.

When taxpayers owe the State back taxes, DOR is authorized by statute to work with taxpayers to reach a compromise that would give the State the most benefit given the taxpayer's circumstances. However, DOR does not have formal, written procedures for handling an offer and compromise request from a taxpayer. GS §105-237.1 sets forth general criteria concerning how offer and compromise requests should be handled. At least one of the four criteria listed in the statute must be met in order for a taxpayer to be eligible for offer and compromise. Not all of the criteria are clearly defined, such as taxpayer 'insolvency', leaving division personnel to use their discretion and creating the opportunity for inconsistent treatment of taxpayers.

We examined the procedures in the Personal Tax, Sales and Use Tax, and Corporate Tax divisions to determine how offer and compromise requests were handled. As a result of the absence of formal policies and procedures, each case in each division is handled somewhat differently, based on the individual specifics of the situation. Additionally, records showed evidence that financial information submitted by taxpayers to support

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[4] Calculation: Total $ of cases / Total number of cases = average $ per case; Total number of cases X error rate from sample = number of cases that could have errors; Number of cases that could have errors X average $ per case = Total potential increase in collections.

their compromise requests is being inconsistently verified by DOR personnel. Finally, we found that there is an absence of penalties or consequences for taxpayers who default on compromise agreements.

The lack of formal procedures has and will continue to lead to taxpayers being treated differently in the course of attempting to settle an outstanding tax balance owed to the State. The lack of procedures also makes employees' duties more difficult because they do not have any guidelines on the acceptable range that should be collected from the tax, penalties, and interest owed.

RECOMMENDATION

DOR management should develop a comprehensive, standard set of procedures and guidelines for handling the offer and compromise function. Specific, step-by-step procedures should be included for each division, along with guidelines for handling situations where there may be differing details. Once the procedures are in place, management should monitor the adherence to and success of these guidelines in each of the tax areas, modifying them as needed.

OFFER AND COMPROMISE FILES ARE NOT BEING PROPERLY FILED OR TRACKED.

Except for the most recently handled cases which have yet to be filed, offer and compromise files are sent by the various divisions to the Central Filing unit with background and supporting material attached to a referenced year's tax return package. We randomly selected 31 recent files from the Personal Tax, Sales and Use Tax, and Corporate Tax divisions for examination. The Central Filing unit was only able to locate 7 of the 31 files requested, and it took more than a week to retrieve these. Personnel from the units examined stated that the response we got was not unusual. We learned that there is no cross-referencing system to help locate offer and compromise files, track their movement once released from Central Files, or to record their location within the building. The lack of an effective filing and tracking system slows DOR employees' work, makes it difficult to find and examine previous years' files, and limits employees' use of previously provided material to check reporting or make decisions.

RECOMMENDATION

Offer and compromise files, with supporting documentation, should be kept in a central location in each tax division while they are being processed. Once completed, the files should be forwarded to Central Filing. The Central Filing unit should implement changes in its file

request process to allow quicker response times. Additionally, the unit should implement a computerized tracking system that would give better control over the location of previous years' tax files and allow anyone in the agency to determine the location of needed files.

THE TAXPAYER ASSISTANCE SECTION LACKS ADEQUATE STAFF TO RESPOND TIMELY TO TAXPAYERS' WRITTEN CORRESPONDENCE.

The Taxpayer Assistance section has no documented, objective, written response time standards for responding to written correspondence. Section management reported that their response time goal is 30 days. As of July 31, 2000, the Taxpayer Assistance section had average response times for correspondence ranging from 26 to 201 days (see Table 2). The unit had a total backlog of 3,459 pieces of various types of unresolved written correspondence, some dating back to October 1996. Corporate and individual tax items accounted for 73% of the backlogged items and sales and withholding tax items made up the remaining 27%.

TABLE 2 DOR's Taxpayer Assistance Section Monthly Correspondence Tracking Report As of July 31, 2000					
	Corporate Taxes	Individual Income Taxes	Sales Taxes	Withholding Taxes	Total
Ending Inventory July 31, 2000	1,724	812	555	368	3,459
Percent of Total Inventory	50%	23%	16%	11%	100%
Average Response Time in Days	201	43	53	26	
Oldest Date of Correspondence	10/96	3/00	8/99	1/99	
Source: DOR Records					

Based on our review, we conclude that the existing correspondence backlog occurred for following reasons:

- The section's lack of performance standards,
- Provision of back-up relief for **telephone assistance** to taxpayers,
- Fluctuations in staffing levels, and
- The loss of dedicated staff for this function.

As a consequence, the Taxpayer Assistance section fails to provide timely responses to taxpayer correspondence.

RECOMMENDATION

DOR management should formally document response time standards for responding to non-routine written correspondence. Management should review the types of correspondence currently being handled by the Taxpayer Assistance section to determine if using technology, such as voice mail or e-mail, could increase efficiency. Additional staff is needed to eliminate the backlog and to handle daily correspondence. See finding on page 68.

CASE FILES IN THE CRIMINAL INVESTIGATIONS DIVISION (CID) DO NOT ALWAYS INDICATE WHY THEY ARE DECLINED OR RESOLVED.

The Criminal Investigations division receives potential tax fraud cases referred from DOR's revenue officers or field auditors, or through tips from DOR's Fraud Hotline. Once referred, the division performs an initial assessment to determine if it will accept the case and proceed with criminal prosecution. If the case is declined, it can be referred to a field auditor to be resolved through civil disposition. A review of 20 cases that had been declined revealed that 5 case files (25%) did not contain either a case data sheet or a final investigation report documenting how the case was investigated or resolved. Therefore, while there was documentation showing the case disposition, information was not readily available to justify or document the decision process or the final disposition of the case.

RECOMMENDATION

The Criminal Investigations division should develop and maintain within each case file a checklist to determine what documentation should be included. A checklist would assure consistency among case files and provide assurance that all files contained adequate pertinent information.

FINDINGS AND RECOMMENDATIONS

1B -- Information Security and Business Continuity

| Overview: | DOR continues to face enormous challenges to manage and secure its systems, given the rapid change rate associated with technology, the department's numerous missions that require specialized hardware and |

software implementations, and resource constraints. DOR recognized these challenges and has taken proactive steps to further protect its systems, including establishing a new organizational structure, obtaining approval for additional staffing, and developing information security policies to support newer technologies. DOR is also involved in a pilot project with the Department of Commerce to review new alternatives to securing electronic information. The key to managing risk associated with confidentiality of taxpayer data will be DOR's ability to obtain additional technical personnel that can focus on information security risk and establish processes to enforce compliance by DOR personnel to newly established policies.

ITAS Application

DOR'S SECURITY PRACTICES AND PROGRAMS ARE NOT FULLY DEVELOPED.

Current informal computer security practices are dependent on end-users being aware of their security responsibilities and taking measures to protect computer resources assigned to them. This includes maintaining password secrecy, physically securing computer terminals, notifying the Security division of transferred or terminated employees whose authorized computer access should be updated or eliminated, and appreciating the need for confidentiality. However, we noted that there is no formal, ongoing, security awareness program to periodically remind users of and reinforce their responsibilities to protect confidential information. As a result, efforts by DOR to protect computerized information and equipment from unauthorized use and theft are increasingly difficult and DOR's ability to provide a secure technology infrastructure is diminished.

RECOMMENDATION

DOR should immediately develop a formal, on-going security awareness program for all employees. This program should be one of the primary responsibilities of the Security division and should be continually monitored and updated as needed.

FINDINGS AND RECOMMENDATIONS

DOR IT Infrastructure

LACK OF ADEQUATE SECURITY RESOURCES HAS NEGATIVELY IMPACTED DOR'S ABILITY TO PROVIDE A SECURE ENVIRONMENT FOR ITS CLIENT/SERVER PLATFORMS.

DOR does not currently have the security resources necessary to perform daily administrative tasks (such as audit log review, intrusion detection, etc.), as well as participate in other technology projects requiring information security considerations. As the security program matures at DOR, additional resources with specialized skill sets will be required to support the numerous technology related projects, establish policy, and adequately monitor daily activities.

As part of the audit, KPMG performed a general security review of the non-mainframe platforms at DOR. DOR currently has risk exposure resulting from insecure operating systems, weak password controls, shared user and administrator accounts, and outdated antivirus definition files. We feel this risk will remain until additional personnel and resources are obtained.

RECOMMENDATION

DOR management should expedite the hiring of personnel to fill the three remaining positions identified during its recent organizational change in the Security function. The proposed organizational changes at DOR should provide the security staff with the infrastructure needed to perform daily security monitoring tasks, as well as participate in systems development/enhancement projects.

SYSTEMS ADMINISTRATORS ARE NOT TRAINED IN SYSTEMS SECURITY ADMINISTRATION.

Currently, DOR's systems administrators for the various computer systems are responsible for performing daily administrative tasks, including keeping the systems secure. While the systems administrators appear knowledgeable of their systems, they are not trained in systems security administration. Based upon the time required for the Security function to obtain additional personnel, implement automated tools, and provide effective security administration over these systems, we believe security training for current systems administrators is needed. This training would allow the systems administrators to identify and address security risks posed to the information infrastructure.

<div align="center">

RECOMMENDATION

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DOR management should make immediate provisions for all system administrators to receive specific systems security administration training. It is critical that the systems administrators receive this training and keep updated on current information security issues and trends.

Business Continuity Planning

Overview

DOR has implemented a number of new systems (Data Capture, Electronic Filing, Electronic Funds Transfer) during the last several years that are used to receive and process taxpayer information more efficiently. These systems rely on newer technology and are now critical to DOR's ability to get taxpayer data in electronic format to the ITAS system for processing. As a result, it is increasingly important for DOR to have alternative processing methods identified should a long-term systems outage occur with one or all of these key systems. Most of DOR's continuity emphasis has been placed on the recovery of the ITAS application, which is now reliant on processing completed by these other DOR systems.

RECOVERY OF SUPPORTING PROCESSES AND TECHNOLOGY FOR DOR PROCESSING ARE AT RISK IN THE EVENT OF A LONG-TERM RECOVERY REQUIREMENT.

DOR's disaster recovery planning efforts to date have been limited to processing by the ITAS application and do not cover critical processes and subsystems in place to capture and process taxpayer data. A disaster could affect all non-mainframe systems, as well as ITAS, including the newly implemented Data Capture system. A disruption in the Data Capture activities would significantly jeopardize DOR's ability to successfully recover processing on ITAS. Currently, DOR does not have a disaster recovery plan that covers its non-mainframe systems. DOR has contracted with IBM, however, to provide disaster recovery information for the Data Capture system. The department will then need to develop a recovery plan that will include recovery measures for the Local Area Network as well.

Several informal plans have been discussed, including one that would allow administrative operations to continue in the event the DOR facility is damaged. There is an undocumented agreement with the Employment Security Commission that will provide continuous mail sorting operations in the event of damage to the mail sorters in the building. Administrative services has available warehouse space that would allow for the manual sorting of mail, and contracts with two outside vendors for pre-sort and

outbound mail services are available. While these scenarios may be part of an overall, coordinated plan, these types of fragmented, informal plans do not discuss system availability and access to computer resources.

RECOMMENDATION

We commend DOR's decision to contract with the vendor for the information to develop a disaster recovery plan. DOR should develop the recovery plan as soon as possible, to encompass the Data Capture System and related Local Area Network. DOR should implement and test business recovery plans for technology, people, and processes required to support key tax processing components.

Communication

Overview High performance technology organizations have realized that alignment to business functions requires measurement and communication. These organizations utilize staff to develop opportunities and educate users about the use of information technology. They measure their success in agency terms and report on their performance and successes. They strive to communicate to all users and bring them into many facets of the project life cycle.

DOR DOES NOT HAVE A REGULAR COMMUNICATIONS PROGRAM FOR ITAS INTERNAL USERS.

The Planning, Development, and Technology division (PD&T) is responsible for managing the IT and ITAS functions for DOR. We found that communication from PD&T to users regarding IT and specifically ITAS is informal and inconsistent. One reason for this may be the lack of an enterprise infrastructure that promotes the sharing of information. That is, not all units and locations utilize e-mail or voice mail. Additionally, PD&T does not measure user satisfaction, which can be a useful tool in establishing strong lines of communication.

One primary vehicle for ITAS communication is the ITAS Planning Team. Surveys and interviews indicated that ITAS users receive limited information regarding changes and problems with ITAS. Many users do not understand why it takes so long for changes to be made to the system. Users expressed a desire for more communication as to why changes are or are not made. PD&T does send out status of projects reports to requestors monthly.

RECOMMENDATION

DOR should develop and implement an on-going communications plan for internal users of ITAS. Improvements to the existing infrastructure, which are already planned, will be required to provide additional communication tools. Additionally, PD&T should consider conducting annual user satisfaction surveys to gauge support of, and facilitate communication with end users.

1C - Costs of ITAS and Other Automation Projects

Overview

The overall DOR budget for fiscal year 1999-00 is approximately $102 million dollars. The IT portion is approximately $15.8 million or 15.5% of the total budget. Table 3 shows the main components of the IT budget. The IT budget does not include implementation funds for special projects such as the E-Commerce strategy initiative, E-Commerce deployment, and the Data Capture project. Costs associated with ITAS are estimated at $8.25 million (52.2% of the IT budget) for this year, which includes Information Technology Services (ITS) costs, software fees, network costs, and staffing. The ITAS system supports 1,000 users in Raleigh, statewide field offices, and the interstate auditors for administration of corporate tax, franchise tax, personal tax, sales and use tax, motor fuel tax, and privilege license tax. The remainder of the IT budget ($7.55 million, 47.8%) is used to support the other main DOR systems listed in Table 4. DOR does not capture costs at the individual system level; therefore, we are unable to accurately reflect the costs associated with each system. The fiscal year 1999-00 budget for DOR shows a separate line item for the Data Capture Project of $17.5 million for purchase of equipment and for operations.

TABLE 3 Major Components of DOR'S IT Budget (in millions) FY99-00	
Component	Amount
ITAS-ITS Costs	$ 5.7
Staff	5.0
Contractors	1.7
Maintenance and Licenses	1.0
Personal Computers	.7
Telecommunications	.6
Training	.1
Other Support	1.0
TOTAL	$15.8
Source: DOR Records	

TABLE 4 DOR Computer Systems Other Than ITAS	
Data Capture	Electronic Filing (ELF)
Revenue Collection and Analysis (RCA)	Java Enabled Tax System (JETS)
Electronic Funds Transfer (EFT)	Unauthorized Substance Tax System
Intangible Tax System	Tartan Data Entry
DOR Web Site	
Source: DOR Records	

DOR DOES NOT MEASURE AND REPORT THE BENEFITS OF AUTOMATION.

In 1987, DOR embarked on a major initiative to redesign and modernize its aging automation environment. Since that time, records indicate that DOR has expended approximately $60 million, composed of DOR reserves and appropriations from the General Assembly, as shown in Table 5. The largest portion of these funds was used to purchase, modify, and implement the Integrated Tax Administration System (ITAS) and the Data Capture System.

TABLE 5 COSTS OF COMPUTERIZATION FY87-88 TO FY99-00 (numbers shown in bold are for ITAS and Data Capture)	
87-88	$ 732,720
88-89	4,651,536
89-90	5,091,431
90-91	3,047,331
91-92	0
92-93	0
93-94	**3,009,800**
94-95	**10,558,294**
95-96	**10,612,862**
96-97	**4,255,874**
97-98	**0**
98-99	**12,272,148**
99-00	**5,779,395**
TOTAL	$60,011,391
Source: NC Department of Revenue	

When DOR decided to utilize a computerized tax accounting system in 1992, it was estimated that project costs would be approximately $6.3 million for an existing program being used by another state (Automated Revenue Information System), exclusive of hardware, software, and other infrastructure needed to support the system. Before the State could move on this program, the firm that marketed it ceased supporting it. DOR continued its efforts to locate another program that would work, finding ITAS. In 1993 when the General Assembly approved the project and appropriated $3.4 million, a contract was executed not to exceed $8.0 million. At that time, it was anticipated that it would take approximately 26 weeks to implement ITAS. In 1994, DOR estimated in its budget request that the Phase 1 cost of ITAS would be $18.7 million including the cost of software development, licensing, supporting hardware, software, contractual services, maintenance, and telecommunications. The main justification for acquiring ITAS was that it would increase revenue by approximately 1.5% or $122 million on an annual basis. ITAS was implemented in 1994 and DOR began realizing benefits in 1995. While we were not able to isolate the benefits from ITAS, DOR records show that revenues have increased by an average of 4.79% or $726 million per year since 1995, as shown in Exhibit 2, page 27. A significant portion of that increase can be attributed to automation.

RECOMMENDATION

DOR management should formally measure and report on DOR performance. An important measure to share with stakeholders is attainment of benefits received from funding spent. The appropriate measurement instrument would include financial measures that show the results of actions already taken, as well as operational measures on customer satisfaction, internal processes, and the organization's innovation and improvement activities - all operational measures that are the drivers of future financial performance.

EXHIBIT 2
Increases in Gross Collections vs. Increases in Returns

Chart showing PERCENT CHANGE on the y-axis (ranging from (10) to 10) versus FISCAL YEAR on the x-axis (95-96, 96-97, 97-98, 98-99, 99-00). Two lines plotted: GROSS COLLECTIONS (red) and TOTAL RETURNS (blue). A shaded area labeled "BENEFIT FROM AUTOMATION AND OTHER EFFICIENCIES" appears between the lines near 98-99.

Source: NC DOR Records
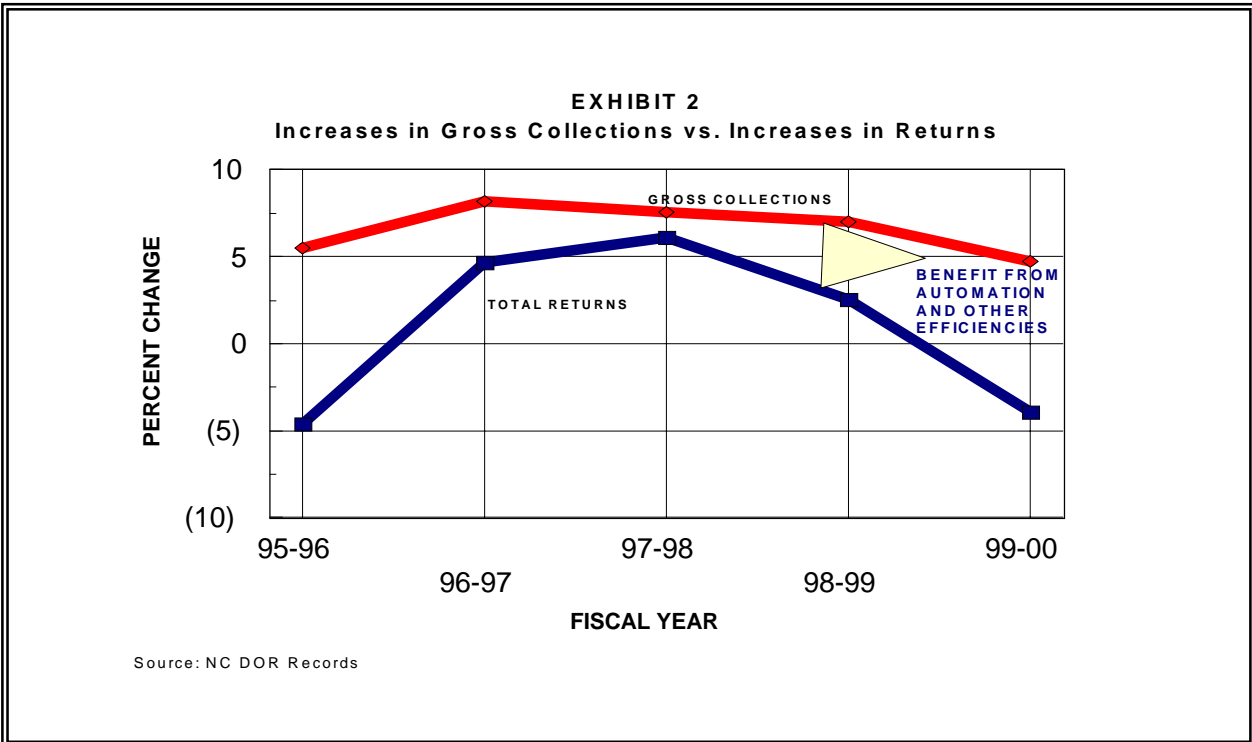
ENABLING TECHNOLOGIES TO SUPPORT TAXPAYER SERVICES WILL REQUIRE SIGNIFICANT EXPENDITURES.

One of the main challenges facing tax collection agencies, state agencies, and the private sector is funding to implement and support initiatives using newer technology, while at the same time maintaining and improving current systems and technology. This is most evident at DOR[5] based on the diversity of computer platforms, programming languages, and the technical architecture of the various systems mentioned above. Another challenge is the ability to attract and retain skilled and experienced staff familiar with all the technologies used by DOR. A related and continuing challenge is dealing with obsolete equipment and systems. Thus, DOR will require continued funding for technology that is changing at an extremely rapid pace.

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[5] A study performed this year by Computer Economics compared government agencies and various IT spending trends. One metric is IT spending per agency employee. For state and local government agencies for the budget year 2000, the 25th percentile was $2,000 per employee, the median was $7,600 and the 75th percentile was $29,100 per employee. DOR spends approximately $13,170 per employee or somewhere between the median and the 75th percentile.

RECOMMENDATION

DOR management should work with the General Assembly to prioritize desired technology advancements. Management should continue to monitor the automation needs of DOR and communicate those needs to the General Assembly. The General Assembly should appropriate necessary funds to continue the modernization of DOR and maintain existing systems.

1D - Efficiency and Effectiveness of ITAS and Other Automation Projects

Overview

In 1992 and 1993 when DOR began looking for an automated tax collection program, the Integrated Tax Administration System (ITAS) was identified as the most appropriate product at the time. A number of other states were in the process of implementing ITAS, or had already successfully implemented it. ITAS' major selling point was that it could handle not only individual income taxes but could also be modified to handle other tax schedules, thereby allowing North Carolina to utilize one system for all tax administration functions. In 1993, when the ITAS project was approved and funded by the General Assembly, decisions were made by DOR management to prioritize certain components of ITAS, generally those handling individual income taxes, to expedite implementation. It should be noted that North Carolina has more tax schedules than other states that have implemented ITAS. This has complicated development of all subsequent ITAS components. Based on the results of interviews and the surveys, not all eight of the key ITAS components were equally developed during original implementation. Internal users indicated functionality for the areas of withholding tax, case management, and auditing has not been as robust as originally promised during initial implementation efforts.

FUNCTIONALITY: KPMG used two proven diagnostic tools (Functional Quality (FQ) and Technical Quality (TQ) surveys) to assess the efficiency and effectiveness of ITAS and other DOR automation projects. These tools are meant to serve as a high level indicator of the functional and technical quality of the system. Scores of both the functional and technical qualities of ITAS have been compiled and summarized below to indicate overall system fitness from the user perspective.

The results of the FQ survey indicated only one category, currency of data, was in the unacceptable range. Nine categories rated as fair included: accuracy, responsiveness, ease of use, help facilities, usability, flexibility, ad hoc processing, user support, and training. In addition these categories identified gaps between functionality provided and functionality required. The overall average of the FQ results was 3.24 (on a 5.0 scale), which places ITAS in the "fair to good" range, indicating a healthy system. Detailed results from this tool can be found in Appendix A, page 85.

The results of the TQ survey indicated three categories were considered unacceptable: portability, ease of analysis, and ease of making changes. These categories showed gaps between functionality provided and functionality required. There were four categories rated as fair, including: accuracy of processing checks and input validation, ability to interface/integrate data to/from other systems, use of system software and hardware resources and their efficiency of use, and ease of determining and rectifying problems. The overall average of the TQ Results was 3.21 (on a 5.0 scale), also in the fair to good range, which indicates a healthy system. Detailed results from this tool can be found in Appendix B, page 87. Combined results of the surveys are shown in Exhibit 3.

EXHIBIT 3
Results of the Functional and Technical Quality Surveys

FQ/TQ Results
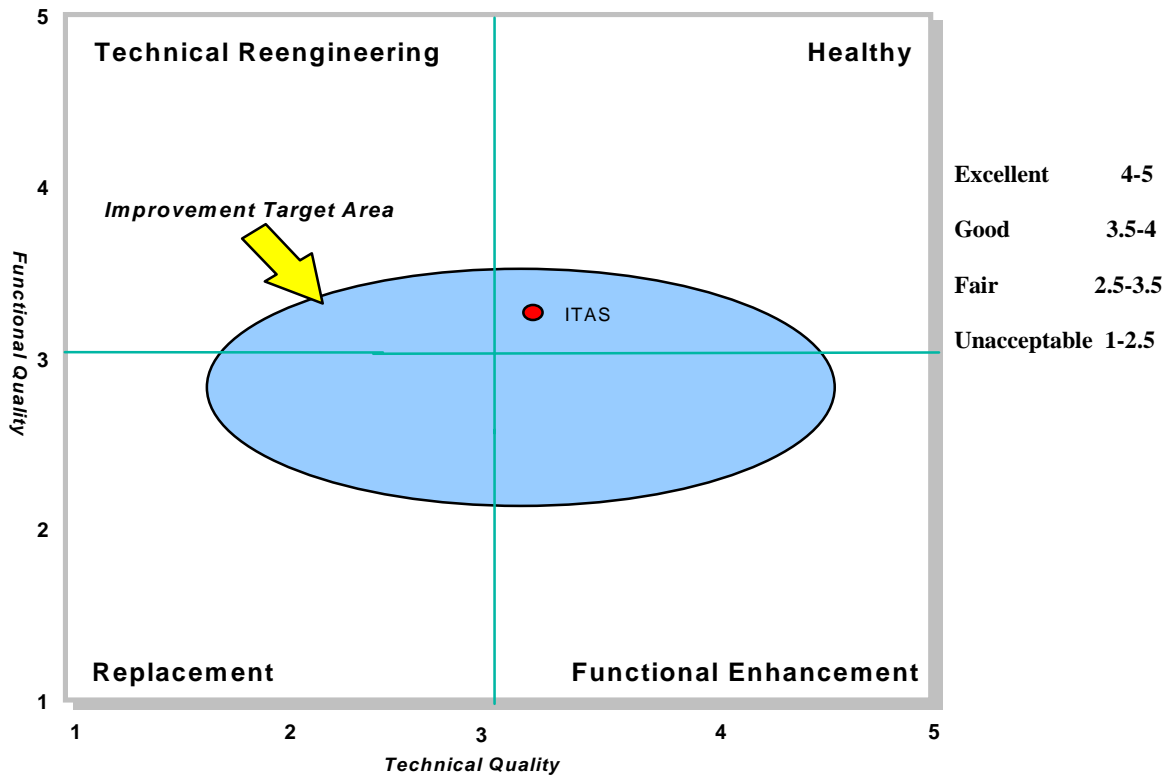
Source: Compiled by KPMG from survey results

INTERNAL USERS OF ITAS BELIEVE MODIFICATIONS ARE NEEDED TO MEET NEEDS.

The Functional Quality Survey also obtains information from internal users of ITAS regarding how the application meets their present and future business needs. They rated the overall application from 1 to 5 using the scale shown in Exhibit 4. The exhibit shows the result of this important attribute by the percentage of respondents in each of the five categories. The consensus is that the system meets the needs of the users but requires minor to significant modifications for current or anticipated needs. Table 6, page 31, summarizes the system requirements (SR) survey results obtained by KPMG. This tool serves as an indicator of the functional modules of ITAS by asking detailed questions to determine how well ITAS functions meet the requirements of users. Detailed results from this tool can be found in Appendix C, page 89.
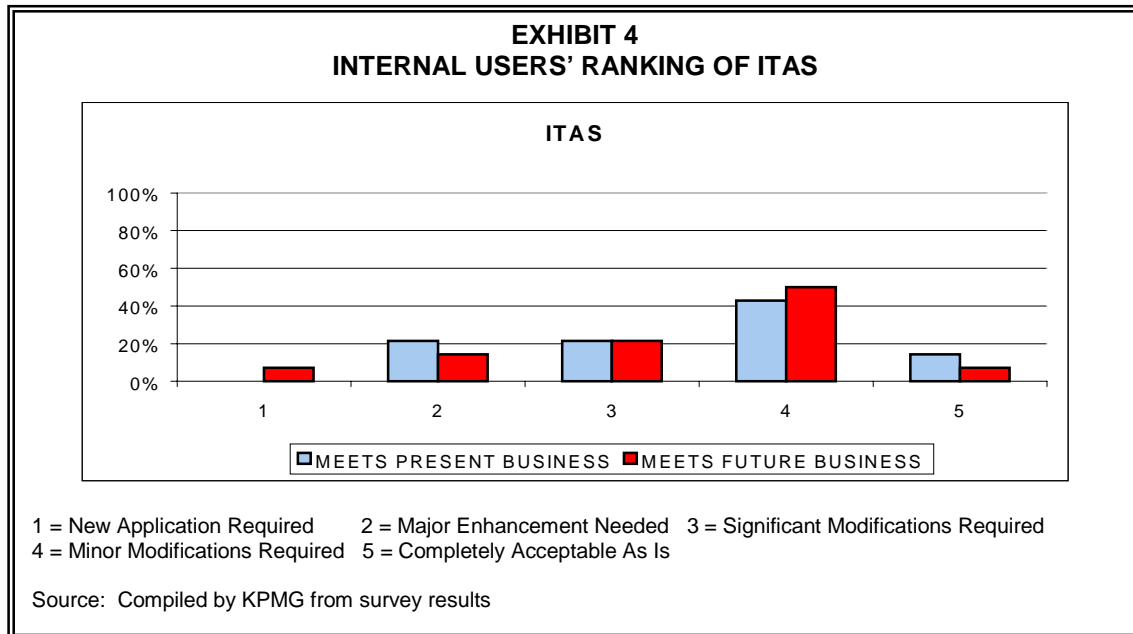
EXHIBIT 4
INTERNAL USERS' RANKING OF ITAS

1 = New Application Required   2 = Major Enhancement Needed   3 = Significant Modifications Required
4 = Minor Modifications Required   5 = Completely Acceptable As Is

Source: Compiled by KPMG from survey results

RECOMMENDATION

DOR management should use the results of the surveys conducted by KPMG to focus development of ITAS' key components. Development of these components should serve to address the majority of functionality issues identified by ITAS users and improve the effectiveness of the system.

Table 6
System Requirements (SR) Survey Results
❑ **Taxpayer Identification Functionality** – The system provides the capability to add, maintain and process taxpayer identification information. In most of the high priority functions rated by users, ITAS is functioning adequately; however, the ability to process returned mail, which was a higher priority among users, ranked poorly.
❑ **Document and Returns Processing Functionality –** The system provides the capability to define documents, enter high and low volumes of data, and to prepare payment transactions. For this area, most of the higher priority functions rated by users are adequate; however the ability to define documents, which is a medium priority, could be improved per user feedback.
❑ **Taxpayer Accounting Functionality –** The system provides the ability to post transactions, adjust taxpayer accounts and process refunds. The majority of the high priority areas rated by users showed the system is adequate; however improvements could be made in the ability to match data against outside sources. Of the medium priority areas, users noted the ability to provide questionable filer detection and produce management revenue reports could be improved.
❑ **Accounts Receivable Functionality -** The system provides the ability to bill a taxpayer, process and apply payments, write-offs, and settlements. Of the high priority functions, users indicated the ability to process payment agreements, process liens and apply payments could be enhanced. Of the medium priority functions, the ability to process dishonored checks could be improved.
❑ **Automated Correspondence Functionality –** The system provides the ability to define and process notices, questionnaires, and correspondence. ITAS processes notices and inquires on correspondence adequately but improvements could be made in the areas of defining new notices, processing questionnaires, producing correspondence, and producing statistical/post office reports.
❑ **Case Management Functionality –** The system provides the ability to define and maintain cases, identify audits, and provide case inquiry. ITAS defines, maintains, and queries case information adequately. However, users noted the system could provide enhanced functionality to process collections, identify audits, and identify/ process non-filers and delinquents.
❑ **Revenue Accounting Functionality –** Within revenue accounting, functionality centers around capturing, tracking, allocating, and distributing revenue. Most of these categories ranked adequately for ITAS; however, the ability to inquire on revenue accounts ranked poorly.
❑ **Other Components Functionality –** The other components are made up of the ability to provide user help, provide access to host systems, and generate ad-hoc reports. The ability to provide user help and generate ad-hoc reports was ranked poorly.
Source: Compiled by KPMG from survey results

SOFTWARE RELEASE ANALYSIS: In the winter of 1999, the ITAS Planning Team reviewed all outstanding requests and compared them to objectives approved by the Quality Council[6]. The team prioritized 85 change requests scheduled for resolution by March 2001. After the first scheduled release on 6/26/00, the ITAS Planning Team was forced to make some adjustments to the original schedule, withdrawing 30 planned requests and adding/modifying 23, leaving 83 requests for resolution by the March 2001 deadline. (Note: many of the requests fell into more than one category; therefore, the numbers above do not add.)

THE ITAS PLANNING TEAM HAS TAKEN STEPS TOWARDS ADDRESSING ITAS FUNCTIONALITY DEFICIENCIES.

In reviewing the functionality gaps within ITAS and comparing them to the release schedule of upcoming software changes, we found that the releases fell into four general categories. It is important to note that requests fell into one or more of these categories. The results of the comparison are as follows:

- **Processing/Revenue Generation** (requests with an impact on improving processing efficiency and/or revenue generation) – 49 requests,
- **Report Generation/Tracking** (requests to provide the ability to generate desired reports, case inquiry, or monitoring/tracking) – 14 requests,
- **Correspondence** (requests with an impact on generating, defining, or processing of correspondence, notices, or questionnaires) – 12 requests, or
- **Compliance** (resolutions to comply with legislation or State/Federal Tax Laws) – 11 requests.

Our comparison and analysis showed that several of the system functionality gaps within the eight ITAS system components not fully implemented are scheduled to be addressed. While the ITAS Planning Team has begun to take steps towards the equal development of functionality issues, in our opinion, additional improvements could be made to meet the functional requirements of all users. Table 7, page 33 is a brief summary detailing the strengths and weaknesses of the proposed release schedule as it relates to functionality gaps within ITAS.

RECOMMENDATION

DOR management should determine if functionality gaps identified by this review not included in the current software release schedule are appropriately prioritized and can be addressed.

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[6] The Quality Council is composed of senior DOR personnel whose responsibility is implementing total quality management, deploying the strategic plan, and identifying improvement opportunities at DOR.

TABLE 7
Summary Of Planned ITAS Modifications

❑ **Taxpayer Identification Functionality** – System Requirements survey (SR) results identified two issues, maintaining license/bond information and processing returned mail, as needing improvement. The software change release schedule indicates several planned requests towards improving the ability to maintain license/bond information and inquires. We did not identify a change request to address the ability to process returned mail, which was a higher priority among users.

❑ **Document and Returns Processing Functionality** - The system needs to provide the capability to define documents, enter high and low volumes of data, and to prepare payment transactions. According to the user responses to the SR survey, the ability to define documents, which is a medium priority, was the one area needing improvement within this component. We did not identify a change request to address the development of this area in the planned release schedule.

❑ **Taxpayer Accounting Functionality** – According to our analysis, the ITAS planning committee has made strides towards the development of this component. Three issues were recognized by users as needing improvement: providing questionable filer detection, matching data against outside sources, and producing management revenue reports. The release schedule indicates that each issue has been addressed with one or more request.

❑ **Accounts Receivable Functionality** - The system needs to provide the ability to bill a taxpayer, process and apply payments, write-offs, and settlements. SR survey results show that the high priority functions; the ability to process payment agreements, process liens and apply payments, need to be enhanced. Of the medium priority functions, the ability to process dishonored checks could be improved. When compared to the schedule releases, all of these gaps are scheduled to be addressed except for the ability to process liens.

❑ **Automated Correspondence Functionality -** According to users' responses to the SR survey, improvements could be made within the areas of defining new notices, processing questionnaires, producing correspondence, and producing statistical/post office reports. According to the change release schedule, each of these functionality gaps are addressed adequately except for the ability to process questionnaires.

❑ **Case Management Functionality** – The ITAS Planning Team has scheduled an adequate amount of requests addressing the functionality issues concerning identifying and processing non-filers and delinquents, identifying audits, providing case inquiry, automatic take action, producing operation and planning reports. We did not identify a request to develop the ability to prioritize case listings as high/medium/low or by dollar amount as requested by users.

❑ **Revenue Accounting Functionality** – Within revenue accounting, functionality centers around capturing, tracking, allocating, and distributing revenue. According to the SR survey results, most of these categories ranked adequately for ITAS. However, feedback indicated improvements could be made to the ability to inquire on revenue accounts. The ITAS Planning Team has scheduled releases to deal with the development of this functionality gap.

❑ **Other Components** - According to user responses to the SR survey, there are two functionality issues of concern not addressed in the change

USER SUPPORT: DOR ITAS system internal users require certain technical and analytical skills and tools to accomplish their jobs efficiently and effectively. Based on the results and comments from surveys and interviews, KPMG discovered support, training, and user involvement for ITAS varies greatly among the divisions. Issues related to ITAS user productivity include: accessibility and reportability of ITAS data, continuous training, current documentation of ITAS processes, and appropriate skills and resources necessary to support ITAS change management activities.

ITAS INTERNAL USERS DO NOT HAVE EASY ACCESS TO ITAS DATA FOR REPORTING.

The ITAS system was designed as a tax processing system and was not designed as a management reporting system. Due to the size and complexity of the system, a detailed level of understanding of ITAS is required to compile data to produce meaningful reports. Surveys indicate users feel ITAS "lacks strong ad-hoc reporting capabilities that can be utilized by employees". Users are frustrated by their inability to generate simple reports on an as-needed basis because existing tools used for ad-hoc reporting were built for technical users. The average user does not have the skills necessary to identify relevant data and create reports and must request reports from PD&T (Planning, Development, and Technology). PD&T gathers necessary requirements, produces the queries/reports, and sends them back to the user. Interviews indicate this process is not always completed timely, resulting in delays to the user. PD&T has begun to address these concerns by creating some queries that allow the users to input certain selection criteria to generate additional reporting.

RECOMMENDATION

DOR management should determine alternatives to provide better management reporting. A support structure should be developed to facilitate users' reporting needs while limiting the impact to ITAS production processing.

> *Auditor's Note: DOR requested $480,000 in its Biennium Budget for fiscal year 2001-02 for data warehouse implementation. This would provide the support structure recommended above.*

DOR DIVISIONS LACK ADEQUATE RESOURCES TO SUPPORT TRAINING AND DOCUMENTATION OF ITAS.

We noted during the audit that ITAS user documentation provided initially by Andersen Consulting[7], in both on-line and hardcopy format, has not been maintained. The ITAS system lacks up-to-date and useful online help facilities and online user manuals. Adequate help facilities would alleviate many of the 'how to' questions by providing answers directly to users. Keeping the documentation current has not been a high priority for DOR personnel due to resource constraints. Lack of current ITAS documentation decreases user productivity, hinders progress of future maintenance projects, and makes revisions to the data more costly.

There are three main types of documentation associated with ITAS: user, system, and operations. Below we discuss the documentation found for each type.

- **User Documentation -** Andersen provided user manuals that included detailed documentation and procedures on ITAS for the various units within DOR. Updating the documentation after system changes are made is a responsibility of the individual units. We found that the level of completeness in user manuals varies among the various DOR units.
- **System Documentation** - Andersen provided system documentation using its proprietary tool Design 1. Unfortunately, the documentation was not kept up to date after numerous changes to ITAS and is not utilized today. Instead PD&T maintains program and change documentation within the programs themselves. Lack of thorough documentation can hinder the ability to troubleshoot, analyze changes, and solve problems.
- **Operations Documentation -** Operations documentation is maintained via DOR's scheduling system, which has been well maintained as operational changes have been made. The test databases used for system testing, however, do not adequately test all aspects due to size limitations.

RECOMMENDATION

Documentation of ITAS processing and user procedures should be improved. In order for documentation to be completed and consistently maintained, resources, including staff, must be allocated to create, update and maintain ITAS online help facilities, user manuals and documentation as changes occur. See finding on page 68.

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[7] Andersen Consulting, Inc. was the vendor selected for the development and implementation of ITAS. Once the original implementation was completed, Andersen turned over the documentation to DOR personnel.

HELP DESK SUPPORT PROCESSES HAVE NOT BEEN FORMALLY ESTABLISHED AND STAFFED.

Currently, there is a lack of staff available to service problems reported from DOR internal users. There is no formal process in place to document and analyze calls received to identify recurring issues. Such a process would reduce the types of issues we noted with initial problem identification and timely assignment to help desk staff. We also noted performance metrics are not in place to identify and measure help desk support effectiveness.

RECOMMENDATION

DOR management should implement procedures for receiving internal user calls, documenting problems, and recording solutions for future reference. In our opinion, DOR should request additional positions to supplement existing help desk staff. (Note: Two positions were requested in the FY97-98 budget but not approved.) See finding on page 68.

CHANGE MANAGEMENT - ITAS: DOR's Planning, Development and Technology division (PD&T) has the responsibility for the development and maintenance of all application systems within DOR. PD&T's philosophy regarding system development is to design, develop, and implement systems and system changes using DOR resources. Where appropriate, DOR resources are supplemented with outside contractors performing some programming and support tasks. PD&T has assumed full responsibility for the project management of most system development efforts. Project Workbench is utilized to control larger projects; others have informal methods to manage project efforts.

DOR has established a group of nine individuals, primarily Assistant Directors who represent most divisions of DOR, that comprise the ITAS Planning Team. This group meets monthly to discuss the status and priorities of ITAS changes and issues. Their main responsibilities include:

- Develop ITAS strategic plan;
- Review and prioritize change requests for future releases;
- Participate in planning of releases;
- Ensuring representatives from user groups are available during the system development life cycle phases;
- Establishing change policies and procedures; and
- Communicating ITAS status and changes to employees.

FINDINGS AND RECOMMENDATIONS

CHANGE MANAGEMENT PROCESSES TO CONTROL SOFTWARE CHANGES TO ITAS CONTINUE TO EVOLVE.

The processes, policies, roles, and responsibilities related to ITAS changes have recently been formally defined, approved, and communicated. However, documentation of potential costs / benefits is not always obtained before priority is assigned to changes. We learned during the audit that DOR does not have automated tools to aid in project estimation, testing, and documentation. DOR also lacks a common mechanism for reporting, logging, and tracking ITAS problems and changes.

RECOMMENDATION

DOR management should establish procedures for thorough documentation of all program changes to ITAS. Automated tools should be considered to assist PD&T in managing program changes, along with a common reporting system to be used by all DOR internal users and support personnel.

DOR DIVISIONS LACK ADEQUATE SKILLS AND RESOURCES TO SUPPORT ITAS CHANGE MANAGEMENT ACTIVITIES.

The Production Systems Integration Coordination division is responsible for most ITAS change management activities. This group consists of three analysts: one dedicated to non-ITAS systems and two who focus on ITAS. The ITAS analysts are responsible for receiving ITAS change requests, validating the change request with the user, acting as liaisons between the programmers and users to complete the change request, and acting as a quality control to review technical programming associated with each change request. These responsibilities, while time consuming, are critical to assuring appropriate changes are made to ITAS in a timely manner that also satisfy user needs. This group has other responsibilities as well, including managing the ITAS planning team, developing the "Policy for Change to ITAS" procedures, and participating in other various user and technical groups regarding ITAS. Based upon the size and complexity of the ITAS application, and assistance required by the various DOR divisions, it is our opinion that this group is severely understaffed to accomplish their assigned job responsibilities in an efficient and effective manner.

RECOMMENDATION

DOR management should reassess the staffing needs for this function. In our opinion, the Production Systems Integration Coordination Group needs additional positions to assure appropriate support and

controlling processes are provided for ITAS and non-ITAS change management activities. See finding on page 68.

CHANGE MANAGEMENT - IT INFRASTRUCTURE:

CHANGE PROCEDURES FOR NON-MAINFRAME SYSTEMS ARE NOT PERFORMED CONSISTENTLY TO ENSURE THAT OPERATIONAL PRIORITIES ARE MET.

Change management procedures for DOR's non-mainframe platforms vary by operating system. This results in inconsistent and ineffective control over hardware and software changes. Changes are not formally communicated to allow management consideration of potential impact to tax processing. As a result, DOR relies heavily on the personnel supporting each computer platform to develop and maintain their own policies, procedures, and methodologies for managing projects, identifying risks, testing, and migrating changes into production. This practice has negatively affected DOR's ability to properly develop and maintain existing systems within the non-mainframe environment. Specifically, we noted the following for the Novell, Sun Solaris, and NT computer platforms:

- None of the platforms reviewed have properly documented policies and procedures for change management.
- Although informal procedures exist for changes to each platform, a formal project management methodology has not been adopted by DOR to ensure that changes to systems and system software do not have an adverse affect on business processing.
- There is currently no formal risk assessment performed to identify how a change may affect a system or subsystem. As a result, there is a risk that a change implemented on one system may adversely affect the processing of another system.
- At the time of the audit, PD&T was in the process of defining the roles and responsibilities of a newly hired Quality Assurance person to aid in risk mitigation during the developing and testing of non-mainframe IT systems. Adequate representation by Quality Assurance is key to ensuring the quality of testing is properly monitored and issues are identified before code or equipment is migrated into production.
- DOR does not track changes made to NT and Novell servers and applications. As a result, there is a possibility that future code changes could conflict with prior code changes, either negatively impacting the integrity of the data or the functionality of the system.
- Changes to the data capture system and DOR's LAN are not being tested before they are put into the production process.
- Change control for the UNIX platform is being performed using group ID's to move program code into the production area. This could lead to issues with code and equipment not being identified before the code is placed into production.

FINDINGS AND RECOMMENDATIONS

RECOMMENDATION

DOR management should establish a communication mechanism to document and inform management of all changes to its non-mainframe systems. Standard procedures should be developed for initiating, testing, and deploying changes for these systems, with clearly defined roles and responsibilities and appropriate system access. All changes to non-mainframe systems should be coordinated and tested to determine potential impact to other DOR systems.

IT/PERFORMANCE:

PD&T DOES NOT HAVE A FORMAL AND MATURE PROGRAM TO MANAGE PERFORMANCE.

PD&T does not have a division-wide plan with specific goals and objectives against which to measure progress and success. The Business Systems and Development and Support section (BSDS) within PD&T developed some key measures and targets in 1998, including: number of open application systems problems, number of ITAS processing problems, and system response time problems. However, the proposed measures do not reflect the true performance, value, and productivity of BSDS.

We learned further that measures of customer satisfaction with ITAS users, for example, use of service level agreements, have not been established. User surveys to ensure user satisfaction with services and to manage their expectations and perception have not been conducted recently. Without trust and confidence of its users, the accomplishments of PD&T could be received with a level of skepticism and disapproval. Surveys and interviews with DOR personnel did indicate a significant decrease in problems since the original implementation of ITAS.

RECOMMENDATION

PD&T should develop and implement additional performance measures. Additionally, PD&T should implement service level agreements with internal users to assure all parties understand what is expected of them.

FINDINGS AND RECOMMENDATIONS

1E – Auditing Activities

Overview:
GS §143B-218 states that the Department of Revenue is responsible for collecting and accounting for the State's tax funds, to include conducting audits of taxpayers. DOR has a number of discovery strategies for choosing which taxpayers are good candidates for audits. ITAS is one element involved in the auditing process at DOR. While ITAS can and does look for specified criteria to identify potential audit candidates, the system does not prioritize audits. Workload prioritization is managed at the field office level with the help of the examination strategy, a policy that outlines where audit resources are allocated. Initiatives are under way to address the functionality issues identified by users relative to ITAS queries. DOR recently established a Discovery and Special Projects Group to identify potential revenue streams, and is developing a document query system to provide the field auditors with a powerful tool that can be used to retrieve and view taxpayer returns online. These efforts will have an immediate impact on the field auditors' ability to perform their work in a timely fashion.

DOR HAS NOT TAKEN FULL ADVANTAGE OF ITAS CAPABILITIES TO AUTOMATE SELECTION OF TAXPAYERS FOR AUDIT.

DOR auditors indicate that auditing of taxpayers is becoming more automated. When the system was initially implemented, ITAS was flagging a majority of the returns processed for auditing. This created a large number of potential audits that required extended processing time and necessitated additional field auditors to handle the volume. As a result, the auditing function within ITAS was scaled back and more selective criteria were implemented. Table 8 shows several methods currently employed to identify and assign potential audit candidates to field offices.

Table 8 DOR METHODS USED TO SELECT POTENTIAL AUDIT CANDIDATES	
ITAS selected	ITAS runs a query against its database of known taxpayers, searching for various criteria such as previous taxes paid, dollar value of taxpayer's assets, and reported non-business income. The criteria used to identify potential audit candidates vary, depending on the particular tax schedule targeted for audit.
Referrals	Taxpayers are identified by various other discovery efforts in specific divisions such as Withholdings, Sales Tax, or CID, and then referred to field auditors for assessment.
Projects	Some taxpayers are identified through special discovery projects and referred to field auditors for assessment. Although these projects were initially sponsored within various divisions at DOR, there has been a recent effort to consolidate special discovery efforts into one central division. In July, 2000 the Discovery and Special Projects Group was created to sponsor and coordinate new discovery initiatives within DOR. Similar groups that have been established in other state revenue agencies have been quite successful in identifying new types of audit candidates and generating revenue for their respective states.
RAR	Some taxpayers are identified through IRS Revenue Agent Reports (RAR) and referred to field auditors for assessment.
Central Office	The central office assigns cases to field offices based on its own discovery efforts, which include tips on non-compliant taxpayers from local citizens.
Exchange Agreements	The Southeastern Association of Tax Administrators has an agreement with DOR to submit a form for every audit assessed >$100,000 against a taxpayer or corporation with an address in North Carolina. Candidates are referred to field offices for assessment.
Source: DOR Records	

Interviews indicated that DOR only recently began to exploit the capabilities of the ITAS system. As automation increases DOR's ability to identify additional revenue generating audit candidates, resources will be required in the field to work the additional cases. DOR will need to continue refining its discovery efforts and streamlining current processes to increase effectiveness of its audits.

RECOMMENDATION

DOR management should continue emphasis on identifying and refining the criteria used by ITAS to select potential audit candidates. Additional use of automated capabilities for selection of candidates and ongoing support for these efforts, both personnel and computer resources, will be required to improve the effectiveness of DOR's overall audit function. As ITAS criteria for selecting candidates is refined, it is expected that the workload will be increased. See finding on page 68.

FINDINGS AND RECOMMENDATIONS

Objective 2: *Review current methods of processing tax returns and payments and the ability to employ the latest technology in this processing.*

To accomplish this objective, OSA and KPMG contacted industry experts and tax collection entities in other states to understand their use of technology. We also interviewed DOR staff and reviewed various documentation to understand current and planned initiatives, including the Data Capture project. Additionally, we examined current operational procedures for the potential to improve effectiveness and looked closely at the causes of late refunds to taxpayers.

Conclusion: **North Carolina is a leader in the use of imaging to capture paper tax returns. The Data Capture project was well planned and included a cross section of system users, strong executive involvement, and effective vendor management. We noted concerns regarding implementation timing and the processes for handling future changes to the system. DOR has made strides in the use of enabling technology for its various tax functions. However, DOR has additional opportunities to improve support of its business mission and expand its use of E-commerce methods. From an operational standpoint, DOR needs to concentrate efforts on taxpayer assistance and developing system and processing measures to more closely monitor operations. Our analysis shows that utilizing a private collection firm to pursue past due accounts could result in significant increases in tax revenues. Lastly, DOR experienced a number of processing problems this year that resulted in late refunds to approximately 6% of taxpayers. A number of the causes, such as taxpayer errors, were outside DOR's control; others resulted from lack of adequate staff to handle the volume of work. One procedural change that could get refunds to taxpayers sooner, and result in potential savings to the State, is implementation of a direct deposit option for taxpayers.**

FINDINGS AND RECOMMENDATIONS

Data Capture

| Overview |

In an effort to solve a Year 2000 technical issue and improve forms processing efficiency within the department, the North Carolina Department of Revenue embarked on a large scale system implementation project called Data Capture. Planning for the Data Capture Project began in early 1997, with assistance obtained from IBM for design and implementation. The project was launched in June 1998 with the delivery of IBM's Project Definition and Planning document, which outlined many of the project requirements. Anticipated benefits to DOR included:

- Process and deposit remittance transactions on the same day;
- Eliminate data entry bottlenecks;
- Respond to taxpayer inquiries in a timely fashion with pertinent available data;
- Image enable selected functions requiring access to tax returns; and
- Minimize disruption to the operations of existing DOR systems.

NORTH CAROLINA'S DOR IS A LEADER IN THE USE OF IMAGING TO CAPTURE PAPER TAX RETURNS.

A number of states have implemented imaging technology to assist in performing various tax processing functions, including Nebraska, Wisconsin, Minnesota, Maine, New Mexico, and Massachusetts. North Carolina's Department of Revenue has embarked on the Data Capture project, which utilizes imaging technology for automation of returns processing. Imaging of these returns will prevent loss of forms, reduce processing time, replace storage and microfilm requirements, and eventually reduce costs. The project uses a combination of optical character recognition (OCR) and intelligent character recognition (ICR) technology to interpret data from machine and handwritten forms. The project is well underway and live scanning of individual income tax returns began in March 2000. It is anticipated that the conversion of all forms to the new technology will take one to two years.

RECOMMENDATION

We commend DOR for its efforts to employ advanced technology in the processing of tax returns. DOR should continue to refine the Data Capture functions to improve tax processing services.

THE DATA CAPTURE PROJECT WAS WELL PLANNED.

DOR management established a cross-functional team of employees to assist in the planning and implementation of the Data Capture project. This team provided a broad perspective to address the various issues the Data Capture project faced, ensuring that most of the business functions and personnel impacted by the project were represented. The project had strong executive involvement and was aggressively scoped to include forms processing and accounting functions for the majority of tax forms and remittances processed by DOR. Data Capture was planned to handle individual income, sales, and withholding taxes. The remittances and forms processed for these tax types comprise the largest processing volumes for DOR.

Additionally, our review shows that DOR has practiced effective vendor management on this project. DOR negotiated a contract with the vendor selected, IBM, that included financial payments tied to functional and technical milestones. IBM has been held to these deliverables and will not receive final payment until all requirements have been met.

The project team conducted two third party project assessments, both conducted by Keane, Inc., which evaluated the Data Capture Project at inception and mid-project. Some recommendations submitted by Keane were integrated into the project to improve the management, reporting, and functional requirements. Having a third party review a project of this magnitude improved the project's effectiveness and protected the interests of DOR. DOR and IBM have successfully implemented most of the functionality negotiated in the original contract.

RECOMMENDATION

> **We commend DOR's planning and management oversight of the implementation of the Data Capture project. DOR should continue to involve personnel from the affected functional areas as the remaining features are implemented and continue to closely monitor Data Capture operations in order to modify procedures and adjust equipment as needed.**

SEVERAL COMPONENTS OF THE DATA CAPTURE PROJECT REMAIN TO BE IMPLEMENTED.

Late in the Data Capture project lifecycle, the project fell behind schedule. Realizing that the implementation of the project was going to coincide with its busiest tax processing season, project management decided to re-scope the project, postponing the implementation of certain parts of the functionality. The management team identified the

data capture components required to efficiently process individual tax returns and had IBM concentrate implementation efforts on these items.

The functionality pieces still to be implemented are processing for remittances for large and small document on the large document scanners, and additional large document forms, including corporate, partnership, etc. Progress is continuing on implementation of these items. However, we learned that the large document scanners are not meeting the required throughput of 75,000 document scans per day. Thus, the hardware and system software may not be able to support the requirements in this area. DOR is continuing negotiations with IBM to address the throughput requirement. At the end of the audit fieldwork, the project was due to be completed by the end of September 2000.

RECOMMENDATION

DOR's Data Capture project management team should continue its efforts to implement the remaining components. As options are added, they should be adequately tested before being placed into production. DOR should continue to hold IBM responsible for meeting the technical commitment stated in the contract.

IMPLEMENTATION OF THE DATA CAPTURE PROJECT DURING TAX SEASON ALLOWED LIMITED TIME TO CORRECT PRODUCTION ISSUES.

As reported above, the timing of the Data Capture project resulted in the implementation of the system during DOR's busiest season. The project went live, with the scanning of individual tax returns, in late March 2000. Given that the individual income tax deadline of April 15 was two weeks away, the forms processing volumes quickly escalated during this time period. The high processing volumes coupled with the new operating procedures and unfamiliar technology stretched the limited work force.

Because of this, the time and effort allocated to testing was limited. DOR management felt that its priority should be on processing as quickly as possible the large volume of individual tax returns being received by DOR. Keane noted this issue in its initial review of the project, released May 1999, and noted in its subsequent review, dated June 2000, that this issue was still outstanding. DOR concurred that there was limited time for testing, but noted that the project team resolved outstanding issues that arose during testing before indicating the testing phase was complete.

RECOMMENDATION

Adequate testing time should be built into the project plan as other forms processing functions are added to the data capture environment and system modifications occur. Future system implementations and upgrades should be scheduled during the least busy season if possible. This will help the workforce adjust to new technology and continue daily operations with minimal interruption.

THERE IS NO FORMAL PROCESS FOR HANDLING FUTURE CHANGES.

Currently, the Data Capture Project team is still operating in a project implementation capacity. Therefore, weekly team meetings are held to address issues and concerns, develop solutions, and revisit the project plan. While management has discussed the need for formal change management procedures, a formal process has not been established to document the impact of changes before implementation. Additionally, feedback from data users is not collected or analyzed to determine problem trends. This shortcoming was reported by Keane in its June 2000 follow-up report. While the weekly project team meetings mitigate some exposure that may arise, DOR still had not established a formal process to document the impact of issues and changes by September 1, 2000, the end of the audit fieldwork.

RECOMMENDATION

As the production environment stabilizes and the project team disbands, a more formal process to address issues, changes, and the project/business impact of the issues and changes should be adopted. Management should also develop a feedback mechanism to analyze reported problems for patterns and educate employees on how to best use the data.

Best Practices

Overview: In reviewing technology best practices utilized by other states' tax collection agencies, we found that the states considered to be leaders focused on continuous improvement and reduction of errors and backlogs. Those states talked about three main objectives: increase in customer service, increase in voluntary compliance, and improvement of tax collection efficiency. Related to technology, we found three common categories:

- **Electronic Commerce** – consists of Electronic Funds Transfer, Electronic Filing and the interactive use of the Worldwide Web;
- **Telephony** – consists of call center software, predictive dialing software, automated call distribution (ACD) and automated switch technology; and
- **Image Technology** – used for scanning of documents utilizing intelligent character recognition (ICR) and optical character recognition (OCR).

NORTH CAROLINA'S DOR HAS CONSIDERABLE OPPORTUNITIES TO EXPAND ITS USE OF ELECTRONIC COMMERCE METHODS AND TO PROVIDE TAXPAYERS REFUNDS IN A SIGNIFICANTLY MORE TIMELY MANNER.

States considered "leaders" in the use of automated solutions to tax administration have developed and implemented a number of automated functions for tax filing and collection. The major automated programs used by other tax administrative agencies are:

- **Electronic Funds Transfer** (EFT) improves cash management by expediting the process of depositing funds, thereby maximizing interest earned. In addition, savings are realized by eliminating the work associated with receiving, sorting, processing, and transporting checks.
- **Electronic Filing** (ELF) allows taxpayers to submit federal and state tax returns electronically either through electronic data interchange (EDI) or via telephone. It is estimated that ELF reduces processing costs by up to 80%. Most states also realize significant reductions in error rates and processing time. The IRS estimates the error rate for ELF is less than 1% compared to 17% for returns submitted by mail.
- **Telefiling** is another electronic method that is showing significant promise. Massachusetts has had tremendous success with telefiling for short-form filers. The Revenue Department there estimates that processing costs for these returns have been reduced by over 75%. To file through electronic data interchange, a taxpayer can utilize a third party tax preparer or a software package for personal computers.

North Carolina already utilizes **EFT** effectively for collection of taxes due the State, with over 50% of its revenues received in this fashion. Businesses are the only users of EFT in North Carolina, composing about 1% of the total number of taxpayers for fiscal year 1999-00 but 56.3% of the revenues. However, at this time, DOR does not offer direct deposit of refunds to taxpayers' accounts. (See page 62.)

TABLE 9 Leading States In Tax Enabling Technology For Tax Year 1999			
State	Total Returns Filed	Returns Filed Electronically	Percent Filed Electronically
California	5,550,601	1,597,593	29
Massachusetts	1,529,455	623,445	41
Michigan	2,286,436	754,254	33
Minnesota	1,173,434	430,806	37
*North Carolina	3,430,228	831,068	24
*As of 10-11-00.			
Source: Federation of Tax Administrators & *NC DOR			

Table 9 shows the percentages of individual income tax returns filed electronically by states considered leaders in their use of tax enabling technology. As can be seen from the data, North Carolina's use of ELF compares favorably with other states.

North Carolina utilizes **ELF** for individual income taxes, receiving them electronically through the federal-state filing program. North Carolinians submit their tax returns to tax program software vendors, who in turn transmit the returns to the IRS. The IRS then strips off the North Carolina return and electronically forwards it to DOR. In 2000, North Carolinians filed approximately 3.3 million individual income tax returns; with approximately 24% (831,000+ to date) of those filed electronically.

While North Carolinians currently have the option of filing their individual tax returns electronically, DOR has only promoted this option on a limited basis. DOR does enclose flyers with State employees' W-2's, advertises in the State Employees' Credit Union Newsletter, provides mailings and posters to larger corporations, and provides information in the individual income tax instruction booklet. Additionally, DOR provides information when conducting seminars or other promotional meetings. Several states (Minnesota, Michigan, Wisconsin) have instituted a public information campaign to inform taxpayers of electronic options and encourage them to submit electronic forms. These campaigns have included advertising, media events, tax credit or prize incentive programs, and guarantees that refunds will be processed in a shorter period of time.

Many states are using the Worldwide Web to perform financial transactions, interactive information requests, taxpayer address changes, and forms requests. Several states are providing web access via libraries, schools, city halls, utility companies, and through kiosks in malls and banks. Many states have budgeted funds to advertise their web sites. North Carolina's DOR has a web site that is used for forms and some frequently asked questions. DOR is currently exploring ways to expand its use of electronic commerce, contracting with Keane, Inc. to conduct a study which outlines an E-commerce strategy. Key business objectives of this four year strategy are to allow DOR to process a majority of all business and individual tax returns electronically, reduce the time required to process a return, and improve customer service. If North Carolina continues to actively promote electronic filing and implements a direct deposit system, the department should adopt a goal of 7 days turnaround for individual income tax refunds. We believe this is an achievable goal as compared with other states.

RECOMMENDATION

We commend DOR for its exploration and implementation of electronic methods of providing services to North Carolina citizens. DOR should continue to build on the success of its electronic filing and electronic funds transfer programs by actively promoting their use. To do this, DOR should consider utilizing some of the promotional activities used successfully in other states. Additionally, DOR should continue developing electronic methods of tax filing, collection, and providing customer service to taxpayers. We fully support the recommendations made in the June 2000 Keane report

that will position DOR as a leader in electronic processing of taxpayer data. Lastly, North Carolina's goal should be the processing of individual tax refunds for returns filed electronically and using direct deposit so that taxpayers refunds are processed and deposited within 7 days of receipt.

Current Operational Issues

Overview
Every organization needs to have a plan for use of its resources and methods established to measure its progress against that plan. As we examined DOR's current use of technology and operational practices, we noted a number of operational and infrastructure issues that we feel could be changed to make operations more effective.

THE TELEPHONE SYSTEM FOR TAXPAYER ASSISTANCE AT DOR IS OUTDATED AND INADEQUATE.

The telephone can be a powerful tool for providing consistent, reliable customer information, as well as for increasing collections. Many states have found that by implementing a coordinated telephone operation, they can improve customer service, enhance revenues and lower costs. Another best practice found was the use of a single unit with taxpayer service responsibilities. Taxpayers had one number to call and menus to help callers choose either interactive voice response assistance, a general assistant or, for certain call types, a specialist.

In examining DOR's telephone operations, we noted the following concerns:

- DOR does not have a toll-free number[8] to accommodate taxpayers seeking assistance or information. Taxpayers outside the Raleigh area must pay long-distance charges to call DOR unless they go to a local DOR field office to make the call.
- DOR only has automated or interactive telephone devices to allow taxpayers to directly access information about their accounts for refunds and an automated system for common individual income tax questions.
- The main telephone line for individual income tax assistance can only handle three phone calls at the same time, with only two additional calls waiting in a queue.
- Each division and field office offers varying levels of telephone assistance.

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[8] DOR requested funds from the 1998-99 General Assembly to install toll free numbers. However, this request was not approved.

With approximately 3.5 million taxpayers located throughout the State, the ability to provide timely, cost-effective assistance to taxpayers is essential. The approach currently used by DOR limits services provided to taxpayers.

RECOMMENDATION

DOR should work with the State's Information Technology Services' (ITS) Telecommunications division to design and implement more effective telephone services. In our opinion, the system should include a taxpayer assistance call center, using a combination of telephone technology, interactive devices, and live assistance. Additionally, the system should be designed to actively monitor the number of calls received by type to better tailor services to the needs of taxpayers. The establishment of a single telephone center[9] with a toll-free number, appropriately staffed to receive and make outgoing collection calls and handle general taxpayer and customer inquiries, will enhance DOR's customer services and pay for itself in increased collections and reduced taxpayer burden through easier access to DOR. Other benefits include:

- **Eliminate employee unproductive time associated with telephone use;**
- **Manage telephone traffic;**
- **Measure volume and type of calls;**
- **Match the number and types of calls with DOR employees;**
- **Reduce overall call volume; and**
- **Expand and allow for 24-hour Voice Response Unit access from taxpayers.**

The new system will result in the need for additional positions to handle the expected increase in calls. See finding on page 68.

> *Auditor's Note: As part of its reorganization efforts, DOR established four major areas of business (taxpayer assistance, collection, processing, and examination) effective September 1, 2000. This change will allow for centralization of telephone strategies and operations.*

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[9] DOR management is proposing ten separate taxpayer assistance / telephone service centers across the state. In its 2001-2002 expansion budget, management requested forty-four additional positions to staff these centers.

THE RETURN MAIL UNIT IS NOT PERFORMING ITS PRIMARY DUTIES EFFECTIVELY.

GS §105-241.1 requires that the Secretary notify the taxpayer in writing of the kind and amount of tax due and the Secretary's intent to assess the taxpayer. The delivery can be in person or by the United States mail sent to the taxpayer's last known address. Except in the case of a jeopardy assessment[10], the Secretary may not assess a taxpayer until the proposed notice has been given. The Secretary must notify the taxpayer when a proposed assessment becomes final and collectible.

We learned during the audit that frequently notices sent through the US mail are returned as undeliverable. DOR established the Returned Mail unit to ensure the ultimate delivery of proposed notices returned as undeliverable by locating the taxpayer's current address. The unit must locate a current address for the taxpayer and send the required notice to that address prior to generation of the final assessment notification. The unit also processes all other returned mail.

One of the unit's primary duties is to ensure that final assessment notifications are not generated and delivered to the taxpayer prior to receipt of the proposed. This is achieved through a process called "notice suppression." To suppress a notice, the Returned Mail staff must manually stop ITAS from generating and sending penalty and final notices. On May 12, 2000, the unit had an inventory of 12,300 returned penalty and final assessment notices. We learned that this inventory resulted from the unit failing to suppress proposed notices. We further learned that these notices were sent to the same bad addresses as the original returned proposed assessment, thereby exponentially increasing the backlog of returned mail.

Based on our analysis of weekly Returned Mail activity reports, staff and management interviews, and administrative policy, we concluded that the unit is unable to fulfill its suppression duties for the following reasons:

- The unit's workload tracking/reporting is inadequate for identifying and tracking, on a daily basis, all the returned mail that needs to be suppressed.
- DOR annually shifts Returned Mail unit staff away from assessment notice suppression to other duties deemed more critical, such as processing of refunds.
- DOR's strict interpretation of "deliver" to mean, "ensure physical possession" results in a notification processing loop for all returned proposed notices that are not suppressed.

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[10] A "jeopardy assessment" is when DOR determines that any taxes due to the State are in jeopardy of collection, it may initiate an immediate assessment of all taxes found to be due.

RECOMMENDATION

The Returned Mail unit should develop a better workload tracking system to avoid compromising assessment suppression. This data should be used to determine the resources required to meet the unit's workload demand. Additionally, DOR management should conduct a cost/benefit analysis of the effort and resources used to collect these outstanding assessments. If the analysis proves that the costs outweigh the benefits, then management should request a modification to GS §105-241.1 to allow DOR to proceed with the final assessment notice after a given number of tries to locate a more current taxpayer address.

AMENDED RETURNS ARE NOT LOGGED OR TRACKED.

When an amended return is received, DOR staff is instructed to immediately deposit any remittance, thus allowing the State to have this revenue available. While the amended returns are filed alphabetically, they are not logged or tracked. Normally, amended returns cannot be processed immediately due to volume and limited personnel in this section. (These individuals are also responsible for working on refunds.) Thus, DOR does not immediately give the taxpayer proper credit for payment. Rather, the taxpayer's account shows "information with payment" or a generic overpayment until staff is able to input the specific tax changes into ITAS.

For amended returns requesting a refund, or amended returns that show a balance due without payment attached, the paper forms are stacked in order of receipt, awaiting input. If a taxpayer calls asking about his return, staff has to physically locate it in the stacks before assisting the taxpayer. (Once located, these forms are worked immediately.) There is a 1-week to 1-year backlog in processing these forms, depending on the tax schedule. Amended returns are worked depending on the priority of the tax schedule they fall within. Table 10 shows the backlog for the last three calendar years.

TABLE 10						
Amended Returns Backlog as of May 1, 2000						
Calendar Year	1999		1998		1997	
	Beginning (1/99)	Ending (12/99)	Beginning (1/98)	Ending (12/98)	Beginning (1/97)	Ending (12/97)
Sales & Use	540	535	860	540	1,020*	860
Withholding	638	3,589	3,120	638	2,440*	3,120
Corporate	1,284*	1,661	1,096	1,284*	814*	1.096
Individual	23,945	7,551	16,539	23,945	10,420	16,539
TOTALS	26,407	13,336	21,615	26,407	14,694	21,615
*Estimated based on averages from other years (some quarterly DOR counts were not performed)						
Source: NC DOR Records						

The process used for amended returns means that all taxpayer accounts with amended returns are incorrect on ITAS for a period of time. This causes confusion for the taxpayer, as well as DOR employees. Since there is no tracking system for amended forms, there is a possibility that forms could be misplaced or unduly delayed in processing.

RECOMMENDATION

DOR should immediately devise a tracking system that logs the receipt of all amended tax returns, noting the amount of payments. To reduce the backlog of returns to no more than 1 week, DOR should add additional positions to the Amended Returns section. DOR should also continue to improve explanations on bills and assessments to reduce inquiries from taxpayers. This would free more personnel for processing. See finding on page 68.

DOR DOES NOT HAVE PRINTED FORMS TO FILE AMENDED SALES AND USE TAX REPORTS.

GS §105-254 requires the Secretary of Revenue to provide forms "…suitable for carrying out the duties delegated to the Secretary." During the audit, we learned that DOR does not have an amended return form for sales and use taxes. To amend a previously submitted sales and use report, taxpayers are told to write 'AMENDED' at the top of a regular report form, use a generic tax form, amend a photocopy of the original report, or write to DOR on company letterhead concerning the change. This presents problems due to the inconsistency of the format and taxpayer failure to note clearly 'AMENDED' on the form. Frequently, amended returns are re-entered as a result. This confusion slows down sales and use tax processing, results in inaccurate sales and use tax records, and increases the existing backlog of work to be processed in the Sales and Use Tax division. Amended sales and use tax reports also affect the accuracy and amount of county and local tax revenues that are distributed from the State.

RECOMMENDATION

DOR should develop a specific amended sales and use tax form for use by taxpayers.

DOR DOES NOT USE PRIVATE COLLECTION AGENCIES AND ADVANCED TELEPHONE SYSTEMS FOR TAX COLLECTION.

One important use of telephone technology as it relates to tax collection is automatic calling or predictive dialing systems[11]. For example, the state of Massachusetts reported up to 20% increase in collections using telephone technology. We found several leading edge states utilizing private collection agencies with sophisticated technology to assist in the collection process. At least 40 states utilize private collection agencies for some aspect of assistance. DOR is in the process of developing a Request for Proposals to contract out the collection function on certain past due tax accounts. See page 73 for discussion.

RECOMMENDATION

DOR should explore alternative methods of tax collection, including the use of private collection agencies and advanced telephone capabilities to collect past due taxes. Based on the experience of other states, we estimate that North Carolina could increase its collections by 20% or $47,093,031 of our past due taxes due more than 365 days. (See discussion on page 73.)

Tax Refund Issues

Overview

Examination of DOR records for fiscal years 1994-95 through 1999-00 show that the number of returns processed by DOR has increased. (See Table 11) On average, approximately 27% of the total returns filed resulted in a refund to the taxpayer. Total refunds for these years averaged $1.46 billion annually, with refunds to individual taxpayers accounting for $970 million (66%) of that amount. Net tax revenues (minus transfers) collected by DOR for fiscal years 1994-95 through 1999-00 are shown in Exhibit 5, page 55, as are the mandated distributions and transfers to local governments and State agencies for these years.

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[11] A "predictive dialing system" would utilize information known about the taxpayer population to perform effective telephone calling during the collection process.

TABLE 11 Number of Returns by Tax Type for FY97-98 through 99-00						
	Number of Returns Processed					
Tax Type	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00
Inheritance Tax	8,527	8,000	7,931	7,959	8,385	6,526
Privilege License Tax	236,399	243,785	252,366	150,000	79,719	85,300
Tobacco Products Tax	13,322	13,448	5,017	5,050	4,878	9,517
Soft Drink Tax	10,580	11,176	7,736	7,476	7,792	0
Franchise Tax	211,901	149,914	161,030	161,075	177,706	166,124
Individual Income Tax						
Individual Income*	3,169,934	3,293,966	3,325,933	3,482,255	3,561,871	3,630,964
Estimated Income	755,559	788,762	818,727	849,218	808,635	787,826
Withholding	1,656,124	1,785,141	1,933,142	2,115,899	2,285,999	2,237,736
Corporate Income Tax	177,538	119,467	138,274	225,045	264,220	225,994
Sales and Use Tax	2,167,903	1,844,162	2,077,810	2,284,299	2,349,059	2,083,188
Beverage Tax	45,959	47,129	50,440	34,000	16,428	5,593
Gift Tax	4,355	4,000	5,142	5,129	5,862	6,039
Intangibles Tax	290,904	15,467	113	38	4	0
Freight Car Lines Tax	116	107	110	100	125	149
Insurance Tax	N/A	4,880	7,052	6,908	7,551	7,586
Piped Natural Gas						67
Real Estate Conveyance Excise Tax	400	400	410	400	410	400
Dry-Cleaning Solvent Tax				168	196	204
Primary Forest Products Tax	1,158	1,149	1,085	1,078	1,035	1,038
Controlled Substance Tax	4,991	5,026	6,069	3,092		6,850
Scrap Tire Disposal Tax	36,657	34,410	33,730	36,595	37,263	37,679
White Goods Disposal Tax	14,340	14,298	15,048	15,168	14,878	14,642
Motor Fuels Tax	169,007	120,910	54,756	54,678	56,444	56,885
TOTAL	8,975,674	8,505,597	8,901,921	9,445,630	9,688,460	9,370,307
*Includes partnerships and fiduciary returns						
Source: NC DOR Records						

EXHIBIT 5
NET TAX REVENUES AND DISTRIBUTIONS
(in millions)

IN MILLIONS

	FY94-95	FY95-96	FY96-97	FY97-98	F798-99	FY99-00
Net Tax Revenues	10287.5	10448.2	11281.1	12118.1	13064	13523.8
Reserves for Local Governments	1176.5	1286.4	1364.9	1456.9	1566.7	1695.5
Other Transfers	349.2	600.8	628.8	657.5	662.1	710.5

Source: NC DOR Records
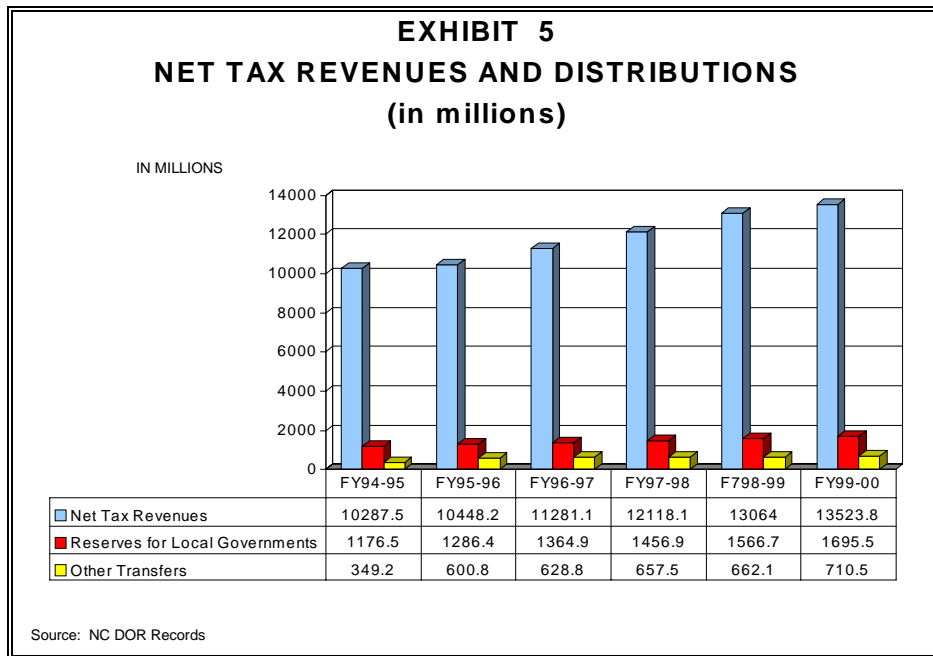
FINDINGS AND RECOMMENDATIONS

DOR'S GOAL FOR COMPLETING INDIVIDUAL INCOME TAX REFUNDS WAS NOT ACCOMPLISHED FOR THE 1999 TAX YEAR.

DOR has a long-standing goal of having all individual tax refunds processed and mailed to taxpayers by June 30 each year. For this past tax season, however, DOR processed 151,284 individual tax refunds between June 30 and August 15, 2000, or 6% of the total individual income tax refunds processed. We learned that DOR's upper management receives periodic statistical updates on certain functions for the agency. These are used to make decisions on movement of resources to address problem areas. However, no formal interim target measurements to monitor the progress of tax refund processing have been communicated to the various division heads. Without communication of the existence of and importance of these measurements, DOR's management efforts are not as effective as they could be. Since the number of individual tax refunds has varied only slightly over the last 3 years, management should be able to use this data to establish both realistic long- and short-term goals to address problem areas more quickly.

RECOMMENDATION

> **DOR should establish specific goals for refund processing, as well as a system to monitor progress, and communicate the importance of these measures to all affected personnel. Each year after the tax season has concluded, management should analyze the tax refund process to see where problems occurred and to identify changes needed.**

DESPITE ITS BEST EFFORTS, DOR'S RECRUITING EFFORTS FOR FISCAL YEAR 1999-00 DID NOT RESULT IN THE NEEDED TEMPORARY STAFF.

Each year DOR experiences a significant increase in workload in March and April as North Carolina's citizens file their individual income tax returns for the previous year. DOR's strategy to cope with the huge influx of tax returns is to use temporary employees to perform tasks that require limited experience, such as opening and preparing tax returns for scanning, managed by a core group of about 12 permanent DOR employees. This strategy requires a strong recruiting effort in an area of the State (the Triangle) where the unemployment rate has been low for the last few years. Another factor affecting DOR's recruiting efforts is its inability to pay a wage comparable to the market due to limited funding for this purpose. For this past year, DOR was only able to pay $7.12 per hour for entry-level temporary help.

DOR normally receives the largest number of returns near the tax deadline date, which this year was April 17, 2000. Despite its best efforts, only 54% of the number of temporary employees that management had determined were necessary to handle the

massive process of extracting and sorting incoming mail were employed by April 12, 2000, the beginning date for the mass opening of tax returns. Although DOR's efforts ultimately resulted in the hiring of 408 temporary employees between January 1 and June 30, 2000, this was only 61% of the estimated 665 temporary workers needed to effectively handle the volume of returns received this year. Because of its problems in obtaining enough temporary employees, management was forced to use permanent employees from all sections of the department to supplement the efforts of the temporaries. While using permanent employees has become a normal yearly practice for DOR, as noted throughout this report, this situation has resulted in numerous areas where "routine" work has backlogged.

RECOMMENDATION

We commend DOR's efforts in finding a way to handle the "tax season" volume by using available resources. Since the pool of entry level people is so small in the Triangle area, one option DOR should explore as a long-term solution is the feasibility of establishing a mail center for opening, sorting, and preparing returns in one of the low employment counties in the State. Table 12 shows unemployment rates for a number of counties within an hour's drive of Raleigh. The prepared returns could be transported back to the Raleigh center for scanning and input into ITAS. Another alternative

TABLE 12 Selected County Unemployment Rate--Year 2000					
County	Month				
	Jan	Feb	Mar	April	May
*Edgecombe	8.3	7.7	6.9	5.8	6.7
*Nash	5.1	6.0	4.8	3.8	4.4
*Vance	5.6	6.4	6.2	8.5	10.1
**Wake	1.5	1.6	1.4	1.1	1.4

*Driving distance: approximately 1 hr from Wake County
** County in which processing and majority of temporary employee recruiting currently occurs

Source: NC Employment Security Commission

would be to bus workers in from a low employment county each day for the "tax season." While both these alternatives have costs and security issues connected to them, both should be fully explored as long-term solutions to the problem. A more immediate solution would be to increase funding for temporaries to allow DOR to offer a competitive wage to entry level personnel in the Triangle area. Lastly, DOR should continue to promote electronic filing of returns as discussed on page 47 to reduce the number of paper returns that must be manually processed.

FINDINGS AND RECOMMENDATIONS

THE START DATE FOR THE MASS MAIL EXTRACTION PROCESS DID NOT CONTRIBUTE TO THE REFUND DELAYS.

Each year, DOR leases commercial space accommodating at least 200 people who do nothing but open and sort tax documents during the "tax season." Historically, this event begins around the individual income tax deadline date, April 15. The process began this year on April 12, 2000, a few days earlier than normal due to the volume of returns already received. On March 30, 2000, there were approximately 714,000 unopened refund envelopes waiting for the mass extraction process to begin. When the process started, the number of tax returns had already reached a level to where many returns received in mid-April were not opened until three weeks after receipt. Extraction continued until the first week of May 2000, a week beyond the previous year's end date, due to the volume and the problems finding temporary help.

This year DOR implemented the Data Capture system which allows DOR personnel to scan tax data into ITAS instead of having to manually input the data. This process will serve to speed up the processing of returns (see discussion on page 43). Of course, the data capture equipment cannot be used to expedite processing until the return is extracted from the envelope. Since this was the first time DOR used data capture, there was a learning curve for personnel and equipment adjustments that had to be made. For these reasons, DOR could not have processed returns any faster even if the mail extraction process had begun much earlier.

RECOMMENDATION

As data capture reaches it full potential, DOR should develop a plan to start the mass extracting and sorting process earlier in the "tax season". This should allow processing of the refunds in a more timely fashion in coming years.

THE TOTAL INTEREST PAID ON LATE REFUNDS FOR FISCAL YEAR 1999-00 EXCEEDED THAT PAID FOR FISCAL YEAR 1998-99.

GS §105-266(b) requires DOR, as the tax collection agency for the State, to pay interest[12] on tax refunds that are not paid timely. Due to the many different situations that can affect the processing of tax returns, paying interest on refunds processed after the statutory deadline is a normal part of DOR's operations and will continue to be.

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[12] Interest on an overpayment of a tax levied under Article 4 or Article 8B of this Chapter accrues from a date 45 days after the latest of the following dates until the refund is paid: the date the final return was filed; the date the final return was due to be filed; or the date of the overpayment.

During fiscal year 1999-00, DOR experienced problems in processing individual income tax returns, resulting in the need to pay taxpayers interest. As shown in Table 13, the total interest paid to *individual* taxpayers was actually less in 1999-00 than it was in 1998-99. The increase in **total interest paid** resulted from a significant increase to *corporate* taxpayers. DOR records reveal several factors played a part in this increase. First, audits of a few large North Carolina corporations revealed that the State owed these corporations refunds on over-payment of taxes, some for previous tax years. Second, unique fiscal circumstances occurring during fiscal year 1999-00 contributed to a projected State budget deficit which resulted in a decision directing the Department of Revenue

Table 13 INTEREST PAID ON REFUNDS As of 8/30/00			
Year	Individual Income	Corporate*	Total
1994	$ 26,445	$	$ 26,445
1995	2,195,488		2,195,488
1996	2,849,819		2,849,819
1997	3,374,644	3,649,469	7,024,113
1998	4,469,450	7,482,234	11,951,684
1999	5,018,908	4,578,268	9,597,176
2000	4,161,121	10,877,213	15,038,334
*Note corporate information was not in ITAS for years prior to 1997 Source: DOR Records			

to hold these refunds until after the beginning of the new fiscal year. As a result of these events, the State had to pay taxpayers approximately 57% more in interest for late refunds this year than it did for fiscal year 1998-99. Table 13 shows the amount of interest paid on individual and corporate income taxes for fiscal years 1996-97 to 1999-00. We should note that the State did earn approximately $3.0 million in additional interest on these funds during the period June – August 2000 that it would not have had if the refunds had been paid prior to June 30.

RECOMMENDATION

DOR management should determine the most common reasons for having to pay interest to taxpayers for late refunds. Management should then devise strategies to reduce the need for interest payments to the extent practical.

TAXPAYER ERRORS CONTRIBUTED TO REFUND DELAYS.

The 1999 North Carolina Individual Income Instructions Booklet contains guidelines for completing individual income tax return forms. We learned during the audit that some taxpayers do not comply with the guidelines or commit errors that delay the processing of returns. During review of the opening and verification process, we observed

TABLE 14 Common Taxpayer Errors That Affect Processing Time
• Math errors
• Personal Exemption and Standard Deduction adjustments
• Not including applicable schedules with returns
Source: DOR Records

returns that exhibited many of the errors listed in Table 14.

Processing delays occur because these errors either required research or caused the return to be manually keyed rather than scanned through the data capture equipment. Returns that require research are delayed due to a limited number of personnel available to research the problems. Errors could delay a refund from a few days to weeks, depending on the number of returns that require review. DOR was unable to provide us the percentage of returns that was delayed due to taxpayer error.

RECOMMENDATION

While there is no way to completely eliminate taxpayer errors, DOR should continue to highlight the effects of errors and non-compliance with instructions in the tax return instruction booklet. Additionally, DOR should highlight this information on its web site and all other tax publications distributed to citizens.

COMPETING DEPARTMENTAL RESPONSIBILITIES CONTRIBUTED TO DELAYS IN REFUNDS.

Although DOR management has made refunds a priority, other departmental responsibilities also require significant attention and are considered priorities. These responsibilities include opening, processing, and depositing tax payments and the preparation and mailing of taxpayer notices and assessments.

Each year the tax refund process is extremely intense between February and June. However during that same period, tax payments are received and must be processed. Although payments are processed as expeditiously as possible, the information on the tax return filed with the payment is not entered in ITAS until a later time since DOR concentrates on processing returns due refunds. During the February - June period this year, DOR processed three million tax payments.

Many of the same resources used to prepare refunds for mailing are also involved in the preparation of the notices and assessments that must be mailed during the "tax season." From January - June 2000, over one million notices for taxes due the State were prepared, reviewed, folded, and mailed from DOR. This task was performed by many of the employees who also prepare, burst, and insert refund checks to be mailed.

RECOMMENDATION

DOR management should continue utilizing existing resources to balance competing priorities. Additionally, DOR should actively market the benefits to taxpayers of electronic filing and implement

direct deposit options. (See discussion on page 62.) Use of electronic commerce options should increase DOR's efficiency and greatly reduce the volume of work that has to be manually handled within the February – June period each year.

INEXPERIENCE WITH NEW EQUIPMENT DELAYED RETURN PROCESSING.

As part of its efforts to modernize the State's tax function, DOR purchased new equipment to enhance the processing of tax information. During the 1999 filing season, DOR placed in operation mail sorters, data capture scanners, and desk-top personal computers. DOR provided initial training to staff under controlled conditions. However, under actual processing conditions, unforeseen difficulties arose that required on-the-job training to solve. Table 15 shows the equipment, its use, and problems that surfaced during processing to hinder the refund process.

TABLE 15 New DOR Equipment And Problems That Resulted			
Equipment	Use	Problems	Result
Sorter	Sort and open tax returns	• Documents received that were too thick to be processed by the sorter would cause the machine to stop	• Mail required re-routing • Mail was processed at a slower rate by hand • Delayed processing of tax information
Data capture scanner	Capture information from return by imaging	• Improper maintenance caused scanners to distort the return image • Determination of the causes for paper jams • Proper document set-up to prevent image duplication	• Information input slowed • Delayed the processing of tax information
Desk-top Personal Computers	Research tax return information	• Operational learning curve for staff assigned to review suspense items • Manipulation of appropriate research screens	• Suspense items were cleared at a slower rate • Delayed refunds process
Source: DOR Employees			

RECOMMENDATION

DOR management should review the efficiency of the employees involved in all phases of the tax return process, especially in the areas in which there were bottlenecks. After this review, management should determine what further training would be beneficial in increasing the effectiveness of these employees. The training program should include both permanent and temporary employees as they join DOR.

REFUNDS WERE DELAYED DUE TO THE LACK OF DIRECT DEPOSIT.

DOR participates in the electronic-filing program with the Internal Revenue Service (IRS). Taxpayers, filing electronically, submit their returns to a tax program software vendor. The software vendor then transmits the return to the IRS. DOR downloads the data approximately 48 hours after the taxpayer files the return. The 48-hour delay results because the IRS has to strip off the North Carolina return and then forward this to DOR. Additionally, DOR does not offer the service of directly depositing refunds to taxpayers' bank accounts. DOR management estimates refunds are delayed 6 to 8 days without this service.

TABLE 16	
Estimated Savings (Costs) Associated With Direct Deposit	
Estimated Costs for Direct Deposit	
a. Total Number Refund Checks (FY1998-99)	2,556,079
b. Estimated Check Production Cost[1]	X $2.50
c. Estimated Cost To Produce Refund Checks (a x b)	$6,390,198
d. Estimated Direct Deposit Transaction Fee[2]	$0.45
e. **Estimated Cost to State for Direct Deposit (axd)**	**$1,150,236**
f. POTENTIAL SAVINGS IF 100% OF REFUNDS ARE DIRECT DEPOSITED (C-E)	**$5,239,962**
Potential Lost Interest	
g. Total Amount of Refunds (FY1998-99)	$1,600,000,000
h. Daily Interest Rate (assumes 6% annual rate)	X .00016438
i. Potential Interest Earned Per Day (g x h)	$263,008
j. Estimated Number of Days Interest Not Earned if Checks Direct Deposited	X 6
k. **Potential Lost Interest (i x j)**	**$1,578,048**
ESTIMATED NET SAVINGS TO STATE IF 100% OF REFUNDS ARE DIRECT DEPOSITED (F-K)	**$3,661,914**
(1) DOR was not able to provide the cost of check production. Estimated by OSA based on experience of other state agencies. Estimate includes: computer time, personnel costs, supplies, postage.	
(2) Estimated transaction fee for direct deposit—First Union National Bank	
Sources: Compiled by OSA based on DOR Records	

Based on our analysis, we

estimate that the State could realize an annual savings from use of direct deposits for tax refunds, as shown in Table 16. The amount of savings would depend on the percent of refunds directly deposited, as shown in Table 17. Savings would result from reduced costs to prepare and distribute the refund checks. There would be some start-up costs associated with implementing a direct deposit option for taxpayers. Issues that would need to be considered include: additional technology costs,

TABLE 17		
Estimated Savings Based On Percent Of Refunds Direct Deposited		
Percent	**Potential Savings**	**Estimated Net Savings**
100	$5,239,962	$3,661,914
80	4,191,970	2,929,531
60	3,143,977	2,197,148
40	2,095,985	1,464,766
30	1,571,989	1,098,574
Sources: Compiled by OSA based on DOR Records		

some staffing costs, telephone assistance costs (see page 50 for recommendation on taxpayer assistance call center), and costs associated with tax form changes to include taxpayer account information. We are unable at this time to estimate the total of the start-up costs.

RECOMMENDATION

DOR should develop a plan to implement direct deposit of tax refunds immediately. As part of the plan, DOR should develop a strategy to allocate the required resources to this project to increase taxpayer satisfaction and reduce the operational costs associated with the mail process.

"SUSPENDED" RETURNS CONTRIBUTED TO REFUND DELAYS.

When the Integrated Tax Administration System (ITAS) detects an error while processing a tax return, the system "suspends" processing. The suspended return is flagged for manual review and correction. By the first week of March 2000, the number of individual returns in suspense status was nearly double the number of suspended returns at that same time for the previous two years. See Exhibit 6. Many of the suspended items were for tax vouchers not in place in prior years. At mid-April 2000, the number of individual income items in suspense had already surpassed the two previous years' highest levels, while continuing to rise. This was before the majority of on-time returns had been opened and processed. The maximum number of individual income items in suspense for the 1999 tax year occurred later this year than in previous years and was more than triple the highest number of individual income items in suspense at any one time for the previous two years.
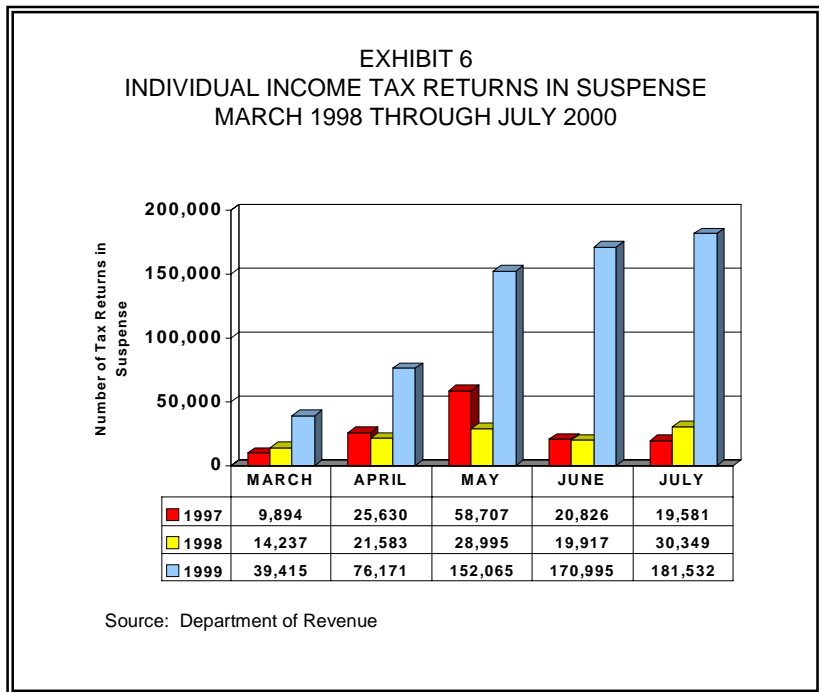
EXHIBIT 6
INDIVIDUAL INCOME TAX RETURNS IN SUSPENSE
MARCH 1998 THROUGH JULY 2000

	MARCH	APRIL	MAY	JUNE	JULY
1997	9,894	25,630	58,707	20,826	19,581
1998	14,237	21,583	28,995	19,917	30,349
1999	39,415	76,171	152,065	170,995	181,532

Source: Department of Revenue

The increase in the number of items in suspense can be attributed to several factors:

- Significant changes in the tax form for 1999, which resulted in taxpayer and other errors,
- Data capture imaging more data than previously entered manually, thereby increasing the chance of an error being detected,
- Data capture not able to scan some forms from specific vendor tax packages due to vendor changes,
- A shortage of employees to handle suspense items, and
- An increase in North Carolina's population resulting in more returns filed.

In order to help resolve the volume of suspense items, DOR shifted personnel from other divisions, where their duties were placed on hold, causing their work to also fall behind schedule.

RECOMMENDATION

To reduce the number of items that are placed in suspense status requiring manual handling, DOR should continue to promote electronic filing. This would reduce the number of taxpayer errors and allow the input of tax information directly into ITAS. Since all taxpayers will not file electronically, DOR should increase its efforts to educate the public concerning the proper methods and format for completing tax forms. Further, DOR should create a tracking system that notes the causes of suspended items and look for trends in order to quickly and efficiently solve repeat problems. Finally, DOR should have a plan in place to quickly resolve any build up of suspense items when the volume reaches a pre-defined level. This may require additional staffing. See finding on page 68.

FINDINGS AND RECOMMENDATIONS

> ***Objective 3: Review the internal organization and management structure, and current and future staffing requirements.***

To satisfy this objective, we examined organizational charts, personnel records, and internal reports on planned organizational changes and DOR management identified staffing needs. Additionally, we determined the number of positions requested from the General Assembly and the number of positions approved. We used this information to compare to the needs we noted in various areas throughout the department as we conducted the audit.

Conclusions: Lack of sufficient and trained staff inhibits DOR productivity. We documented various problem areas throughout the report. One area of specific concern is for information technology staff. DOR is competing for technical staff in an area of the State where the private industry salary ranges are significantly higher than those DOR can offer. Additionally, due to workloads, training needs of DOR staff are not being met. Lastly, we note that there is a potential to increase the tax revenues to the State by increasing the number of interstate audit positions. Overall, we have identified 74 positions that we believe are needed to adequately staff the functions and duties discussed in this report. (We should note that DOR management has identified additional positions that it feels are needed which we did not address in the report.)

Overview

The Department of Revenue has a limited number of staff to perform all duties assigned to it by the General Assembly. DOR management must balance the available staff with the various competing priorities of the department. The movement of employees to different tasks, depending on which area has the greatest need, is a standard practice for DOR. During this past tax season, employees were once again moved to various positions supporting functions in critical need of personnel. However, this year DOR management had to make decisions on where to concentrate resources to handle a number of non-standard situations, including implementation of new technology, refund returns in suspense, the Revenue Generation Project, hurricane impact, processing Federal retirees' refunds, and refunds due to the repeal of the Intangible Tax. Exhibit 7, page 66, shows the organizational structure in place during the audit. DOR was making some organizational changes as the audit progressed to try to address many of the resource issues identified in this report. Exhibit 8, page 67, shows the organizational structure in place as of September 1, 2000.

EXHIBIT 7
NORTH CAROLINA DEPARTMENT OF REVENUE
CURRENT ORGANIZATIONAL STRUCTURE
AS OF NOVEMBER 1999

Secretary of Revenue

Executive Assistant

Personnel

Internal Auditor

Public Information Officer

Special Assistant

Assist. Secretary for Planning, Dev. & Technology

▶ **Business Systems Development & Support**
▶ **Technology Services**
▶ **Database Administration**
▶ **Quality Assurance**
▶ **Production Systems & Integration & Coordination**

Assist. Secretary Hearings Officer

Assist. Secretary for Tax Administration

▶ **Ad Valorem Tax**
▶ **Corp., Excise & Insurance**
▶ **Personal Taxes**
▶ **Sales & Use Tax**
▶ **Tax Research**

Deputy Secretary

Assistant Secretary for Tax Compliance

▶ **Office Exam. Div.**
▶ **Office Services Div.**
▶ **Motor Fuels Tax Div.**
▶ **Doc. & Payments Processing Div.**

Assistant Secretary for Field Operations

▶ **Interstate Audit Div.**
▶ **Examination Div-West**
▶ **Examination Div-East**
▶ **Collection Div-West**
▶ **Collection Div-East**
▶ **Unauthorized Substance Div.**

▶ **Criminal Investiga-tions**
▶ **Admin. Services**
▶ **Planning**
▶ **Security**
▶ **Training**
▶ **Financial Services**

Source: NC Department of Revenue

EXHIBIT 8
NORTH CAROLINA DEPARTMENT OF REVENUE
CURRENT ORGANIZATIONAL STRUCTURE
AS OF SEPTEMBER 2000

Secretary of Revenue

Executive Assistant

Personnel

Internal Auditor

Public Information Officer

Special Assistant

Assist. Secretary for Planning, Dev. & Technology
► Business Systems Development & Support
► Technology Services
► Database Administration
► Quality Assurance
► Production Systems & Integration & Coordination

Assist. Secretary Hearings Officer

Assist. Secretary for Tax Administration
► Property Tax
► Corp., Excise & Insurance
► Personal Taxes
► Sales & Use Tax
► Tax Research

Deputy Secretary
► Criminal Investiga-tions
► Admin. Services
► Planning
► Security
► Training
► Financial Services

Assistant Secretary for Tax Compliance
► Doc. & Payments Processing Div.
► Taxpayer Assistance
► Motor Fuels

Assistant Secretary for Field Operations
► Examination Div.
► Collection Div.
► Unauthorized Substance Div.

Source: NC Department of Revenue

67

Since fiscal year 1987-88, the General Assembly has approved a number of new positions, both permanent and part-time, to allow DOR to better administer North Carolina's tax function. (See Table 18). DOR management has been able to shift positions away from many areas where technology has been implemented to reduce the number of new positions requested. However, the number of taxpayers continues to increase, thereby requiring even more people to handle the volume of returns.

TABLE 18 Changes In Number Of Positions FY87-88 To FY99-00				
Fiscal Year	Permanent Full-Time	Temporary Full Time	Temporary Part-Time	Temporary Time Limited
87-88	25	20	23	0
88-89	11	17	6	0
89-90	152*	45	3	0
90-91	-31	13	4	0
91-92	-8	107	-25	0
92-93	-12	18	3	0
93-94	9	6	9	0
94-95	41**	1	1	0
95-96	-15	9	0	2
96-97	9	68	-10	0
97-98	4	17	41	-2
98-99	8	2	0	1
99-00	51	0	0	1
TOTALS	244	323	55	2

*135 of these positions were for the Taxpayer Amnesty Program
**40 of these positions were for data entry
Source: NC Office of State Personnel and DOR

THE DEPARTMENT OF REVENUE LACKS SUFFICIENT STAFF FOR A NUMBER OF CRITICAL FUNCTIONS.

As we conducted the audit, we noted a number of areas throughout the department where there were backlogs of work, as discussed in this report. We learned that a major factor in the backlogs was DOR management's practice of pulling employees from all sections within the department to process individual tax returns each year. Management has been forced to do this in order to process the tax returns in a more timely manner. As reported earlier, the number of individual tax returns has been increasing as North Carolina's population continues to grow. Additionally, DOR has not been able to find the needed number of temporary employees to handle many of the functions associated with the "tax season" such as opening, sorting, and preparing the returns for processing. (See discussion on page 56.) Thus, management has utilized the personnel resources it has available, balancing competing priorities. However, to adequately staff the functions as identified in this report, we believe DOR's staff should be increased by 74 positions as shown in Table 19. We should note that DOR management has identified a number of additional positions it feels are needed in various areas that we have not included in Table 19. In examining DOR's list of needed positions, we feel that there is validity to the request, but we did not develop the level of detail during the audit that would fully support the request. Therefore, we have not included an additional 28 positions identified by the department. (Beginning on page 70, we have noted areas where we believe DOR management should continue to evaluate the need for additional positions.)

FINDINGS AND RECOMMENDATIONS

RECOMMENDATION

To adequately staff the Department of Revenue, the General Assembly should approve 74 new positions. These positions should be assigned to the areas noted in Table 19. As previously recommended, the General Assembly should approve additional funding for temporary positions so that DOR no longer has to pull permanent employees to perform non-technical functions during the tax season. DOR management should continue to monitor staffing needs and the effects of increasing reliance on technology. In our opinion, the technology DOR is in the process of implementing should ultimately reduce the number of permanent and temporary positions needed if the volume of work remains at the current level.

Division/Function	Positions Needed[1]	Position Titles	Cost of Positions[2]	Costs of Benefits[2]	Total
Office Examinations/ RAR Processing	8	Revenue Tax Auditor I	$360,672	$155,089	$515,761
Office Services/ Correspondence	5	Revenue Admin. Off I	$236,030	$101,493	$337,523
Office Services/ Taxpayer Asst.	9	Revenue Tax Tech.	$284,850	$122,486	$407,336
Office Services/ Taxpayer Asst.	3	Revenue Admin. Off I	$141,618	$60,896	$202,514
Office Services/ Taxpayer Asst.	2	Revenue Admin. Off II	$103,458	$44,487	$147,945
PD&T/ Training	3	Computer Training Spec. III	$118,500	$50,955	$169,455
PD&T/ Training	1	Computing Consultant II	$43,117	$18,540	$61,657
PD&T/ Help Desk	2	Computer Consult. I	$79,000	$33,970	$112,970
PD&T/ PSIC	3	Rev. Admin. Officer II	$155,187	$66,730	$221,917
Office Exam./ Amended Returns	12	Revenue Tax Auditor I	$541,008	$232,633	$773,641
Office Exam./ Amended Returns	7	Revenue Tax Tech.	$221,550	$95,267	$316,817
Interstate Auditing	1	Rev. Field Auditor II	$51,729	$22,243	$73,972
Interstate Auditing	1	Rev. Field Auditor III	$56,744	$24,400	$81,144
Field Examination	9	Rev. Field Auditor I	$424,854	$182,687	$607,541
Field Examination	3	Rev. Field Auditor II	$155,187	$66,730	$221,917
DPPD/ Post Data Capture	5	Processing Asst. IV	$123,040	$52,907	$175,947
TOTALS	74 [3]	**Total**	**$3,096,544**	**$1,331,513**	**$4,428,057**

[1]Number of positions needed as identified by DOR management.
[2]Salary costs are computed based on the midpoint of the pay grade, using 43% for benefits.
[3]The department has requested an additional 28 positions in its budget request which we have not included.
Source: Compiled by OSA & KPMG based on DOR budget request data.

FINDINGS AND RECOMMENDATIONS

DOR USES A NUMBER OF CONTRACTORS TO RUN AND SUPPORT ITAS.

The complexity and sophistication of information technology (IT) requires specialized skill sets and expertise for employees at all levels. The State's existing personnel practices do not support attracting and retaining the best talent to support this critical area. The State salary scales for these positions appear to be below the private market for skilled IT professionals. This hampers the State in competing with local employers for experienced IT professionals or recent college graduates. The classification system compounds the problem by limiting the grade and salary levels of top IT personnel. This prevents the type of career growth available in the private sector.

The PD&T support organization (DOR's IT staff) currently has shortages in a number of key skill areas. To obtain these key skills, PD&T either shifts the work to other areas or employs the use of contractors. This is a standard practice used by other states' revenue departments since many may experience the same type problems. Since DOR must request new positions from the General Assembly before increasing its staff, contractors are used to complete the work. Approximately 20% of the PD&T function is staffed by contractors.

RECOMMENDATION

The State should continue to explore more effective ways of attracting qualified IT professionals such as establishing a career track for technology professionals that would allow advancement. DOR management should determine if the number of positions supporting ITAS requirements should be increased for critical areas within PD&T.

TRAINING NEEDS OF DOR PERSONNEL ARE NOT BEING MET.

Based on the results of interviews and surveys, employees who use ITAS are concerned with the lack of ongoing, hands-on training in the proper use of all ITAS systems. Technical and user training has been minimal since the original ITAS implementation. Lack of proper training forces the user to ask for peer support from other users at DOR who may or may not be able to address the problem. Peer support provides limited effectiveness in increasing knowledge and providing help to ITAS users.

All users feel training is a necessary part of maturation of the system. Staff reported that the training material available on ITAS is poorly designed and documented, which makes it difficult for new staff to understand system set up and operation. Adequate training will help employees learn new skills, reduce time consuming questions made to co-

workers, and generally improve productivity. Based on interviews, the last formal ITAS training occurred 4-5 years ago when the system was implemented.

As discussed throughout this report, DOR experienced considerable work backlogs in a number of key functional areas during this past year. Many of the backlogs can be attributed to the fact that employees were having to learn new duties and procedures on-the-job. In reviewing DOR's training efforts, we learned that DOR does not have a formal training process; most training has been conducted by either the Personnel division or the Planning, Development and Technology division. Cross-departmental coordination of training was minimal. As a result, some sections received more training than others, and some divisions resorted to providing specific training only to their staffs. A poorly trained staff leads to errors, inconsistent procedures, and contributes to inefficiencies.

RECOMMENDATION

DOR management recently established a formalized training function for the department. At the time of the audit, benefits of this function had not yet been realized. Training should be coordinated and flexible to allow supervisors to better coordinate training with the workflow. As a part of DOR's performance management process, supervisors should identify each employee's weaknesses and determine what training would address these and enhance the employee's strengths. Lastly, DOR should make the development of ITAS training courses and training materials for staff a priority.

INCREASING THE NUMBER OF INTERSTATE REVENUE AUDITORS COULD GENERATE SIGNIFICANT NEW REVENUE FOR NORTH CAROLINA.

Many of the corporations that file North Carolina taxes have corporate headquarters located in a state other than North Carolina. North Carolina's DOR has a specific division (Interstate Audit) to audit such companies. There are 38 auditors in this division who perform audits of corporate income taxes, sales taxes, and franchise taxes. Exhibit 9, page 72, shows the states where North Carolina currently has interstate auditors working. For the period under audit, assessments by the 38[13] interstate auditors were

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[13] Of the 38 interstate auditors, 27 live in the states where they conduct the majority of their audits; another 11 interstate auditors operate out of the Raleigh office, travelling an average of 18 weeks per year. Additionally, most Revenue Field Offices have limited out-of-state territories assigned to them.

$85,396,024, or approximately $2,247,264 per auditor[14]. Based on information received from DOR, there are 18,000 active registered merchants with out of state addresses eligible for audit. However, with limited staff, only the most lucrative companies are being audited. Realizing this, the General Assembly approved 8 new positions for interstate auditors during the 1999-00 session. DOR is currently in the process of determining where these new auditors will be located.

RECOMMENDATION

Based on the analysis above, DOR should request additional interstate audit positions from the General Assembly. Increasing this function could significantly benefit North Carolina.

State	# of Positions
California	4
Connecticut	2
Florida	2
Georgia	3
Illinois	2
Maryland	1
Massachusetts	1
Minnesota	1
Missouri	1
New Jersey	1
New York	2
Ohio	2
Pennsylvania	2
Texas	3

EXHIBIT 9
Out-of-State Locations

Source: NC Department of Revenue

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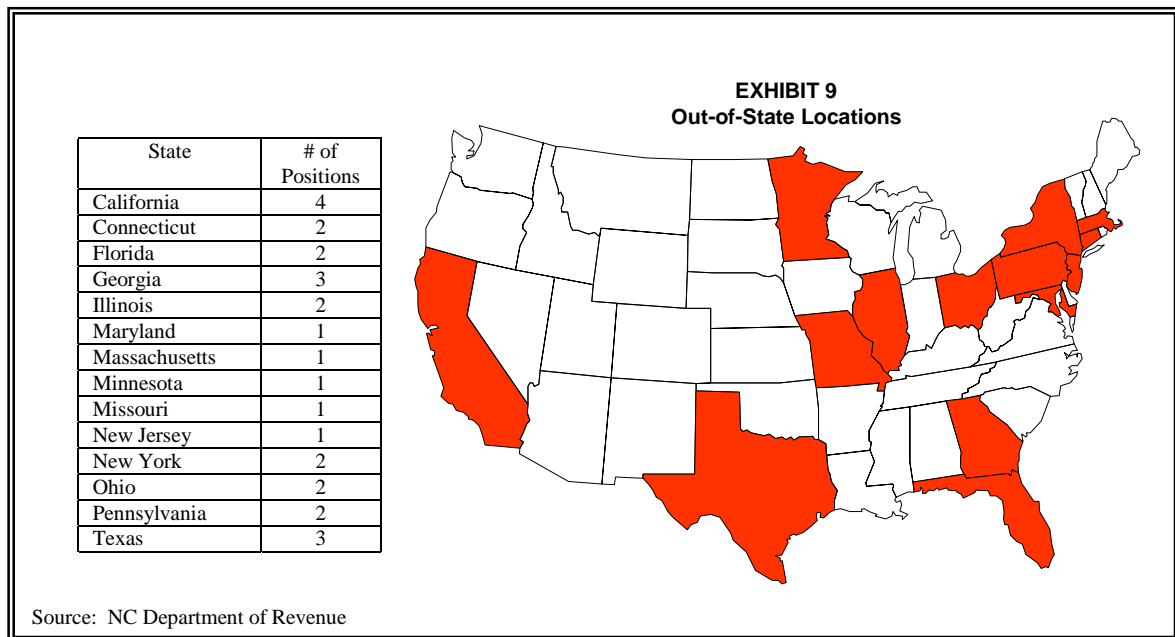
[14] This is compared to $34,951,695 or $249,655 per auditor for the 140 in-state auditors. By this comparison, we **do not** mean to indicate that North Carolina should cease having in-state auditors. They perform a much needed function for the State.

FINDINGS AND RECOMMENDATIONS

> **Objective 4: Review budgeting and the fiscal management aspects of DOR.**

To achieve this objective, we examined DOR's budgeting processes and the fiscal management of State funds by DOR's various divisions. Additionally, we reviewed DOR's Cash Management Plan.

Conclusion: **DOR's accounts receivable balance has increased 28% during the last three fiscal years. Management has not had sufficient staff resources to be able to actively work the accounts receivable and is in the process of contracting with a private collection firm to address this problem. DOR's cash management plan has not been updated since 1987. Additionally, different areas within DOR are not in compliance with the State's Daily Deposit Act, resulting in lost interest to the State. Lastly, we noted that the Motor Fuels division is not properly computing interest on Motor Fuels taxes and refunds due.**

Overview

Budgeting and fiscal management responsibilities are assigned to the Financial/Accounting division within DOR. This division is responsible for all of the financial reporting requirements of the department. This includes the accounting and reporting of all tax revenues and disbursements under the Revenue Laws and the Machinery Act of North Carolina and the accounting and reporting of all departmental budgetary functions: processing of payroll, maintaining time records for employees, payments to vendors, budgetary transfers, daily, monthly and annual financial reports, reconciliation of bank accounts, and processing manual tax refunds. Additionally, the division prepares all annual and biennial expansion and continuation budgetary requests for the department.

ACCOUNTS RECEIVABLE HAVE BEEN INCREASING OVER THE PAST THREE YEARS.

Accounts receivables are assessments due from taxpayers, in layman's terms, uncollected revenues. Currently, the Office Service division of DOR has responsibility for accounts receivable. Over the past three years, DOR's accounts receivable have been increasing, as shown in Table 20. At

TABLE 20 Aging of Accounts Receivable: FY1997-98 through FY1999-00			
	FYE 6/30/98	**FYE 6/30/99**	**FYE 6/30/2000**
0-30 days	$ 15,376,522	$ 11,198,779	$16,205,239
31-60 days	$ 12,042,233	$ 9,247,132	$12,420,417
61-90 days	$ 21,660,720	$ 8,613,896	$11,229,176
91-120 days	$ 4,741,326	$ 7,818,783	$10,366,947
121-180 days	$ 44,006,472	$ 22,271,264	$21,381,165
181-365 days	$ 16,456,552	$ 42,133,576	$35,282,741
Over 365 days	$ 152,313,030	$211,887,823	$235,465,156
Total	**$ 266,596,855**	**$313,171,353**	**$342,350,841**
Source NC DOR			

June 30, 2000, accounts over 365 days past due had risen to 69% of the total accounts receivable balance, up from 57% at June 30, 1998. This increase is due to limited ITAS support, lack of staff, and lack of technology tools to effectively manage the receivables. Failure to collect these accounts results in lost revenue to the State, and increased work for staff in the form of correspondence and telephone calls, thereby increasing costs to the State. Additionally, the older the receivable, the less likelihood of collection. DOR is in the process of developing a request for proposals for a performance-based contract for collecting difficult tax assessments, which should begin to address some of these issues.

RECOMMENDATION

DOR should implement additional case management functionality to more effectively manage its accounts receivable. This functionality should allow debt scoring and performance measures which will automate payment agreements and wage garnishments, track debt activity, prioritize cases, reduce case cycle time, increase the collection rate, and move cases to the most efficient collection resource. DOR should also move the accounts receivable function from the Office Service division to the Financial/Accounting division to allow for more effective oversight. Lastly, DOR should continue its efforts to hire a private firm to collect past due tax assessments.

DOR'S CASH MANAGEMENT PLAN IS OUTDATED.

As part of the audit, we obtained a copy of DOR's *Cash Management Plan* on file with the Office of State Controller. The plan has not been updated since its original development in 1987. Much of the Cash Management Plan is out-dated and needs to be made current. GS §147-86.10 requires all state agencies to have a cash management plan and to file it with the Office of the State Controller.

RECOMMENDATION

DOR should update its Cash Management Plan to reflect current policies and procedures. The plan should be updated periodically and forwarded to the Office of the State Controller to be in compliance with statewide policy.

SECTIONS IN DOR ARE NOT IN COMPLIANCE WITH THE DAILY DEPOSIT ACT.

The State has established certain timeframes for agencies to meet regarding the deposit of State funds to maximize availability. In certain situations, the State Treasurer may grant

an agency an exemption from strictly meeting these deadlines. Our examination showed that in 1987, DOR requested and received permission from the Treasurer to have leeway in making deposits from its field offices. However, this exemption did not specify the timeframe that DOR should meet, nor has it been reviewed and updated.

DOR has 37 field offices located throughout the State as shown in Exhibit 10. One of the responsibilities of the field revenue officers is to collect monies from taxpayers on delinquent accounts. Additionally, they accept payments for current non-delinquent accounts. Collections are recorded on a daily report and the following day the reports along with the collections are sent via state courier mail to Raleigh to be processed and deposited. Based on data supplied by DOR, this process results in receipts being deposited on average 4 to 6 days after the initial collection. For fiscal year 1999-00, the field offices collected in excess of $210,000,000 on delinquent accounts and current collections, an average of $843,373 daily. The State could earn as much as $693 daily (6% interest annually) on that money. Therefore, we estimate the current process used by DOR for field receipts is costing the State $172,500 in lost interest annually.

EXHIBIT 10
Field Office Locations

Source: NC Department of Revenue
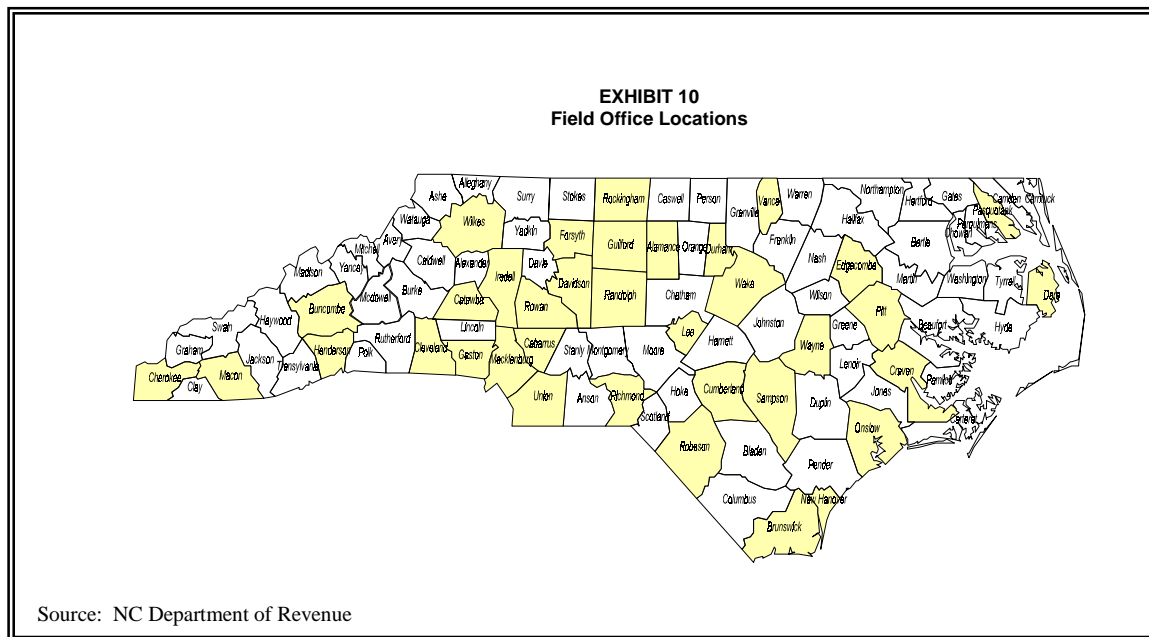
The State Treasurer has the authority to set-up depositories at local banks to accept deposits from the field offices. These funds would be credited to the State's account as soon as the deposit is made. While there are costs[15] associated with using depositories, these are minimal.

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[15] Costs are for maintenance fee, deposit fee, deposit slip cost, per check depositing fee, and encoding fee for foreign checks (not their check) deposited.

We also found that the Bankruptcy unit is not in compliance with the Daily Deposit Act. This unit receives checks from taxpayers, directly and through Bankruptcy Court trustees, to reduce their tax liability. As checks are received, the date is stamped on the check stub and the check is placed in the appropriate employee's bin to process. The unit's procedures state the check

TABLE 21 Analysis of Checks Located In Bankruptcy Unit June 12, 2000			
Days in Unit	Number of Checks	% of Total Number	Amount of Checks
111 to 196	5	6%	$ 3, 863.92
11 to 31	32	41%	$ 59,853.16
5 to 10	41	53%	$ 58,937.40
Total	**78**	**100%**	**$122,654.48**
Source: DOR Records			

turnaround process should be completed within seven to ten days. On June 12, 2000, we reviewed the unprocessed checks in the Bankruptcy unit. Table 21 details our findings.

RECOMMENDATION

DOR should consult with the State Treasurer to determine the feasibility of opening depositories at local banks close to the Revenue Field Offices. This would allow daily deposits of all field office collections. If the depositories are set up, DOR would need to modify its field office procedures to allow daily deposits while having the offices continue to forward the daily reports and deposit slips to Raleigh. Additionally, management should review the procedures used by the Bankruptcy unit to require adherence with the Daily Deposit Act.

THE MOTOR FUELS DIVISION IS NOT CALCULATING INTEREST CORRECTLY ON PAYMENT PLANS FOR SOME TAXPAYERS.

The Motor Fuels division is responsible for collecting, assessing and distributing motor fuel taxes in accordance with the International Fuel Tax Agreement. Since 1991, the division has used an automated computer system to track audits and assessments for Motor Fuels. The system, VISTA (Vehicle Information System for Tax Apportionment), also calculates the distribution of motor fuels taxes to other taxing districts based on the International Fuel Tax Agreement audits completed and returns processed. If an assessment was made prior to 1992, or the division manually calculated the assessment, the information would not be in VISTA. For all manual assessments, the division uses a spreadsheet to track assessments, payments, and payment plans.

A review of a random sample of 30 accounts receivable revealed that the interest owed by motor fuel taxpayers was not being calculated correctly on manual assessments set up

for payment plans. Payment plans should be updated in a timely manner with accurate information that results in the correct account balance being posted.   Division management does not have adequate controls in place to check the interest calculation on manually updated accounts or to check for data entry errors on manually tracked accounts.

RECOMMENDATION

The division should establish procedures that require manually entered or calculated data be reviewed by a supervisor as a secondary review. In addition, the division should develop a spreadsheet that could accurately track and calculate all payment plan accounts not on VISTA. A spreadsheet that automatically calculates the interest accrued based on the payment amount and date would help prevent any miscalculation of the account balances.

MOTOR FUELS AUDIT SOFTWARE IS NOT CALCULATING INTEREST CORRECTLY.

The IFTA agreement requires the State to pay interest to the taxpayer at a rate of one percent per month on credit balances over ninety days old. During our review of motor fuels audits, we noted that the audit software used by the Motor Fuels division incorrectly calculated interest on accounts with credit balances. Specifically, when an auditee has a credit balance in a quarter when a report is due, the software does not calculate interest due to the auditee. This creates a State liability to affected taxpayers.

RECOMMENDATION

The Motor Fuels division should take immediate steps to have the audit software changed to accurately calculate taxes owed. Until such time that the software is corrected, the division should take alternate steps to manually calculate interest owed or due resulting from an audit. Additionally, the division should review past audits to identify taxpayers affected by the mis-calculation and re-calculate interest to properly credit those taxpayers in accordance with IFTA regulations.

FINDINGS AND RECOMMENDATIONS

> ### *Objective 5: Review any other issues as may be deemed necessary or desirable by the State Auditor.*

To accomplish this objective, we examined a number of issues that arose during the audit that appeared to have a direct affect on employee productivity and/or issues of equity among the different employee classifications at DOR. These are issues that affect DOR employee morale and productivity and may be outside DOR's control.

Conclusion: DOR should request a review of the interstate audit positions by the Office of State Personnel, specifically to address issues surrounding "locality pay."

INTERSTATE AUDITORS WHO ARE RESIDENTS OF OTHER STATES ARE NOT RECEIVING RETIREMENT BENEFITS, DISABILITY, OR LONGEVITY PAY ON THEIR "LOCALITY PAY."

DOR employs 27 interstate auditors who are residents of the other states where they conduct audits. Twenty-one of the 27 interstate auditors receive a "differential pay," ranging from 2.5% to 45%, in addition to their base salaries based on the cost of living in those states. This differential or "locality pay" is intended to make the salaries comparable to the salaries of like positions in those locations. The differential is subject to income tax and social security withholding; however, North Carolina is not withholding State retirement on the differential portion of the interstate auditors' pay. Similarly, disability payments and longevity payments are not computed including the differential portion of these salaries.

GS §135-1 states that the average final compensation for retirement purposes "…shall not include any compensation, as determined by the Board of Trustees, for the reimbursement of *expenses or payments for housing or any other allowances* whether or not classified as salary or wages." Since the interstate auditors receive a separate reimbursement of expenses, the differential is not a reimbursement of expenses. We found no evidence that the Board of Trustees of the Teachers' and State Employees' Retirement System had ever issued a ruling on differential pay paid to North Carolina employees who are residents in other states.

We did find, however, that when the interstate audit positions were initially set up, DOR requested a ruling from the Attorney General in February 1988 as to whether the differential should be included for retirement and longevity purposes. That opinion states ". . . the Office of State Personnel did not consider the cost of living supplement to be

part of the individual's salary and would not be considered in calculating longevity." The opinion was based, however, on the assumption that the interstate auditors were residents of North Carolina who would be moving back at some point. We learned that the majority of the current interstate auditors are recruited from the states in which they work and are residents of those states in which they perform their duties for North Carolina.

We surveyed other states to determine how they compensate their interstate auditors. Most states surveyed pay either a higher base salary than North Carolina does or do consider the locality differential as part of the employees' base pay. Every state reporting out-of-state resident auditors consider the differential subject to retirement withholding.

RECOMMENDATION

> **DOR management should request the Office of State Personnel and the Board of Trustees of the Teachers' and State Employees' Retirement System to re-visit this issue. If the Board determines that the differential should be included as regular salary for retirement withholding, the employees should be given the opportunity to purchase the amounts not previously withheld to add to their retirement accounts.**

THE DIFFERENTIAL PAY FOR INTERSTATE AUDITORS IS NOT ADJUSTED ONCE ESTABLISHED.

The differential is sometimes referred to by DOR as the "COLA" (cost of living adjustment). We learned that once the differential is established for a location, there is no adjustment made for changing economic conditions. By not adjusting the differential, some auditors could be over compensated while others are penalized based on changes in the economic conditions over time.

We found that the federal government also pays additional compensation to its employees to adjust for differing economic conditions. This pay, called a "locality pay," is used to provide federal employees comparative salaries in high cost of living areas. These rates are changed periodically based on changes in economic conditions as shown in national labor statistics.

RECOMMENDATION

DOR management should request the Office of State Personnel to review the equity of DOR's current differential pay. State Personnel should give consideration to using the method of adjustments established by the federal government. Should State Personnel find that adjustments are required for some of the interstate audit locations, DOR should request pay adjustments for these individuals to bring their salaries up to the local market level.

Overview

The North Carolina Department of Revenue (DOR) was created in 1921 when the General Assembly instituted the State's first net income tax. The Department is authorized by GS §143B-217. At its creation, the department had 16 employees. At the beginning of the 21st century (fiscal year 2000-01), as a result of increases in North Carolina's population, industry, and the increased complexity of the modern taxation system, DOR now employs 1,290 full-time staff, as well as numerous temporary employees during the "tax season." DOR has staff located in the central office in Raleigh, 37 field offices throughout the State, and 38 interstate auditors who examine revenues of taxpayers who live or operate in states outside of North Carolina.

DUTIES AND RESPONSIBILITIES: DOR has been authorized to collect property tax, inheritance and gift tax, beverage and cigarette taxes, corporate income and franchise tax, gasoline tax, individual income tax, sales and use tax, and to administer privilege licenses, in addition to other administrative duties. The statutes state that it is the duty of the department to ". . . collect and account for the State's tax funds, to insure uniformity of administration of the tax laws and regulations, to conduct research on revenue matters, and to exercise general and specific supervision over the valuation and taxation of property throughout the State."

MISSION AND GOALS: DOR's mission is to ". . . administer the tax laws and collect the taxes due the State in an impartial, uniform and efficient manner." In addition to this, DOR's larger goal is to ". . . create a seamless organization of highly motivated employees empowered by leadership and state-of-the-art technology to provide customer service and increase voluntary compliance." Through the course of its work, DOR staff is guided by 6 key values:

*Employee Involvement	*Productivity
*Customer Service	*Education
*Organizational Integrity	*Accountability

By working within these key values, DOR management hopes to successfully reach its primary strategic goals to:

- Expand communication capability both internally and externally;
- Provide comprehensive training and development;
- Improve taxpayer services;
- Improve compliance;
- Analyze and prioritize resources;
- Implement Total Quality Management; and
- Develop a comprehensive business plan.

ORGANIZATION: DOR is headed by a Secretary of Revenue who is appointed by the Governor. The Secretary is assisted by a Deputy Secretary and 5 Assistant Secretaries

who are responsible for the functional areas of: 1) Tax Administration, 2) Planning, Development and Technology, 3) Administrative Tax Hearings, 4) Field Operations, and 5) Tax Compliance. DOR management is in the process of realigning functions to make the department more responsive to taxpayers and to improve overall operations. Exhibit 7, page 66 shows the organizational structure in place as of September 1, 2000.

DOR currently uses several computerized application systems to administer North Carolina's tax laws, including the Integrated Tax Administration System (ITAS). Plans are for ITAS to eventually contain all the information relevant to each tax schedule in one central database. DOR also uses automation and computerization for everything from opening and sorting mail to retrieving written data from tax forms and producing notices of amounts due and refunds for taxpayers. One of management's most important assignments is to meet the expectations of increased collection and audit activity and greater demands for taxpayer assistance with greater employee productivity, value-added services,

Table 22 Facts about Department of Revenue Operations Fiscal Year 1999-00	
DOR Certified Budget	$102.4 million
Departmental Employees	1,290
Gross Collections	$17.6 billion
Average Daily Deposit	$67.2 million
Number of Tax Returns Processed	9,370,307
Number of Pieces of Mail (Incoming)	12,161,851
Number of Pieces of Mail (Outgoing)	8,940,809
Number of Individual Income Refunds	2,422,037
Value of Individual Income Refunds	$1.1 billion
Source: NC Department of Revenue	

and wise use of available technology. Table 22 contains a snapshot of DOR activity for fiscal year 1999-00.

BUDGETARY INFORMATION: The Department of Revenue is one of the largest departments in North Carolina state government. It collects and distributes more than $15 billion dollars annually for governmental operations. These functions are achieved with resources provided by its $80+ million budget. Table 23 contains a summary of DOR's budget requirements for the past five years.

TABLE 23 Actual Expenditures/Revenues for 1995-96 through 1999-00					
	1995-96	1996-97	1997-98	1998-99	1999-00
Expenditures	80,830,820.48	90,061,734.98	95,457,796.72	108,939,327.46	99,315,982.57
Revenues	9,126,668.48	44,136,736.04	24,954,635.23	7,886,733.51	20,512,336.57
Appropriations	71,704,152.00	45,924,998.94	70,503,161.49	101,052,593.95	78,803,646.00
Source: NC Department of Revenue					

APPENDICES

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Functional Quality (FQ) Questionnaires

The FQ questionnaires were completed with the key internal users of the ITAS system. The responses provided significant insight on the strengths and weaknesses of the overall system. The FQ also allowed for the respondent to specify potential areas of improvement and assess how well the system meets current and future needs.

Upon completion of the interviews and questionnaires, the data was compiled through a set of KPMG proprietary algorithms to determine an application "score". These algorithms take into account the application's strengths and weaknesses compared with the department's requirements and relative importance of the various questions. The "Provided" column is the degree to which each attribute is currently provided by ITAS; the "Required" column is the degree to which the attribute is required by the internal users to perform their functions. There were varying descriptions for each attribute with "1" representing the worst/lowest response and "5" representing the best/highest response. The averaged results of the FQ surveys are displayed below.

Exhibit 11
ITAS Functional Quality Attributes
Provided vs. Required

Source: Compiled by KPMG
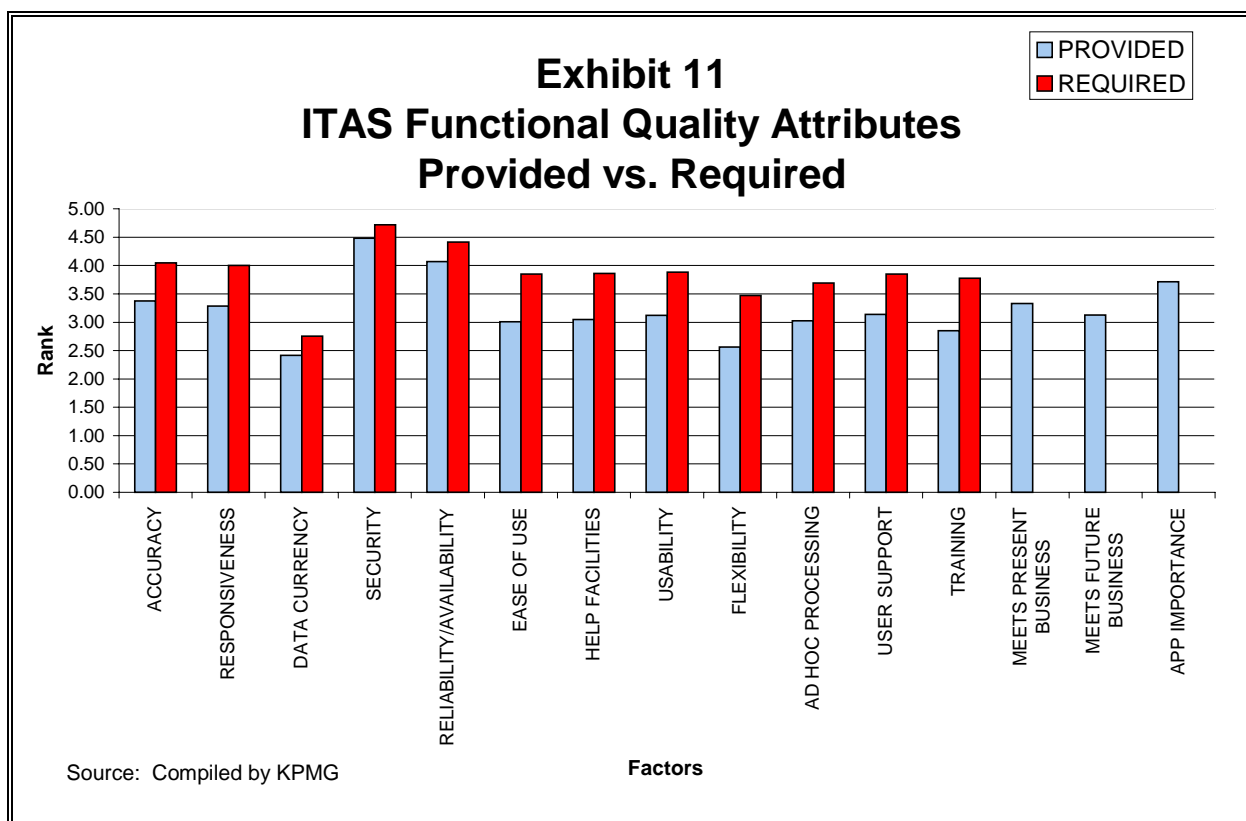
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APPENDIX B

Technical Quality (TQ) Tool

The TQ tool was utilized as a guideline for discussion during a workshop with key internal ITAS application managers and developers. The TQ allows KPMG to assess the soundness and quality of the application from a technical perspective. The "Provided" column is the degree to which each attribute is currently provided by ITAS; the "Importance" column is the degree to which this attribute is important. There were varying descriptions for each attribute with "1" representing the worst/lowest response and "5" representing the best/highest response. The averaged results of the TQ tool are displayed below.

Exhibit 12
ITAS Technical Quality Attributes
Provided vs. Importance

Source: Compiled by KPMG

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APPENDIX C

System Requirements (SR) Survey

The system requirements survey was sent out to internal users who responded to the FQ survey and who utilize ITAS in their daily job res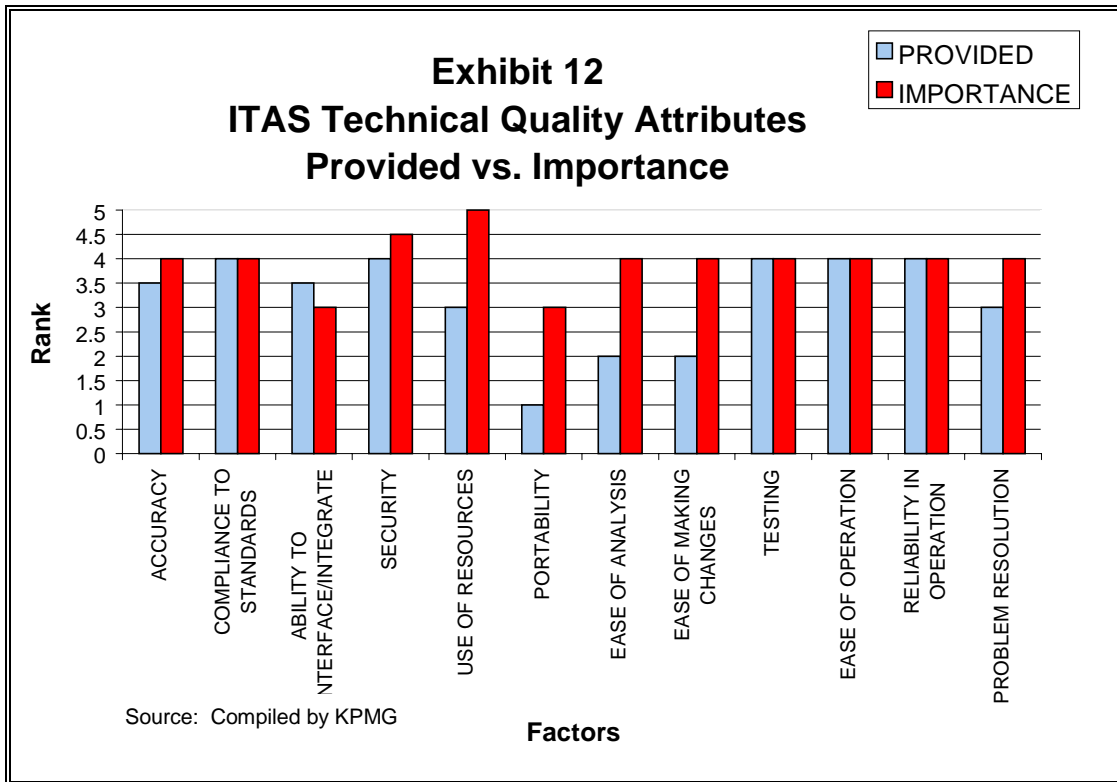ponsibilities. This tool asked detailed, questions regarding ITAS to determine how each system function meets the requirements of the internal user, as well as the priority of this function to daily job responsibilities. The responses provided significant insight on some of the detailed strengths and weaknesses of the system as well as possible functionality gaps with ITAS. The "Meets Requirements" column is used to specify how well ITAS meets the requirement, with "1" being the system cannot perform this function and "5" being system does this function well. The "Priority" column indicates whether the requirement is considered to be (H) High, (M) Medium or (L) Low priority. The averaged results of the SR survey are displayed below.

Table 24
ITAS System Requirements Survey Results

Priority Average	Meets Requirements Average	Functional Requirements Description
		Taxpayer Identification Functionality
M	4.3	Ability to add a taxpayer
H-	4.3	Ability to maintain taxpayer information
M	3.3	Ability to consolidate a taxpayer
M	3.5	Ability to maintain related party information
H-	3.8	Ability to make taxpayer or related party inquiries
M	2.9	Ability to maintain license bond information
M	2.8	Ability to process license/bond inquiries
M+	2.3	Ability to process returned mail
M	3.1	Ability to produce tax return mailings
M+	3.6	Ability to match data against outside sources
		Document and Returns Processing Functionality
M	3.0	Ability to define a document
M+	3.6	Ability to enter data-low volume
M+	3.6	Ability to enter data-high volume
M+	3.9	Ability to prepare payment transactions
M	3.9	Ability to request source documents
		Taxpayer Accounting Functionality
M	2.9	Ability to provide questionable filer detection
H-	3.8	Ability to post transactions
H-	3.8	Ability to adjust taxpayer accounts
H-	4.1	Ability to make account period inquiries
H-	3.8	Ability to process refunds or credits
M+	3.3	Ability to match data against outside sources
M	2.8	Ability to produce management revenue reports
M+	3.7	Ability to bill a taxpayer
M+	2.6	Ability to process payment agreements
M+	3.3	Ability to process liens
M+	3.3	Ability to apply payments
M	3.2	Ability to process dishonored checks
M	3.8	Ability to process write-offs
M	3.4	Ability to process settlements
M	4.0	Ability to process offsets

Table 24 (continued)
ITAS System Requirements Survey Results

Priority Average	Meets Requirements Average	Functional Requirements Description
		Automated Correspondence Functionality
M	3.4	Ability to define a new notice.
M+	3.7	Ability to process a notice
M	1.9	Ability to process questionnaires
M	2.9	Ability to produce correspondence
M+	3.8	Ability to inquire on correspondence
L+	2.6	Ability to produce statistical and post office reports.
		Case Management Functionality
M+	4.5	Ability to define cases to ITAS
M+	4.1	Ability to maintain case information
M+	3.2	Ability to process collections
M+	3.0	Ability to identify audits
M+	3.0	Ability to identify and process non-filers and delinquents
M	3.0	Ability to automatically take action
M+	4.0	Ability to provide case inquiry
M	3.7	Ability to maintain employee/organization
M	2.5	Ability to produce operation and planning reports
		Revenue Accounting Functionality
M	3.6	Ability to capture revenue transactions
M	3.3	Ability to track revenue
M	3.4	Ability to allocate receipts
M	3.6	Ability to distribute funds
M+	3.0	Ability to inquire on revenue accounts
		Other Components Functionality
M	2.9	Ability to provide user help
M	3.8	Ability to provide "hotkey" access to host systems
M	2.8	Ability to generate ad-hoc reports via DB2's QMF
Source: Compiled by KPMG		

North Carolina Department of Revenue

James B. Hunt, Jr.
Governor

October 25, 2000

Muriel K. Offerman
Secretary

Honorable Ralph Campbell
Office of the State Auditor
2 South Salisbury Street
Raleigh, North Carolina 27699-0601

Dear Mr. Campbell:

I have reviewed the report of the performance audit of the Department of Revenue conducted by your office pursuant to House Bill 1476 as enacted by the 1999 Session of the General Assembly.

The report clearly indicates that the Department of Revenue is understaffed in many areas. This is an issue we have struggled with for many years. Because we do not have adequate staffing, we have been unable to attain the level of service expected of us by the citizens of North Carolina and the General Assembly. We will ask the General Assembly for the funding needed to address these deficiencies.

Our responses to the recommendations directed to the Department of Revenue are contained in the attached document titled Response to the Performance Audit of the North Carolina Department of Revenue.

As you will note, we concur with most of the recommendations. We have responded to certain recommendations where we believe a response is appropriate to (1) clarify our understanding of the recommendation, (2) address implementation of the recommendation, particularly with respect to funding for personnel and other resources, or (3) qualify our plan to implement the recommendation. We have not commented on those recommendations with which we fully concur and we will implement them accordingly.

We take exception to two of the recommendations. Our reasons for doing so are also included in the above document on pages 15 and 16.

I wish to commend your staff for their objectivity, expertise and professionalism exhibited during the course of the audit.

Sincerely,

Muriel K. Offerman

Muriel K. Offerman

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> Pages 15 and 16 referred to above are now pages 108 and 109 in the report.

The response from the Department of Revenue has been reformatted to conform with the style and format of the rest of the audit report. However, no data has been changed.

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The response from the Department of Revenue has been reformatted to conform with the style and format of the rest of the audit report. However, no data has been changed.

**Response to the Performance Audit of the North Carolina
Department of Revenue**

RECOMMENDATION

DOR management should devote more auditors to reviewing and processing RARs on a full-time basis to reduce the RAR inventory for individual income taxes. Management should also implement a tracking tool to indicate who the RAR was assigned to, when it was assigned, dollar amount assessed, date return was received, date of assessment, and length of time to it takes to process RARs to improve management control of this process.

DOR agrees that additional auditors should be dedicated to reviewing and processing RARs on a full-time basis in order to reduce the RAR inventory for individual income tax. The Examination Division currently has two auditors assigned to work RARs. DOR is taking immediate action to dedicate additional resources to process RARs.

In order to reduce the backlog of RARs and to maintain a current status of all RARs received, DOR will request six (6) income tax auditors and two (2) corporate tax auditors in its expansion budget.

DOR agrees that a tracking tool is needed for RARs. The Examination Division will develop and implement a tracking system to capture the items noted in the recommendation.

RECOMMENDATION

DOR should implement an automated case management tool to more effectively track and work accounts receivables. A computerized tracking spreadsheet/software should be used to track accounts, flagging them when they become overdue. A list of flagged accounts should be printed and distributed to the auditors assigned to collections. Division Management should more closely monitor collection efforts. Lastly, management should assign additional auditors to work the backlog of past due accounts.

DOR agrees that more should be done to collect motor fuels delinquent accounts receivables. Currently, collection of motor fuels delinquent accounts is the responsibility of the Motor Fuels Tax Division. As a part of the Departmental reorganization, this responsibility is being reassigned to the Collection Division. This move will incorporate

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the motor fuels accounts receivables into the normal collection processes established for all other tax schedules.

In addition, the 1999 General Assembly directed the Department to conduct a study of best collection practices in House Bill 1433. The Department employed PricewaterhouseCoopers to conduct the study and presented findings to the Revenue Laws Study Commission. The 2000 General Assembly authorized the Department to enter into a performance-based contract to implement the study findings as a part of House Bill 1624. New technologies, including enhanced case management systems were recommended as a part of this study.

RECOMMENDATION

DOR management should more closely monitor bankruptcy cases to assure the timely processing of Bankruptcy Proof of Claim Forms. DOR should implement a bankruptcy status report detailing the payment and closeout status of both individual and corporate cases. Lastly, all personnel should be cross-trained to assure timely processing of case files.

DOR concurs with the finding that all personnel in the Bankruptcy Unit should be cross-trained. Most of the support level employees have been cross-trained. The two administrative officers, however, need to be cross-trained and efforts have been implemented to begin this training.

DOR also has in place as one of its performance measures the tracking of cases to ensure that all claims are filed timely. While we believe this tracking system is adequate, we will more closely monitor these cases to ensure that the system is working properly. We believe the cases that were not filed timely were exceptions to the usual process employed in bankruptcy cases. The $7,579,179 in projected lost revenue was estimated from claims not timely filed. We believe a larger sampling would result in a much lower projected lost revenue.

RECOMMENDATION

DOR management should develop a comprehensive, standard set of procedures and guidelines for handling the offer and compromise function. Specific, step-by-step procedures should be included for each division, along with guidelines for handling situations where there may be differing details. Once the procedures are in place, management should monitor the adherence to and success of these guidelines in each of the tax areas, modifying them as needed.

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The administration of offers in compromise will be transferred to the Collection Division to facilitate implementation of these recommendations.

RECOMMENDATION

DOR management should formally document response time standards for responding to non-routine written correspondence. Management should review the types of correspondence being handled by the Taxpayer Assistance section to determine if using technology, such as voice mail or e-mail, could increase efficiency. Additional staff is needed to eliminate the backlog and to handle daily correspondence. See finding on page 68.

DOR concurs that the response time standard of 30 days should be documented in writing. In 1997, a business process reengineering team reviewed the processes of the Taxpayer Assistance Section with regard to correspondence and implemented several major actions that enabled the employees to concentrate on their correspondence. While DOR is very open to using additional technology to improve performance, we believe the current processes are close to maximizing employees' time. DOR management has conducted a personnel needs study and provided your staff with those findings.

RECOMMENTDATION

The Criminal Investigations Division should develop and maintain within each case file a checklist to determine what documentation should be included. A checklist would assure consistency among case files and provide assurance that all files contained adequate pertinent information.

DOR concurs that five declined case files did not contain case data sheets or final investigative reports. DOR takes exception to the statement that information was not readily available to justify or document the decision process or the final disposition of these cases. In four of the five cases identified, the files contained information on how the cases were resolved; however, the information was not on a case data sheet or final investigative report. The other case was resolved by the department's civil audit staff and a written explanation on the final resolution was not included in CID's case file. CID was able to quickly provide the examining auditor with an explanation of the relevant facts in each of the cases cited.

CID management recognizes the importance of maintaining consistent documentation on the resolution of criminal tax referrals and has taken the steps to insure more uniformity

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in division files. Case data sheets are now required for all numbered referrals and will include information on the final disposition of every case.

RECOMMENDATION

DOR should immediately develop a formal, ongoing security awareness program for all employees. This program should be one of the primary responsibilities of the Security Division and should be continually monitored and updated as needed.

DOR concurs that a security awareness program should be implemented for all employees. The current level of staffing in the Security Division is not adequate to fulfill this recommendation. In order to implement and maintain the security awareness program, a Computer Training Specialist III position will be requested in the expansion budget.

RECOMMENDATION

DOR management should expedite the hiring of personnel to fill the three remaining positions identified during its recent organizational change in the Security function. The proposed organizational changes at DOR should provide the security staff with the infrastructure needed to perform daily security monitoring tasks, as well as participate in systems development/enhancement projects.

DOR concurs. To provide these remaining security positions DOR is required to identify and reclassify existing positions. DOR will continue to identify and reclassify positions to provide the Security Division with adequate staffing to perform the required security functions. In addition to the three positions listed in the recommendation, three additional security positions will be requested in the expansion budget.

RECOMMENDATION

DOR management should make immediate provisions for all system administrators to receive specific systems security administration training. It is critical that the systems administrators receive this training and keep updated on current information security issues and trends.

DOR system administrators are currently tasked with limited security responsibilities. DOR concurs with the prior recommendation to appropriately staff the security functions. At that time, all system security administration will be transferred from the system administrators to these positions and all security personnel will be trained in systems security administration.

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RECOMMENDATION

We commend DOR's decision to contract with the vendor for the development of a disaster recovery plan that encompasses the Data Capture System and related Local Area Network. DOR should implement and test business recovery plans for technology, people, and processes required to support key tax processing components.

DOR concurs, and has been developing a complete Business Continuity Plan that will provide a means for critical business functions to continue in case of a disaster. DOR will continue this effort as resources allow.

RECOMMENDATION

DOR should develop and implement an on-going communications plan for users of ITAS. Improvements to the existing infrastructure, which are already planned, will be required to provide additional communication tools. Additionally, PD&T should consider conducting annual user satisfaction surveys to gauge support of, and facilitate communication with end users.

DOR concurs. The recently approved Policy for Change to ITAS is now in effect and requires regular status reporting of ITAS releases. Also, PD&T plans to utilize a user satisfaction survey to enhance communications with users.

RECOMMENDATION

DOR management should work with the General Assembly to prioritize desired technology advancements. Management should continue to monitor the automation needs of DOR and communicate those needs to the General Assembly. The General Assembly should appropriate necessary funds to continue the modernization of DOR and maintain existing systems.

DOR concurs. Funding for E-commerce and technology initiatives, including positions to support development and maintenance of the E-commerce applications and hardware, will be requested in the expansion budget. DOR will continue to monitor technology advancements and state-wide E-commerce initiatives to ensure that the Agency can most effectively and efficiently meet the needs of taxpayers.

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RECOMMENDATION

DOR management should use the results of the surveys conducted by KPMG to focus development of ITAS' key components. Development of these components should serve to address the majority of functionality issues identified by ITAS users and improve the effectiveness of the system.

DOR concurs that specific components of ITAS are not as robust as originally promised and may require enhancements. In addition to modifications, some of the components may only require additional training for DOR personnel so that they can fully understand and implement all of the existing functionality.

DOR believes ITAS meets the basic processing requirements and it is worth investing time and resources into better understanding the system. To meet that objective, DOR has requested funding as recommended in this report for staff positions to provide training and documentation for ITAS. Until the current system functionality and capabilities can be fully reviewed, understood, and documented, DOR does not have adequate information to make a cost-effective decision regarding enhancing ITAS vs. implementing additional functionality outside ITAS.

RECOMMENDATION

DOR management should determine if functionality gaps identified by this review not included in the current software release schedule are appropriately prioritized and can be addressed.

DOR concurs. In February, 2000, the DOR Quality Council chartered the ITAS Design Review team to identify areas of ITAS where design modifications are required to enable ITAS to be used more effectively. The areas currently in review include Noticing, Amended Returns, Payment Processing, and Review Items. Once the team's review and analysis has been completed, recommendations for design changes will be submitted for prioritization. Implementation of the approved recommendations will be dependent upon programming resource availability and funding.

RECOMMENDATION

DOR management should determine alternatives to provide better management reporting. A support structure should be developed to facilitate users' reporting needs while limiting the impact to ITAS production processing.

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DOR concurs. The current staffing level is inadequate to support both ITAS Production and ongoing information reporting needs. As an alternative to requesting additional staff positions, funding for implementing a data warehouse and reporting tools to provide users with direct access to data for queries and reporting will be requested in the expansion budget.

RECOMMENDATION

Documentation of ITAS processing and user procedures should be improved. In order for documentation to be completed and consistently maintained, resources must be allocated to create, update, and maintain ITAS online help facilities, user manuals and documentation as changes occur.

DOR concurs. Funding for one training supervisor and three training specialists will be requested in the expansion budget. These positions would maintain the standard ITAS user documentation for use by all divisions in the agency and provide ITAS user training.

Operating divisions within DOR currently maintain ITAS user manuals that are specific to how that division uses ITAS, and parts of these manuals would continue to be needed.

RECOMMENDATION

DOR management should implement procedures for receiving user calls, documenting problems, and recording solutions for future reference. In our opinion, DOR should request additional positions to supplement existing help desk staff. (Note: Two positions were requested in the FY97-98 budget but not approved.)

This finding refers specifically to ITAS support and DOR concurs. Funding for these positions will be requested in the expansion budget.

RECOMMENDATION

PD&T should develop and implement additional performance measures. Additionally, PD&T should implement service level agreements with internal users to assure all parties understand what is expected of them.

PD&T is an active participant in the Department's business planning process. PD&T's first formal involvement in that process covered the biennium period 1999-2001. It is anticipated that as the process matures, the level of performance measurement throughout the agency will expand and develop. Meaningful performance measurement processes in

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organizations tend to evolve over time and require some level of experience and practice before the process reaches maturity. PD&T as well as all other divisions at DOR are fulfilling all of their responsibilities under the performance management system mandated by the Office of State Budget, Planning and Management.

RECOMMENDATION

DOR management should continue emphasis on identifying and refining the criteria used by ITAS to select potential audit candidates. Additional use of automated capabilities for selection of candidates and ongoing support for these efforts will be required to improve the effectiveness of DOR's overall audit function. As ITAS criteria for selecting candidates is refined, it is expected that the workload will be increased.

DOR concurs with this finding and is actively pursuing all opportunities to improve the effectiveness of the overall audit function. Using existing audit personnel, DOR has created a new section called Special Projects/Discovery. This section will actively pursue the refinement of criteria for selection of potential audit candidates by evaluating the success of each initiative. A case management process will separately identify ITAS audit selections and their assignment to field examination districts and track the progress of the case to final resolution. This section will continue to explore the use of automated capabilities and the full utilization of internal and external databases to identify potential audit candidates.

The Special Projects/Discovery Section will focus on the expanded identification of audit candidates using IRS tape extracts. This section will refine selection criteria to evaluate return discrepancies between federal returns and state return information on ITAS. Audit initiatives from tape extracts will impact examination personnel. Much of this audit process is being automated, however, the potential for expanded use of IRS tapes with ITAS return information will require additional audit resources.

As a result of this recommendation, DOR will request in its expansion budget 25 auditor positions and nine tax technician positions in the first year of the biennium and ten auditor positions in the second year.

RECOMMENDATION

We commend DOR for its exploration and implementation of electronic methods of providing services to North Carolina citizens. DOR should continue to build on the success of its electronic filing and electronic funds transfer programs by actively promoting their use. To do this, DOR should consider utilizing some of the

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promotional activities used successfully in other states. Additionally, DOR should continue developing electronic methods of tax filing, collection, and providing customer service to taxpayers. We fully support the recommendations made in the June 2000 Keane report that will position DOR as a leader in electronic processing of taxpayer data. Lastly, North Carolina's goal should be the processing of individual tax refunds for returns filed electronically and using direct deposit so that taxpayers' refunds are processed and deposited within 7 days of receipt.

DOR concurs. Funding for two positions to support the development of E-commerce applications will be requested in the expansion budget.

DOR also requested statewide E-Grant money for direct deposit, but the initiative was declined by the E-Government Steering Committee. DOR has requested funding for direct deposit in the expansion budget. DOR is launching an E-Commerce Strategy Implementation Team to determine an appropriate implementation plan that balances the business needs of the agency, our internal capacity to manage change, and available funding to maximize benefits for DOR and the State. We anticipate implementing direct deposit of refunds for the tax year 2001 (2002 filing season), contingent upon funding.

DOR also agrees that electronic methods of providing services to North Carolina citizens should be explored. By implementing e-commerce options, both paper returns and electronically filed returns would be captured in formats that improve the efficiency and effectiveness of our operations. Our E-Commerce Strategy Implementation Team will also ensure that DOR uses existing technology and processes in a manner that complements our e-commerce strategy. This way we can ensure that our plans are aligned with existing business strategy and that all resources are focused on pursuing the strategic goals of the agency. DOR concurs that a case management tool and automatic collection processes are critically important because such tools can have a very positive effect not only on collection efforts but also on examination and customer service activities. House bill 1624 from the 2000 session of the General Assembly promotes the development and implementation of technologies that will positively impact the areas cited in the recommendation and we strongly support its goals. We believe that such investments in technology would reap a multitude of benefits for the State of North Carolina and we will ask for support of these efforts through legislative funding.

As is customary in our agency, we welcome the opportunity to examine our internal processes for the purpose of continuously improving operations. We also realize that a customer-focused, mission driven organization uses its planning processes to identify goals, objectives and strategies that promote processes that add value for citizens. DOR believes that your thorough examination of the agency has revealed that there is a true commitment in the agency to such activity. DOR will endeavor to identify appropriate

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goals and measures for our business processes including those that relate to refund processing and direct deposits.

RECOMMENDATION

DOR should work with the State's Information Technology Services' (ITS) Telecommunications division to design and implement more effective telephone services. In our opinion, the system should include a taxpayer assistance call center, using a combination of telephone technology, interactive devises and live assistance. Additionally, the system should be designed to actively monitor the number of calls received by type to better tailor services to the needs of taxpayers. The establishment of a single telephone center with a toll-free number, appropriately staffed to receive and make outgoing collection calls and handle general taxpayer and customer inquiries, will enhance DOR's customer services and pay for itself in increased collections and reduced taxpayer burden through easier access to DOR. Other benefits include:

- **Eliminate employee unproductive time associated with telephone use;**
- **Manage telephone traffic;**
- **Measure volume and type of calls;**
- **Match the number and types of calls with DOR employees;**
- **Reduce overall call volume; and**
- **Expand and allow 24-hour Voice Response Unit access from taxpayers.**

DOR concurs that a taxpayer assistance call center should be implemented and has requested funding in the expansion budget to begin the project. DOR worked closely with ITS staff when the automated voice response unit (VRU) was replaced in December 1999 to ensure that DOR purchased a system that was expandable to a full service call center. DOR is measuring the volume and types of calls received, but call center technology would enable more data to be captured. DOR also concurs that funding should be made available to establish toll-free telephone numbers along with the technology to distribute calls to employees across the state based on volume of calls and available personnel. The recent reorganization establishing a Taxpayer Assistance Division will allow DOR to more effectively manage this function. One of the primary components of the Taxpayer Assistance Division will be 10 regional taxpayer assistance service centers across the state that will serve taxpayers locally, whether by personal contact at the center or by telephone. DOR believes the 10 service centers will allow more effective and convenient service to taxpayers who will not have to drive more than 50 to 75 miles for personal service rather than trying to communicate with the central office in Raleigh. The call center in Raleigh will be linked to these service centers to make effective use of the service center staff when they are not assisting taxpayers who

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come to the centers. DOR will request the personnel and technology in its expansion budget.

RECOMMENDATION

The Returned Mail unit should develop a better workload tracking system to avoid compromising assessment suppression. This data should be used to determine the resources required to meet the unit's workload demand. Additionally, DOR management should conduct a cost/benefit analysis of the effort and resources used to collect the outstanding assessments. If the analysis proves that the costs outweigh the benefits, then management should request a modification to GS 105-241.1 to allow DOR to proceed with the final assessment notice after a given number of tries to locate a more current taxpayer address.

DOR concurs that returned mail is a significant problem. If returned mail from the Post Office is not quickly entered into ITAS, additional assessment notices may be sent thereby increasing the backlog. In 1999, DOR established a team to review the returned mail processes and make recommendations. From that internal study came a better understanding of why returned mail is increasing and recommendations to improve the process. Based on those recommendations, DOR has taken several steps: forwarding certain returned mail to field office staff to assist in locating taxpayers; placing an identifier on notices to allow the Returned Mail unit to sort the mail more efficiently; and moving forward with defining changes to ITAS that will automate the resending of mail when a better address is identified. The Returned Mail unit does track the volume of mail on a weekly basis, but tracking individual pieces of mail outside of ITAS would be very time consuming, and given the backlog of returned mail, we do not see this as a good use of time. We do, however, concur that a cost/benefit analysis of the effort and resources needed for returned mail would be beneficial. DOR will conduct an internal analysis during 2001.

RECOMMENDATION

DOR should immediately devise a tracking system that logs the receipt of all amended tax returns, noting the amount of payments. To reduce the backlog of returns to no more than 1 week, DOR should add additional positions to the Amended Returns section. DOR should also continue to improve explanations on bills and assessments to reduce inquiries from taxpayers. This would free more personnel for processing.

DOR concurs with this recommendation and is implementing a system to track the receipt of amended returns.

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DOR also concurs that the backlog of amended returns should be reduced. Twelve (12) auditors and seven (7) tax technicians will be requested in the expansion budget in order to reduce the backlog and maintain an inventory of these returns on a current basis. The ITAS Design Review Team will also make recommendations to the Quality Council that will include procedures for automating the processing of all amended returns.

RECOMMENDATION

DOR should explore alternative methods of tax collection, including the use of private collection agencies and advanced telephone capabilities to collect past due taxes. Based on the experience of other states, we estimate that North Carolina could increase its collections by 20% or $47,093,031 of our past due taxes due more than 365 days.

DOR concurs with this recommendation and is currently in the process of identifying alternative methods of tax collection. In House Bill 1433, the 1999 General Assembly directed the Department to conduct a study of best collection practices. The study was conducted by PricewaterhouseCoopers and the 2000 General Assembly authorized the Department, in House Bill 1624, to enter into a performance-based contract to implement the study findings. New technologies, including new telephone based collection systems, were recommended as a part of this study.

The Department is proceeding with implementation of this initiative in several stages, the first of which is to refer the out-of-state account receivables to a private collection agency. Current plans are to begin outsourcing out-of-state account receivables on November 1, 2000.

A request for proposals for a performance based contract for a major technology enhancement will be issued during late spring, 2001. The technologies described in PwC's report will be the primary focus of this initiative.

DOR believes that additional personnel resources will be required in order to utilize the new technology and ten (10) telecollector positions will be requested in the expansion budget.

RECOMMENDATION

DOR should establish specific goals for refund processing, as well as a system to monitor progress, and communicate the importance of these measures to all affected personnel. Each year after the tax season has concluded, management should

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analyze the refund process to see where problems occurred and to identify changes needed.

DOR has goals for processing refunds each year as indicated in the performance measures established for the department. Attention will be given to ensuring that goals are clearly communicated to all employees. The total quality management philosophy that DOR embraces includes the review of work processes and the department will continue its review of the processing experience to refine the entire effort so that maximum efficiency may be realized.

RECOMMENDATION

We commend DOR's efforts in finding a way to handle the "tax season" volume by using available resources. Since the pool of entry level people is so small in the Triangle area, one option DOR should explore as a long-term solution is the feasibility of establishing a mail center for opening, sorting, and preparing returns in one of the low employment counties in the State. Table 12 shows unemployment rates for a number of counties within an hour's drive of Raleigh. The prepared returns could be transported back to the Raleigh center for scanning and input into ITAS. Another alternative would be to bus workers from a low employment county each day for "tax season." While both these alternatives have costs and security issues connected to them, both should be fully explored as long-term solutions to the problem. A more immediate solution would be to increase funding for temporaries to allow DOR to offer a competitive wage to entry level personnel in the Triangle area. Lastly, DOR should continue to promote electronic filing of returns as discussed on page 47 to reduce the number of paper returns that must be manually processed.

DOR believes this recommendation requires substantial study to determine the costs of implementation and the benefits to be derived. Issues regarding the establishment of an off-site mail center include security of the site and the mail, recruiting logistics, mail routing implications, length of the employment period for temporary employees and transportation. DOR has requested additional funding for temporary employees in its expansion budget in order to offer a more competitive wage.

RECOMMENDATION

DOR management should review the efficiency of the employees involved in all phases of the tax return process, especially in the areas in which there were bottlenecks. After this review, management should determine what further training would be beneficial in increasing the effectiveness of these employees. The training

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program should include both permanent and temporary employees as they join DOR.

The review of work processes is inherent to DOR's approach to its work. With the introduction of new technology, DOR has continued to refine procedures to eliminate non-value added activities as well as reducing or eliminating inefficient procedures. Baselines established during the processing season are important in modifying existing procedures and determining the level of training needed by employees. In addition to increasing the effectiveness of employees, DOR will request eleven additional employees in the expansion budget for document preparation and data capture.

RECOMMENDATION

DOR should develop a plan to implement direct deposit of tax refunds immediately. As part of the plan, DOR should develop a strategy to allocate the required resources to this project to increase taxpayer satisfaction and reduce the operational costs associated with the mail process.

DOR concurs with the recommendation. Funding was requested from the E-Government Steering Committee, but the application was declined. DOR has requested funding in its expansion budget to implement a direct deposit program.

RECOMMENDATION

To reduce the number of items that are placed in suspense status requiring manual handling, DOR should continue to promote electronic filing. This would reduce the number of taxpayer errors and allow the input of tax information directly into ITAS. Since all taxpayers will not file electronically, DOR should increase its efforts to educate the public concerning the proper methods and format for completing tax forms. Further, DOR should create a tracking system that notes the causes of suspended items and look for trends in order to quickly and efficiently solve repeat problems. Finally, DOR should have a plan in place to quickly resolve any build up of suspense items when the volumes reaches a pre-defined level. This may require additional staffing.

DOR concurs that there is a need to continue promoting electronic filing as the most advantageous method for filing returns. DOR personnel responsible for the development of forms and instructions solicit input from employees involved in taxpayer assistance and review of returns to secure suggestions for improving the format and instructions each year. The identification of possible errors in returns is the reason that returns suspend in ITAS. The suspense criteria are required to ensure data integrity. DOR does

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monitor the causes for suspense; however, the causes are not always easily resolved and often require revision of forms or instructions in future years. DOR is developing a formal contingency plan designed to address the build up of suspense items above a pre-defined level. In addition, DOR has requested five additional employees for resolving suspended returns in its expansion budget.

RECOMMENDATION

DOR management recently established a formalized training function for the department. At the time of the audit, benefits of this function had not yet been realized. Training should be coordinated and flexible to allow supervisors to better coordinate training with the workflow. As a part of DOR's performance management process, supervisors should identify each employee's weaknesses and determine what training would address these and enhance the employee's strengths. Lastly, DOR should make the development of ITAS training courses and training material for staff a priority.

The elements of this recommendation are already in place. In February, 1998, the DOR Quality Council established a team whose mission was to assess the training needs for the Department of Revenue. This included:

- Identifying training requirements (What training is needed to accomplish the Department's mission)
- Recommend training plan for employee classifications
- Identifying areas of training to be used in the training plan for employee classifications
- Recommending more effective use of Registrar System for tracking employee training
- Gathering information from public/private organizations on how they are structured for training

The team, which was composed of trainers and others who were affiliated with training processes, made recommendations to the Quality Council. The team had the authority to review and assess existing training processes within the agency and consider what future training should be. The recommendation report that the Training Team ultimately presented addressed all of the areas cited in the performance audit recommendation. The cornerstone of the team's recommendations was to establish a separate training organization in the department responsible for all training. That training organization was officially created in the Spring of 2000. The unit is currently staffed by five positions with plans to add additional support position as they can be identified within the agency.

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RECOMMENDATION

Based on the analysis above, DOR should request additional interstate audit positions from the General Assembly. Increasing this function could significantly benefit North Carolina.

DOR's Interstate Audit Section is currently expanding with the addition of 8 auditors to be employed by January 2001. A request for 2 auditors will be included in the expansion budget. The recruitment and training of new interstate auditors requires substantial planning and significant resources for the agency to successfully deploy these auditors.

DOR will continue to evaluate the need for additional interstate auditors and the placement of these auditors across the United States upon completion of the current expansion.

RECOMMENDATION

DOR should implement additional case management functionality to more effectively manage its accounts receivables. This functionality should allow debt scoring and performance measures which will automate payment agreements and wage garnishments, track debt activity, prioritize cases, reduce case cycle time, increase the collection rate, and move cases to the most efficient collection resource. DOR should also move the accounts receivables function from the Office Services division to the Financial/Accounting division to allow for more effective oversight. Lastly, DOR should continue its efforts to hire a private firm to collect past due tax assessments.

DOR concurs that an automated case management system should be implemented. Our current case management system resides within ITAS. As part of the project to determine case management needs, the current ITAS functionality will need to be fully documented and evaluated to determine the enhancements needed to meet the business requirement. Once that has been completed, DOR will perform a cost/benefit analysis comparing enhancements to ITAS with the implementation of a new case management tool and we will proceed according to the results of that analysis.

We do not concur with the recommendation that the account receivables function should be moved to the Financial/Accounting division. The collection of all delinquent accounts are, or will become, the responsibility of the Collection Division who will carry out the collection function and will exercise the appropriate oversight of the activity.

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Outsourcing of past due assessments to private firms was addressed in the response to the recommendation relating to "alternative methods of tax collection".

RECOMMENDATION

DOR should update its Cash Management Plan to reflect current policies and procedures. The plan should be updated periodically and forwarded to the Office of the State Controller to be in compliance with statewide policy.

DOR concurs that the Plan should be updated to reflect recent changes in receiving and depositing tax receipts resulting from the installation of new data capture and remittance processing equipment. There had been no substantive changes in these procedures since 1986 when an automated remittance processing system was first installed and the Plan was first written to describe those processes.

RECOMMENDATION

DOR should consult with the State Treasurer to determine the feasibility of opening depositories at local banks close to the Revenue Field Offices. This would allow daily deposits of all field office collections. If the depositories are set up, DOR would need to modify its field office procedures to allow daily deposits while having the offices continue to forward the daily reports and deposit slips to Raleigh. Additionally, management should review the procedures used by the Bankruptcy unit to require adherence with the Daily Deposit Act.

DOR does not concur with this recommendation. The issue of field personnel depositing tax receipts to local banks has been studied a number of times and we do not find it to be practical or feasible. Deposits by local offices would prevent DOR from utilizing the data capture and remittance processing equipment recently installed at the agency. In addition, there would be quality control issues in allowing 36 offices to process tax payments and deposits; the image of the check as the standard audit trail would be lost; reconciliation of deposits and processing of tax returns will still have to occur in the Revenue Building when the tax returns and payment documents are received from the local offices; the Department of the State Treasurer would incur the cost of time and personnel to perform bank reconciliation functions with deposits being made by local offices across the state; and deposit duties would be an additional responsibility to field collection personnel whose time is already being fully utilized to collect outstanding tax liabilities. As an observation to the recommendation, the calculations for interest earnings assumed the total $210,000,000 was available to earn interest for the entire year. The monies cited in the report were collected throughout the year.

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The Bankruptcy unit concurs with the finding and has now implemented a revised process for checks received in the Bankruptcy unit. The checks will be sent to the Financial Services Division for deposit within 24 hours of receipt of the check.

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October 27, 2000

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