



PERFORMANCE AUDIT REPORT

**Reviewing Various Issues Related to the
Department of Revenue's Handling and
Processing of Income Tax Returns**

Executive Summary
with Conclusions and Recommendations

**A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
December 1999**

Legislative Post Audit Committee

Legislative Division of Post Audit

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December 15, 1999

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To: Members of the Kansas Legislature

This executive summary contains the findings and conclusions, together with a summary of our recommendations and the agency responses, from our completed performance audit, *Reviewing Various Issues Related to the Department of Revenue's Handling and Processing of Income Tax Returns*.

The report also contains appendices showing results of survey responses from Department of Revenue employees, and a chart that reviews solutions for computer related issues that caused problems with processing tax returns in 1999.

This report includes several recommendations that address the following:

- reducing the amount of inaccurate information being entered into the computer system, reducing the chances of improper payments made to taxpayers, and reducing delays in future refunds,
- ensuring tax revenues owed to the State aren't delayed, ensuring that future computer programs are properly tested, ensuring the State pays appropriate interest on late refunds, and ensuring that the Department can effectively handle taxpayer phone calls,
- clarifying State law, and clarifying confusing language in taxpayer correspondence.

We would be happy to discuss the findings presented in this report with any legislative committees, individual legislators, or other State officials. These findings are supported by a wealth of data, not all of which could be included in this report because of space considerations. These data may allow us to answer additional questions about the audit findings or to further clarify the issues raised in the report.

If you would like a copy of the full audit report, please call our office and we will send you one right away.

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**Reviewing Various Issues Related to the
Department of Revenue's Handling and
Processing of Income Tax Returns**

EXECUTIVE SUMMARY

LEGISLATIVE DIVISION OF POST AUDIT

**Question 1: Has Income Tax Processing Under
Project 2000 Worked As Intended?**

By most accounts, income tax processing under Project 2000 page 7
didn't work as well as intended during 1999. *In October 1998, the Department installed new computer systems to process individual income and withholding taxes. These programs were updated in January 1999 to reflect changes the 1998 Legislature had made to the tax laws. When this new system was first used to process income tax returns in early 1999, a number of problems, for both taxpayers and tax preparers, surfaced.*

The computer programs processed a large number of tax page 8
returns without problems, but in some cases inaccurate information and program deficiencies created problems. *No new computer system can be expected to work perfectly when first installed, and the new income tax programs the Department installed were no exception. In 1999, about 85% of the nearly 1.5 million income and homestead returns were processed essentially without problems. Unfortunately the problems that did occur caused significant inconvenience for the taxpayers involved. For example, the Department billed some taxpayers for unpaid income taxes because it hadn't given those taxpayers credit for estimated tax payments they already had sent in.*

Many of the errors taxpayers complained about appear to have been caused by inaccurate information being entered into the computer system, either because of human error or because of problems with computerized imaging equipment. For example, the equipment the Department uses to read data from tax returns often confused handwritten numbers like 1's and 7's and 4's and 9's, and letters like D's and P's. In addition, it sometimes couldn't distinguish a box on the return that was checked from one that wasn't checked but that had some mark in it (i.e., part of a signature or a mark from a copier). These items didn't get flagged for manual review and correction. Data conversion problems from the old computer system to the new one also caused problems. When inaccurate information was flagged, staff sometimes mis-keyed the new information or didn't make the changes they should have. In addition, taxpayers and tax preparers sometimes sent in inaccurate information or used unapproved forms.

A number of "glitches" in the computer software also contributed to problems processing income tax returns in 1999, including incorrectly matching people as filing joint returns, and allowing some taxpayers to receive larger refunds than they were entitled to. In addition to these system "glitches," we identified several control weaknesses the Department needs to fix to prevent money from being paid to taxpayers when it shouldn't be. For example, because there weren't enough edits in the system, the comput-

er allowed duplicate refunds to be issued to some taxpayers. Also, Department employees can do things like generate tax refunds outside of normal processing, or override the system to change interest amounts owed to taxpayers, without any automatic documentation or review of those actions.

Shortcomings in testing the 1998 computer programs may have contributed to some computer problems going undetected until tax processing was in full swing in 1999. *The new programs were tested before they were brought on-line; however, staff told us that the Department had relied too heavily on American Management Systems during the testing, and that the testing wasn't as well-designed, complete, or as thorough as it should have been. In addition, involving the Department's internal auditors in developing and reviewing the computer system also could have helped identify potential shortcomings in that system.* page 13

New software that was installed in November 1999 is supposed to address many of the problems that occurred in handling income tax returns in 1999. *While Department staff had mixed views on how responsive the Department has been at fixing computer problems, based on a sample of items we reviewed, it appeared the Department was taking a reasonable approach to fixing the problems that have been identified to date. For example, the Department will manually review all boxes on the tax forms to make sure the recorded information is correct.*page 14

The new sales tax systems being installed for 2000 also are likely to experience problems. *Problems with any new software system are to be expected the first year, especially with software as complex as that being developed for the Department. However, the Department could have more problems than normal because of the amount of incomplete or inaccurate information about sales and withholding taxes being converted from the old system to the new one, and because of the need to rush through the testing phases due to Y2K issues.* page 15

Question I Conclusion: *Project 2000 is a very large undertaking, and a lot of good things have been accomplished by it, but there's no doubt that income tax processing using new computer programs developed as part of the Project didn't go well during 1999. The problems with the computer programs themselves weren't disastrous in nature, and seemed to us to be the types of things that might be expected in any new computer system. In addition, the Department appears to have gone a long way toward identifying and fixing those problems with the computer programs. Unfortunately, it can't be known for sure if those fixes have worked until income tax returns begin arriving in large number after the start of the calendar year 2000 processing season.* page 19

The key factor contributing to tax processing problems seemed to be that information going into the computer system wasn't accurate. To address that problem, Department officials will need to consider such things as adjusting tolerances on the equipment that reads the information from tax returns to make sure it's more accurate in reading critical items such as the taxpayer's Social Security number. They also may need to increase supervision and oversight of temporary and permanent staff who are supposed to correct information before it is processed.

Department officials also will have a number of clean-up issues to deal with, such as correcting inaccurate information that's already been

entered into the system, recouping erroneous payments that may have been made as a result of some of the data and programming problems, and the like.

Difficulties similar to those experienced in 1999 should be expected for several months after the new sales tax programs are completely installed and operating. That's because the Department was up against an extremely tight installation deadline due to Y2K issues, and consequently wasn't able to spend as much time with data clean-up and testing as would normally be desirable. It will be important for the Department to use American Management Systems as much as possible to assist in fixing these problems before AMS completely leaves the Project next year.

Question 1 Recommendations: To help reduce the amount of inaccurate information being entered into the computer system, we recommended changes to tax forms, changes to equipment so that questionable items would be kicked out for review and correction, continued efforts to clean up the inaccurate information transferred from the old computer system, closer supervision of staff, and more involvement by the Department's internal audit staff. To help lessen the chance of improper payments or adjustments being made to taxpayer accounts, we recommended that staff document reasons for adjustments, that supervisors approve those adjustments, that exception reports be procedued and reviewed by management, and that the internal audit staff run periodic tests. Finally, we recommended that the Department recover erroneous duplicate refunds when it's cost-effective to do so, and that it promptly clear up existing inaccuracies on 1998 income and withholding tax accounts so it can bill taxpayers for any balances they may owe.

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In its response, the Department generally concurred with these recommendations. It didn't agree with the recommendation requiring supervisors to approve adjustments to taxpayer accounts because it thinks other procedures already in place would provide sufficient controls over those adjustments.

Question 2: To What Extent Were Refunds Delayed in 1999, And What Factors Contributed to the Delays?

In 1999, it took the Department an average of 4.5 weeks to process income tax refunds, compared with 2.5 weeks in 1998. These processing times are based on a weighted average of about 95%-99% of refunds issued in each year. The Department took longer to process all refund types (paper, electronic, telefile), with paper processing averaging 5.5 weeks. In late October, we found 134 refunds were still pending. Taxpayers had filed these returns as early as February, and all had been kicked out of the system for review or correction. For a sample of these pending refunds, we found it had taken the Department more than 4 months on average to even begin corrective action, such as contacting taxpayers to obtain additional information.

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The computer programming changes needed to implement tax law changes passed by the 1998 Legislature created a backlog at the start of the 1999 tax processing season that was difficult to overcome. In 1998, the Legislature made several changes to the tax laws that were

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effective for the 1998 tax year. Two of the significant changes—making adjustments to the food sales tax refund form and requirements, and allowing an earned income tax credit—required the Department to make changes to its tax forms and computer software. These changes came into play during the midst of implementing the new tax processing software. The Department decided to finish developing the new tax processing software (that had been started before the legislative changes were made), and then develop a new version of the software with the legislative changes to be implemented in January 1999. In January, the Department processed only small batches of tax returns for 30 days to see how well the new version worked. During this time the Department had a growing backlog of returns waiting to be processed.

The volume of tax processing work increased somewhat between 1998 and 1999, while staffing levels decreased. page 26
Overall, 4% more income tax returns were filed in 1999 than in 1998, but the number of paper returns filed actually decreased. However, in 1999, the Department began electronically imaging one supporting schedule (Schedule S), which significantly increased the number of documents imaged. The number of refunds processed was up significantly in 1999 from about 640,000 to about 820,000 or about 28%. The number of tax returns and related forms kicked out for manual review and corrections also rose significantly in 1999 from about 186,000 to about 255,000, or about 37%. The Department had 14% fewer staff to help process income tax returns and make manual corrections in 1999 than in 1998.

Not updating taxpayers' addresses, when new address information was available, also contributed to taxpayer refunds being delayed in 1999. page 29
Nearly 3% of all refund checks the Department had mailed out through September 1999—or about 21,000 checks—were returned as undeliverable. Department employees are supposed to manually check and update all addresses where a taxpayer checked the box indicating he or she had moved, or where taxpayers didn't use the pre-printed address labels from their tax booklets. Sometimes these corrections were overlooked, or only partially made. Also, electronic returns didn't have an address change indicator, so the Department wasn't alerted to update the taxpayer's address in its records. We also noted during this audit, that the Department's mail opening and sorting equipment didn't always work as intended. The sorter only sorted about 17% of all paper tax returns received, and the extraction machine often cut the contents of envelopes. These problems likely contributed to delays.

The Department paid more interest on delayed refunds in 1999 than in previous years. page 30
State law allows the Department two months to process refunds without paying interest. The two-month clock starts on the latest of either April 15th, the approved extension due date, or the date the return is actually filed. Through early September 1999, the Department had paid about \$1.2 million in interest on late refunds, significantly more than in previous years. In general, interest was higher in 1999 because the Department took longer to process refunds, because of a significant number of refunds arising from older tax years, and because of a programming error by AMS. The way the Department has interpreted the law related to amended income tax returns results in the State paying a significant amount of interest that it otherwise wouldn't pay.

We found two areas where the Department's actions or policies page 33
may not have been in compliance with State law. First, the Department has begun granting automatic extensions to the April 15th income tax filing deadline (whether or not the taxpayer requested it) without clear statutory authority to do so. Second, the Department's policy for granting food sales tax refunds allows taxpayers filing as head of household to claim a higher refund than they are allowed by law, which costs the State about \$3 million a year.

Question 2 Conclusion: *The Department was slower in making* page 35
refunds in 1999 than it was in 1998. Some of that slowness could be expected with implementation of new tax processes—putting new processes in place always requires some learning and some working out of kinks. In addition, some of that slowness seemed due to circumstances beyond the Department's control, such as dealing with changes made by the 1998 Legislature and reduced staffing. Nevertheless, part of the slowness seemed excessive—it took several months even to begin resolving questions about some returns and related documents—and part seemed unnecessary—the return of thousands of refunds for wrong addresses probably could have been avoided or at least reduced. The Department's slowness in making refunds had an adverse fiscal impact because it caused an increase in the amount of interest paid in 1999. That fiscal impact was compounded by additional interest paid on refunds and excess food sales tax refunds because of policies and procedures contrary to State law.

Question 2 Recommendations: *We recommended that the Depart-* page 35
ment review its procedures and staffing for dealing with returns that need review or corrections, and that it continue to work with vendors to adjust the mail sorting and extraction machines. We also recommended that the Department correct the policy and programming errors that didn't allow for a two-month period to process refunds without paying interest, and that the Department begin requiring some proof of eligibility from taxpayers claiming food sales tax refunds and homestead refunds, or seek legislative changes in this area. In addition, we recommended that the Senate and House tax committees or other appropriate legislative committees review and clarify the law relating to interest paid on amended tax returns. Finally, we recommend that the Legislature amend State law to clearly allow or disallow an extra exemption in computing food sales tax refunds for heads of households.

In its response, the Department generally concurred with these recommendations. The Department thinks that requiring taxpayers to submit proof of eligibility for tax refunds would be burdensome to taxpayers and costly to administer. Instead, it plans to rely on risk-based auditing of taxpayer claims.

Question 3: How Well Did the Department Communicate with Taxpayers?

Much of the department's correspondence to taxpayers in 1999 page 37
was unnecessary or confusing. During the 1999 tax processing season, legislators and tax preparers received many complaints about letters from the Department that seemed to be in error or were confusing. For example, the Department sent letters to living taxpayers notifying them they were reported as deceased, letters that adjustments were made which resulted in

no change to the amount of tax due, and letters billing taxpayers for small amounts (less than \$5.) Some of the letters were generated in error because of the types of problems discussed in Question 1. The Department also sent out some of the letters on purpose to educate taxpayers about errors they'd made on their returns. The Department has taken steps to improve its taxpayer correspondence, but the content of some letters may still be confusing.

It was very difficult for taxpayers to contact the Department by telephone during the 1999 income tax processing season. page 39
Many taxpayers reported not being able to get through to the Department at all on the phone. In fact, the Department's two areas that answer income tax telephone calls, the Taxpayer Assistance Center and the Wage Earner Section, answered half as many calls in 1999 as they did in 1998. In 1999 the Department received 284,000 more calls than in 1998, and answered 11,000 fewer calls.

Several factors contributed to the increased number of calls the Department received in 1999. The problems the Department experienced with its new automated tax processing system generated a significant number of calls. Taxpayers likely called the Department to inquire or complain about such things as why their refund was delayed, why their refund check had the wrong Social Security number, and the like. In addition, the refund status hotline, a toll-free number taxpayers call to receive an automated message about their refund, gave incorrect information to many tax payers during most of 1999. This likely caused taxpayers to call the Department to find out what happened to their refund. In addition, because so few callers were able to get through to the Department, it's likely many callers hung up and called back later.

The Department had assigned more staff to answer the telephone in 1999 than in 1998, but those additional people handled fewer calls each, on average. The Department had 15 full-time employees assigned to answer telephones during 1998 and 17.5 during 1999. In 1998, the Department employees answered about 3,400 calls each, on average, compared with an average of about 1,900 calls in 1999. A Department official pointed out that more staff answered fewer calls because staff were unfamiliar with the new system and new responsibilities, some calls required a significant amount of time, and during peak processing times, staff who normally were assigned to answer telephones were helping process returns instead of answering calls.

The Department has made some fairly significant changes to its phone system. page 41
The Department has drafted a multi-phase improvement plan that's scheduled to be completed in February 2001. The Department has implemented Phase One of the plan, routing all calls to a central number and then routing them out to the tax area based on the taxpayers selection. The Department has also acquired 96 additional phone lines to use as hold queues for callers waiting to speak to a representative, stopped accepting voice mail, fixed the refund status hotline, and started monitoring call volumes hourly to adjust needed staff.

Regardless of improvements made to the Department's phone system, if future tax processing doesn't go smoothly, the Department may not be able to handle taxpayer telephone calls effectively during peak times. page 43
The Department's goals for the year 2000 are to answer 25% of the calls it receives during peak times, and 75% during non-peak times. It

will likely be difficult for the Department to meet the goals, given that in 1998, before all the problems associated with the new automated system occurred, the Department only answered 11% of the calls it received.

The Department's ability to answer telephone calls more effectively in 2000 may well depend on how smoothly the tax processing goes. If few problems occur, fewer taxpayers will call and the call volume should be more manageable because of the Department's ability to monitor call volumes and shift staff accordingly.

Our analysis of the new system for processing sales taxes in 2000 identified problems with the accuracy of information transferred from the old system to the new one. If these or other situations cause numerous problems, the Department again could be faced with not being able to answer most of calls. In addition, if the Department diverts significant numbers of employees from processing taxes to answer the phone the problem may become circular-increasing processing time, which could lead to more delays and more phone calls.

Question 3 Conclusion: During the 1999 tax process season, the Department didn't do very well communicating with taxpayers. Many letters it sent to taxpayers raised questions, and caused the recipients to phone the Department to get clarification. In addition, delays in processing refunds caused taxpayers to phone the Department about the status of their refunds. When taxpayers called the Department, they often couldn't get through. When they did get through, they often didn't get good information about the status of their refunds. If they left voice mail messages, the Department didn't respond in a timely basis. All of this added up to significant taxpayer dissatisfaction. The Department is taking steps to eliminate unnecessary letters, make correspondence more easily understandable, and provide more responsive phone service, but more work may be needed to solve the kinds of problems that occurred in 1999 and to overcome negative perception in the minds of many taxpayers.page 43

Question 3 Recommendations: We recommended the Department thoroughly review their form letters and eliminate or clarify confusing language and fully explain terms, processes, and programs that taxpayers may not be familiar with. To ensure that it's able to effectively handle taxpayer phone calls, we recommended that the Department thoroughly test the refund status hotline, continue its plan to implement a "call center" for answering phone calls, and continue to monitor staffing needs. The Department concurred with these recommendations.page 44

Question IV: Does the Department Have an Adequate Process for Ensuring that Checks Remitted By Taxpayers Are Properly Accounted For and Aren't Accidentally Destroyed?

Our review focused on the reasonableness of the Department's process for finding taxpayer checks among envelopes and other documents before they might be accidentally destroyed. The Department receives a large number of checks from taxpayers. Thosepage 45

checks are separated from returns and other forms, then deposited in the State Treasury. After the returns and other forms have been processed and electronically recorded, those documents are sent to the Department's warehouse, where they are stored for a period then shredded. Earlier this year, newspapers reported an allegation that some taxpayer checks would have been at risk of being accidentally shredded at the warehouse if it weren't for a review process put in place by temporary staff. Because the Department's overall receipts handling procedures are reviewed annually as part of the Statewide audit done by a CPA firm, we focused our review on the specific procedures the Department uses to find taxpayer checks among other documents.

The Department's system of checks and controls to try to ensure that taxpayers' checks aren't accidentally shredded appears to be adequate. page 46
The Department has established specific procedures to look for checks that might have been left among other documents sent in by taxpayers. Those procedures involve both electronic and manual checks, and include a review by warehouse employees of documents before they are shredded. That review, including the recording of checks found in a steno pad, was developed at the direction of Department officials in 1997, when the Department began to "image" tax returns and related documents. From December 1998 through June 1999, warehouse staff found 143 taxpayer checks among the documents they'd received before they were shredded. Most of those checks were found in December when the Department hired several additional temporary employees to work off a backlog. Based on staff estimates and the results of the warehouse reviews from January through June 1999, it's likely that very few checks actually get shredded. Even if a taxpayer check is shredded, no money is lost because the taxpayer will be billed for the amount of tax unpaid. Although in such a case the taxpayer will be inconvenienced, very few taxpayers should be affected.

Question 4 Conclusion: page 49
The Department has established a system of reviews and checks to make sure that the number of taxpayer checks accidentally shredded is minimized. That system appears to be effective. Although it's possible that a few taxpayer checks may accidentally get shredded in spite of those checks and reviews, no cost-beneficial system can guarantee that such an occurrence never happens. Ways of attempting to reduce the frequency of that occurrence even further likely would add to the Department's costs, and could result in additional delays in processing tax returns.

Appendix A: Scope Statement page 51

Appendix B: Surveys of Department of Revenue Employees page 54

Appendix C: Review of Fixes for Computer-Related Issues That Caused Problems With Tax Return Processing in 1999 page 59

Appendix D: Agency Response page 61

This audit was conducted by Leo Hafner, Chris Clarke, Sonja Erickson, Allan Foster, Anthony Perez, Jill Shelley, LeAnn Schmitt, and Jennifer Wagner. Randy Tongier was the audit manager. If you need any additional information about the audit's findings, please contact Leo Hafner at the Division's offices. Our address is: Legislative Division of Post Audit, 800 SW Jackson Street, Suite 1200, Topeka, Kansas 66612. You also may call (785) 296-3792, or contact us via the Internet at: LPA@lpa.state.ks.us.