



PERFORMANCE AUDIT REPORT

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

**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 8, 1999

To: Members, Legislative Post Audit Committee

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This report contains the findings, conclusions, and recommendations 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 the results of surveys of Department employees and the Department's plans to fix computer-related problems.

The report includes several recommendations for improving the Department's tax processing systems and procedures, increasing its adherence to State law, and bettering its communications with taxpayers. We would be happy to discuss these recommendations or any other items in the report with any legislative committees, individual legislators, or other State officials.

Barbara J. Hinton
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EXECUTIVE SUMMARY
LEGISLATIVE DIVISION OF POST AUDIT

**Question I: 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 problems with computerized imaging equipment. Furthermore, a number of "glitches" in the computer software also contributed to problems processing income tax returns in 1999, including incorrectly matching people as joint filers and allowing some taxpayers to receive larger refunds than they were entitled to. In addition to the 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.*

Shortcomings in testing the 1998 computer programs may have page 13
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.*

New software that was installed in November 1999 is supposed page 14
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, one cause of incorrect information in the Department's taxpayer records was inaccurate electronic reading of certain boxes on the tax forms. To fix this problem, the Department will manually review all boxes to make sure the recorded information is correct.

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

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Question I Recommendations: page 20

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.page 23

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 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.page 25

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 higher 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 may not have been in compliance with State law. page 33
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: page 35

Question 2 Recommendations: page 35

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

Much of the department's correspondence to taxpayers in 1999 was unnecessary or confusing. page 37
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 improve-

ment 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. 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.

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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: page 43

Question 3 Recommendations: page 44

Question 4: 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. Those 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

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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

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 us at (785) 296-3792, or contact us via the Internet at LPA@lpa.state.ks.us.

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

The Department of Revenue is the State's primary tax agency. As such, it administers the State's key tax laws—enforcing the provisions of law, providing assistance to taxpayers, collecting amounts due the State, and making refunds to taxpayers when appropriate.

Legislative questions have been raised about the accuracy of some of the information the Secretary of Revenue provided in testimony before the Legislative Post Audit Committee, about the amount of interest paid on delayed refunds, about how well Project 2000 has worked to date, and about the adequacy of the Department's quality control process over checks remitted by taxpayers. Concerns also have been raised about whether the Department is taking adequate and timely steps to address problems in these areas. This performance audit answers the following questions:

- 1. How accurately did the Department of Revenue report to the Legislative Post Audit Committee about the extent and causes of delays in income tax refunds for the 1998 tax year?**
- 2. For the 1998 tax year, how much interest did the Department pay on delayed income tax refunds, and how does that figure compare with previous years?**
- 3. What plans has the Department established for improving the income tax refund process and the handling of taxpayer phone calls for the 1999 tax year, and do those plans appear to be sufficient to address the problems that occurred this year?**
- 4. Has Project 2000 worked as intended to date?**
- 5. Does the Department have an adequate process for ensuring that checks remitted by taxpayers are properly accounted for and aren't accidentally destroyed?**

A copy of the scope statement approved by the Legislative Post Audit Committee is contained in Appendix A. To answer these questions we reviewed the Department's computerized tax processing system to see how well it works, whether it's been adequately tested, and whether problems within the system have been fixed. We also interviewed both Department and American Management System, Inc. (AMS) staff on all of these issues, observed staff at work, and surveyed Department staff who work directly with the system--both those who use it and those who helped design it. In addition, we talked to other states about their experiences with AMS.

Our audit work answered each of the five specific questions listed above, however, for reporting purposes we've collapsed those questions into four.

In conducting this audit, we followed applicable government auditing standards set forth by the U.S. General Accounting Office, except we were not able within the timeframe for this audit to assess the accuracy of the data generated from the Department's computer without adversely affecting the Department's implementation of its new sales tax processing systems. Department staff who would have had to help us test the reliability of those data were the same people responsible for testing and implementing the new systems.

As a result, the reader should be aware that most of the computer-generated data used throughout the audit are self-reported. Without testing, there's no way to know how accurate those data are, but we saw nothing to suggest that the data are so grossly or systematically wrong as to affect our findings and conclusions. We did note inconsistencies in the data and in how data were reported from one source to another. Thus, the numbers and dollar amounts presented in this report should be viewed as indicators, and not as absolutely precise. Our findings begin on page 7, following an overview of Project 2000.

Overview of Project 2000

Project 2000 Is a Multi-Year Effort Designed to Install New Computer Programs and Completely Overhaul the Department's Business Practices

In 1993, Department officials requested information from several consultants about the services and products available to help meet the following Department goals:

- to implement a system that was flexible and customer oriented
- to simplify and improve the tax process
- to increase overall tax revenues
- to increase the number of taxpayers voluntarily paying their taxes

The Department requested specific information on approaches to re-engineering the way it did its work internally, and the way it dealt with its customers--the taxpayers. In addition, it requested information about computer hardware and software options available to update and integrate its tax processing and accounting systems. In 1994, using the information supplied by the consultants, the Department put together a request for proposals for Project 2000. The work was envisioned to be done in three stages.

Project 2000 involved much more than just installing new computer systems to process taxes. It called for a wholesale redesign of the Department from top to bottom, and a complete change in its culture to make it more customer oriented. Previous divisions and bureaus, such as the Division of Taxation, were replaced by four "core processes" that would serve all tax areas. These core processes are described in the boxes on the next page.

The reorganization was intended to make it easier for people to deal with the Department. For example, since the reorganization, a business owner can now make a single call to the Department to ask questions about all the taxes that taxpayer is responsible for (i.e., income tax, sales tax, withholding tax). Before the reorganization, the taxpayer had to make multiple phone calls to get such information.

In addition to restructuring its divisions and bureaus, the Department redesigned its procedures and rewrote job descriptions for its employees, which resulted in a massive change in its way of doing business.

The Department chose American Management Systems, Inc. to help it implement Project 2000. After issuing a request for proposals and evaluating the bids it received, the Department entered into a fixed-price contract with American Management Systems (AMS) for stage one of the Project. The table on page 5 summarizes the costs and work involved for all stages and contract amendments related

**The Department of Revenue's Four "Core Processes"
That Serve All Tax Areas**

1

Channel Management

To streamline the processing of tax information

This core process is designed to efficiently handle taxpayer information--like a tax return--throughout the steps it must travel while being processed.

2

Customer Relations

To help citizens understand the tax laws

Taxpayer education, licensing, problem resolution, and payment of accounts receivable are some of the services provided by this core process.

3

Compliance Management

To encourage taxpayers to obey the law and pay their taxes

Employees in this core process use a number of tools to identify taxpayers who aren't paying taxes, such as electronic and on-site audits, compliance reviews, dispute resolution, and the like.

4

Enforcement

To take action against taxpayers who don't pay their taxes

If a taxpayer still fails to pay taxes, actions such as investigations, tax liens, and criminal prosecutions are used in this core process to compel taxpayers to pay their taxes.

to Project 2000. After the first stage was completed, the Department signed a second contract with AMS for stages two and three. One unusual aspect of the contract: AMS was to be paid only out of any additional revenues the Project generated.

The Department has modified its contract with AMS several times for things that weren't envisioned in the original contract. All modifications were approved by the Secretary of Administration and the Division of Purchases. With these contract modifications, the actual contract costs are now expected to be \$45.4 million. AMS also is eligible for an additional \$10 million if the Project generates at least \$189.9 million in additional revenues within two years of its completion date. If the Project brings in less, AMS gets 10% of the additional amount collected.

**Project 2000 Will Cost About \$6.3 Million
More Than Originally Estimated**

Originally, the total cost of the Project was estimated at \$70.8 million. After the contract modifications, the Department estimates the Project will cost \$77.1 million. The table on the bottom of the next page shows a breakdown of those costs.

Summary of Project 2000 Contracts and Contract Modifications

Date	Event	Payments to Contractor	What Was Supposed To Be Done?
6-2-95	Signed Contract for Stage One	\$9,491,875	<ul style="list-style-type: none"> • Implement the system to track additional revenue generated by the Project • Reorganize the Department's business practices • Plan stages two and three and prepare a cost proposal for them • Implement "Fast Track," projects designed to improve customer service and help pay for the Project
7-8-96	Signed First Contract Modification (Added Additional Work and Moved Some Work Forward)	\$5,890,854	<ul style="list-style-type: none"> • Provide some additional hardware • Add a 1-800 line to one of the Fast Track initiatives • Provide support personnel to replace Department staff who were assigned to the Project
12-6-96	Signed Stage Two and Three Contract	\$34,523,023	Implement the following systems: <ul style="list-style-type: none"> • collections • business tax registration and licensing • individual income, fiduciary, homestead, and food sales • withholding • sales and use • unemployment tax
1-5-98	Signed Third Contract Modification (Added Additional Work)	\$2,069,852	Revised stage two and three contract to include: <ul style="list-style-type: none"> • additional staff for one of the Fast Track projects • additional computer assistance services
7-20-98	Signed Fourth Contract Modification (State Mandates Required Additional Resources)	\$2,430,000	Modifications had to be made to the plan for the individual income tax, homestead and food sales system to comply with statutory changes made during the 1998 legislative session.
As of 11-15-99	Currently Negotiating Fifth Contract Modification (Originally Scheduled Work Was Substituted)	\$992,000	The Department is currently negotiating to drop the unemployment tax system and substitute it with a corporate income tax system at no additional cost.

Total Costs of Project 2000 (in millions)

	Original Costs	Revised Costs
Stage One Contract Cost	\$15.4	\$15.4
Stage Two and Three Contract Cost	\$24.5	\$29.0
Maximum Additional Payments	<u>\$10.0</u>	<u>\$10.0</u>
Total Fees Paid to AMS	\$49.9	\$55.4 (a)
Total Fees Paid to Other Vendors	\$11.2	\$11.3 (b)
Salaries and Wages for Department Staff	<u>\$9.7</u>	<u>\$10.4 (b)</u>
Total Project Costs	\$70.8	\$77.1

(a) The original contract was modified to cover additional costs.

(b) Original estimates of these costs were projected only through December 1998.

As the table shows, Project costs have increased because the Department contracted with AMS for additional work not envisioned when the original contracts were signed, and because estimates for salaries and wages for Department staff and subcontractor fees were projected only through December 1998.

The increased costs have no effect on the additional payments that AMS can receive. Those payments still are capped at \$10 million. The Department estimates that the Project will generate more than \$220 million in additional taxes over an eight-year period that it otherwise wouldn't have collected. Under this assumption, the additional Project costs will be more than offset by the enhanced collections.

Overall the Project Has Met Its Scheduled Completion Deadlines With the Exception of One Tax

Project 2000 was designed to be completed in three stages. The first stage included reorganizing the Department, initiating "fast track" projects that were designed to bring in additional revenues and improve customer service, and planning stages two and three. These tasks were completed on time in September 1996.

Stages two and three included designing and implementing a new tax collection system and a new business tax licensing and registration system, and automating several individual income, sales and use, unemployment, and withholding taxes. (The corporate income tax system wasn't included because the Department planned to build it in-house after Project 2000 was completed.) All work was scheduled to be completed by December 1999, with AMS staff remaining to provide support until March 2000.

The individual income tax and withholding tax systems were completed in October 1998, and the sales tax system was completed on schedule in November 1999. Except for the unemployment tax system, all scheduled tax systems have been completed, although modifications may be needed to fix any problems found in 2000.

The Department and AMS are negotiating a contract modification to substitute the corporate income tax system for the unemployment tax system. Work on the unemployment tax system originally had been scheduled to start in 1998. However, when Project officials realized they couldn't finish the more important tax systems on time if they were working on unemployment tax, they decided to put off work on that system until the other tax systems were completed.

Department officials recently decided it would be better to have AMS do the corporate tax system rather than the unemployment tax system. AMS has agreed to do that for about \$1 million. AMS started work on that system in October, and is scheduled to complete it in October 2000.

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

It's important to understand that this question focused only on the processing of income tax returns during 1999--not on all aspects of Project 2000. An August 1997 audit we'd done of Project 2000 showed the Department was following most of the "best practices" in developing a major computer system, and had reorganized its internal processes and staff. It has since created single points of contact for taxpayers, automated many of its tax processing activities, and brought two major computer programs on-line.

Despite the benefits the State has received, no one would question that income tax processing under Project 2000 didn't work as well as intended during 1999. Although the Department's computer processed a large number of returns without problems, in some cases inaccurate information and program deficiencies created problems for both taxpayers and the Department. Most of the problems taxpayers experienced were caused by inaccurate information being entered into the computer. Other problems were caused by "bugs" or a lack of "edits" in the computer software. We also noted that the system for processing income taxes and refunds lacked some important controls to prevent inappropriate refunds or adjustments to taxpayer accounts from being made. It appeared that some of these problems may have been prevented if the Department had done a better job of testing the systems that came into production, and had made better use of its internal audit staff.

A new version of the software being installed in November 1999 contains fixes for many of the types of problems that occurred when processing income tax returns in 1999. It also will bring the processing of sales taxes on line. This new system likely will experience problems in the coming year because of testing schedules that were too short and some incomplete and inaccurate data being transferred into the system. These and related findings are discussed in more detail in the sections that follow.

**By Most Accounts, Income Tax Processing Under Project 2000
Didn't Work as Well as Intended During 1999**

In October 1998, the Department had just installed new computer programs that were designed to process individual income and withholding taxes. Those programs were updated in January 1999 to take into account the effects of changes the 1998 Legislature had made to the tax laws (the Kansas Tax Reduction and Reform Act). These programs were brand new and, except for the testing that was done before implementation, hadn't been used to process income taxes in Kansas before.

When income tax returns began to be processed in early 1999, problems began to surface in early March, and taxpayers began to complain to their tax preparers and

legislators. During this audit we interviewed a sample of those tax preparers, reviewed taxpayer complaint letters, talked with many Department staff, and reviewed Department documents to identify the types of problems taxpayers had experienced. Some of the issues they cited included:

- delayed income tax refunds
- duplicate refunds to taxpayers
- erroneous bills to taxpayers for taxes or penalty and interest they didn't owe
- taxpayers not getting credit for estimated tax payments they'd made
- "deceased taxpayer" notices being issued to living taxpayers telling them a beneficiary needed to be designated for the refund
- taxpayers getting food sales tax refunds when they hadn't checked the box requesting the refund
- taxpayers getting refund checks with somebody else's Social Security number on them
- taxpayers' refunds being withheld to cover liabilities on the Department's books related to the homestead property tax refund program

The Department doesn't have the kind of information that would allow us to quantify how often many of these types of problems occurred. To find out how these and other types of problems happened, we observed staff fixing problems with tax returns, we talked to staff who corrected those problems, we ran tests on the computer database to try to identify possible problem situations, and then we reviewed cases generated by those tests to determine whether there really were problems. We also surveyed a total of 240 Department staff who were involved in the development of the computer programs or who were the end users of the data provided by those programs. Complete results of the surveys can be found in Appendix B.

The Computer Programs Processed a Large Number of Tax Returns Without Problems, but in Some Cases, Inaccurate Information and Program Deficiencies Created Problems

Department Staff We Surveyed Had Conflicting Opinions About How Well Computer Programs Are Working

During this audit, we surveyed 240 Department employees to gather their opinions about a number of issues related to Project 2000. We received 67 responses: 10 from computer staff who are involved in developing computer programs for the Project, and 57 from the staff who are the end users of the new system.

The two groups offered conflicting opinions about how well the system was working. For example, 100% of the computer staff who responded rated the overall effectiveness of the computer systems as very good or excellent. In contrast, almost two-thirds of the end users rated the system's overall effectiveness as fair or poor.

No new computer system can be expected to work perfectly when first installed, and the new income tax programs the Department installed in late 1998 and early 1999 were no exception. Nonetheless, during 1999 nearly 1.5 million income and homestead returns were processed using the new computer programs. About 1.2 million of those returns, or 85%, were processed essentially without problems. (Comparison data for previous years aren't available.) Unfortunately, the problems that did occur caused significant inconvenience for the

Department Staff Offered A Mix of Positive and Negative Comments About Project 2000

During this audit, we established a hotline for two weeks to allow Department employees to contact us who otherwise might not have felt comfortable doing so. We got only one call--from an employee who thought Department employees were working harder than they ever had, but who were getting demoralized by the frequent criticism and scrutiny. This person also said that if people understood how huge and complex the project was, they'd understand it was unreasonable to expect there wouldn't be any "bugs."

We also surveyed Department employees. Following are some of the comments they made--both positive and negative

"To be able to see the image of the return where in the old system we would have to pull returns from the file room which could take 2 to 3 days. In the new system it is easier to move payments posted to the wrong account. In the old system moving some payments could take months."

"The new system when established, far outshines any 'computer' system Revenue has had since I came aboard."

"I think [ASTRA tax processing is] slower. The old way got people's returns faster and more efficient. All we are getting now are letters of complaints . . . a lot of time and money is being wasted."

"On [ASTRA tax processing] we have to look at more screens as where on the old system we could get the same information on one screen. . . . Taxpayers aren't very patient when they are calling us (several times in most cases) long distance."

taxpayers involved, and required a lot of cost and effort on the part of the Department to correct them. They also contributed to delays in taxpayer refunds, as discussed in Question 2.

Inaccurate information being entered into the computer system significantly hampered the processing of income tax returns during 1999, and appears to have caused many of the errors taxpayers complained about. In general, the inaccurate information--including wrong Social Security numbers and wrong amounts--got entered into the system in one or more of the following ways:

- **Equipment the Department uses to read data from tax returns didn't realize it had "misread" some critical information, so it didn't reject those items and flag them for manual review and correction.** As part of Project 2000, the Department installed scanning equipment that electronically creates an image of the return, and ICR (intelligent character recognition) equipment that "reads" scanned images directly into the computer. Whatever this equipment can't read, Department staff check and enter by hand.

In reviewing the corrections made to tax returns during 1999, we noted a lot of cases where the equipment had misread the data without "kicking it out" for manual review. For example, it often confused handwritten numbers like 1's and 7's and 4's and 9's, and letters like D's and P's. Also, it sometimes couldn't distinguish a box on the return that was checked from one that wasn't. As a result, it misread change-of-address boxes, deceased-taxpayer boxes, and the like. Officials in two other states we contacted who use scanning equipment told us they require staff to check the accuracy on 100% of certain key items--such as Social Security numbers--before tax returns are processed.

- **The staff who were reviewing and correcting items that had been rejected by the ICR equipment sometimes mis-keyed the “new” information they entered, or they passed on items as being accurate when they weren’t.** Many of the people who made these corrections during 1999 were temporary workers, and we heard complaints from other staff about the quality of their work. In response to our surveys, some staff also said inaccurate information was being passed on just to be able to meet “quotas” established by the Department, which require workers to make a certain number of corrections in a day.
- **Some data converted from the old computer system didn’t transfer completely to the new one, and some data that did transfer had errors in it.** An example of the first problem: some taxpayers’ estimated tax payments from the old system didn’t show up in the new system, so those taxpayers didn’t get credit for having paid these amounts. An example of the second problem: on joint returns, a lot of spouses’ Social Security numbers were incorrect when transferred to the new system. The old system hadn’t used spouses’ Social Security numbers to match files, but the new system needs both the taxpayers’ Social Security numbers to be correct.
- **Taxpayers and tax preparers sometimes sent in inaccurate information or unapproved forms.** For example, although people who were filing a tax return just to get a food sales tax refund weren’t supposed to list their income on the return, many elderly people listed their Social Security income, which is non-taxable. The computer picked this up as taxable income. As a result, instead of getting a food sales tax refund, many of these people got a tax bill for the income they’d reported. In addition, taxpayers or preparers sometimes used forms the ICR equipment couldn’t read correctly.

One action the Department took last year contributed to a large number of misread Social Security numbers. For privacy reasons, the Department decided to stop printing Social Security numbers on the label that taxpayers peel off their tax booklets and attach to their returns. Taxpayers had to write their Social Security numbers on the return, making the numbers much more difficult for the equipment to read.

A number of “glitches” in the computer software also contributed to problems processing income tax returns in 1999 Some were caused by computer “bugs” (a piece of program code that doesn’t work as intended), while others were caused by edits or the lack of edits (rules built into the computer program) that allowed something to happen that wasn’t intended. Some of the types of problems we identified by reviewing internal documents at the Department and talking to Department staff are summarized below:

- **The computer sometimes created multiple 1998 tax accounts for one taxpayer.** This happened when taxpayers sent in all four quarterly estimated tax payments together at the start of the year, instead of sending in four separate estimated payments throughout the year.
- **The computer matched up some unrelated people and showed them as filing a joint return.** This happened when a change-of-address box had been checked and the equipment misread the taxpayer’s Social Security number as another taxpayer’s valid Social Security number. The computer then matched these two unrelated people into a joint account.

**Computer Problems Have Contributed to Delays
In the Department's Billing of Balances Owed on Income Tax
and Withholding Tax Accounts**

Although problems with delayed refunds received most of the public's attention during 1999, there also have been problems with both sales and withholding tax accounts where taxpayers owe money. Department staff informed us that about 17,000 individual income tax accounts and 6,000 withholding tax accounts ended up on worklists to be manually reviewed and fixed before the tax payments could be posted to the taxpayer's accounts. Some of these accounts owe the Department additional taxes, but until all of them have been reviewed for errors, the Department can't bill the taxpayers, because it doesn't know the correct amount to bill them.

According to Department staff, there still were about 3,000 of these accounts to correct as of the first of November. At that time, they estimated they wouldn't be able to begin billing the amounts due on 1998 tax returns until after the start of calendar year 2000. The Department couldn't provide estimates of how many of these accounts may owe additional taxes, or what the total amount waiting to be billed might be.

- **The computer allowed some taxpayers to receive larger refunds than they were entitled to.** Department staff had told us about a problem with the computer "zeroing out" the percent of tax owed to Kansas on non-residents' tax returns, which caused the computer to refund the entire amount the taxpayer had had withheld. The Department's computer showed that 9,368 people who had filed non-resident tax forms received at least 100% of their withholding as a refund. We reviewed 60 of those cases, and found only one where this problem had occurred. We also found that 8 of these 60 non-resident taxpayers (13%) received larger refunds than they should have for other, varied reasons, such as putting their Kansas adjusted gross income on the wrong line or incorrectly figuring tax credits.
- **Early in the season, the computer reportedly didn't recognize a Schedule S form filed with a return.** This happened even when a schedule and return had been submitted and scanned into the system.

One byproduct of some of the computer problems is that the Department hasn't been able to bill taxpayers for additional amounts of tax they may owe. This problem has affected both individual income and withholding tax accounts, as discussed in the profile box above.

We also identified several control weaknesses the Department needs to fix to prevent money from being paid to taxpayers when it shouldn't be. Those weaknesses can be summarized as follows:

- **The computer allowed duplicate refunds to be issued to some taxpayers.** The Department's computer system showed that 561 taxpayers had gotten duplicate refunds of identical amounts. They received about \$186,000 in total refunds. Some of these situations were legitimate. For example, some taxpayers were owed refunds, but sent a check to the Department apparently thinking they owed tax. The Department had to refund the check the taxpayer sent in and also had to send them a check for the amount of the refund from their tax return. Hence they legitimately

got two checks for the same amount. However, we identified 162 cases worth more than \$41,000 that we think have a very high likelihood of being erroneous duplicate refunds. We reviewed 20 of these cases, and found 17 where the taxpayer received a refund he or she wasn't entitled to. In all, 12 of those taxpayers cashed both refund checks. We think these duplicate refunds occurred because there weren't enough edits in the system to identify when two checks for the same amount were going to the same taxpayer.

- **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.** There may be good reasons for staff to take either of these actions. However, it's important that all manual changes or overrides be posted to an "exception" list that is reviewed and verified by management as needed to ensure such changes are accurate and appropriate. Without this control, there's a significant risk that errors, inappropriate actions, or outright fraud could happen and not be caught.
- **The computer doesn't keep a record of the changes Department staff make electronically to returns that are kicked out for manual review and correction.** If a return must be manually processed to fix problems, the file shows codes for those problems. Once those problems are corrected, however, the associated error codes are deleted from the record and there's nothing left to show what those errors were and when they were fixed. Such information would provide an important trail for auditing and assisting management in identifying what adjustments actually were made to taxpayer records, why, how long they took to make, and whether they were appropriate. The system does have a place in the record for staff to make notes about any corrections they make to returns, but we found that, in a number of cases were reviewed, there weren't adequate notes to know what was adjusted and why.
- **The Department doesn't require people who apply for food sales or homestead property tax refunds to submit proof of non-financial eligibility, even though the law requires them to.** To be eligible for either, a person must have an income below \$25,000 (what's included in

Some Revenue Staff Feel that Negative Publicity Is Overshadowing Their Hard Work

As we spoke with staff at the Department of Revenue, we generally got the sense that many people were working as hard and as fast as they could to correct problems that occurred during the most recent tax processing season. Several survey responses we received brought to light how some Department employees feel about all the negative publicity the Department has received in the past year.

One employee wrote--- *"A couple of months back, I was reading the paper at 6 a.m., having been up since 4 a.m. attending to Project business, and in that day's issue was a letter to the editor.... berating the Department of Revenue again. This was upsetting to me because from my vantage point I can see that there are a lot of really good people working very hard on this Project. I just wish the critics could drive by the State Office Building in the evening or wee hours of the morning, or on Saturday or Sunday, and see the cars, or that they could know how many people are dialed in and working from home at various times. I wish that they could get to know some of the AMS associates; they are some of the brightest and most dedicated people in the world – if anyone can accomplish the huge task we have set out to do, they can. KDOR has definitely benefitted from the partnership with AMS."*

Another respondent said that the Department owed taxpayers an apology, but went on to say that *"State employees have really worked hard, harder than what the public perception is of us."*

Still another respondent said, *"the media isn't fair or factual in their reporting about the Secretary and other employees of the Department."*

income is different for each type of refund) and must meet at least one of the following criteria for the entire year: be at least 55 years old, be blind or totally and permanently disabled, or have a dependent child under 18 living at home. The law also requires anyone claiming a food sales or homestead property tax refund to supply the Department with reasonable proof of age, disability, and household income. However, the Department assumes people are eligible if they apply, so it doesn't require them to submit any documentation. Without such documentation, neither we nor the Department can determine whether ineligible people are receiving food sales or homestead refunds.

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 programs designed to automate tax processing for individual income and withholding taxes were tested before they were brought on-line. However, staff we interviewed and surveyed 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 thorough as it should have been. The types of problems they cited are summarized below:

- **Testing wasn't as independent as it could have been, because the Department relied heavily on the contractor who developed the programs.** American Management Systems' staff managed the testing for these programs because the Department's testers were inexperienced. However, the company went through three test managers during that time, and staff told us each manager led the test team in different directions. For one of the smaller components of testing, the Department had almost no participation. Testing software programs is a critical step in bringing a new system on-line--it lets the Department know whether those programs will do what they were intended to do. However, letting the contractor that developed the programs control the testing makes that testing less objective. Also, the Department knows its needs better than the contractor does, so it's in a better position to perform those tests.
- **The design documents for income tax computer programs weren't specific enough.** Normally a system is designed based on a long list of specific detailed design requirements, which testers subsequently use to develop their tests. However, the design for the individual income tax system wasn't specific enough to make it easy for the testers to understand the income tax system or to develop appropriate tests.

Improved testing likely would have caught some of the problems noted earlier, and could have minimized taxpayers' frustrations with the way their income tax returns were handled.

Involving the Department's internal auditors in developing and reviewing the computer system also could have helped identify potential shortcomings in that system. The Department's internal auditors could have played two significant roles. First, they could have been involved throughout the design and implementation of the computer systems, and could have suggested controls that should be built into those programs from the start. While the auditors were used extensively in developing and

monitoring the system of measuring revenue attributed to Project 2000, they were only involved for a week in reviewing the general design of the new computer systems.

Second, the internal audit staff could have played an on-going role in checking the system to help determine whether unintended things were happening when returns were being processed. For example, during this audit we conducted a number of tests to identify such things as duplicate payments being made to the same taxpayer, or refunds being generated when there was no record of a tax return being filed. Some of these tests identified improper payments. These are the types of things the internal audit staff could do periodically to help identify new controls that may need to be established to prevent these types of things from occurring.

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

In November 1999, the Department brought new software on-line to process sales and use taxes. That new software also included a new version of the income tax processing program that's intended to fix many of the computer bugs identified during the 1999 income tax processing season. The new programs also contain a number of new edits designed to help catch inaccurate information that may get into the system through mis-reading of images, data entry errors, or taxpayer errors.

Department staff had mixed views on how responsive the Department has been at fixing computer problems, but 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. In response to our surveys, all 10 computer staff who responded said the Department's approach to fixing problems had been good or excellent. Only 17% of the other staff we surveyed rated the Department's responsiveness as good or excellent, while 53% said it was fair or poor.

We noted that the Department had established an extensive system for identifying, logging, and monitoring fixes for problems that were related to the computer programs. We selected a sample of 10 problem items and traced them to documents showing the steps the Department had taken to correct them. In all cases, we found that the Department had taken what appeared to be reasonable steps to address the problems. Two examples are provided on the top of the next page.

A complete listing of all the problems we reviewed and their associated causes and fixes can be found in Appendix C. Although we reviewed the descriptions of the fixes for reasonableness, we didn't run any test data through the programs or do other specific tests to ensure that these fixes work. In many cases, we saw documentation that the Department had tested the fixes and they'd passed the tests.

**Examples of Fixes for Computer-Related Issues
That Caused Problems With Tax Return Processing in 1999**

<u>Problems</u>	<u>Causes</u>	<u>Fixes</u>
Boxes on returns were being read as checked when they weren't actually checked, or vice versa.	These problems had several causes including signatures sloping over into the boxes, tax preparers using forms on which the boxes didn't line up as needed for the equipment to read them accurately, and photocopied returns with stray marks.	When processing returns in 2000, Department staff will review boxes to determine whether or not they were checked.
Social Security numbers were being incorrectly paired up, which resulted in unrelated people being matched and recorded as filing a joint return.	If the box for a name or address change was checked and the system also misread the Social Security number and that number happened to be the number for another Kansas taxpayer, the computer would overlay the new person's information over the other person's record.	Anytime a Social Security number and the first four letters of the taxpayer's last name don't match up with what's already in the system, the return will be kicked out to be manually reviewed by Department staff.

**The New Sales Tax Systems Being Installed for 2000
Also Are Likely To Experience Problems**

Problems with any new software systems 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 testing of the new individual income tax software. Each area is discussed below.

Some taxpayer account information converted from the old system to the new one was incomplete or inaccurate. Converting data from one system into another is generally a difficult and time-consuming task. Department records show the Department was able to "clean-up" most of the problems with taxpayer account information in the old system. However, Department officials have identified 28 data conversion issues that weren't able to be fixed before the new software went into the phase called "controlled production" on November 8th. These data problems include the following:

- taxpayers' sales and withholding tax accounts have different temporary federal employer identification numbers (60,000 accounts)
- taxpayers' Standard Industry Code (SIC) numbers are unknown (10,500 accounts)
- taxpayers' names don't match on their sales and withholding tax accounts (4,320 accounts)
- employers' SIC codes were read as their federal employer identification number (132 accounts)
- accounts have invalid tax period end dates (1,541 accounts)

**Local Government Officials Have Expressed Concerns About
The Effects Project 2000 May Have on Their Sales Tax Distributions**

Local retailers collect sales taxes imposed by the State and by local municipalities when they sell goods at retail to the general public. The retailers send those taxes to the Department of Revenue monthly, quarterly, or annually depending on the amount of taxes they collect. The Department of Revenue is responsible by law to deposit the State and local shares of that money into appropriate accounts, and to redistribute the local shares back to the appropriate municipalities quarterly. In practice, the Department distributes the money to the municipalities once a month.

Local government officials have expressed concerns about the effect of the Department's new sales tax processes on the amounts of their sales tax distributions and reports they receive. We heard these concerns expressed:

- Local governments may get less money than they are due, because distributions will be based on estimates made by the Department rather than on actual amounts collected.
- Local governments no longer will receive detailed reports showing sales tax collections by retailer, which they have used in the past to monitor sales tax collection activity and to prepare their budgets.

If these concerns are valid, local governments would be affected over about a three-month period, during which time the Department is converting from the old sales tax system to the new one.

Here's how cities and counties will be affected during the three-month conversion period. The amounts distributed to each municipality will be based on estimates rather than actual amounts the retailers submitted with sales tax returns. The Department must base distributions on estimated amounts to avoid holding up revenues that the cities and counties need and should be receiving. That's because during the conversion and controlled production period, the Department won't be able to process sales tax returns as quickly as they will be able to once the system is fully up and running. Therefore, if the distributions were based on the actual returns processed during this time period, all localities would receive far less sales tax revenue than they're used to, and then they'd receive a huge distribution once the Department is in full production. The smaller payments during the conversion and controlled production likely would place some localities in a cash crunch.

To avoid this situation, the November, December, and January distributions, for municipalities, will be based on the amount distributed to them during those same months last year. Department officials tell us they will adjust the amount distributed to municipalities upward or downward based on the trend they've shown from fiscal year 1998 to fiscal year 1999. At the end of the controlled-production period, the amounts paid to the localities will be reconciled against actual sales taxes collected, and an adjustment will be made on their February distribution.

During this time, the Department won't be able to produce detailed listings by retailer to provide to the cities and counties for monitoring and budgeting purposes.

After the conversion to the new system is complete, the amounts of sales tax revenues distributed to localities will once again be based on the actual returns filed. The Department also will have the added flexibility to speed up getting the sales tax moneys to the local units. That's because the new system will have ability to adjust distribution periods somewhat. So if a large amount of tax revenue comes in a day or two after the usual deadline for a particular month, the Department can include it in the current month's distribution rather than holding it up for an entire month.

In addition, Department officials tell us that they'll once again be able to provide the same sorts of detailed listing of sales taxes generated by each retailer that they have provided in the past. Once the reconciliation is complete in February 2000, the Department will be able to provide a report on request that will list all money processed since conversion to the new system.

Some of these issues will have a direct impact on taxpayers' bills if they can't be fixed by the time the software goes into full production on January 1, 2000. For example, incorrect information was put into about 1,600 accounts last year because the federal employer identification numbers were misread. If these accounts aren't fixed, some taxpayers may receive bills intended for someone else.

Other items—such as cleaning up the temporary federal employer identification numbers the Department issued—won't have as direct an effect on taxpayers, but will need to be fixed for the Department to achieve such goals as having a single point of contact for taxpayers or sending each taxpayer one bill that combines all applicable taxes.

Department officials estimated it would take more than 14,000 hours to address all 28 data issues. Because they don't have enough staff to fix them all by January 1, they said, they are working on the 11 issues that most directly affect taxpayers' bills. The other issues will be addressed next year.

Although it greatly improved its testing this year over last year, the Department didn't allow enough time to thoroughly test parts of the new systems being put into production. The Department allotted itself only seven weeks to test the new version of the software for individual income taxes that AMS delivered to it in September. In our opinion, seven weeks was too little time to thoroughly test such complex and important software.

However, the Department had to limit its testing timeframe because the old sales tax computer systems aren't Y2K compliant, and couldn't be used after January 1, 2000.

While this software was being tested, the testers identified more than 2,300 computer bugs, or problems in the program codes that would cause the software not to work as intended, as follows:

- Nearly 200 of these computer bugs were considered to be **critical**.
- About 1,000 bugs were considered to be **serious**.
- About 900 bugs were labeled as **moderate**.
- About 250 bugs were considered to be **cosmetic** only

The more computer bugs that are identified and have to be fixed, the more testing is disrupted and the more time it takes to retest the "fixes." The testers we talked to said AMS had done a good job of fixing the bugs quickly, but about 350 still remained to be fixed at the end of "user acceptance" testing in late October. However, user acceptance testing should be conducted on software that is fairly bug free, or the Department reviewers can't really know if the software will do what was contracted for.

Officials From Kansas and Most Other States We Contacted Were Relatively Happy With American Management Systems

During this audit we surveyed the information systems staff at the Department of Revenue who work most closely with AMS staff on Project 2000. Although only 10 of the 85 surveys we distributed were filled out and returned by staff, those who did comment had positive things to say about AMS. Eight out of 10 rated the products the Department has received from AMS as excellent or good, and 9 out of 10 said that the Department has received good support from AMS in fixing bugs identified in the programs associated with Project 2000.

We also contacted five other States that have used American Management Systems to develop projects. Officials we talked to in all states except Mississippi told us they were reasonably happy with what they'd received from American Management Systems. Some basic information about those projects is provided in the table below.

State	Scope of Project(s)	Project Cost	Time frame	Comments
California	Automating collection of delinquent business and corporate taxes	\$21 million	May 1994-June 1996	An official said all three projects have been on schedule, within budget, and the two completed projects have already paid for themselves.
	Automation of corporate auditing	\$75 million	March 1995 - est. Oct. 1999	
	Automating collection of delinquent personal income taxes	\$60 million	April 1998-est. 2000	
Mississippi	Integrating data entry, analysis, & transfer among six types of taxes collected	\$12 million (AMS fee only)	Dec. 1993-April 1999	Mississippi is suing AMS for \$984 million in compensatory and punitive damages. AMS countersued.
Missouri	Statewide accounting, payroll, and procurement system	\$40 million	approx. Sept. 1997-Nov./Dec. 2000	An official said they'd been very pleased with AMS and that AMS has done a good job of fixing bugs in the system.
Utah	System to support collection of past-due accounts	\$40 million (AMS fee only)	Dec. 1997 - March 2000	State officials said they were pleased with AMS at present. They'd had some disagreement with AMS in Fall 1998 because the state didn't want to implement the integrated tax system until it was successful in at least one other state.
	Automation of vehicle titling and registration			
	Integrating data entry, analysis, & transfer among all types of taxes collected			
Vermont	Total integration of data entry, analysis, & transfer among trust, personal income, corporate, property, and transfer taxes	\$4 million (AMS fee only)	Fall 1995-late 2000/early 2001	Officials said they've been frustrated by AMS's changes to its tax product, but overall they're pleased with AMS.

In the end, Department officials put off signing the user acceptance documents by about two weeks. This gave AMS time to fix, and the Department time to retest, a large number of bugs before the Department finally accepted the software. By the time the documents were assigned, the number of unfixed bugs had fallen to 98. This reduced the risk considerably. It would have been better to put off the user acceptance testing for two weeks so final testing would have been conducted on software that was more problem-free. However, Department officials noted there wasn't time to do that and still meet the January 1, 2000, deadline for replacing the old software.

Contractually, AMS is no longer responsible for fixing computer bugs after the Department has signed off and accepted the software. The only exceptions are bugs the Department listed in the acceptance documents as needing to be fixed before they accepted the software. According to Department officials, AMS has agreed to continue fixing bugs through December 1999, which will be the end of controlled production. After that, responsibility for the software shifts to the Department. Even though the Department has responsibility, AMS will assist the Department in fixing remaining bugs until the end of March 2000.

AMS' continued involvement mitigates to some extent the risk assumed by the Department when it rushed the testing of the software. However, the risk still exists that important bugs won't be discovered until after the Department has accepted responsibility for the software.

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 numbers after the start of the calendar year 2000 processing season.

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 (AMS) as much as possible to assist in fixing these problems before AMS completely leaves the Project next year.

Recommendations

1. To help reduce the amount of inaccurate information being entered into the computer system for processing tax returns, the Department of Revenue should do the following:
 - a. consider possible formats for tax forms that would allow the use of pre-printed labels with the taxpayer's Social Security number shielded from public view.
 - b. set higher confidence levels on the ICR equipment for key items such as Social Security numbers, so that questionable items are more likely to be rejected for staff review before being entered into the system.
 - c. look for ways to modify tax forms to help prevent such things as signatures slopping over into boxes.

- d. continue its efforts to clean up inaccurate information transferred from the old computer system into the new system, and ensure that this is a priority issue with sufficient staff assigned to it.
 - e. provide closer supervision of temporary staff making data corrections, so that those staff don't just pass wrong data into the system simply to meet production quotas.
 - f. have its internal audit staff or others conduct periodic tests of the accuracy of taxpayer account information entered into the computer system.
2. To help lessen the chance of improper payments or adjustments being made to taxpayer accounts, the Department should:
 - a. ensure that staff provide complete and accurate documentation for adjustments made to taxpayer accounts.
 - b. require supervisory approval of adjustments to taxpayer accounts that require additional money to be sent out. (The Department may wish to set a dollar threshold for this review.)
 - c. program the computer to produce "exception reports" of adjustments made by staff, and have management periodically review those reports for items that may be out of the ordinary.
 - d. have its internal audit staff run periodic queries on the tax databases to identify possible improper payments, and controls or edits that could be built into the system to help detect them.
3. The Department should recover erroneous duplicate refunds made to taxpayers when it's cost-effective to do so.
4. To ensure that tax revenues owed to the State aren't unduly delayed, the Department should promptly clear-up existing inaccuracies on 1998 income and withholding tax accounts, and bill taxpayers for any balances due as soon as possible.

5. To ensure that future computer programs, including those for corporate income tax and other projects, are properly tested and installed with the least amount of problems, the Department should:
 - a. ensure that data transferred from existing records is cleaned up and accurate before entering it into the new system.
 - b. assign experienced staff to the testing of those programs, and allow them sufficient time to complete the testing well in advance of program implementation.
 - c. to the extent possible, involve its internal auditors in reviewing these programs up front so they can suggest controls that could be built into the programs to prevent unwanted occurrences from happening.

**Question II:
To What Extent Were Refunds Delayed in 1999, and
What Factors Contributed to the Delays?**

It took an average of 4.5 weeks to issue refunds in 1999, or almost twice as long as in 1998. The Secretary of Revenue provided information to the Legislative Post Audit Committee in July and August 1999 about the extent and causes of those delays. We found the major factors contributing to delays seemed to be the implementation of changes made by the 1998 Legislature, and an increased amount of work to be done by fewer staff. Other factors included not updating taxpayers' addresses when new address information was available. With some fairly minor exceptions, what we found was consistent with the information the Secretary reported.

Delays in making refunds in 1999 and other factors significantly increased the amount of interest paid on refunds in 1999. As of September, \$1.2 million in interest had been paid in 1999, compared with an average of about \$560,000 for the three previous years. 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. Further, we found two other areas where the Department's actions or policies may not have been in compliance with State law. For example, the Department's policy for granting food sales tax refunds allows taxpayers to claim a higher refund than they are allowed by law, which costs the State about \$3 million a year. These and other findings are described in the sections that follow.

**In 1999, It Took the Department an Average of
4.5 Weeks To Process Income Tax Refunds,
Compared with 2.5 weeks in 1998**

Processing tax returns and paying refunds can be affected by many things, including:

- ◆ whether taxpayers provide all the necessary information, and whether that information is accurate
- ◆ how efficiently returns are handled when they come into the Department
- ◆ whether information from the returns is entered accurately into the Department's computer system
- ◆ whether staffing levels are sufficient to handle the workload
- ◆ how long returns that need to be manually reviewed and corrected sit without any action being taken
- ◆ whether equipment and software are working adequately

To determine how long it took to process returns with refunds, we were able to obtain the "weighted" average processing times for about 95%-99% of the income tax refunds for 1998 and 1999 (through October 2). The table on the next page summarizes the differences from year to year in average length of time to process refunds.

**Average Length of Time to Process Income Tax Refunds (a)
1998 and 1999**

Type of Filing	1998 Average Time to Process Returns with Refunds	1999 (thru 10/2) Average Time to Process Returns with Refunds
Paper	2.9 weeks	5.5 weeks
Electronic (b)	1.6 weeks	2.3 weeks
Telefile	1.3 weeks	1.6 weeks
Total	2.5 weeks	4.5 weeks

Developed by Legislative Post Audit from data provided by the Department.

- (a) We weren't able to obtain processing times on every refund. However, the data we have covers about 95-99% of income tax refunds for both years. Homestead refunds are not included for either year.
- (b) The Department has established a goal to process non-problematic electronic claims for refunds in 5 business days (1 week). Because the Department's figures don't separate problem and non-problem refunds, we didn't have a way to measure the Department's performance on this goal.

We conducted an independent test on the 1999 data, the results of which gave us confidence in the figures provided by the Department. Information wasn't available to test the 1998 figures.

The Department took longer to process all refund types in 1999 than in 1998. Although all processing times were up, the table shows the most significant increases occurred in processing paper tax returns where a refund was due. Through October 2nd, those refunds took an average of 5.5 weeks to process.

In her July 1999 testimony before the Legislative Post Audit Committee, the Secretary of Revenue indicated that all refunds for the 1999 tax season were out. However, her statement referred to refunds that had no major errors or didn't need a significant amount of additional information from taxpayers. Returns with such problems weren't included.

In late October 1999, 134 refunds still were pending. Although many refunds were processed very quickly in 1999 (especially those filed electronically or by Telefile), others took a long time. As of October 21, a total of 134 income tax refunds still were being processed because they'd been kicked out of the system and needed some kind of correction or additional information to complete. Taxpayers had filed these returns as early as February 1999.

In looking at a sample of seven of these returns that had been filed in April or before, we found the following:

- it took about a month on average from the date the Department received the return until that return was kicked out to a worklist as needing corrective action
- it took more than 4 months on average for the Department to begin its corrective efforts, including contacting taxpayers to obtain additional information. One return that has been on the worklist for about six months has had no action.

The accompanying box provides additional information about how returns that had been kicked out were handled in 1999, and how long they took to process.

In July and August testimony before the Legislative Post Audit Committee, the Secretary of Revenue cited the following as reasons for delays in processing returns and refunds in 1999:

- changes the Department had to make because of new legislation passed by the 1998 Legislature
- more work needing to be done (more returns being filed, more refunds owed, and more returns being kicked out for manual fixes)
- fewer staff to handle to number of returns filed and refunds issued

During this audit, we looked at the information available in each of these areas, as well as in other areas that likely contributed to the delays in processing income tax refunds. These are discussed in the sections that follow.

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 effective for the 1998 tax year. Two of the more significant changes are summarized on the following page:

Many Returns Are Delayed as They Wait for Manual Review And Correction

Because of legislative questions about how returns that had been kicked out were handled in 1999, and how long they took to process, we obtained additional information from the Department in this area. In general, we found that returns that had been kicked out went to a "worklist" in the same order they failed automatic tax processing.

Once on the worklist, they generally were sorted into returns with and without refunds due. Those with refunds generally were processed first. Customer representatives sorted the worklists so they could look first at the forms that had been on the list the longest; sometimes there was an additional sort so that, of those on the list the longest, they worked on the largest refunds first.

Despite this sorting, forms sometimes stayed on the worklist a long time. The Department doesn't have any data on how long, overall, returns sit on a worklist. To make this determination, we looked at a sample of returns currently on a worklist. At the end of October, we looked at 20 forms, the next 20 on that list, from people who weren't expecting refunds. Most of those had arrived at the Department in April; the range was from February 16 to August 14.

- **making adjustments to the food sales tax refund.** The Legislature moved the “application” for a food sales tax refund from the homestead tax return to the K-40 individual income tax return, changed the eligibility requirements for the refund, and changed the figure on which the refund was based.
- **allowing an earned income tax credit for eligible taxpayers.**

Like most amendments to the tax laws, the 1998 adjustments required the Department to make changes to tax forms and to the computer software. Department officials have indicated the 1998 amendments caused delays in processing income tax returns and refunds for the following reasons:

- **The Department decided to finish developing the income tax processing software that had been started before the legislative changes were made.** This program was well under way when the 1998 amendments were passed, and was scheduled to be implemented in October 1998. The Department made this decision because the income tax portion of the software was intertwined with the withholding portion, and it would be difficult and inefficient to separate the two. Department officials also said they thought it would be helpful to implement the initial income tax program in October 1998 (without the legislative changes) and have it run for three months before the tax season started. Employees were trained on this new system during the summer and fall of 1998.
- **The Department and AMS began developing a new version of the software that incorporated the 1998 legislative changes soon after the new laws went into effect.** This new version was slated to be implemented in January 1999.
- **The Department spent the first 30 days after the new software was installed processing only small batches of returns, which created a backlog of returns waiting to be processed.** After the new version of the software was installed in January, the Department began a 30-day process called “controlled production.” During this time, it processed only very small batches of returns to see how well the new system worked, and to try to identify any glitches before it began processing the rest of the returns that had begun flowing in.

The legislative changes likely delayed the processing of income tax returns. A Department official commented that the magnitude of the 1998 legislative changes was larger than previous years’ tax law changes. Department staff pointed out that 10 changes were made in 1999, as compared to no changes in 1997 and one change in 1998. Department officials also pointed out that the changes to the food sales tax refund confused taxpayers, resulting in taxpayers sending in more than one K-40 and calling the Department with questions.

The Volume of Tax Processing Work Increased Somewhat Between 1998 and 1999, While Staffing Levels Decreased

In her July testimony to the Legislative Post Audit Committee, the Secretary of Revenue projected the following:

- the number of returns filed in 1999 would increase 14% over 1998
- the number of refunds issued in 1999 would increase 20% over 1998
- 21% of returns would need manual review and correction during the 1999 tax processing season, up from 15% in 1998

She also provided information showing that staffing levels for tax processing had dropped 18% between 1996 and 1999. We looked at more updated figures in each area, but focused our comparison of staffing levels on 1998 and 1999.

Overall, 4% more income tax returns were filed through September 26, 1999 than in all of 1998, but the number of paper returns filed actually decreased. Those figures are shown in the following table.

**Number of Income Tax Returns Filed Through September 26, 1999
And % Change from 1998**

Type of Return	Number Filed in 1999	Change From 1998
Paper	1,101,022	-0.5%
Electronic (a)	199,981	34%
Telefile	70,763	13%
Homestead	82,136	3%
Total	1,453,902	4%

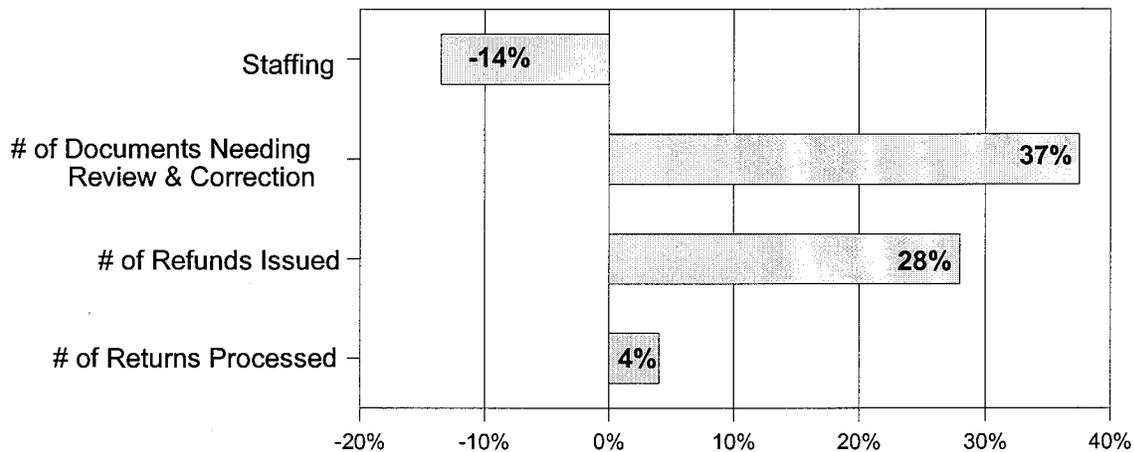
Developed by Legislative Post Audit using data provided by the Department.

As the table shows, most of the increase between the two years occurred in the number of returns filed electronically and through Telefile. The number of paper returns filed actually decreased slightly. However, in 1999 the Department began electronically processing information from Schedule S. (In general, that schedule reconciles certain federal and State income figures, and calculates non-resident tax percentages.) That change substantially increased the number of documents handled electronically.

The number of refunds processed was up significantly in 1999, from about 640,000 to about 820,000, or an increase of 28%. The figures we have were through September 9th, but it's likely that only a small number of additional refunds will be issued during the year. The processing of returns with refunds doesn't require significant additional work, unless there's some problem with the return. As the table on page 24 showed, refunds associated with paper tax returns took the longest to process.

The number of income tax returns kicked out for manual review and correction rose significantly between 1998 and 1999. As described in Question 1, returns filed in 1999 were kicked out for such reasons as data entry errors (manual or

% Change in Workload and Staffing From 1998 to 1999

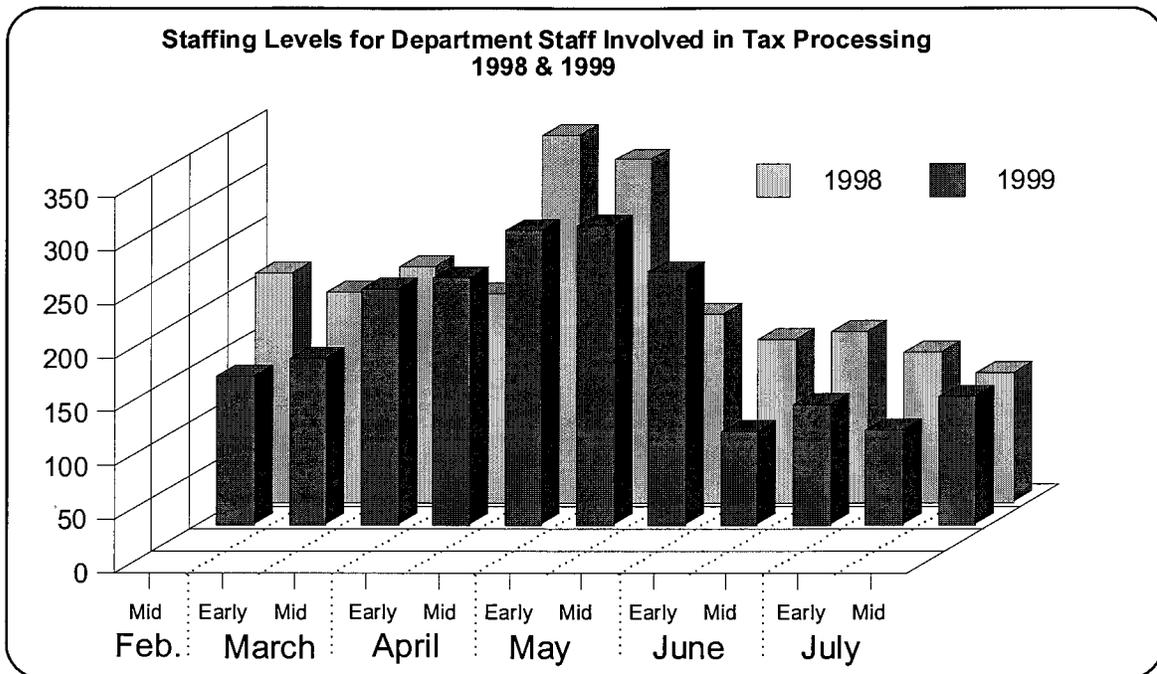


automated), data conversion errors, and taxpayer or tax preparer errors. The Department also may program the computer to kick out certain returns. For example, if the taxpayer includes correspondence, both the correspondence and return are kicked out.

Information the Department provided us on November 5th showed that about 255,000 income tax, homestead returns, and related documents had kicked out for manual review in 1999, compared with about 186,000 returns in 1998, an increase of about 37%. In all, about 15% of the 1999 returns were kicked out for review.

The Department had 14% fewer staff to help process income tax returns and make manual corrections in 1999 than in 1998. To identify actual changes in staffing levels, we obtained and compared information for both years for staff in the areas responsible for receiving, sorting, and opening mail, scanning returns, entering data, and correcting problem returns that were kicked out for manual review. We accounted for full-time staff, temporary staff, loaned staff from within the Department, and staff borrowed from other departments. Because staffing levels fluctuate greatly throughout the season, we selected two-week intervals to measure staffing levels for each year. The results of our comparisons are shown in the graph on the graph at the top of the next page.

As the graph shows, staffing levels generally were lower—sometimes significantly so—in 1999 than in 1998. Overall, the Department experienced about a 14% drop in staffing for tax processing. According to Department officials we talked with, staffing levels were down for several reasons:



- **the Department had difficulty hiring and retaining temporary staff, and couldn't replace all employees who retired**
- **the Department dismissed temporary workers during the tax processing season because of budget shortfalls at the end of fiscal year 1999.** It dismissed 57 temporary workers between May 20 and June 1, about half of whom were re-hired in July. For the same reason, the Department also released 24 temporary employees on June 12, and re-hired 19 of them two days later (the first payroll period for next fiscal year).

In her August 1999 testimony before the Legislative Post Audit Committee, the Secretary indicated that the Department had requested 20 new positions to address staffing needs related to the proposed changes in income tax. Only seven were approved.

**Not Updating Taxpayers' Addresses,
When New Address Information Was Available,
Also Contributed To Taxpayer Refunds Being Delayed in 1999**

Nearly 3% of all refund checks the Department mailed out through September 1999—or about 21,000 checks—were returned as undeliverable. Similar information isn't available for 1998 for comparison purposes.

Department employees are supposed to manually check and update all addresses where a taxpayer checked the box showing he or she had moved, or where taxpayers

didn't use the pre-printed address labels from their tax booklets. But sometimes these corrections were overlooked or only partially made. For instance, the street name may get updated, but not the city or zip code. Another problem: electronic returns didn't have an address change indicator, so the Department wasn't alerted to the need to update an address.

In a recent study of 500 returned refund checks, the Department found that 429 checks (86%) had been sent to the wrong address because the Department hadn't correctly updated the taxpayer's address in its records. For 87 of these, the taxpayer had checked the change of address box so the Department was alerted to update its records.

This summer, the Department assigned 10 temporary employees to work the backlog of returned refund checks for three weeks. In October, a Department employee was working on refund checks that had been returned to the Department in June and July. The following is a summary of the status of the nearly 21,000 refund checks returned as undeliverable as of the end of September:

- 16,897 (81%) refund checks were re-mailed to taxpayers using updated addresses the Department may have gotten from tax returns, driver's license records, or taxpayers
- 2,303 (11%) refund checks had no better address, and were still at the Department waiting for taxpayers to call
- 1,597 (8%) refund checks still hadn't been processed by Department staff

For the 2,300 checks with no better addresses on file, the Department doesn't call the phone number listed on the taxpayers return to try to get a better address. We called five of these taxpayers and were able to locate better addresses for two of them.

We also noted during this audit that problems with the Department's mail opening and sorting equipment could delay returns from being put into the processing queue. This problem is described more fully in the profile at right.

The Department Paid More Interest on Delayed Refunds In 1999 Than in Previous Years

State law calls for the Department to pay interest on refunds that aren't timely. By law, a refund is timely if it's made within two months of the latest of the following three dates:

- the basic filing date (April 15th following the applicable tax year)
- an approved extension date for filing the return
- the actual filing date of the return

Problems With Mail Opening and Sorting Machines Likely Contributed to Delays

As part of Project 2000, the Department bought an automatic sorting machine and extraction machines to make mail processing quicker and more efficient, but they haven't worked as hoped.

The **sorting machine** is supposed to sort envelopes into bins according to tax type and whether a refund is due. We were told that, for the entire year, the sorter worked for only about 17% of all paper returns received, or around 200,000 out of 1.2 million. (Paper income tax returns were a third of all mail received during the year.) Staff from this and other areas had to manually sort the rest.

The sorter works much better for sales and withholding taxes and for other types of mail labeled "working mail." In April 1999 the sorter sorted 99% of the withholding tax and 97% of the sales tax returns.

These are some of the specific problems with the sorter:

- It doesn't handle non-standard sized envelopes or envelopes thicker than the width of three dimes.
- It can't effectively handle envelopes that are years old, which have different kinds of bar codes and check boxes than those currently used.
- It doesn't reliably read the refund check box on the outside of the return envelope, so that staff must check the mail after it's sorted to make sure it gets into the right bins.
- At least two of the machine's other functions—being able to detect checks in envelopes by recognizing magnetic ink and opening envelopes—don't work well and usually aren't used.

The **extraction machines** are supposed to slit the envelopes and then pull the sides apart so the contents can easily be removed. Sales, withholding, and other tax types are opened on the extraction machines. (Income tax mail is opened by a different machine.) Department staff also reported problems with the extracting machines cutting the contents of envelopes, which requires workers to stop and manually tape documents back together before they can be scanned.

If a refund isn't made within two months of the applicable date, the Department owes interest on it at a rate set by the Legislature. That interest rate was set at 9% for 1999. Interest is owed on late refunds from the date the refund was made back to the date of the overpayment of the tax.

For most purposes, this "overpayment" date is considered to be April 15. For example, if someone paid in more than enough in withholding taxes in 1999 to cover his or her tax liability and filed a return by April 15, the Department had until June 15 to make a timely refund. If the refund wasn't paid until July 15, it would be considered late by law and the Department would owe 9% interest on it from July 15 back to April 15.

Through early September 1999, the Department had paid about \$1.2 million in interest on late refunds. The table at the top of the next page provides comparative information about the interest paid on late refunds for 1996 through 1999.

Interest Paid on Late Refunds, 1996 - 1999

	1996	1997	1998	1999 (through Sept. 9)
# of Refunds Paid	603,253	598,537	637,907	818,944
# of Refunds Getting Interest	32,841	26,922	33,976	82,037
% of Refunds Getting Interest	5.4%	4.5%	5.3%	10.0%
Amount of Interest Paid	\$380,682	\$394,773	\$910,187(a)	\$1,207,274
Average Interest Paid per Refund	\$11.59	\$14.66	\$26.79 (a)	\$14.72

(a) According to Department officials, interest paid in 1998 was high because, late in the year, the Department processed a significant number of late refunds that applied to old tax years, which would have had a longer-than-usual interest period.

The 1999 figures are through early September, while the other years' figures are for the entire calendar year. Thus, it's likely the 1999 figures will increase somewhat by the end of the year.

Interest on refunds was higher in 1999 than in previous years because a higher percentage of refunds was paid with interest. The Department paid interest on about 5% of the refunds issued in 1996, 1997, and 1998. In 1999, the Department paid interest on about 10% of the refunds—or twice as many as in the previous three years.

There were three reasons we identified for this increase. First, it took significantly longer to process some of those refunds. According to agency records, almost 80% of the refunds with interest paid in 1999 were for the 1998 tax year. Second, according to agency officials, the Department processed a significant number of refunds from old tax years in 1999. Those refunds would almost always be late. Finally, because of a programming error by AMS, starting in October 1998 any refund was considered to be late if the tax return itself came in more than two months after April 15. This programming error doesn't give the Department its statutory two-month grace period for processing returns. Department officials estimate this problem resulted in about \$84,000 in interest being paid that shouldn't have been paid. According to agency officials, the Department is taking steps to correct this problem with the system changes going into effect in November 1999. In addition, they told us they haven't yet decided whether or how they're going to try to recover these overpayments.

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. Department records indicate that almost 80% of the interest paid on refunds in 1999 through early September—or almost \$1 million of the \$1.2 million paid—was for tax years before 1998. By far, most of those refunds would have been based on amended returns.

State law doesn't specifically discuss when refunds from amended income tax returns should be considered late. As a result, in deciding when, whether, and how much the State owes in interest on late refunds for amended tax returns, the Department applies the general rules for regular income tax returns—a refund is considered to be late if it's made more than two months after the original due date for filing a return (April 15th of the following year), the approved extension date for filing a return, or the date the return actually was filed, whichever is later.

For the following reasons, however, applying these general rules to amended income tax returns results in the State paying a significant amount of interest income:

- **because refunds from amended returns will almost always be paid more than two months after the original filing date, all refunds from amended tax returns are considered to be late, and interest is paid on them.** The Department doesn't give itself the two-month grace period for processing those amended returns and getting any refunds out to the taxpayers.
- **the amount of interest paid on refunds for amended tax returns is computed all the way back to the original filing due date (April 15th of the original tax year), not to the date the amended return was filed.** For example, if a taxpayer filed an amended return in mid-1999 for 1995, the Department would pay interest dating back to April 15, 1996, on that refund—a period of more than three years.

Although the law isn't clear in this area, we think it could be interpreted to give the Department a grace period for processing amended returns, and to limit the interest period to the time the refund is paid back to the filing date of the amended return—a much shorter interest period. If that's what the Legislature intended, the Department is paying out significantly more in interest income than it should.

We Found Two Areas Where the Department's Actions Or Policies May Not Have Been in Compliance With State Law

During this audit, we became aware of two additional areas where the Department's policies or actions may not be in compliance with State law. Both issues are described in more detail in the following sections.

The Department has begun granting automatic extensions to the April 15 income tax filing deadline without the clear statutory authority to do so. As long as taxpayers have paid at least 90% of the taxes they owe before April 15, State law and administrative regulations allow them to request an extension to the April 15 income tax filing date. However, for those taxpayers paying at least 90% of their tax liabilities, in 1999 the Secretary of Revenue began granting an automatic extension whether or not the taxpayer requested it.

Giving these automatic extensions also results in an automatic waiver of any statutory penalties that otherwise would have applied to people who file their returns late. Given the scope of our audit and its limited time frame, we couldn't determine the fiscal impact of this policy.

The Department's policy for granting food sales tax refunds allows taxpayers to claim a higher refund than they are allowed by law, which costs the State about \$3 million a year. Under current law, eligible taxpayers with Kansas adjusted gross incomes of \$12,500 or less are entitled to a food sales tax refund of \$60 for each member of the household. That refund amount drops to \$30 for each member of the household for eligible taxpayers with incomes between \$12,501 and \$25,000.

K.S.A. 79-3633 defines "household" for food sales tax refund purposes as "a claimant and all other persons for whom a personal exemption is claimed who together occupy a common residence." However, in computing the amount of food sales tax refund eligible taxpayers filing as "head of household" should get, the Department adds one additional member to each household. In other words, if an eligible taxpayer has a total of 4 members in his or her household, the Department pays that taxpayer a food sales tax refund based on 5 people.

The Department adopted this approach based on the income tax law, which lets individual taxpayers filing as "head of household" claim one additional exemption for income tax purposes. But this interpretation seems to contradict the language in the food sales tax law. Further, if the intent of that law is to give lower-income taxpayers a break on the food sales taxes they actually paid, it wouldn't make much sense to give them credit for more than the actual number of people living in the household.

According to Department officials, this policy adds about \$3 million a year to the cost of the food sales tax refund program. The Special Committee on Assessment and Taxation considered this issue during the 1999 interim session, and concurred with the Department's policy of allowing an extra exemption for heads of households.

Conclusion

The Department was slower in making 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.

Recommendations

1. To reduce delays in processing future refunds, the Department of Revenue should do the following:
 - a. review its procedures and staffing for dealing with returns that don’t go cleanly through the system. While it’s true that staff often have responsibilities in addition to working on problem returns, those responsibilities should be balanced to avoid lengthy processing delays.
 - b. continue to work with vendors to adjust the mail sorting and opening equipment so that it’s more reliable and doesn’t damage materials received in the mail.
2. To ensure that the State pays appropriate interest on late refunds, the Department of Revenue should make sure that it has corrected the policy and programming errors that kept it from getting its statutorily allowed two-month period to process refunds without paying interest.
3. To ensure that the State pays appropriate interest on refunds from amended tax returns, the Senate Assessment and Taxation

Committee, House Taxation Committee, or other appropriate legislative committees should review and clarify the law relating to when interest should be paid on refunds due on amended tax returns.

4. To ensure that the Department is in compliance with the laws regarding food sales tax and homestead property tax refunds, and to ensure that those refunds aren't provided to ineligible individuals, the Department should require some proof of eligibility from the taxpayer as outlined in the law, or seek legislative change.
5. To ensure that the intent of the Legislature is clear regarding how heads of households should be treated for food sales tax refund purposes, the Legislature should amend State law to clearly allow or disallow an extra exemption.

**Question III:
How Well Did the Department Communicate with Taxpayers?**

In processing taxes, the Department sends out correspondence to taxpayers and responds to taxpayer inquiries. During 1999, much of the Department's correspondence to taxpayers was unnecessary or confusing. Partially as a result of that confusion, and partially as a result of delays in processing tax refunds, significant numbers of taxpayers tried to contact the Department by phone. Most of them couldn't get through to the Department at all, and many of those who did and left voice mail messages didn't get a response on a timely basis. Further, many taxpayers received incorrect information from the Department's refund status hotline.

The Department is taking steps to address problems with its written correspondence, although some of the rewritten letters we reviewed still are confusing. It's also trying to improve its ability to answer taxpayers' phone calls. But if problems similar to those that occurred in 1999 occur again during the next tax processing season, the volume of calls still likely will be too large to handle. These and related findings are discussed in more detail in the two major sections that follow.

Much of the Department's Correspondence to Taxpayers in 1999 Was Unnecessary or Confusing

During the 1999 tax processing season, legislators and tax preparers received many taxpayer complaints about letters from the Department that seemed to be in error or were confusing. Some tax preparers we talked with said taxpayers were confused by the correspondence and assumed that they or their tax preparers had made mistakes on their returns. One local CPA commented that more than two dozen of his clients had received letters saying that adjustments had been made but that there was no net change to the amount of tax they owed. Some examples of the types of letters that were confusing or incorrect are summarized in the table below.

Type of Letter	Cause of Confusion
Letters that said the Department had made adjustments to the taxpayer's return, but the net effect was <u>no change</u> on the amount of tax due.	Taxpayers wondered why they received a letter showing no change in the amount of tax they owed, or in the amount of refund they were due.
Letters billing taxpayers for small amounts (less than \$5) of additional tax.	Part of each letter says that amounts less than \$5 need not be paid, while another part bills the taxpayer for an amount less than \$5. Taxpayers wondered why these letters were sent.
Letters notifying taxpayers that they were deceased.	Living taxpayers wondered why such letters were sent to them.

Examples of Confusing Letters Sent to Taxpayers

We received two letters that were sent to legislators to illustrate the confusion caused by letters sent by the Department. The following is a quote from a letter sent to a homestead property tax refund recipient, with extremely confusing language:

"Your Individual Income tax refund has been adjusted based upon a balance due to the Kansas Department of Revenue. The following schedule shows the adjustment:

<i>Overpayment</i>	<i>60.00</i>
<i>Homestead/Food Sales tax, 1998 balance due</i>	<i>141.00</i>
<i>Amount offset to 1998</i>	<i>60.00</i>
<i>1998 Credit</i>	<i>0.00</i>
<i>1998 Balance Due</i>	<i>81.00</i>

If you have a refund after the off set amount is deducted, your check will be mailed as shown within 30 days, unless it is reduced by a previous debt. If you have requested a credit forward of this amount, it will be refunded instead. According to Kansas law (K.S.A. 79-32,105) a refund of less than \$5.00 will not be paid."

We received a more detailed account about another letter the Department sent. The situation is summarized below.

After a young taxpayer had filed an accurate return and paid the \$88 in taxes she owed, she received a letter from the Department of Revenue billing her for \$1.03 in additional taxes and interest. The letter stated, "We have made an adjustment to your income tax return, shown on the next page. The reason for this adjustment is as follows: Extension payment claimed on your return does not agree with the amount paid with original extension."

In response, the taxpayer's father wrote a letter to the Department's office of administrative appeals expressing his frustration. He correctly pointed out that his daughter's 1998 tax return had been filed on time and with the full amount of taxes paid. He further pointed out that:

- no extension was ever requested, and so the basis for the letter was incorrect*
- the bill sent by the Department was for \$1.03, but the letter said amounts of less than \$5 need not be paid.*
- the amount of tax computed by the Department didn't agree with the amount of tax shown in the Department's tax booklet for his daughter's income amount.*

In the words of the taxpayer, the letter was "a complete waste of taxpayer time and money and bordered on harassment."

When we reviewed the Department's letter and accompanying worksheet, we couldn't understand what the letter was talking about. It was only after discussions with Department staff we learned that the Department's equipment had mistaken the payment as an extension payment, which caused the computer to make several adjustments to the return and generate an extra \$1 in taxes and three cents in interest.

Some of these letters were generated in error because of the types of problems discussed in Question 1. For example, letters asking living taxpayers to verify proof of death were generated when the processing equipment mistakenly "read" the deceased taxpayer box as being checked.

The Department also sent out letters on purpose to try to educate taxpayers. For example, Department officials decided to send out letters notifying taxpayers of adjustments—even if that adjustment had no effect—to help educate them about errors

they'd made on their returns. (Information about the number of each type of problem letter mailed out to taxpayers wasn't available.)

The Department has taken steps to improve its taxpayer correspondence, but the content of some letters still may be confusing. In brief, the Department has done the following:

- in response to a large number of complaints, it stopped sending out letters that said adjustments had been made when those adjustments had no impact
- it created a "correspondence viewer," which allows Department staff to pre-screen blocks of letters before they go out, and delete them if they seem unnecessary or may cause confusion
- it has begun working on the wording of some letters. The Department's new correspondence standards offer more than 50 pages of guidance on drafting letters. In addition, a correspondence team was created to upgrade the quality and clarity of all customer correspondence.

We reviewed some of the newer letter templates during this audit, and found that many of the templates use words or terms that taxpayers might not be familiar with, such as "fiduciary" and "warrant." Others refer to programs or processes that some taxpayers might not be familiar with, such as "debtor set-off program" and "homestead refund advance." Such letters, even if sent for appropriate reasons, still may result in confusion.

It Was Very Difficult for Taxpayers to Contact the Department By Telephone During the 1999 Income Tax Processing Season

The Department's Taxpayer Assistance Center and Wage Earner Section are the two primary areas that receive telephone calls about income taxes. In 1999, taxpayers who made calls to either of these areas:

- were connected to a representative
- received an option to leave a message for the Department
- received a busy signal
- or received a message that the voice mailbox was full

In addition, the Department operated a line that taxpayers could call to hear recorded answers to frequently asked questions, and a refund status hotline that taxpayers could call to get an automated update about the status of their refund.

The Department answered half as many calls in 1999 as it did in 1998. During her July testimony to the Legislative Post Audit Committee, the Secretary of Revenue reported that the two areas that handle individual income tax calls answered about 3% of the calls they received during March, April, and May 1999, compared with about 8% over the same time period in 1998.

Using Southwestern Bell reports we obtained from the Department, we compared the number of calls these two areas received with the number of calls they answered from

January through September 1999. We performed these same calculations for the same time period in 1998. The results are shown in the following table.

	1998	1999	Change
Calls Received	543,358	827,188	Received 283,830 more calls
# of Calls Answered	59,553	48,422	Answered 11,131 fewer calls
% of Calls Answered	11%	6%	Calls got answered only half as often

Developed by Legislative Post Audit using data from Southwestern Bell reports

As the table shows, in 1999 the Department received 284,000 more calls than in 1998, and answered 11,000 fewer calls. Our numbers are somewhat higher for both years than the ones the Secretary reported, because our comparison was for a longer time period. But both sets of calculations show the Department received a huge number of calls in 1999, and didn't answer very many of them.

Several factors contributed to the increased number of calls the Department received in 1999. For one thing, the problems the Department experienced with its new automated tax processing system undoubtedly generated a significant number of calls. Taxpayers are much more likely to call and complain, or at least try to find out what's going on, when their refund checks are significantly delayed or the checks they get have the wrong Social Security numbers, or when they get erroneous bills, letters saying they're dead, or other confusing or incorrect letters. Other major factors that contributed to the increased number of calls in 1999:

- **The refund hotline gave incorrect information to many taxpayers during most of 1999.** The refund hotline is a toll-free number taxpayers can call to receive an automated message about the status of their refund. Through June 1999, many people who called the refund hotline received wrong information. The system didn't recognize returns that had been kicked out for manual review and correction, so no information about those returns was passed on to the hotline. Instead, callers received a message saying the Department had no income tax return on file for that taxpayer. This situation apparently occurred because the Department hadn't thoroughly tested how the hotline would work with the new computer system. We estimated the problem could have affected about 15% of the refunds owed during the 1999 tax processing season, or about 120,000 returns.
- **Because of the bad information they got from the refund status hotline, and because refund checks were delayed, many people likely called the Department's other numbers to ask a representative to find out what had happened to their refund.** Other potential problems: some taxpayers may have filed a duplicate tax return after being told by the hotline that the Department hadn't received their return.
- **Because so few callers were able to get through to the Department, it's likely many callers hung up and called back later.** This would increase the call volume.

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. We compared staffing levels for both years for employees who were assigned to answer the telephone in the Taxpayer Assistance Center and the Wage Earner Section from January to June, the time period when these two areas received the most calls.

The Department had 15 full-time employees assigned to answer telephones during 1998, and 17.5 during 1999. However, the number of employees who actually are available to answer the phone can fluctuate. For example, employees in the Taxpayer Assistance Center also answer questions for walk-in taxpayers. And during the peak tax processing season, some employees in the Wage Earner Section are pulled from their regular phone duties to help process returns.

In 1998, the Department employees answered about 3,400 calls each, on average, compared with an average of about 1,900 calls each in 1999. A Department official pointed out the following reasons why Department staff answered fewer calls, even though more staff were assigned to answer calls:

- **Staff were unfamiliar with the new system and with their new responsibilities.** Employees were learning the new tax processing system, and some were working in unfamiliar areas because of a personnel reorganization.
- **Some calls required a significant amount of time.** For example, some of the Department's correspondence to taxpayers required a significant time to explain. In addition, because taxpayer records and images of returns are now on computer, a representative can immediately access and resolve problems while callers are on the phone. In previous years, representatives would have to write down the complaint, pull the taxpayer's file, resolve the problem, and call the taxpayer back. Thus, the new system increases the time a representative is on the phone, but decreases the overall time it takes to resolve the taxpayer's problem.
- **During peak processing times, staff who normally were assigned to answer telephones were helping process returns instead of answering calls.** During peak times in 1999, there were times when only 2-5 associates were answering the phones, rather than the 17.5 who were assigned this responsibility.

The Department Has Made Some Fairly Significant Changes to Its Phone System

The Department has drafted a multi-phase improvement plan that's scheduled to be completed in February 2001. According to plan documents, the goals of the improvement plan are to allow the Department to be able to accurately project call volumes, and to handle the projected volume of calls by answering taxpayers' questions quickly and accurately.

This improvement plan would establish a customer relations call center. The center's improved technology would allow the Department to forecast call volumes, assign enough staff to handle many more of the calls received during peak times, route calls to the correct areas, provide account-specific information in a self-service format, and provide accurate information. The three phases of that plan are:

- **Phase One**—focuses on short-term additions to the Department's phone capacity, and sets the groundwork for the call center.
- **Phase Two**—includes hiring a call center manager, further developing the call center structure and its operational procedures, and buying additional hardware.
- **Phase Three**—includes buying advanced software and computer equipment that will automatically bring up a taxpayer's account information on the employee's screen when a call is received, and will allow correspondence to be handled by telephone, e-mail, fax, internet, or regular mail.

The Department implemented Phase One of its telephone improvement plan in September 1999. The major changes to the Department's telephone system are discussed in the table below.

OLD	NEW
Callers dialed different numbers for each tax area, and didn't have the option of being transferred to the refund status hotline or the frequently asked question area.	All calls are routed to a central number. Based on the taxpayer's selection, those calls then are routed to the appropriate tax area, refund status hotline, or frequently asked questions area.
Callers were either connected to a representative, received an option to leave a message, or received a busy signal. Callers had to dial a different number to hear frequently asked questions.	Hold queues have been added. This allows callers to stay on the line for the next available representative, and the system updates callers about their position in line (i.e., "There are 4 callers ahead of you.") 96 telephone lines were added to use as hold queues and frequently asked question areas. (These 96 lines don't represent an additional capacity for answering calls, only for "holding" callers until an employee can answer the call on his or her regular line.)
If there were room in the voice mailbox, callers were able to leave a message; otherwise, they received a message that the voice mailbox was full.	Callers no longer have the option of leaving a message. Not accepting voice mail will be more efficient for the Department because messages won't have to be transcribed, employees won't have to return a call only to leave a message and have the taxpayer call again, and employees won't be returning multiple calls from the same taxpayer.
Managers didn't receive call volume data in time to adjust phone staffing needs.	New hourly call volume monitoring should allow the Department to make staffing adjustments as needed.
The refund status hotline gave out incorrect information.	The refund status hotline has been repaired. This should result in fewer calls being made to the Department because taxpayers won't have to call the Department to ask about the incorrect information.

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

The Department's goals for fiscal year 2000 are to answer 25% of the calls it receives during peak times, and 75% during non-peak times. This goal recognizes that, during the peak of the tax processing season, there's simply no way the Department could cost-effectively answer all the calls it receives. Still, that goal will be difficult to meet. In 1998, before the Department experienced all the problems associated with the implementation of the automated tax system, it was able to answer only 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 there are few problems affecting relatively few taxpayers, the number of calls coming in should be much more manageable because of the Department's new ability to monitor the volume of calls coming in on an hourly basis, and adjust staffing needs accordingly. If there are many problems affecting a large number of taxpayers, the number of calls coming in may be more than the Department can handle, regardless of how improved its phone system may be.

Our analysis of the new system for processing sales taxes in 2000 identified problems with the accuracy of the data being transferred from the old system to the new one. If these or other situations cause numerous problems affecting many taxpayers, the Department again could be faced with not being able to answer most of those calls with its existing staff, or diverting significant numbers of employees from their regular jobs to answer the phone. The problem then becomes circular—diverting those employees could lead to increased processing times, which could lead to more delays and more phone calls.

Conclusion

During the 1999 tax processing 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 refunds. If they left voice mail messages, the Department didn't respond on a timely basis. All of this added up to significant taxpayer dissatisfaction. The

Department is taking steps to eliminate unnecessary letters, make its 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 a negative perception in the minds of many taxpayers.

Recommendations

1. To ensure that the letters it sends to taxpayers are more understandable, the Department of Revenue should thoroughly review those form letters to eliminate or clarify confusing language and fully explain terms, processes, and programs that taxpayers may not be familiar with.
2. To ensure that it's able to effectively handle taxpayer phone calls, the Department should do the following:
 - a. Thoroughly test the refund status hotline to make sure it works with the updated version of the income tax processing software.
 - b. Continue with its plans to implement a "call center" for taking taxpayer calls
 - c. Continue to monitor the staffing needed to respond to taxpayer phone calls

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?**

The Department's process for ensuring that checks sent in by taxpayers are properly accounted for and aren't accidentally destroyed appears to be adequately designed. It includes several steps to look for taxpayers' checks that might have been left among envelopes and other documents. One of those steps involves a review of documents sent to the Department's warehouse for shredding. That step appears to have been established by Department officials as part of its quality assurance system in 1997, after the Department began imaging documents and shredding the hard copies they'd previously maintained.

For the seven months ending June 1999, Department records show that warehouse staff found 143 taxpayer checks among the documents sent to the warehouse for shredding. Based on warehouse staff estimates and other Department information, we estimate about a dozen taxpayers' checks could have been accidentally shredded during the first six months of 1999. That's about one check for every 40,000 checks received. In such cases, the taxpayer wouldn't have been given credit for the payment, and the Department would attempt to recover the lost payment. These and other findings are provided in the following sections.

**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**

According to its records, the Department processed about 500,000 income tax payments during the first half of 1999. Checks taxpayers submit for estimated or actual taxes owed are sent in with tax return forms and sometimes other documents, such as letters or supporting documentation. Those checks may be loose inside envelopes, or they may be included among the forms or documents.

These checks are deposited into the State Treasury, and the amounts are credited to taxpayers' accounts. (This process is reviewed each year as part of the annual Statewide audit conducted by CPA firms under contract with this office. No problems have been identified.) In addition, as described earlier in this report, the forms and documents are "imaged" and "read" into the Department's computer using automated equipment. They're then sent to the Department's warehouse for storage and shredding.

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 in the warehouse. Those reports apparently were based on allegations by an employee who'd been hired through a temporary employment agency to help out during the peak tax processing season.

To evaluate the adequacy of the Department's process for identifying and removing checks from among these envelopes or other documents, we reviewed and observed that process from start to finish, including a review of how warehouse employees handle discarded materials. We also interviewed Department employees and temporary staff provided by the temporary employment agency (including the person who initially made the allegations), and reviewed and analyzed records related to checks found by the warehouse reviewers.

Given the volume of documents the Department handles, no process can cost-effectively guarantee that no taxpayers' check will ever be shredded. However, that system should be designed and carried out in such a way to limit the risk of accidentally shredding a taxpayer check to an acceptably low level.

In this audit, we assessed the reasonableness of the process in cost-effectively minimizing that risk. Because of legislative questions in this area, our assessment included an in-depth review of the process used to record checks that had been accidentally sent to the warehouse.

The Department's System of Checks and Controls To Try To Ensure That Taxpayers' Checks Aren't Accidentally Shredded Appears To Be Adequate

The Department has established specific procedures to look for checks that might have been left in envelopes or among tax return forms or other documents sent in by taxpayers. That process involves both manual and electronic reviews at several stages in the processing of taxpayer documents.

One of the electronic reviews, referred to by the Department as "candling," uses a machine that scans supposedly empty envelopes to make sure they actually are empty. Another part of the process involves independent reviews of all forms and documents to see if any checks had been left among them. The applicable procedures followed after envelopes are opened and emptied are shown in the table at the top of the next page.

Based on our review of this process, we concluded it was adequately designed to cost-effectively limit the risk of accidentally shredding a taxpayer check to an acceptable level.

**Department of Revenue's Established Process for
Trying to Find Taxpayer Checks Left in Envelopes or Among Documents
Before They Might Be Accidentally Shredded**

Envelopes

**Tax Returns and
Other Documents**

At the Department's Main Offices

Electronic "candling" of envelopes after contents are removed
Manual review of empty envelopes

Assembly of contents of envelopes for processing
Independent manual review of assembled contents
Review of scanned images to look for checks that might still be with the original documents

At the Department's Warehouse

Manual spot check of empty envelopes for unremoved materials

Manual check of boxes with income tax returns
Observation as items go into the shredder
Listing of any checks found at the warehouse
Return of any found checks to the main office to record in taxpayer account and deposit

The process for writing down any checks found at the warehouse apparently was developed at the direction of Department officials in 1997, after it began imaging tax returns and related documents. Before 1997, the Department maintained the original materials they received from taxpayers for three years before those materials were shredded. If questions arose about whether a check had been sent in but had gotten lost, Department staff could search the hard copy materials for the check. Given that system, the risk of accidentally shredding a check that was left among other materials was very low.

Once the Department began imaging documents, it shredded the hard copies about a month or so after they were processed. That meant the risk of accidentally shredding a taxpayer check had increased significantly because hard copies were no longer available for a lengthy period of time in case of later inquiries.

To address that increased risk, the Department instituted the warehouse review process, as follows:

- Any checks found in the materials sent to the warehouse are recorded in a steno pad and returned to the Department's main offices. Those checks are recorded in the taxpayer's account and deposited in the State Treasury.
- The information recorded in the steno pad includes the amount of the check, the date it was found, and the employee at the main offices who was responsible for making sure no checks were left in those materials. With this information, the Department can monitor and correct the performance of the employees reviewing materials in the main offices.

One allegation reported in the media was that the process for keeping the steno pad was developed by the temporary employees in the warehouse, rather than at the direction of Department officials. In reviewing this allegation, we interviewed permanent and temporary employees involved in the process, both at the main offices and at the warehouse. The only person who indicated the process had been developed by the temporary employees rather than by the Department was the person who'd initially made that allegation.

From December 1998 through June 1999, warehouse staff found 143 taxpayer checks among the documents they'd received before they were shredded. Those were the figures recorded on the steno pad from that period. The only other steno pad available at the time of our field work was the one currently in use, covering the time period since June 1999. According to Department officials, older steno pads were reviewed to identify any patterns of poor quality assurance work, and then were discarded.

Accurately identifying the number of checks that may have been shredded is impossible, because those are the checks that didn't get found. Most warehouse staff we interviewed thought that very few if any checks actually got shredded. Their estimates ranged from almost none (most staff we interviewed thought this) to one check shredded for every three checks found (the employee who initially raised this issue thought this).

During the first six months of 1999, the Department received about 480,000 tax payments. During that same period, the warehouse staff found 35 checks. (All 108 of the other checks listed in the steno pad we reviewed were found in December 1998, when the Department hired additional temporary staff and worked off a large backlog of documents. Given that, it was impossible to relate those checks to the time period when they were received.) If staff estimates are correct, between zero and 12 checks could have been shredded during this time. At most, that's one check shredded for every 40,000 checks received.

If a taxpayer's check is accidentally shredded, the Department's records for that taxpayer will show an amount still due from that taxpayer. That's because a payment received isn't recorded in a taxpayer's account unless the check itself is on hand and ready for deposit. Because the taxpayer's account will show a balance due, the Department will send a notice to the taxpayer to collect the amount due, and the State ultimately should collect the amount that's owed. Although the taxpayer will be inconvenienced and probably irritated if this happens, very few taxpayers should be affected.

Conclusion

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

This appendix contains the scope statement approved by the Legislative Post Audit Committee for this audit on August 30, 1999. The audit was requested by Representatives Kenny Wilk and Jim Garner, and Senator Anthony Hensley.

APPROVED SCOPE STATEMENT

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

The Department of Revenue is the State's primary tax agency. As such, it administers the State's key tax laws-enforcing the provisions of law, providing assistance to taxpayers, collecting amounts due the State, and making refunds to taxpayers when appropriate.

For the 1998 tax year, the Department was much slower at processing individual income tax refunds than it was the year before. Among other things, there was some concern the Department had laid off many of its temporary employees before the refunds were completed. Allegations of problems also have been raised about the adequacy of the Department's process for handling checks that taxpayers remit. Other reported problems have surfaced in the customer relations area, including taxpayers being given inaccurate refund information through the "refund status line," receiving letters that led some to believe they owed more money when they didn't, and never being able to reach anyone through the taxpayer assistance telephone hot line or through other attempts to communicate with the Department. Several legislators have indicated they've received numerous complaints from their constituents in these areas. In addition, legislators have expressed concerns about whether the new Project 2000 tax systems being designed and implemented by American Management Systems will be successful.

In July 12th and August 26th appearances before the Legislative Post Audit Committee, the Department Secretary indicated that many of these problems were the result of statutory changes made during the 1998 legislative session, a significant increase in the number of returns and refunds processed, a significant decrease in full-time temporary staff, and difficulty finding qualified temporary help. She also said that some problems were inevitable, given the major changes occurring within the Department as Project 2000 was being implemented. The Secretary indicated that refunds for the 1998 tax year were out, and that the Department was working to try to resolve these and other problems before the next year. The Department has been getting input from outside groups, the Secretary said, and she plans to set up an advisory group of experts from within the business community to assist the Department.

Legislative questions have been raised about the accuracy of some of the information the Secretary has provided to the Committee, about the amount of interest paid on delayed refunds, about how well Project 2000 has worked to date, and about the adequacy of the Department's quality control process over checks remitted by taxpayers. Concerns also have been raised about whether the Department is taking adequate and timely steps to address any problems in these areas. A performance audit in this area would answer the following questions:

- 1. How accurately did the Department of Revenue report to the Legislative Post Audit Committee about the extent and causes and extent and causes of delays in income tax refunds for the 1998 tax year?** To answer this question, we'd perform the reviews, interviews, and tests necessary to determine how long it took the Department to process individual income tax refunds for the 1998 tax year, how those results compare with processing delays in previous years, and what the current status of those 1998 tax refunds is. We'd also review relevant records and processes (including project management documents or other internal quality control reports), interview Department officials or others, review a sample of returns that took a long time to process, and perform any other tests needed to determine why these delays occurred. In conducting our reviews and analyses, we'd consider the impact of the statutory changes to tax credits and exemptions the Legislature made for the 1998 tax year, staffing levels, and other appropriate factors. We'd also look at what information taxpayers received regarding these delays. We'd report on the results of our reviews and tests, as well as our comparisons of the information we obtained with the information the Department has provided to the Committee.
- 2. For the 1998 tax year, how much interest did the Department pay on delayed income tax refunds, and how does that figure compare with previous years?** We'd review Department records and calculations to determine the amount of interest paid on delayed refunds in Kansas for the 1998 tax year, and compare that figure to previous years. To the extent the information is available, we'd report these results on a per-unit basis, such as interest paid per dollar of refunds processed.

3. **What plans has the Department established for improving the income tax refund process and the handling of taxpayer phone calls for the 1999 tax year, and do those plans appear to be sufficient to address the problems that occurred this year?** In answering this question, we'd identify the problems that have occurred by reviewing pertinent records and taxpayer correspondence or complaints and by interviewing Department staff or others as needed. We'd then identify the plans the Department has established for addressing problems with its income tax refund process and its handling of taxpayer phone calls, and any actions it has taken to date in these areas. In assessing how sufficient these plans appear to be, we'd determine such things as:
- whether these plans seem to address all the problems that have occurred or are occurring
 - whether the actions the Department has taken to date appear to have fixed any of these problems
 - whether any internal records or reports suggest that some problems can't or won't be addressed
 - whether employees or other knowledgeable people think the suggested solutions are likely to fix the problems
 - what real or potential barriers Department employees or our auditors identify that could prevent these problems from being addressed
4. **Has Project 2000 worked as intended to date?** Project 2000 was undertaken in part to make the Department more efficient and customer-oriented. In answering this question, we'd assess whether and how well various goals of the Project have been met so far in these areas. We'd focus our reviews on the automation of certain tax processing activities (such as automatic scanning, imaging, and handling of tax returns), and the completed or scheduled automation of the processing of certain types of taxes (such as sales or income taxes). We'd also review and assess the Department's success at meeting its goals for improving customer relations. To determine how well these goals have been met we'd do such things as review any relevant project management documents, quality control reviews, or internal audits or memos; review, assess, and test as needed a sample of Department processes; review our findings about customer satisfaction from question three; and compare and contrast any available and relevant statistics from before and after Project 2000 was implemented (such as the number of transactions processed per employee, or the percentage of returns processed automatically). As needed, we'd survey a sample of taxpayers, CPAs or tax preparation firms who have used various new services offered by the Department, such as Telefile or Tel-Assist. In addition, we'd interview or survey a sample of people who've contacted the Department this year regarding the tax refund process, as well as other individuals the Department may be working with to try to address the problems it has experienced. We'd also interview or survey Department employees who process tax returns and deal with taxpayers on a daily basis to get their opinions about any problems they may be experiencing. We'd also review project schedules, changes to the original schedule, and current progress reports to assess whether the project is still on time, and identify and report on any additional costs the project is expected to incur or has incurred above and beyond what was originally estimated. In addition, we'd contact other states where AMS has been implementing tax management and processing systems to identify any specific failures that have occurred in those projects. We'd then try to assess whether these same areas appear to be problematic in Kansas. For any of the areas we review where there are unresolved problems and Project 2000 doesn't appear to be working as intended, we'd determine why not, identify what the Department is doing or plans to do to address these situations, solicit opinions about any barriers to addressing these situations, and try to assess whether those actions appear to be sufficient.
5. **Does the Department have an adequate process for ensuring that checks remitted by taxpayers are properly accounted for and aren't accidentally destroyed?** To answer this question, we'd review the established system, practices, and procedures with Department officials, identify any potential problems or inadequacies in these areas, and perform any testwork needed to determine whether those processes are being followed. We'd also determine what policies and procedures have been established and followed for warehouse staff to record and return any checks they find that have been sent to the warehouse for storage or shredding.

Estimated time to complete: 12-14+ weeks (using one large audit team)

APPENDIX B

Surveys of Department of Revenue Employees

During this audit we conducted surveys of two different groups of Department employees.

One survey was of employees in the Channel Management and Customer Relations Core Processes. It was designed to obtain opinions on the effectiveness of the new systems, the quality of American Management Services' work, and the testing of the systems. Responses to the two surveys are summarized on the following pages. We distributed surveys to 155 Channel Management and Customer Relations staff members, and received 57 responses, for a response rate of 38%.

The other survey was of employees in the the Information Services section. It was designed to obtain opinions on the overall effectiveness of the new tax processing systems and the problems and benefits of those systems. We distributed surveys to 85 Information Services staff members, and received a total of 16 responses, only 10 of which were useable, for a useable response rate of 12%.

**Legislative Post Audit
Survey of Department of Revenue Tax Processing Employees**

The Legislative Post Audit Committee of the Kansas Legislature has directed the Legislative Division of Post Audit to conduct a performance audit looking at Project 2000 and examining reasons for delays in income tax refunds to taxpayers during the 1999 tax processing year. As part of that audit, we are asking Department staff who process tax returns for their opinions about how well the new tax processing system is working. Also, we are seeking your assistance in identifying any significant problems with the system that still need to be fixed.

The following survey is brief and should not take more than a few minutes to complete. This survey is designed to be anonymous, so you don't need to provide your name. The actual survey documents themselves will become part of our permanent audit working papers which become public documents after the audit is completed. Therefore, if you are concerned about anonymity, don't include any information on the survey form that you think might personally identify you. If you have any questions about this survey, please call Jill Shelley or Leo Hafner at 296-3792. Thank you for your assistance.

Total responses: 57 Response rate: 37%

For each question below the total number of responses and corresponding percentage for each answer is given.

1. Based on your experience and personal knowledge, how would you rate the effectiveness of the new tax processing computer system (ATP) the Department has installed as part of Project 2000? (Circle your answer) *57 responses*

3% Excellent 21% Good 7% Average 46% Fair 18% Poor 5% Don't Know

2. If you are aware of any specific errors in processing 1998 tax returns attributable to the computer or functions that the computer system didn't perform well during the most recent income tax processing season, please list the most significant of those problems in the space provided below, or on the back of this sheet as needed. ***(Please only list those problems that occurred frequently or caused significant problems in processing tax returns. Be as specific as possible.)*** *57 responses*

Most common answers:

- Imager/scanner doesn't read the Social Security number correctly.
 - posting of payments to wrong accounts
 - mismatching of filers and spouses
- Imager/scanner doesn't accurately read the change of address box
 - refunds returned and reprocessed
- Other system problems such as: if the chickadee checkoff box was checked a refund was sent to the taxpayer and a like amount to the checkoff, sometimes refunded penalty and interest that the taxpayer didn't pay

3. How would you rate the Department's overall responsiveness in correcting computer problems that slow down tax processing or cause inaccurate posting of information to taxpayer accounts? *54 responses*

3% Excellent 13% Good 28% Average 28% Fair 26% Poor 2% Don't Know

4. What factors other than computer problems would you say contributed to tax processing problems during the most recent tax processing season? (*Check any of the selections that apply, or add and explain other factors you can think of.*) *57 responses*

Number who selected each factor:

49 Insufficient staff to handle the number of returns received

41 Insufficient training for staff

18 Lack of adequate supervision

34 Sorting, Scanning, or Extraction machines didn't work properly

36 Incorrect or incomplete information from the taxpayers

7 Other (please explain): Poor management

7 Other (please explain): Poor phone system

6 Other (please explain): Poor quality of temps

5. What do you see as the main benefits or improvements in tax processing that have occurred as a result of the implementation of ASTRA Tax Processing (ATP)? *33 responses*

Most common answers:

- quick and easy to access accounts and fix them
- ability to view and adjust actual forms on computer while talking to customer
- less paper

6. Please use the space below or additional sheets as needed to make any comments you would like to make about ASTRA Tax Processing (ATP), or to point out any problems you think still need to be addressed. *41 responses*

Issues noted here were generally the same as those mentioned in other questions, including: lack of staff, erroneous letters to taxpayers, and need for more training.

Thank You

Legislative Post Audit Survey of Department of Revenue Information Systems Employees

The Legislative Post Audit Committee of the Kansas Legislature has directed the Legislative Division of Post Audit to conduct a performance audit looking at Project 2000 and examining reasons for delays in income tax refunds to taxpayers during the 1999 tax processing year. As part of that audit, we're asking Department staff involved in the development of the new tax processing system to give us their opinions about how well the system is working. Also, we're seeking your assistance in identifying any significant problems with the system that still need to be fixed.

The following survey is brief and shouldn't take more than a few minutes to complete. This survey is designed to be anonymous, so you don't need to provide your name. The actual survey documents themselves will become part of our permanent audit working papers which become public documents after the audit is completed. Therefore, if you are concerned about anonymity, don't include any information on the survey form that you think might personally identify you. **If you have any questions about this survey**, please call Jill Shelley or Leo Hafner at 296-3792. Thank you for your assistance.

Total Responses: 16 (only 10 were useable because six marked the box below)

For each question below the total number of responses and corresponding percentage for each answer is given.

Please Read This Before Answering Any Survey Questions!!! We are soliciting the opinions of information systems staff who have had significant involvement in the testing and development of computer systems related to Project 2000. If you haven't been involved with these systems, or have worked on them for less than a year, please check the following box, don't answer any further questions and return the form to us.

1. Based on your experience and personal knowledge, how would you rate the overall effectiveness of the parts of the new tax processing computer system the Department has installed to date as part of Project 2000? (Please circle your answer)

# of Responses		Excellent	Good	Average	Fair	Poor	No Opinion
10	Individual Income Tax	20%	80%				
10	Withholding Tax Accounting	10%	80%				10%
10	Homestead/Food Sales	20%	50%			10%	20%
10	Business Registrations	20%	50%				30%

2. Based on your experience and personal knowledge, how would you rate the overall quality of the products supplied by American Management Systems for the components that have been implemented so far?

# of Responses		Excellent	Good	Average	Fair	Poor	No Opinion
10	Individual Income Tax	10%	80%	10%			
	Withholding Tax Accounting		80%	10%			10%
	Homestead/Food Sales		70%				30%
	Business Registrations		80%				20%

3. Based on your experience and personal knowledge, was adequate testing done on the various components of the system before they were brought on line for active processing?

of Responses

9	Individual Income Tax	44% Yes	22% No	33% No Opinion
10	Withholding Tax	60% Yes	10% No	30% No Opinion
10	Homestead/Food Sales	50% Yes	10% No	40% No Opinion
10	Business Registrations	40% Yes	10% No	50% No Opinion

4. If you answered “No” to any part of question 3, please explain below which components you think weren’t adequately tested, and what additional tests you think should have been performed. **Please be as specific as possible and please explain what you mean in terms a layperson can understand.**

Component	Release date	What should have been done but wasn’t?
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There were only 2 responses to this question and both referred to the October 1998 income tax system release.

5. Has testing improved for the components that currently are under development? 10 responses

90% Yes No 10% No Opinion

6. In your opinion, is the Department promptly fixing “bugs” that are identified in the ASTRA Tax Processing system? 10 responses

100% Yes No No Opinion

7. In your opinion, has the Department received adequate support from American Management Systems in fixing bugs or addressing problems identified with system software? 10 responses

90% Yes No 10% No Opinion

8. Please use the space below, or additional sheets as necessary, to make any comments you would like to make about ASTRA Tax Processing, or to point out any problems you think still need to be addressed. Thanks for your help. 8 responses

Answers included the following:

- Bugs should be expected in a project of this size.
- Not enough testing time.
- Tired of criticism from legislators and media who don’t appreciate all the hard work going into project.
- Department has benefitted from partnership with AMS.
- Turnover of AMS staff.

APPENDIX C

Review of Fixes for Computer-Related Issues That Caused Problems With Tax Return Processing in 1999

The following table contains information about fixes for a sample of the computer-related problems we reviewed in this audit. Although we reviewed the Department's proposed fixes for reasonableness, we didn't run data through the system to verify that these fixes will work as described.

<u>Problem</u>	<u>Causes</u>	<u>Fix</u>
Boxes on returns were being read as checked when they weren't actually checked, or vice versa.	These problems had several causes, including signatures slopping over into the boxes, tax preparers using forms on which the boxes didn't line up as needed for the equipment to read them accurately, and photocopied returns with stray marks.	When processing returns in 2000, Department staff will review all boxes during the data repair process just after imaging to determine whether those boxes were checked.
Social Security numbers were being incorrectly paired up, which resulted in unrelated people being matched and recorded as filing a joint return.	If the box for a name or address change was checked and the system also misread the Social Security number and that number happened to be the number for another Kansas taxpayer, the computer would attach the new person's information to the other person's record.	Anytime a Social Security number and the first four letters of the taxpayer's last name don't match up with what's already in the system, the return will be kicked out to be manually reviewed by Department staff.
People who were eligible for food sales tax refunds were denied as ineligible.	Persons often entered non-taxable Social Security income in the income section of their tax return just to show they were eligible.	If the amount of tax owed on the return shows "0" and the computer calculates an amount due, a new edit will kick that return out for Department staff to review manually.
Payments sent in with tax returns sometimes were recorded as extension payments instead of remittances to pay the entire tax obligation.	There's a box on the voucher the taxpayer sends in with his or her tax payment to indicate if an extension is being requested. The equipment was misreading the box as being checked when it wasn't.	An edit has been added to check the amount of any extension payment posted to the taxpayer's account against the amount shown on the tax return as an extension payment. If the two don't agree the return will be kicked out for Department staff to review.
The computer calculated a slightly different amount of tax than the tax tables showed, and if other corrections also were made on the account, the taxpayer would be billed for the additional tax.	The tax tables aren't programmed into the computer. Instead, the computer does its own calculations, which can sometimes produce a slightly different tax amount than the tax table shows.	A new tolerance has been built into the system telling the computer not to send an adjustment letter for a difference of less than \$5.
For non-resident taxpayers, the system was zeroing out the non-resident percentage the taxpayer entered on the return, which effectively cancelled out any taxes they owed to Kansas.	Part of the system wasn't reading the salaries and wages line on Schedule S, so the computer thought there were no salaries and wages and it automatically adjusted the tax due to "0."	This error was caught early in the 1999 processing year, and the computer programs were corrected to read the salaries and wages line for non-resident filers.
For taxpayers who were eligible for homestead property tax refunds, their income tax refunds were being used to offset a tax "liability" shown on the Department's books.	This was a timing issue. The tax refund was processed before the taxpayer's homestead claim, so the computer thought the taxpayer owed money under the homestead program.	For the 2000 processing season, individual income tax refunds won't be applied to a taxpayer's homestead balance until a homestead claim has been posted to the taxpayer's account.
Early in the 1999 tax processing season, the system wasn't linking forms together, such as an income tax return and a required Schedule S.	The computer would misread the Social Security number on either the K-40 or the Schedule S, so system couldn't match the forms up for processing.	If the Social Security number and the first four letters of the taxpayer's last name don't agree with what's already on the record, the forms will be kicked out for staff to review, better ensuring forms will be matched.
When estimated tax payments were processed, the system sometimes created multiple accounts for the same taxpayer.	Social Security numbers on the payment vouchers got into the system incorrectly, so the computer didn't always post a payment to the taxpayer's correct account.	A new edit is being installed that will kick out a return for manual review if an estimated tax payment results in a new customer account being created.
A return would pass through one phase of the tax processing system as being correct, only to be kicked out in a later phase as needing address information.	Various parts of the system containing address information weren't well synchronized or linked.	For the 2000 tax processing season, the databases will be the same.

APPENDIX D

Agency Response

We sent a rough draft of this report to the Department of Revenue on November 24, 1999, and a completed draft on November 29, 1999. At the Secretary of Revenue's request, audit staff met with Department officials on December 2, 1999, to clarify certain sections and correct inaccurate information in the draft.

We then received the Department's formal written response on December 7, 1999, and have included it in this appendix.

STATE OF KANSAS

Bill Graves, Governor

DEPARTMENT OF REVENUE

Karla Pierce, Secretary

Office of the Secretary
Kansas Department of Revenue
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Topeka, KS 66612-1588

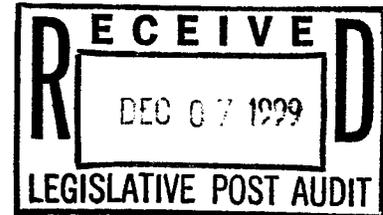


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Office of the Secretary

December 7, 1999

Ms. Barbara Hinton
Legislative Post Auditor
Legislative Division of Post Audit
800 SW Jackson, Suite 1300
Topeka, Kansas 66612



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

Dear Ms. Hinton:

Thank you for the opportunity to respond to this audit. I want to thank the Legislative Post Audit Division for their professionalism in completing this audit and allowing us to meet our implementation deadlines required due to Y2K. The audit provided an informed, objective review of key aspects of our current operations and of Project 2000. We always find it valuable to have a second opinion, as we consider options for creating the future of tax administration in Kansas.

As the auditors noted, the 1999 Income Tax processing was plagued by the "things that might be expected in any new computer system." Nonetheless, these were problems we had hoped would not occur and worked hard to avoid.

The disappointment for me and for our management team is that implementation problems manifested themselves in ways that affected our customers. As we have told the Legislature on numerous occasions, we are laboring to create a system that will exceed the expectations of our customers, and that translates, among other things, into getting refund checks to taxpayers sooner and answering their telephone calls.

Our associates are dedicated to these tasks. Our new tax system, though not perfect, enabled us to handle record volumes of transactions. However, shortcomings in key elements of our infrastructure, such as our telephone system, difficulties many associates had in coming up the learning curve for their new positions, and several significant system problems combined to prevent us from fully achieving our goals.

Our customers have been patient with us during this time of being "under construction." But we had hoped that the detours and delays experienced would have been less troublesome than they have been. As the date of completion of our new system draws near, our customers rightfully expect that our performance will improve.

I am pleased the audit confirmed a number of issues. First, we have been honest and forthright with the Legislature about the problems and difficulties that we have experienced in this journey. Second, we've identified and are addressing the major impediments to achieving our vision. Finally, our course and process for improvement is sound.

I would like to elaborate on a few key points and respond to the recommendations presented in the audit.

Project 2000 cost increases were incurred to pay for implementing legislative mandates and to pay AMS for temporary staffing used to offset turnover in KDOR technical staff.

Over 50% of the cost increase for Project 2000 is related to the 1998 legislative changes. We would not have incurred these costs but for the implementation of the related changes. The remaining increases were for FY 98 on-going operating costs the Legislature directed us to take from the ATS fund and for additional KDOR salaries of those assigned to complete project tasks due to delaying the implementation one year following the 1997 tax season. The \$2.0 million third contract modification was to extend the Tax Discovery employees six months and pay for work completed by AMS that KDOR was contractually responsible for due to a large turnover in Information Systems staff in 1997.

The characterization of the AMS Contract as \$45.4 million with a \$10 million bonus is incorrect.

The actual contract payment for deliverables from AMS is a fixed price of \$55.4 million. Payment for approved deliverables associated with the first \$45.4 million of this total has been made on a "first dollar" basis from enhanced revenues generated by the project and credited to the Automated Tax System (ATS) fund. Payment for the final \$10.0 million in approved enhanced revenues credited by the ATS fund above \$89.9 million up to \$189.9 million. The Department is committed to track enhanced revenues for two full fiscal years following completion of the project.

The computer programs processed the majority of tax returns without problems.

As the conclusion of the first question points out, there was no meltdown and no disaster, but rather, problems that can be expected when large systems are implemented. Most taxpayers were served well, but some were not. KDOR staff learned many things from the implementation that were applied to our recent plans used to implement the November 99 release. While we will continue to have challenges with recruiting and maintaining temporary staff, we are committed to doing our dead level best to provide refunds 2 weeks sooner this year.

Implementing a new computer system requires staff to learn new ways to do their jobs. For example, we are asking staff who handle business taxpayers to know more about all taxes a business pays to provide a single point of contact for these business customers. We are executing detailed plans to support the staff with training, hands on assistance, and additional subject matter experts who work with associates on the front lines. However, learning takes time. The next two months are going to be critical to assimilate the staff and prepare for tax season. We also have data clean-up activities related to conversion.

KDOR is employing a sound testing strategy in response to the difficulties of implementing the new sales tax system.

While implementation difficulties should always be expected in a system of this magnitude, our approach to minimizing problems is to adhere to a rigorous testing plan. The baseline core systems that include sales and withholding taxes were delivered July 1 and have been undergoing testing in Topeka since that time, for a total of four months. In addition, they were tested for three months at AMS' offices in Fairfax, VA before being delivered. Over 6,000 business requirements were tested and relatively few bugs remained upon implementation. Even though extensive testing was completed, additional incidents are always found when "live" production data is processed through a new system. That is why we employ a two-month "controlled production" process, where we have weekly software upgrades to fix issues discovered during this period. The rate of discovering bugs is already declining for all tax types.

KDOR's representations to the Legislature have been accurate.

This audit verified the testimony provided to the Legislative Post Audit Committee on both July 12 and August 26. As the report states, *"With some fairly minor exceptions, what we found was consistent with the information the Secretary reported."* The "minor exceptions" are related to additional information being available subsequent to my report.

The Department grants extensions to all taxpayers who pay 90% of their tax liability by April 15.

The fact is, the statute doesn't give any criteria to approve or deny a requested extension except that the taxpayer must pay at least 90% by April 15. As long as the taxpayer has met this criterion, the extension to file is automatic, and imposing additional paperwork would not add any value to the process.

The purpose of the 90% payment rule is to determine which cases to apply a penalty for underpayment. Our treatment has been consistent. KDOR assesses interest on all amounts underpaid by the due date. But no penalties were assessed on any returns where the taxpayer had met their responsibility to pay 90% of their liability by the due date, in accordance with Kansas statutes.

The Department is improving its communications with customers.

In communicating with the taxpayer, we certainly haven't done as well as we intended. However, we took many steps to improve this part of our business operations during 1999. There are many more steps needed, as outlined in our Quality Improvement Plan. The work we are doing with our Advisory Council of taxpayers, tax practitioners, and private sector managers will be very important as we strive to progress in this area. We will continue to review feedback from written correspondence and make improvements.

The new telephone system project is on schedule to implement phase II during February 2000. It will require tuning and modification as we learn how taxpayers are responding to the system.

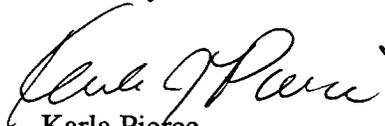
However, phase III is included as an enhancement in our budget request for FY 2001. It will need to be funded to continue the work required to establish a full capability call center.

The Department employs a sound system for ensuring checks aren't accidentally destroyed.

I would like to thank the auditors for their thorough review of this part of our business operations. As they conclude, "the Department's process for ensuring that checks sent in by taxpayers are properly accounted for and aren't accidentally destroyed appears adequately designed." KDOR management designed and implemented this process in 1997. All current associates of the warehouse staff thought there was little or no probability of checks being shredded. Simply put, there is no evidence or indication of any checks being lost.

This concludes my comments regarding the observations and conclusions documented in the text of the report. A detailed response to each recommendation is attached.

Sincerely,



Karla Pierce,
Secretary of Revenue

Detailed Response to Recommendations

Recommendations: p. 20-22.

1. To help reduce the amount of inaccurate information being entered into the computer system for processing tax returns, the Department of Revenue should do the following:
 - a. consider possible formats for tax forms that would allow the use of pre-printed labels with the taxpayer's Social Security number shielded from public view

KDOR Response: We concur. This and other options will be considered in future years.

- b. set higher confidence levels on the ICR equipment for key items such as Social Security numbers, so that questionable items are more likely to be rejected for staff review before being entered into the system.

KDOR Response: We are reviewing options for increasing scanning accuracy. We plan to use more manual intervention in the upcoming year.

- c. look for ways to modify tax forms to help prevent such things as signatures slopping over into boxes.

KDOR Response: We concur. Our new form for the 1999 tax year has already been modified.

- d. continue its efforts to clean up inaccurate information transferred from the old computer system into the new system, and ensure that this is a priority issue with sufficient staff assigned to it.

KDOR Response: We concur.

- e. provide closer supervision of temporary staff making data corrections, so that those staff don't just pass wrong data into the system simply to meet production quotas

KDOR Response: We concur. Our Quality Improvement Plan outlines steps to improve supervision and training including reducing the temp/leader ration to 5:1, devoting more time to training, and developing management reports to monitor team and individual operating performance.

- f. have its internal audit staff or others conduct periodic tests of the accuracy of taxpayer account information entered into the computer system

KDOR Response: We have established a Quality Assurance Team, whose responsibilities include monitoring and testing samples of returns processed, identifying common errors, and providing training to associates on improving processing accuracy and throughput.

2. To help lessen the chance of improper payments or adjustments being made to taxpayer accounts, the Department should:

- a. ensure that staff provide complete and accurate documentation for adjustments made to taxpayer accounts

KDOR Response: We concur. We are training associates to provide better on-line documentation on 'notes screens' to evidence adjustments made to taxpayer accounts.

- b. require supervisory approval of all adjustments to taxpayer accounts that require additional money to be sent out

KDOR Response: We disagree. It would be prohibitively costly to provide prompt customer service if supervisory approval was required on all adjustments. Options A, C, and D will achieve the same control, when implemented.

- c. program the computer to produce "exception reports" of adjustments made by staff, and have management periodically review those reports for items that may be out of the ordinary

KDOR Response: We concur. This is an appropriate control in a reengineered environment.

- d. have its internal audit staff run periodic queries on the tax databases to identify possible improper payments, and controls or edits that could be built into the system to help detect them.

KDOR Response: We agree with the suggestion of using data queries to identify potential overpayments. These can be adjusted in accordance with appropriate tolerance levels. It is neither cost-effective nor practical for the system to check every transaction.

3. The Department should recover erroneous duplicate refunds made to taxpayers when it's cost-effective to do so.

KDOR Response: We plan to initiate collection efforts on all erroneous duplicate refunds.

4. To ensure that tax revenues owed to the State aren't unduly delayed, the Department should promptly clear up existing inaccuracies on 1998 income and withholding tax accounts, and bill taxpayers for any balances due as soon as possible.

KDOR Response: Plans are already in motion to correct remaining data errors and resume billing.

5. To ensure that future computer programs including those for corporate income tax and unemployment tax are properly tested and installed with the least amount of problems, the Department should:

- a. ensure that data transferred from existing records is cleaned up and accurate before entering it into the new system.

KDOR Response: We concur.

- b. assign experienced staff to the testing of those programs, and allow them sufficient time to complete the testing well in advance of program implementation.

KDOR Response: We believe that our existing testing methodology is sound. Rigorous testing of ASTRA 2.0 has resulted in the identification and correction of a substantial number of 'system bugs.' After the user acceptance test phase of testing, we employ a controlled production plan, which is completed before system implementation. Without the Y2K issue and its associated deadline, we anticipate having more time for testing in future system implementations.

- c. to the extent possible, involve its internal auditors in reviewing these programs up front so they can suggest controls that can be built into the programs to prevent unwanted occurrences from happening.

KDOR Response: We concur. One IA staff member was devoted full time to Project 2000 over the last two years. He assisted in revenue tracking, review of system designs, and prepared a Risk Analysis paper for Project 2000 management. In the future, we hope to use this position to a greater extent in consulting activities for control design and review.

Recommendations: p. 35-36

1. To reduce delays in processing future refunds, the Department of Revenue should do the following:
 - a. Review its procedures and staffing for dealing with returns that don't go cleanly through the system. While it's true that staff often have responsibilities in addition to working on problem returns, those responsibilities should be balanced to avoid lengthy processing delays.

KDOR Response: We have already completed such a review and have documented planned changes in our Quality Improvement Plan. A new tool that we will employ in 2000 is a Process Model that will help predict processing bottlenecks and backlogs. This tool will allow us to forecast expected data inflows and track internal flows of data and documents and adjust staffing assignments accordingly.

- b. Continue to work with vendors to adjust the mail sorting and opening equipment so that it's more reliable and doesn't damage materials received in the mail

KDOR Response: We have maintained a continuing relationship with the vendor of the sorting machine, who has spent numerous hours on site, helping to improve performance. We will continue to monitor and improve utilization of this and all equipment that is an integral part of the return processing system.

2. To ensure that the State pays appropriate interest on late refunds, the Department of Revenue should make sure that it has corrected the policy and programming errors that kept it from getting its statutorily allowed two month-period to process refunds without paying interest.

KDOR Response: We have already corrected the computer program in question. However, an issue remains with the treatment of interest on refunds resulting from amended returns. We plan to seek clarification of this law and adapt our policies and procedures accordingly, in 2000.

3. To ensure that the State pays appropriate interest on late refunds from amended tax returns, the Senate Assessment and Taxation Committee, House Taxation Committee or other appropriate legislative committees should review and clarify the law relating to when interest should be paid on refunds due on amended tax returns.

KDOR Response: In dealing with the ambiguities that exist in the law, KDOR's philosophy has been to structure our policies in concert with the Taxpayer Fairness Act. We hope to work with the Legislature in the upcoming session to clarify issues and make appropriate changes to the law and/or our administrative practices.

4. To ensure that the Department is in compliance with the laws regarding food sales tax and homestead property tax refunds, and to ensure that those refunds aren't provided to ineligible individuals, the Department should require some proof of eligibility from the taxpayer as outlined in the law.

KDOR Response: We disagree. Requiring taxpayers, especially those affected by these programs, to submit proof of eligibility is burdensome to the taxpayer and costly to administer. KDOR already has in place a program to deter and detect fraud. We intend to focus our efforts on a risk-based approach to auditing taxpayer claims and seek a legislative change that will allow us to effectively administer these programs without delaying refunds to the majority of taxpayers.

5. To ensure that the intent of the Legislature is clear regarding how heads of households should be treated for food sales tax refund purposes, the Legislature should amend State law to clearly allow or disallow an extra exemption.

KDOR Response: We concur. The 1999 Special Committee on Assessment and Taxation noted in its Interim Committee report that "[i]t was the intent of the 1998 legislature to allow heads of household to receive an extra refund amount similar to the provision of the individual income tax law which allows such filers to receive an extra personal exemption amount." We agree that the legislative intent should be clarified in statute.

Recommendations – p. 44

1. To ensure that the letters it sends to taxpayers are more understandable, the Department of Revenue should thoroughly review those form letters to eliminate or clarify confusing language and fully explain terms, processes, and programs that taxpayers may not be familiar with.

KDOR Response: We concur. We have already modified some language to be more easily understood. Our Quality Improvement Plan outlines strategies for improving accuracy of data used for letter generation, including more manual review by KDOR associates. The Plan also details our new Correspondence Standards practices and review process, designed to ensure that letters are customer-focused, with sufficient detailed information to address the customers' needs.

2. To ensure that it's able to effectively handle taxpayer phone calls, the Department should do the following:
 - a. Thoroughly test the refund status hotline to make sure it works with the updated version of the income tax processing software.

KDOR Response: We concur.

- b. Continue with its plans to implement a "call center" for taking taxpayer calls.

KDOR Response: We concur and have made significant progress, with appropriate organizational and technological changes being solidified at this time.

- c. Continue to monitor the staffing needed to respond to taxpayer phone calls.

KDOR Response: As noted in the report, our objective is to avoid the need for most phone calls by prompt, accurate return and refund processing and by providing self-service channels that are available for customers when they need them. However, we will adjust telephone staffing during 2000 to the best extent possible within the constraints of available personnel to administer key customer service functions.