Lexington-Fayette Urban County Government
OFFICE OF INTERNAL AUDIT

Jim Newberry
Mayor

Joe Kelly
Senior Advisor for Management

INTERNAL AUDIT REPORT

DATE: September 24, 2009

TO: Jim Newberry, Mayor

CC: Joe Kelly, Senior Advisor for Management
Bill O'Mara, Acting Commissioner of Finance & Administration
Rama Dhuwaraha, Chief Information Officer
Susan Straub, Communications Director
Urban County Council Members
Internal Audit Board Members

FROM: Bruce Sahli, Director of Internal Audit

RE: Revenue Tax Gap Process Audit

Background

The Division of Revenue is responsible for administering the occupational license fees for Lexington and Fayette County. License fees are regulated by Chapter 13 of the Code of Ordinances. Chapter 13 states that every person or business entity engaged in any business for profit, and any person or business entity that is required to make a filing with the Internal Revenue Service or the Kentucky Revenue Cabinet, shall be required to file and pay to the Urban County Government an occupational license tax for the privilege of engaging in such activities within the Urban County Government. The occupational license fee is 2.25% of wages and net profits, imposed solely for revenue purposes of the general fund.

Division of Revenue License Fee Regulations states that failure to timely file any return or report and/or pay any license fee due under the Ordinance or these Regulations shall result in the assessment of interest and penalties. Interest accrues at the amount of 12% per annum for any remaining unpaid license fees. Penalty on Net Profits and Employee Withholding accrues at five percent (5%) of unpaid license fees for each calendar month or portion of a calendar month, not to exceed 25% of total amount due nor be less than $25.00.

Our audit focused on the Tax Gap of the Occupational License Fee. Tax Gap is defined as the difference between what taxpayers should have paid and what they actually paid on a timely basis. Understanding and monitoring the Tax Gap allows management to make better decisions about tax policy, allocation of resources for tax administration, and to manage fiscal challenges and responsibilities.

Scope and Objectives

The general control objectives for the audit were to provide reasonable assurance that:

- Written procedures exist for monitoring the Tax Gap
- The collection process is sufficient to identify businesses who have not filed taxes
- Underreported taxes are identified and collected in a timely manner
- Interest and Penalties are appropriately applied and collected

The period of our audit was all active businesses registered with the LFUCG prior to 2007 that were subject to Occupational License Fees.

Statement of Auditing Standards

We conducted our audit in accordance with the International Standards for the Professional Practice of Internal Auditing. Those standards require that we plan and perform the audit to afford a reasonable basis for our judgments and conclusions regarding the organization, program, activity or function under audit. An audit also includes assessments of applicable internal controls and compliance with requirements of laws and regulations when necessary to satisfy the audit objectives. We believe that our audit provides a reasonable basis for our conclusions.

Audit Opinion

In our opinion, the controls and procedures did not provide reasonable assurance that the general control objectives were being met. Limitations within the information technology used to identify and collect unpaid taxes, penalties, and interest is the primary basis for this opinion. Opportunities to enhance controls are included in the Summary of Audit Findings.

Priority Rating Process

To assist management in its evaluation, the findings have been assigned a qualitative assessment of the need for corrective action. Each item is assessed a high, moderate, or low priority as follows:

> High - Represents a finding requiring immediate action by management to mitigate risks associated with the process being audited.
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> Moderate – Represents a finding requiring timely action by management to mitigate risks associated with the process being audited.
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> Low - Represents a finding for consideration by management for correction or implementation associated with the process being audited.

Management Response Note: The Director of Revenue is also currently the Acting Commissioner of Finance.

SUMMARY OF AUDIT FINDINGS

Finding #1. Technological Improvements Needed to Address Tax Gap Issues
Priority Rating: High

Condition:
Using computer assisted audit techniques and data contained on the LFUCG mainframe, we obtained the entire population of active businesses for Fayette County identified in the LFUCG mainframe and matched this data against Employee Withholding and/or Net Profit tax return data (for purposes of this test, timeliness of filing was not considered). We determined that 17% of businesses identified in the mainframe as active in 2005 did not file an Employee Withholding Return, while for 2006 and 2007 those percentages were 15% and 21%, respectively. Using these same computer assisted audit techniques, we determined that 18% of businesses identified in the mainframe as active in 2005 did not file a Net Profit Return, while for 2006 and 2007 those percentages were 20% and 24%, respectively.

The current process for collecting occupational taxes is labor intensive. The Division of Revenue processed 381,413 Employee Withholding license fee returns and 133,867 Net Profit returns during calendar years 2005 through 2008 using dated mainframe software. The Director of Revenue stated the current tax processing software was already in place when he was hired in 1995. This software is used to maintain and manage the Occupational License Fee process, which includes all tax payment information.

Division of Revenue management stated during the initial phases of the audit that the current tax software package lacks the automation necessary to establish tax accounts receivable and track the aging of accounts, adequately manage delinquent accounts or refunds, or provide effective trend analysis necessary to identify potential issues within the tax collection process. We noted the absence of these automation tools during our fieldwork.

Effect:
Failure or inability to promptly detect, notify, and monitor businesses that do not file these required returns increases the likelihood of uncollectible taxes, particularly when the nature of business turnover in the current economic environment is considered. The use of dated software increases the financial risk that unpaid taxes and applicable penalties will not be collected in a timely manner, a fundamental tax gap issue.

Recommendation:
The Division of Revenue should seek funding to obtain a tax software program with the capability to manage large amounts of data. This software package needs, at a minimum, the ability to employ system logic to identify delinquent taxpayers and maintain an accurate accounts receivable database that generates reports enabling Division of Revenue personnel to track the aging of tax accounts receivable and to effectively manage delinquent accounts. The software should also have the capability to automatically generate notices to taxpayers who have missed filing deadlines, track the filing status of businesses that have been granted filing extensions, and automatically calculate penalties and interest. Once this software is purchased, Division of Revenue management should also develop written procedures to accompany this software providing instruction regarding the monitoring of receivables and the timely resolution of anomalies.

Acting Commissioner of Finance Response:
The Division of Revenue concurs with the recommendation to seek an updated tax software application. Discussion regarding a replacement application date back to when the Enterprise Resource Planning (ERP) project began in 2004. It was requested to incorporate the needs of the tax software into the scope of the PeopleSoft financial implementation. In subsequent years, demands to support the PeopleSoft implementation have dominated LFUCG software development. The plan going into FY2010 was to evaluate third party tax software

applications and design the scope of LFUCG needs, with the intent to develop or buy a third party application for implementation in FY2011.

The limitations of the existing tax software dominate the audit findings of this report. Revenue has endeavored to compensate for the lack of automated features or delinquent/exception reporting with supplemental reports and/or business processes.

Chief Information Officer Response:
Computer Services will be gathering requirements for the Division of Revenue software in FY2010 with the intent of implementing it in FY2011. There are a number of legacy software applications that are being phased out and the revenue application is one of them.

Finding #2. Computer Services Report of Unpaid Taxes Inaccurate
Priority Rating: High

Condition:
The Division of Revenue relies on the Division of Computer Services to generate mainframe system reports of all entities or individuals who have not paid taxes. Computer Services provided Internal Audit this same report listing all active businesses registered as of December 31, 2006 that had not filed a Net Profit return for 2006. Using computer assisted audit techniques, we also produced a report from the same mainframe files of all businesses that had not filed a Net Profit return for 2006. A comparison of the two reports noted 5,689 differences between the Computer Services report and the auditor's report.

Our research into this anomaly determined that the Master File Computer Services originally submitted to the auditors did not contain the entire population, as there were 191 entities identified on the Computer Services report that were not included in the Master File provided to Internal Audit. Additionally, 130 of these 191 entities contained on the Computer Services report had a business start date of 2007 or later, yet were noted as having paid Net Profit taxes for 2006. We further noted there were 2,068 active businesses that had not paid Net Profit taxes for 2006, but were omitted from the Computer Services report to Revenue.

Effect:
Reliance upon computer-generated reports containing faulty logic or incomplete data impairs management's ability to administer the tax collection process and monitor its effectiveness, the extent of which could not be determined during the audit.

Recommendation:

The vigilant loading of a complete population of all active businesses into the new tax software program recommended in Finding #1 with an adequate reporting module should address this problem. If this option is not available, Division of Revenue management should discuss with the Division of Computer Services the details of future report production methodologies to obtain reasonable assurance it contains complete and accurate information. Sampling or reporting methods should be sufficiently documented so that the sample and/or report methodology can be reviewed and/or replicated, if necessary, by the requester as part of a reasonability check.

Acting Commissioner of Finance Response:
Concur with recommendation of the need for clean and accurate data in a software application. Concerted effort will be required to edit/purge/correct existing master file data when implementing a new software application.

Concur with audit recommendation to adopt sample testing of computer reports.

Identifying and purging inactive accounts is further challenged by the nature of the self reporting tax system. A taxpayer is to file a tax return when due. For the first time, the 2008 ordinance update included a penalty for the failure to file a return. Up until that time, there was not an incentive for a taxpayer who ceased to do business to report closing an account. The minimum license fee implemented in 2009 further incentivized taxpayers to notify LFUCG when a business no longer had activity in Fayette County. Both steps have improved the accuracy of “active accounts” in the database . A more accurate “active account” listing would reduce the number of non-filers in the audit findings.

This finding, as well as subsequent findings, reflects the shortcomings of the existing data. A database developed in the 1980’s is limited in data size and functionality, and has errors in data input accumulated over time. Input options adopted to overcome field size or information limitations over time have made it difficult to apply computer assisted audit techniques.

Chief Information Officer Response:
A new tax revenue application will give the capability to overcome some of the limitations in the current software. Computer Services will discuss the shortcomings of the existing system with the Division of Revenue and address what needs to be fixed currently and what issues will be fixed as part of the new implementation.

Finding #3. Data Integrity Issues
Priority Rating: High

Condition:
We noted that in the License Year-to-Date table, which contains all returns filed and/or paid, there were 10,784 records with a blank (i.e., nonexistent) period-end date. The Period-End date defines the reportable business period. Failure to maintain this date field makes it impossible to electronically calculate and monitor late filing penalty and interest due.

We also noted 249 data validity errors in the mainframe Master File, which includes business account numbers, address information, and the dates businesses opened in Fayette County. Some of the errors noted in the Account Field had zero for an account number. We further noted an inconsistent use of the business address field; i.e. an Address Field One might contain a street address for a given business, while for another business this same field might contain the name of the city. The Master File also contained three duplicate records. It appears that edit checks for the Master File have not been established, or have not been activated.

Effect:
The fields identified in this finding are integral to determining if a business has filed a Net Profit Return, and in determining taxes due based on the business start date.

Recommendation:
Edit checks are a common programmable control in current data entry software programs. Therefore, the purchase of new tax software recommended in Finding #1, and the activation of reasonable edit checks within that software, should provide the system controls to address this problem. If this option is not available, we recommend an evaluation of Master File fields to determine the necessity for the data contained therein. If the data has a business purpose, edit checks should be developed to ensure data completeness and correctness.

Acting Commissioner of Finance Response:
Concur with the recommendation that edit checks are an important component of the scope requirements for the proposed new tax software.

While the Division of Revenue was not able to duplicate the finding of 10,784 records with blank Period-End dates, it is possible that because of the date formatting in the software, the Period-End date referred to was 00/00/00 which equates to 12/31/2000 in the process used by Revenue.

As stated previously, input errors or input standards have accumulated over time, some as responses to software shortcomings, others as a matter of business practice. Cumulatively, they have impaired the data to run database wide inquiries.

AUDITOR'S NOTE: A re-examination of the data files confirms that 10,784 records contained blank period-end dates. This is separate from any 00/00/00 period-end dates.

Chief Information Officer Response:
As stated in the previous response, Computer Services will include edit checks as part of the new application.

Finding #4. Penalty and/or Interest not Consistently Applied
Priority Rating: High

Condition:
We identified 1,939 (17%) Net Profit returns that were paid at least one month after the extension deadline of October 15, but had no Penalty and/or Interest amounts assessed (late filings ranged from 1-209 months). It is important to note that it was not within the scope of this audit to evaluate the circumstances surrounding specific instances of unapplied penalty and/or interest, but rather to determine that procedures to apply and collect interest and penalties due are appropriately and consistently applied. However, if full collectability is assumed for all 1,939 of these returns, uncollected revenue from failure to assess Penalty and/or Interest on those returns totaled $1,070,305.

This information was provided to Division of Revenue management during the audit. Division of Revenue management responded after fieldwork was completed, stating they had manually conducted additional research of the top 55 returns (based on penalty and interest amounts) and noted that 31 of the 55 represented amended returns for which no penalty and/or interest had been assessed. Revenue personnel also noted that nine of the 55 returns had been coded incorrectly, while in seven instances the filers had been sent collection letters.

We also identified 6,864 (34%) of Employee Withholding returns that were paid at least one month after the quarter end deadline, but no Penalty and/or Interest was assessed to these businesses (late filings ranged from 1 to 208 months). It is again important to note that it was not within the scope of this audit to evaluate the circumstances surrounding specific instances of unapplied penalty and/or interest, but rather to determine that procedures to apply and collect interest and penalties due are appropriately and consistently applied. However, if full collectability is assumed for all 6,864 of these returns, uncollected revenue from failure to assess Penalty and/or Interest on those returns totaled $2,023,530.

This information was provided to Division of Revenue management during fieldwork. Division of Revenue management responded after fieldwork was completed, stating they had manually conducted further research of the top 115 returns (based on penalty and interest) and noted that 29 of those accounts are in civil suit and seven are in bankruptcy. Revenue personnel also noted that 26 of these accounts had been coded incorrectly, 14 had been sent collection letters, and nine were non-taxable government entities. Details are included in the Acting Commissioner of Finance's Management Response.

Per LFUCG License and Regulation Guidelines, interest should be applied to all amended returns. The Guidelines do not address penalties assessed for amended returns. The coding errors represent misapplied payments and not opportunities for additional tax collection. Those accounts involved in civil suits or bankruptcy are questionable as to whether any taxes will be collected.

Division of Revenue management also stated during the audit that the current tax software package does not automatically calculate penalty and interest, but that such calculations must be performed manually, increasing the possibility of costly errors.

Effect:
The current tax software's inability to automatically calculate Penalty and/or Interest due, and the manual processes required to calculate them, represent an additional limitation to Revenue's ability to address unpaid taxes in a timely manner. In addition, the failure to identify and collect on amended returns indicates opportunities for improvement in the current collection process procedures.

Recommendation:
As stated in Finding #1, the purchase of new tax software capable of automatically calculating interest and penalties due is recommended to address this issue. If such a purchase is not available due to lack of funding or software incompatibility, the Division of Revenue should seek assistance from the Division of Computer Services to develop new software programs in-house to provide automated calculation of Penalties and/or Interest, and to establish an accounts receivable program to track the payment status thereof. The Office of Internal Audit has provided the Acting Commissioner of Finance the list of businesses we identified that have not paid Penalty & Interest.

Acting Commissioner of Finance Response:
Concur with the recommendation that automated identification of delinquent filings and automated calculation of penalty and interest is essential in any new application.

The Division of Revenue has incorporated manual reviews to identify delinquent accounts as well as periodic reports from Computer Services. However, both processes are not as effective as functionality available in current software packages.

The Division of Revenue respectfully considers the estimated impact of unapplied interest and penalties as stated above to be overstated. The transactions identified above are in fact transactions for which no penalty and interest was paid, but we do not agree with the assumption of full collectability.

The Division of Revenue researched the top 55 Net Profit transactions listed as having not paid penalty and interest. Of these 55 returns, 48 (or 87%) were knowingly not charged for the following reasons: 31 amended returns, 9 coding errors (the return period was inaccurately input, making the actual transaction not late), 8 bankruptcy or other court proceedings. Similar research was conducted on the Withholding transactions. Of the 115 transactions analyzed, 71 (or 62%) were knowingly not charged for the following reasons: 26 coding errors, 36 bankruptcy or court proceedings, 9 government agencies. In addition, the Division has contacted 14 of the remaining accounts in an attempt to collect. If the results of the research reflects equally on the test population, the potential revenue over a three year period is, $509,700 and $526,100 respectively. These amounts are still material and warrant a concerted effort to minimize or eliminate. The Division of Revenue accepts responsibility for pursuing all amounts due the government and is expanding processes to identify and pursue delinquent amounts.

AUDITOR'S NOTE: This response was discussed with the Acting Commissioner of Finance. The Acting Commissioner stated that penalties would not be assessed on the returns Revenue examined (as detailed above) due to reasons such as amended returns, bankruptcy filings, miscoding, etc, but that collection of interest for some of the amended returns is feasible. The Office of Internal Audit agrees that accounting for the specific circumstances surrounding the 55 largest (stratified) Net Profit transactions with no interest and penalties assessed, and specific circumstances surrounding the 115 largest (stratified) Withholding transactions with no interest and penalties assessed, produces a significantly different estimate of uncollected amounts when those results are extrapolated onto the entire population in question.

As stated twice in the finding, it is important to note that it was not within the scope of this audit to evaluate the circumstances surrounding specific instances of unapplied penalty and/or interest, but rather to determine that procedures to apply and collect interest and penalties due are appropriately and consistently applied. In discussing these calculations with the Acting Commissioner, it was also agreed that if Revenue had conducted a random (rather than stratified) sample of the total population, a third estimated amount would likely have been calculated.

The purpose of this finding is to raise management's awareness of the potential effect of unapplied interest and penalties on returns identifiable in the current tax system as being late, but it is not the purpose of this finding to provide a list of specific accounts to be re-billed or of specific collectable amounts. The Office of Internal Audit acknowledges that circumstances surrounding any such account should be examined before additional tax assessments are actually billed.

Chief Information Officer Response:
Computer Services concurs with the recommendation and will address the need for automatic interest calculation in the new software.

Finding #5. Checks not Endorsed upon Receipt
Priority Rating: Moderate

Condition:
License fee returns are processed in the Processing Section of the Division of Revenue. If a license fee return is filed late, or is submitted for an amount other than the actual tax due amount, or contains an address change, or contains certain other changes, the license fee forms and related check are forwarded to the Division's Revenue Compliance Section. This Section then researches the taxpayer's account, posts corrections and/or additions to the taxpayer's account, and returns the forms and related check to the Processing Section, which will then deposit the check.

Compliance Section management estimates they receive five to fifteen such forms and related checks per day, which they stated are processed and returned to the Processing Section within 24 hours.

Effect:
The unnecessary transferring of checks between Sections increases the likelihood of lost, misapplied, or misappropriated payments.

Recommendation:
The Processing Section of the Division of Revenue should log, endorse, and secure checks for deposit immediately upon receipt. Copies of checks or scanned images may be used if documentation is needed to accompany the license fee forms through processing.

Acting Commissioner of Finance Response:
Concur. Procedures are being developed to incorporate the recommendations.

Finding #6. Division of Revenue Website should be Updated
Priority Rating: Moderate

Condition:
The Division of Revenue's external website contains License Fee Regulations that have not been updated since November 1, 2000. Effective December 6, 2007, Council amended Ordinance 13-7 and increased the penalty on payment in arrears for Net Profits and the failure to withhold on Employee Withholdings from four and one-half percent (4.5%) to five percent (5%).

Effect:
Outdated information compromises a primary purpose of this website, i.e. to inform the public of its tax payment responsibilities and the punitive effect of non-compliance.

Recommendation:
The License Fee Regulations on the Division of Revenue's external website should be updated to inform the public of all fees, penalties, and interest currently in effect. The Division of Revenue website should also consider providing improved guidance regarding filing requirements on its front page, and not just in its regulations.

Acting Commissioner of Finance Response:
Concur that the Revenue website should be as up to date as possible. The Division's website contains the most recent version of the License Fee Regulations. New Regulations are in the processing of being updated in accordance with the new Ordinance passed in January 2008. When the revisions are finalized and approved by Council, the Division's website will be updated accordingly.

Chief Information Officer Response:
Replacements regulations have not been adopted yet by the Urban County Council. Once adopted it will be on the website.

Finding #7. Automation Recommended to Improve Filing & Review
Priority Rating: Low

Condition:
Occupational License fee tax forms must be manually filed by taxpayers and manually reviewed by Division of Revenue auditors.

Effect:
The manual nature of these processes makes them both time-consuming and prone to errors and omissions. Some publications opine that much of unpaid tax is due to taxpayers being unaware of their tax liabilities.

Recommendation:
The Division of Revenue should consider a timetable to automate filing and review. Automated services could include electronic forms processing, on-line payment processing, tax education and outreach to small businesses, and providing prior tax return information online. Automating taxpayer services also offers convenience to the taxpayer, possibly increasing compliance with the Tax Regulations.

The Division of Revenue should also consider collaborating with business training centers to provide improved education and outreach in an effort to reduce the burden of complex filing and reporting requirements for these businesses.

Acting Commissioner of Finance Response:
All of the License Fee forms are available in electronic format. Lexington is also fortunate to have electronic versions of the Net Profit License Fee return be included in the major tax preparer software packages used by most tax professionals. Other forms can be downloaded from the Division's website.

Evaluation of additional e-government options are underway, including the acceptance of electronic payments.

Chief Information Officer Response:
We are currently evaluating e-government options.