

PERFORMANCE AUDIT REPORT

Retailer Sales Taxes: Assessing Whether the Amounts Distributed to Localities Have Been Computed Accurately

**A Report to the Legislative Post Audit Committee
By the Legislative Division of Post Audit
State of Kansas
March 2001**

Legislative Post Audit Committee

Legislative Division of Post Audit

THE LEGISLATIVE POST Audit Committee and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about \$8 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of governmental agencies. The audit work performed by Legislative Post Audit helps provide that information.

We conduct our audit work in accordance with applicable government auditing standards set forth by the U.S. General Accounting Office. These standards pertain to the auditor's professional qualifications, the quality of the audit work, and the characteristics of professional and meaningful reports. The standards also have been endorsed by the American Institute of Certified Public Accountants and adopted by the Legislative Post Audit Committee.

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March 12, 2001

To: Members, Legislative Post Audit Committee

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This report contains the findings, conclusions, and recommendations from our completed performance audit, *Retailer Sales Taxes: Assessing Whether the Amounts Distributed to Localities Have Been Computed Accurately*.

The report includes several recommendations for establishing a systematic process for identifying and distributing sales tax payments that come into the system without a tax return, for reviewing the amounts each locality received relating to the initial 3-month conversion process, and for periodically checking a sample of payments to verify that the correct distribution was made to the correct locality.

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

Barbara J. Hinton
Legislative Post Auditor

EXECUTIVE SUMMARY

LEGISLATIVE DIVISION OF POST AUDIT

Question 1: Has the Department of Revenue Accurately Distributed Local Sales Tax Revenues to Local Units of Government?

Most localities in our sample eventually received the correct sales tax amount relating to the “conversion” period, but there were some problems. *During the first 3 months of the new computer system, the Department of Revenue distributed taxes to cities and counties based on estimates. It later went back and made adjustments to reflect actual amounts due. The adjustments didn't go smoothly. The end result was that the Department recouped about \$13.4 million from cities and counties, and it did a poor job of explaining the adjustments to them. In all, 9 of 10 localities in our sample ultimately were paid the correct amount of sales taxes owed to them during the 3-month conversion period. One city received about \$31,000 more than it was due.* page 7

The Department of Revenue accurately distributed sales tax payments that could be processed, but several million dollars in payments without a return aren't being distributed quickly. *We reviewed 249 sales tax payments to ensure that they were accurately distributed. Of the 222 tax payments that included the information the Department needed to process and distribute them, 218 (98%) were accurately distributed. 27 sales tax payments (11% of the sample) couldn't be distributed because the information the Department received from retailers was incomplete or wrong. Most of these involved the Department receiving a sales tax payment, but no return. In fact, more than \$3.2 million in sales tax payments owed to cities and counties hasn't been distributed because the Department doesn't routinely research and act on payments that come in without a return.* page 8

Officials in 2 states we contacted told us they eventually distribute sales tax payments even if they haven't received a corresponding return. The Department could improve its procedures for handling undistributed sales tax payments that are more than a year old and may never be resolved.

The Department of Revenue's computer system has built-in checks to make sure all sales tax payments that are processed are paid out, but it doesn't ensure that those moneys went to the right locale. *To address this potential problem, periodically the Department could track a sample of payments through the system, as it did in its recent audit.* . . . page 12

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Question 2: Why Did \$19.5 Million Need To Be Transferred from the State General Fund and Highway Fund into Local Sales Tax Funds?

The Department of Revenue informed State budget officials in October 2000 that \$19.5 million needed to be transferred from State funds to several local tax funds. *At that time, the Department needed about \$75 million for upcoming distributions to localities, but the correct amount of money hadn't been put in the local tax fund to cover those distributions.* . . . page 15

We confirmed that \$17.5 million of the transfer related directly to problems with how the new computer system handled utility sales tax payments. *The new computer didn't recognize that some utility "sales" are exempt from State sales tax, so some of the calculations the computer performed were incorrect. This error had no impact on the amounts actually paid to localities—they were paid the correct amounts. When Department staff recognized the shortfall in June 2000, they quit making other routine adjustments to the fund balances, apparently causing some additional shortage. In October 2000, Department staff began making monthly adjustments to compensate for the computer glitch.* . . . page 16

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This audit was conducted by Chris Clarke, Scott Frank, Allan Foster and Joe Lawhon. Leo Hafner was the audit manager. If you need any additional information about the audit's findings, please contact Ms. Clarke 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.

Retailer Sales Taxes: Assessing Whether the Amounts Distributed To Localities Have Been Computed Accurately

Retailers that sell goods and services within Kansas are required to collect both State and local sales taxes at the time of sale, and to remit those taxes to the Department of Revenue within a certain time period. The Department in turn distributes the local sales taxes back to the cities and counties that levied them.

Since the mid-1990s, the Department has been working on Project 2000, which is designed to re-engineer the way the Department manages the taxes it's responsible for collecting. The Project includes not only a new computer system, but also a whole new way of doing business that is focused on taxpayer needs.

In late 1999 and early 2000, the Department converted retailers' sales tax accounts from the old computer system to the new one. During the conversion process, the Department took small groups of returns and processed them through the system, manually checking each for accuracy - a time consuming method. To ensure uninterrupted cash flows to local entities, the Department made 3 estimated monthly payments to cities and counties for sales tax revenues based on their historical collection trends. Later the Department reconciled the estimated payments it had made to the localities with the actual sales tax returns it had processed to ensure that cities and counties were paid the right amount.

In the months since the conversion took place, the Department and legislators have heard repeated concerns from local officials who think they haven't received the correct amount of sales taxes. A number of local officials voiced these concerns during hearings held by the Special Committee on Assessment and Taxation during the 2000 interim. Another concern related to the reasons for transferring about \$19.5 million from the State General Fund and the State Highway Fund into local sales tax funds.

To address these concerns, this performance audit answers the following questions:

- 1. Has the Department of Revenue correctly and equitably allocated and distributed local sales tax revenues to local units of government?**

2. Why did \$19.5 million need to be transferred from the State General Fund and State highway funds into local sales tax funds?

To answer these questions, we reviewed State law and testimony provided to the Special Committee on Taxation, and interviewed Department staff about the procedures they use to process sales tax returns and distribute sales tax receipts to cities and counties. We also examined a random sample of 249 sales tax payments the Department received during October 2000 to determine whether it had correctly distributed the local sales tax portion of those payments to cities and counties.

In addition, we reviewed and evaluated the Department's procedures for handling sales tax returns or payments that get hung up in the system for some reason and can't be distributed to the localities. We also reviewed the general design of the new computer system to make sure it had appropriate controls built in to catch any significant errors in distributions of sales tax receipts. Finally, we contacted officials in 2 other states to find out how those states handle "problem" returns.

A copy of the scope statement the Legislative Post Audit Committee approved for this audit is included in Appendix A. Although the scope statement contained only one question, for reporting purposes we separated it into 2 questions.

In conducting this audit, we followed all applicable government auditing standards set forth by the United States General Accounting Office. Our findings begin on page 7, following a brief overview.

Overview of the State's Sales Tax Collection System

The Kansas Retailers' Sales Tax was enacted in 1937. Originally set at 2%, the State sales tax rate has been increased numerous times over the years to its current rate of 4.9%. In all, 45 states levy a sales tax. Since 1978, Kansas cities and counties also have had the option of imposing a local sales tax. Currently, 75 counties and 169 cities impose an additional local sales tax.

Retailers Are Required To File Sales Tax Returns And Remit the State and Local Sales Taxes They've Collected To the Department

Vendors are required to collect both State and local sales taxes on the goods and services they sell at retail. Then either monthly, quarterly, or annually they're required to file tax returns and send the sales taxes they've collected to the Department. As the following table shows, businesses collecting the largest amounts of sales taxes are required to file more frequently.

Annual Tax Due	Filing Frequency	Approximate # of Retailers
\$0-\$80	Annually	33,000
\$80.01-\$1,600	Quarterly	51,500
\$1,600.01 +	Monthly	33,500

Regardless of which schedule a business is on, sales taxes are due by the 25th of the month following the end of the period. For example, if a business is on a quarterly schedule, it must send in the sales taxes it collected during January, February, and March by the 25th of April. One exception: the largest retailers (those that collect more than \$32,000 in sales taxes a year) must remit those taxes on an accelerated schedule. They're required to pay the last half of the previous month's taxes and the first half of the current month's taxes by the 25th of the current month.

The sales tax returns retailers file include information the Department of Revenue needs to determine how much in local sales tax receipts should go to which cities and counties. The sales tax returns are recorded in one part of the Department's system and the payments in another. The payment and corresponding return are eventually matched as processing continues.

The sales tax receipts that retailers send in are deposited into separate State and local accounts in the State Treasury. The Department of Revenue can't know what portion of these sales tax payments should go to cities and counties and what portion to the State until it processes the sales tax returns that accompanied

them. Until it can process those returns, here's what the Department does:

- ! it immediately deposits all sales tax payments it receives from retailers into a clearing fund
- ! it then allocates those moneys to 3 different funds based on State law and a formula that takes into account the amount of sales tax receipts the State and localities historically have gotten. Those funds and their historical percentages are as follows:

1. State General Fund (93/98 ^{ths} of the State's share)	72.5%
2. State Highway Fund (5/98 ^{ths} of the State's share)	3.9%
3. Local Sales Tax Fund	23.6%

Allocating the payments to these accounts before the sales tax returns are processed helps ensure that monies are deposited timely. Further, it gives Department officials and other decision makers a daily gauge of how much money is available in each fund.

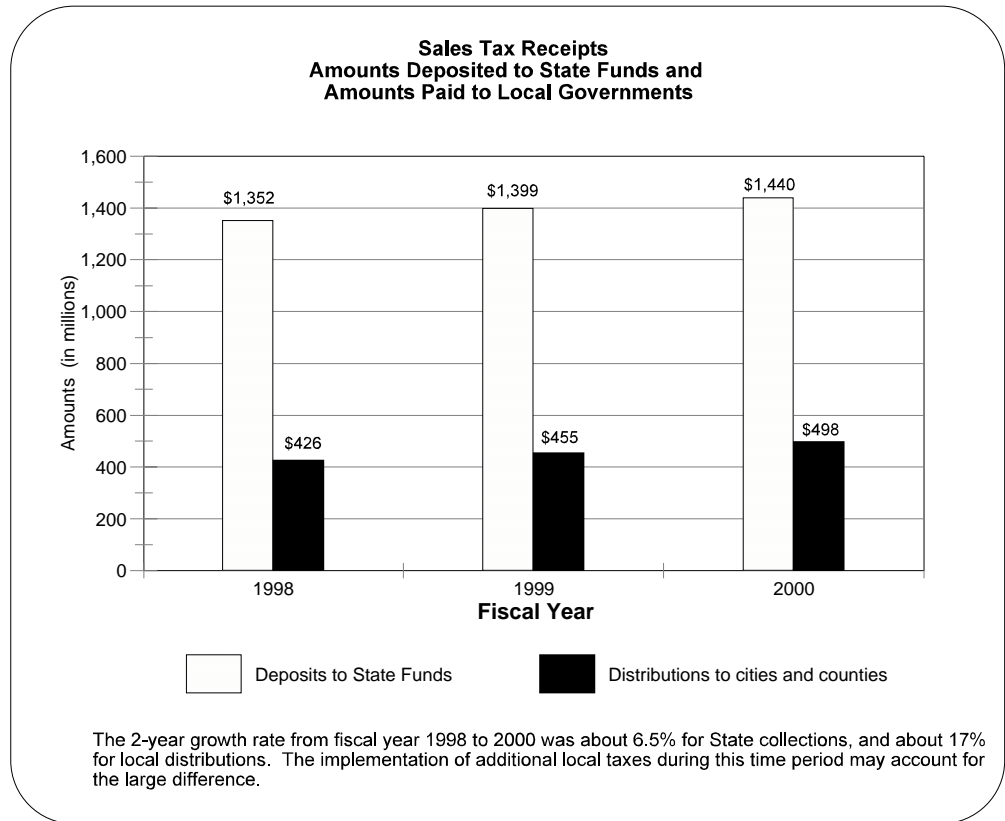
Once the Department processes the sales tax returns that accompanied these payments, it can determine the exact amount of sales taxes that should go the State, and the exact amount that should go to specific cities and counties. Using this information, the Department adjusts the amounts deposited into the 3 funds. Money from the Local Sales Tax Fund is distributed once a month (around the 25th), even though State law only requires them to be made on a quarterly basis. Department officials said this practice helps ensure that local units of government have adequate cash flow to finance their operations.

The Department began using its new computer system to process sales tax returns in October 1999. The Department wanted to check this system out for a few months before relying on the information it generated about how local sales taxes should be distributed. Thus, for the first 3 months the amounts distributed to localities were based on estimates of the local sales taxes owed to them, given their previous year's actual distribution for those same 3 months plus or minus a growth factor.

After distributing estimated payments in November, December, and January, the Department used the new computer-generated data to determine how much it actually should have paid each city and county during those 3 months. It made corresponding corrections in the sales tax distributions sent out in April and July 2000.

In Fiscal Year 2000, the Department Distributed About \$500 Million In Local Sales Taxes to Cities and Counties in Kansas

That same year, the State received about \$1.4 billion in State sales tax revenues. The accompanying graphic shows that, over the past 3 fiscal years, both State and local sales tax revenues have increased steadily Statewide.



As the table shows, State sales tax revenues grew by about 6.5% from 1998 to 2000, while local sales tax distributions grew by nearly 17%. The larger growth for local distributions is possibly due in part to implementation of new local sales taxes.

The Kansas Department of Revenue - Retailers Sales Tax AT A GLANCE

Authority: K.S.A. 79-3603 authorized the State to begin assessing retail sales taxes in 1937. Cities and counties were given the option of imposing a local sales tax in 1978 (K.S.A 12-187).

Staffing: The Department's Tax Operations Program administers virtually all State taxes, including personal and corporate income, retail sales and use, minerals, motor fuels, and excise. Full-time staff of about 500 aren't segregated by tax type.

Budget: The Tax Operation Program's funding comes mostly from the State General Fund. For the most recent year, its expenditures were a little more than \$24 million.

Tax Income: The following is a breakdown of taxes collected by the Department of Revenue for the State (adjusted for refunds), deposited into the State General Fund in fiscal year 2000:

	(in millions)
Individual Income Tax	\$1,854.7
Retailers Sales Tax (State portion)	\$1,440.3
Motor Fuel Tax	\$364.5
Corporate Income Tax	\$250.1
Compensating Use Tax (State portion)	\$210.0
Estate Tax	\$62.9
Cigarette Tax	\$49.1
Financial Institution Privilege Tax	\$22.3
Tobacco Products Tax	\$3.8

Question 1: Has the Department of Revenue Accurately Distributed Local Sales Tax Revenues to Local Units of Government?

During the initial 3 month conversion period, when the Department began processing sales taxes with its new system, most of the localities in our sample eventually received the correct sales tax distribution, but there were some problems. The Department initially calculated the adjustments incorrectly and exacerbated the problem by not explaining things well to the localities. Further, we found at least one city that appears to have gotten about \$31,000 too much. Based on a sample of sales tax payments coming into the Department in October 2000, the Department accurately distributed those that processed without error. However, several million dollars of payments that don't process automatically may experience delays in getting to localities because they aren't systematically identified and resolved. Some moneys in the system will likely never be distributed to local taxing entities under the current system, unless the Department makes some changes.

Most Localities In Our Sample Eventually Received the Correct Sales Tax Amount Relating To the "Conversion" Period, But There Were Some Problems

The Department converted its sales tax accounts to a new computer system in the last 3 months of 1999. During the transition period, it distributed local sales taxes to cities and counties based on estimates of the amounts owed to them. The Department later determined how much each locality actually should have received, and made subsequent adjustments in April and July 2000 to make each city and county "whole."

These adjustments didn't go smoothly. In April 2000 the Department sent a letter to localities noting any additional amounts owed to them relating to the conversion period had been sent out with the February and March sales tax distributions. The Department had computed that, Statewide it had underpaid localities almost \$2 million for this period.

The Department later discovered it had made an error in its calculation—it had mistakenly included payments it received during the transition period that hadn't been processed until later. When it corrected this error, the Department realized it actually had overpaid localities about \$13.4 million for the period.

Without notifying localities, the Department reduced the amount of local sales taxes it distributed to them in April by about \$6.7 million, or half the amount overpaid. In July 2000, the Department sent a letter to the localities explaining the \$13.4 million overpayment, and notifying them that the July distribution of local sales taxes had been reduced by the remaining \$6.7 million.

The confusion caused by these letters contributed to local officials' concerns about whether they'd eventually received the correct amounts for the local sales taxes owed to them during the conversion period.

In all, 9 of the 10 localities in our sample ultimately were paid the correct amount of sales taxes owed to them during the 3-month conversion period. We checked the amounts paid to these 10 localities from November 1999 to August 2000 against the total amount of sales taxes owed to them to ensure that they received the correct amounts. We determined that 9 of the 10 localities in our sample did receive the correct amounts. However, we noted the following:

- ! **After all adjustments were made, the City of Salina received about \$31,000 more than it was due in sales tax distributions for the 3-month conversion period.** Department records show approximately \$101,000 should have been recouped from Salina, but only about \$70,000 actually was. Department officials attributed this discrepancy to problems with converting information from the old sales tax system to the new system.

*The Department
Accurately Distributed
Sales Tax Payments
That Could Be Processed,
But Several Million
Dollars in Payments
Without a Return Aren't
Being Distributed Quickly*

Each month the Department collects about \$166 million in sales tax payments, and distributes roughly \$40 million to localities. To determine whether such payments are being accurately distributed, we reviewed a random sample of 249 of the 48,000 retail sales tax payments the Department received from vendors in October 2000. Our sample size was large enough to provide 95% confidence that the results we saw in our sample didn't differ by more than 5% from what actually happened with all sales tax payments for that period.

We traced these payments through the Department's system, calculated the amount of tax due to the localities, and compared this figure to the amount of local sales tax actually distributed. The results of our review are summarized below:

- ! **Of the 222 sales tax payments that included the information the Department needed to process and distribute them, 218 payments, or 98%, were accurately distributed.** The Department distributed 3 payments totaling less than \$8 twice because of computer processing errors. Department officials told us the "bug" that caused these duplicate payments was fixed in December 2000. The 4th payment for \$12,853 was distributed incorrectly because the taxpayer reported having negative net sales in some jurisdictions. In accordance with Department policy, Department staff entered these negative figures as positive numbers in the computer, causing the distribution to be off.

! 27 sales tax payments (11% of the total sample) couldn't be distributed because the information the Department received from retailers was incomplete or wrong. The Department didn't receive a sales tax return for 25 of these payments. Most of these cases involved retailers that were supposed to submit their returns electronically using Telefile. Also, one retailer wrote the wrong account number on the payment voucher, and another didn't provide information about net sales or the tax jurisdiction.

Given that 1 in 10 payments in our sample couldn't be immediately distributed to localities, and getting money out to the localities was one of the concerns behind this audit, we explored in greater detail what was being done when payments get hung up in the system for missing or incorrect documents, missing checks, or lack of information.

More than \$3.2 million owed to cities and counties hasn't been distributed because the Department doesn't routinely research and act on payments that come in without a return.

Department data show that, it is able to process and distribute about 90% of its monthly sales tax receipts within 30 days, and about 95% are distributed within 60 days. But as noted above, a number of things can prevent a payment from being successfully processed and distributed through the Department's automated sales tax processing system.

To determine the extent to which this was happening, we reviewed and evaluated the Department's procedures for handling returns and payments that have errors, are incomplete, or otherwise aren't processed immediately upon receipt.

In general, we found that Department staff systematically researched and quickly resolved most sales tax returns that were "worklisted" because of problems with the returns, or that were put on the "overpaid inventory" list because the payment appeared to be significantly more than the amount of sales tax due. These situations are described more fully in the box on the next page.

However, we found problems with the way the Department handles sales tax payments that come in without a return. Those payments get deposited into the State Treasury but don't get included on either the "worklist" or the "overpaid inventory" lists that Department staff actively research and resolve.

The Department reviewed these payments that came in without a return in July and October 2000. It ran a customized computer report to identify these payments, then assigned staff to try to re-

solve them. The July computer run identified nearly \$19 million in sales tax payments without a return. Department staff were able to resolve all but \$7 million. By October, these payments had grown again, but were worked back down to \$5.4 million.

Tax Payments the Department Routinely Attempts to Resolve

	Worklist	Overpaid Inventory
Description of Group	Includes sales tax returns that can't be processed for some reason.	Includes accounts where the retailer appears to have overpaid the sales tax liability by more than \$100.
Reasons Why a Return or Payment Could Be Included in this Group	<ul style="list-style-type: none"> ◆ A return or payment couldn't be processed because it had incorrect information, such as an invalid taxpayer identification number. It's possible for both the return and the payment to be on the worklist. ◆ A return contains significant mathematical errors. ◆ The taxpayer misreported the local jurisdiction or calculated taxes based on the wrong rate. 	<ul style="list-style-type: none"> ◆ A return and payment are received, but the payment amount exceeds the tax due amount by more than \$100. ◆ The taxpayer didn't include any estimated payments already made, when calculating amounts due. ◆ The taxpayer listed the wrong identification number and the payment was applied to a different account, causing the other account to have a credit balance in excess of \$100.
Amount of unprocessed items received during October 2000 remaining to be worked as of November 3, 2000	\$8.2 million (2,031 items)	\$4.1 million (838 items)
Amount from Oct 2000 that was still outstanding as of January 4, 2001	\$14,777 (32 items)	\$286,895 (71 items)
As the last 2 rows of the table show, although the value of either group can be several million dollars, Department staff research and resolve most items relatively quickly.		

During this audit we asked Department officials to run the customized report for us as of February 2001. That report identified about \$13.7 million in undistributed sales tax receipts, comprising nearly 7,900 payments. The table at the top of the next page shows the age and value of these undistributed amounts:

Undistributed Sales Tax Payments with No Corresponding Return

<u>Date of Payments</u>	<u># of Payments</u>	<u>Value</u>	<u>Local Share</u>
Oct-Dec 1999	853	\$1,732,331	\$408,830
Jan-Mar 2000	426	\$813,260	191,929
Apr-Jun 2000	412	\$994,310	234,657
Jul-Sep 2000	1,390	\$1,549,142	365,598
Oct-Dec 2000	<u>4,793</u>	<u>\$8,626,929</u>	<u>2,035,955</u>
Total	7,874	\$13,715,972	\$3,236,969

An estimated 23.6% of this money is owed to localities, which means more than \$3 million of this amount represents local tax moneys that haven't been distributed. Department officials told us they haven't made it a high priority to systematically identify and resolve these unprocessed sales tax payments.

Our Sample Results Indicate the Department Has Improved Its Processing of Sales Tax Returns

In May 2000, the Department began reviewing its system for processing sales tax returns and distributing payments to assess how well it was working, and to identify and correct any potential problems. As part of that review, the internal audit group reviewed a sample of 450 sales tax payments submitted by retailers in November 1999 (the second month the new computer system was in use). That review showed the Department was able to successfully process 81% of the payments it had received. The remaining 19% couldn't be processed because of missing, incomplete, or erroneous tax returns. If you look at our sample of 249 payments that retailers submitted in October 2000 the same way, it shows the Department was able to successfully process 88% of the payments it had received, and only 12% couldn't be processed because of missing, incomplete, or erroneous tax returns. On this basis, the system's performance has improved.

If the Department were to routinely identify and review these payments, a substantial amount of information is available to help determine which cities and counties these moneys are owed to. This information includes the following:

- ! the retailer's name is usually identified on the sales tax payment
- ! the Department has contact information for each retailer in the retailer's account file
- ! retailers that file an electronic Telefile return have a single fixed business location (which doesn't change)

Officials in 2 states we contacted told us they eventually distribute sales tax payments even if they haven't received a corresponding return. We asked revenue officials in Missouri and Iowa how they handle these situations. Both states have implemented procedures to distribute these payments based on an estimate. The states look at the retailers prior filing history, and calculate the distribution based on that. If the sales tax return appears later on, the officials can make any necessary adjustments at that time.

Officials from these 2 states told us they implemented these procedures to avoid creating a backlog of unprocessed checks, and felt that an estimated distribution was better than no distribution at all.

The Department could improve its procedures for handling undistributed sales tax payments that may never be resolved.

Department officials told us that, given their current workload, their practice is to process newer and larger items first. As a result, unprocessed older items involving smaller amounts of money

get deferred. For example, the Department has a tax return from September 1999 for \$962 with no company name or federal employer's identification number on it. The Department has no direct way of determining who sent the return, and officials said it could take hours to figure out who to contact.

Older payments that never get resolved can add up to a significant amount of money. Altogether, about 900 items totaling more than \$1.8 million on the Department's "worklist," its "overpaid inventory list," and the list of unprocessed payments are more than one year old.

A Recent Problem With the Distribution of Countywide Sales Taxes Appears to Be an Isolated Incident

At the end of this audit, we learned the February 2001 distribution of countywide sales taxes in Johnson County was incorrect. Countywide sales taxes are distributed to each county and the various cities within that county according to a formula that is based on the population and property tax base of each entity. Updated information is supplied to the Department and the formulas in the computer system are adjusted every 6 months.

Department officials told us they calculated the February 2001 distribution of countywide sales taxes manually, and the payments for Johnson County were determined incorrectly. They told us the amounts paid to localities in Johnson County will be corrected. The problem is related to the manual calculation and appears to be isolated. We also checked the distributions of countywide sales taxes made to all jurisdictions during our October 2000 test period and found that they were accurate.

The Department hasn't developed any formal policies or guidelines for handling this large number of older, unresolved items. Formal guidelines would give employees direction on such things as which items should be pursued and to what extent, which items should be written off, how any undistributed payments should be distributed, and on what basis.

The Department's Computer System Has Built-In Checks To Make Sure All Sales Tax Payments That Are Processed Are Paid Out, But It Doesn't Ensure That Those Moneys Went To the Right Locale

To protect the integrity of the sales tax data being processed, a computer system should have automatic "edits" built in to check the data at different points. For example, after the data are entered the computer software could automatically check such things as whether the account number matches an existing account, or whether the math on the sales tax return is correct. The computer software also could be programmed to check that numbers don't inadvertently change when data go from one process to another.

As part of this audit, we reviewed the Department's sales tax computer system to see how information flowed through it, and what methods the Department used to make sure those data remained accurate throughout the process. We found the Department had good procedures for making sure the data are entered correctly, and for reconciling the total dollars going into and out of the system. We also found the system has the most of the appropriate "edits" that we'd expect to see.

However, the Department doesn't have an automatic check built-in to ensure that the correct amounts went to the correct local entity. Thus, if the computer processed a sales tax return and allocated a tax payment to the wrong cities or counties, the Department would have no way of knowing a mistake had been made. Currently, the only way the Department could identify such a mistake is if one of the local entities complained they weren't getting enough money. To address this potential problem, periodically the Department should track a sample of payments through the system, as it did in its recent audit.

Conclusion Cities and counties throughout the State depend heavily on sales tax receipts for revenue, and rely on the Department to distribute those receipts to them in a timely manner. Overall, the Department does a good job of quickly and accurately distributing most local sales taxes. But a significant number of payments don't get distributed quickly because a sales tax return didn't come in with them. Even though these undistributed payments may seem small compared to the millions of dollars processed and distributed each month, they still amount to several million dollars and are very important to the localities they're owed to. The Department needs to make sure it works to distribute all sales tax receipts in the most timely and efficient manner.

Recommendations

1. To ensure that cities and counties receive their share of sales tax payments in a timely manner, the Department of Revenue should immediately establish a systematic process for identifying payments that come into the system without a tax return, using all available information to determine which localities are owed these payments, and distributing those payments as quickly as possible. Staff should be assigned to research and resolve these payments as needed. For those payments that can't be resolved after a reasonable period of time, the Department should develop procedures that will allow it to estimate the portion due local jurisdictions and distribute that money accordingly.

2. To ensure that all cities and counties were actually “made whole” relating to tax payments distributed during the 3-month transition period, the Department should review the adjustments made to each locality. It should report the results of its review to the Legislative Post Audit Committee and other appropriate legislative committees by August 2001.
3. To ensure that the right amount of money is going to the correct locality, the Department should establish a procedure to periodically check a sample of payments. This review should track the incoming payment all the way through the system, and verify that the correct distribution was made to the correct localities.

Question 2: Why Did \$19.5 Million Need to Be Transferred from the State General Fund and Highway Fund into Local Sales Tax Funds?

The Department informed State budget officials in October 2000 that \$19.5 million needed to be transferred from State funds to several local tax holding funds to cover a one-time shortfall in those local funds. This transfer was needed primarily because a glitch in the Department's new sales tax computer system caused more of the sales tax payments the Department received to be credited to the State funds than they should have, and less to the local tax fund. This error, which only affected utility company payments on sales that were exempt from State sales taxes, went undetected for about 8 months. In June 2000, staff realized there was a shortage in the County-City Sales Tax Fund. While they were investigating this problem, they quit making other routine adjustments to the State and local funds, which apparently caused some additional shortages in the 3 local funds.

Since October 2000, Department staff have been making manual adjustments to work around this problem and to avoid the need for additional transfers. The computer problem is supposed to be fixed by the end of April 2001. These and related findings are discussed in more detail in the sections that follow.

The Department Informed State Budget Officials in October 2000 that \$19.5 Million Needed To Be Transferred from State Funds to Several Local Tax Funds

The Department reported that this one-time transfer was needed to cover a shortfall in the local tax funds. At the time, the Department needed \$75 million for upcoming distributions to localities, but the correct amount of money hadn't been put in the local tax fund to cover those distributions. Those figures are shown in the box on the next page.

The Department's memo said this transfer was needed primarily because of problems related to processing sales tax returns through the new computer system. It cited problems with the way the computer handled utility companies' sales tax returns, and with sales and use tax refunds. The memo indicated the Department should be able to avoid this situation in the future because it had changed its procedures to work around the problems, and was making monthly adjustments until the computer program glitch could be fixed.

Given the State's tight budget, this issue raised a number of legislative concerns about why this \$19.5 million transfer was needed. To verify that this transfer was appropriate, we reviewed the work Department staff had performed to identify the reasons for the shortage in the local funds.

Remedies for the Shortfall in Local Funds

Shortfall in Local Tax Funds		Steps Requested To Address the Shortfall	
Local taxes payable to cities and counties as of September 20	\$75.0 million	Amount To Be Transferred:	
		from State General Fund	-\$18.5 million
		from State Highway Fund	-\$1.0 million
		Total	-\$19.5 million
Amount available In local funds	<u>\$51.0 million</u>	Amount To Be Deposited to the:	
Shortfall in Local Funds	\$24.0 million	County-City Sales Tax Fund	+\$17.9 million
		County-City Consumers' Compensating Use Tax Fund	+\$0.9 million
Amounts scheduled to be recouped from localities (see box at right)	<u>-\$4.5 million</u>	County-City Retailers' Compensating Use Tax Fund	+\$0.7 million
Amount of Shortfall to be recovered through transfer	\$19.5 million	Total To Be Deposited Into Local Funds	\$19.5 million

We Confirmed that \$17.5 Million of the Transfer Related Directly To Problems with How the New Computer System Handled Utility Sales Tax Payments

The new computer didn't recognize that some utility "sales" are exempt from the State sales tax, so some of the calculations the computer performed were incorrect. As a result, when a utility company submitted a sales tax payment to the Department, the computer ended up crediting more money to the State funds than it should have, and less money to the local sales tax fund.

This error had no impact on the amounts actually paid to localities—they were paid the correct amounts. The error was in how much money ended up being deposited to each fund. (This error is more complex than we've described here. For those who are interested, Appendix B provides a more detailed explanation.)

Department staff weren't aware of this problem until late June 2000, when they realized there was a significant shortfall in the County-City Sales Tax Fund. By August the Department's internal auditors had identified the problem involving utility sales tax returns. They subsequently determined that, from October 1999 (when the new computer system came on line) to September 2000, this computer glitch resulted in the County-City Sales Tax Fund being shorted by almost \$17.5 million.

When Department staff recognized the shortfall in June, they quit making other routine adjustments to the fund balances, apparently causing some additional shortages. As described in the overview, when a sales tax return is processed and matched up with the sales tax payment it came in with, several adjustments

need to be made. First, the amount of the sales tax payment initially deposited into the State funds and the local tax funds based on historical estimates is “reversed out.” Second, the correct amount owed to the State and the localities based on information from the sales tax return has to be deposited into the right funds. Finally, the local taxes owed to the localities need to be distributed.

Problems with Issuing Refunds Accounted for About \$4.5 Million of the Shortages in the Local Sales and Use Tax Funds

Of the \$24 million shortfall in the local sales and use tax funds, Department staff determined that \$4.5 million of that amount could be recouped from cities and counties because of a computer error involving the issuance of refund checks.

When the Department issues a refund check for sales and use taxes overpaid it pays the full amount. To recover the local share of the refund, the computer system should recoup that money from the appropriate cities and counties by withholding money from the next distribution to those localities. Department staff determined that the new computer system failed to recoup moneys from cities and counties when tax refunds were issued for periods before October 1999.

Officials also told us that as of February 1, 2001, the Department had recovered all but \$750,000 of the \$4.5 million owed by local taxing entities. According to Department officials, the remainder is owed by one city that has agreed to reimburse the Department by June 30, 2001. They plan to proceed with a computer programming fix for this problem in March and will have it operational before the end of April 2001.

When Department officials became aware of the shortage in the County-City Sales Tax Fund, they stopped making these normal adjustments to the State funds and all 3 local fund balances. They continued to deposit sales tax payments into the State funds and local funds based on historical estimates, but for several months didn't do any reversals as the corresponding sales tax returns were processed.

Department staff attribute the remaining \$2 million shortfall to its suspension of these normal adjustments.

In October 2000, Department staff began making monthly adjustments to compensate for the computer glitch. Since then, Department officials have been making manual adjustments to the cash balances in the State and local funds

to ensure that the right amounts are deposited, reversed out, and paid. These manual adjustments should avoid the need for any unanticipated transfers in the future. Department officials told us a computer program “fix” is scheduled for March 2001, and the new software should be operational before the end of April 2001.

Conclusion The Department of Revenue's new computer system didn't process certain sales and compensating use tax transactions correctly, which resulted in the local tax holding fund being shorted by about \$17.5 million, and the State General and Highway Funds being overcompensated by the same amount. That's the primary reason why the \$19.5 million transfer needed to be made. The Department has identified the computer problems that caused these errors, and plans to have computer fixes in place by April 2001. This appears to be a one-time problem that shouldn't be repeated in the future.

APPENDIX A

Scope Statement

This appendix contains the scope statement approved by the Legislative Post Audit Committee for this audit on December 1, 2000. The audit was requested by Representative Aurand.

SCOPE STATEMENT

Retailer Sales Taxes: Assessing Whether the Amounts Distributed to Localities Have Been Computed Accurately

When goods and services are sold at retail in the State, the sales taxes generated are remitted to the Department of Revenue, which in turn distributes the local shares of those taxes to cities and counties that levy the tax.

Since the mid-1990s, the Department has been working on Project 2000, which is designed to re-engineer the way the Department manages the taxes it is responsible for collecting. The Project includes not only a new computer system, but also a whole new way of doing business that focused on taxpayer needs.

For about three months in late 1999 and early 2000, the Department was converting retailers sales tax accounts from the old system to the new system established for Project 2000. During that time cities and counties received estimated distributions of their sales tax revenues based on the collection trends they had exhibited in the past. A reconciliation was performed at the end of the process to ensure that municipalities were paid what was actually collected on their behalf during the period.

In the months since the conversion took place, the Department and legislators have heard concerns from local officials who think they haven't been receiving the correct amount of sales taxes under the conversion and the new system. A number of local officials voiced these concerns during hearings held by the Special Committee on Assessment and Taxation during the 2000 interim. The Committee has requested that an audit be done to determine whether the concerns being expressed are founded in fact. A performance audit on this topic would address the following question:

- 1. Have sales tax revenues been correctly and equitably allocated and distributed to the State and local units of government?** To answer this question, we'd review testimony provided to the Special Committee on taxation and contact local officials as needed to learn about the specific concerns of those officials. Through discussions with Department officials we'd determine how they estimated the amounts owed to various localities during the conversion process, and how those amounts were reconciled with actual collections after the conversion was complete. We'd test a sample of computations to ensure that they were accurate. On a test basis, we'd also look at distributions of sales tax revenues in the months following the conversion to determine whether the new system is working accurately. We'd review additional information and conduct other testwork as needed.

Estimated time to complete: 8-10 weeks

APPENDIX B

A Detailed Explanation of How the Department of Revenue's New Sales Tax Computer System Mishandled Utility Sales Tax Payments

In October 2000, the Department of Revenue informed the Division of Budget and other State officials that \$19.5 million needed to be transferred from the State General and Highway Funds into several local tax funds that were used to hold tax moneys owed to the localities. At the time, \$75 million in local sales and compensating use taxes was ready to be distributed to localities, but there wasn't enough money in the Local Tax Funds to make those distributions.

As we explained in the report text, this \$19.5 million transfer primarily related to problems with the way the new computer system mishandled utility sales tax payments. When that new computer came on line in October 2000, it didn't recognize that some utility sales are exempt from the State sales tax, so some of the calculations it performed were incorrect. As a result, when a utility company submitted a sales tax payment to the Department, the computer ended up crediting more money to State Fund than it should have, and less money to the local tax accounts. This problem accounted for \$17.5 million of the amount that needed to be transferred.

The example on the following page provides more detail about how this computer glitch affected the amounts deposited in the State and local tax funds and, ultimately, the need for a transfer to make those local funds "whole."

In this scenario, an electric utility company had the following situation:

Net taxable sales of electricity:	\$100,000	State tax rate:	4.9%
Sales subject to State sales tax		Local tax rate:	2.0%
(some sales are exempt):	\$ 10,000	Total tax rate:	6.9%

If all the utility company's sales of electricity had been taxable, it would have collected and sent in a total of \$6,900 in State and local sales taxes (\$100,000 X 6.9%).

But because some of its sales were exempt from State sales tax, this company correctly collected and remitted a total of only \$2,490 in State and local sales taxes ([$\$10,000 \times 4.9\%$], + [$\$100,000 \times 2\%$] = \$2,490).

The Department's new sales tax computer system didn't recognize that some utility sales are exempt from State sales tax. To illustrate how the shortage occurred, we've developed the example below.

Two Basic Processes for:	Scenario: A utility company remits a \$2,490 sales tax payment	What should have happened		What did happen (errors are in large bold type)	
		State Funds	Local Funds	State Funds	Local Funds
Handling the initial sales tax payment before the sales tax return has been processed	1. Deposit the payment (based on estimates of how much each group should get: 76% State, 24% local)	\$ 1,890	\$ 600	\$ 1,890	\$ 600
Handling the sales tax payment after the sales tax return has been processed and matched with the sales tax payment (now know exactly how much the State and localities should get)	2. Reverse out the estimated deposit	- \$ 1,890	- \$ 600	- \$ 5,244	- \$ 1,656
	3. Deposit the amount actually owed each group (as determined from the sales tax return)	\$ 490	\$ 2,000	\$ 4,900	\$2,000
	4. Pay out the amount actually owed to each group	- \$490	- \$ 2,000	- \$ 490	- \$ 2,000
	Amount over- or underpaid to funds	\$0	\$0	\$ 1,056 over	- \$ 1,056 under

As this example shows, the calculations under step 2 and step 3 were made as if all sales were taxable; in other words, the calculations were erroneously based on taxes due of \$6,900. The correct amount of taxes due was \$2,490. It should be noted, however, that the amounts paid to the localities were correct.

APPENDIX C

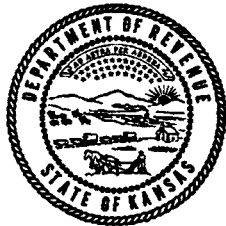
Agency Response

We provided copies of the draft report to the Kansas Department of Revenue on March 2, 2001. We received the Department's written response on March 12, 2001, and include it in this appendix.

STATE OF KANSAS

Bill Graves, Governor

Office of the Secretary
Kansas Department of Revenue
915 SW Harrison St.
Topeka, KS 66612-1588



Office of the Secretary

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March 9, 2001

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

Re: Retailer Sales Taxes: Assessing Whether the Amounts Distributed To Localities Have Been Computed Accurately

Dear Ms. Hinton:

Thank you for the opportunity to respond to this audit. I want to thank members of the Legislative Division of Post Audit team for their professionalism in completing this report. This document provides an informed, objective review of key aspects of our distribution process.

We at KDOR consider the accurate and timely distribution of local sales and use taxes of paramount importance. As you know, prior to the Legislative Post Audit engagement, KDOR conducted its own internal review. The project gave us a chance to carefully examine the distribution process, validate the accuracy of distributions, investigate problem areas, and develop ways to improve our process. Most of these corrective actions have already been completed.

Overall, we believe our new tax system is achieving its intended result. As the auditors' review bears out, KDOR's system is accurately processing and distributing over 99 percent of local sales tax revenues. Of the 249 receipts selected for review, four items required system corrections. These errors had already been identified. Corrective programming has been designed and tested and will be implemented by May 1, 2001.

We are also pleased to receive LPA confirmation that, after the adjustments made in October 2000, the state and local funds are in balance, that the correct amounts were paid to the localities and our accounting procedures preclude the necessity of making similar adjustments in the future.

The key finding in the LPA report relates to "undistributed" tax payments. As noted in the report, KDOR does require the taxpayer to file an accurate return, which provides the

information we need to distribute the local taxes remitted. We employ a series of edits designed to identify errors and flag these returns for further examination. LPA noted how successful and timely our efforts have been to resolve discrepancies where taxpayer errors or omissions prevent the immediate processing of the local tax amounts for distribution.

When taxpayers make payment, yet fail to file a return, this becomes more problematic. Your audit correctly points out the need for a more systematic approach to non-filed returns. As part of our plan to improve performance, we will include revised efforts for contacting non-filing taxpayers and for seeking prompt resolution of these discrepancies. This will allow us to reduce the balance of undistributed local tax receipts.

We plan to make further enhancements by developing new program reports that will make it easier to balance the fund accounts without employing time consuming manual workarounds. We will examine the accounting records for Salina and all other entities, and correct any discrepancies resulting from the estimated distribution period. And we will carefully consider the recommendations contained in this report and the suggestions offered by our Local Advisory Group as we continue to look for ways to improve the quality and efficiency of the distribution process.

Overall, we support the recommendations contained in the LPA report. A detailed response to each recommendation is noted below.

Recommendation 1 suggests we develop procedures to estimate the portion due local jurisdictions for unidentified payments. We agree. We intend to formalize a process of routinely identifying payments received without returns, place these transactions on standard management reports, and promptly seek resolution from the taxpayer or create tax filings from historical information for single location taxpayers. This will allow distribution of the tax payments.

Recommendation 2 concludes we should review the adjustments made during the legacy system transition. We agree. KDOR will review the distributions from the old legacy system into the ASTRA system again to resolve any remaining inconsistencies. We will report the results of this work to the LPA Committee in August 2001.

Recommendation 3 suggests we need a procedure to periodically check the accuracy of distributions by jurisdiction. We believe that a better approach is to expand on our on-going review of the largest taxpayers' returns by developing system edits to verify processing accuracy for reported jurisdictions. This will allow early detection of errors and preclude periodic checks. We will evaluate this approach as part of updates to our system of internal controls.

Sincerely,



Stephen S. Richards,
Secretary of Revenue

