

FINANCIAL AUDIT OF THE  
DEPARTMENT OF TAXATION

Conducted by the  
Office of the Legislative Auditor  
State of Hawaii  
and  
Peat, Marwick, Mitchell & Co.  
Certified Public Accountants

A Report to the Governor and the Legislature of the  
State of Hawaii

Submitted by the  
Legislative Auditor of the State of Hawaii

Report No. 85-3  
January 1985

## FOREWORD

This financial audit report is the result of an examination of the financial statements and records of the Department of Taxation for the fiscal year ended June 30, 1984. The audit was conducted by the Office of the Legislative Auditor and the certified public accounting firm of Peat, Marwick, Mitchell & Co.

This report is divided into three parts. Part I contains an introduction and some background information on the Department of Taxation. Part II presents our findings and recommendations on the systemization and documentation of the general excise tax law and the accounting practices and procedures of the department. It also includes the department's financial statements, including the audit opinion on the fairness and accuracy of the statements. We have followed our customary practice of requesting the agency affected by the audit to comment on the findings and recommendations. Part III contains the Department of Taxation's response to this report and our comments on the department's response.

We wish to express our sincere appreciation for the cooperation and assistance extended by the staff of the Department of Taxation.

Clinton T. Tanimura  
Legislative Auditor  
State of Hawaii

January 1985



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## PART I

### INTRODUCTION AND BACKGROUND

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## Chapter 1

### INTRODUCTION

This is a report of our financial audit of the Department of Taxation.

The audit was performed pursuant to Section 23-4, Hawaii Revised Statutes, which requires the State Auditor to conduct post-audits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions. The audit was conducted by the Office of the Legislative Auditor and the certified public accounting firm of Peat, Marwick, Mitchell & Co. (Peat Marwick).

#### Objectives of the Audit

The objectives of the audit were:

1. To assess the adequacy, effectiveness, and efficiency of the systems and procedures for the financial accounting, internal control, and financial reporting of the Department of Taxation; to recommend improvements to such systems, procedures, and reports; and to render an opinion on the reasonable accuracy of the financial statements of the department.

2. To ascertain whether or not expenditures and other disbursements have been made and all revenues and other receipts have been collected and accounted for in accordance with federal and state laws, rules and regulations, and policies and procedures.

3. To ascertain the extent to which recommendations contained in Chapters 3 and 5 of the Legislative Auditor's Audit Report No. 75-5, *Financial Audit of the Department of Taxation, State of Hawaii, Fiscal Year Ended June 30, 1974*, have been implemented.

4. To ascertain the extent and adequacy with which the rules and regulations, directives, official announcements, and other interpretations relating to the tax laws are compiled, systematized, and documented to foster consistent application among all taxpayers. Of particular concern is the general excise tax law.

#### Scope of the Audit

The audit's scope included an examination of the financial statements, internal accounting controls, and legal compliance of the department for the period July 1, 1983 to June 30, 1984. The accountant's opinion as to the fairness of the financial statements presented is that of Peat Marwick.

The audit's scope also included a review to determine the extent recommendations made in Chapters 3 and 5 of the Legislative Auditor's Audit Report No. 75-5 were implemented. Where the recommendations had not been or had been only partially implemented, the reasons therefore were evaluated. Also included was a study of the

extent and adequacy with which rules and regulations, directives, official announcements, and other interpretations of the general excise tax law are compiled and documented for consistent application among all taxpayers.

### **Organization of the Report**

The report is organized into the following parts.

Part I (Chapters 1 and 2) presents this introduction and background information on the department.

Part II (Chapters 3 and 4) presents our audit findings and recommendations on the systemization and documentation of interpretations of the general excise tax law and the accounting practices and procedures of the department. It also includes the department's financial statements for the period July 1, 1983 to June 30, 1984 and the accountant's opinion on the statements.

Part III contains the response of the department to our recommendations, together with our comments on the department's response.



## Chapter 2

### BACKGROUND

This chapter describes the responsibilities and organization of the Department of Taxation.

#### Responsibilities of the Department

The Department of Taxation is a department established under Chapter 26, Hawaii Revised Statutes. It is headed by a single executive, the Director of Taxation, who is appointed by the Governor with the advice and consent of the Senate. Section 26-10, HRS, assigns to the department the following responsibilities:

"The department shall administer and enforce the tax revenue laws of the State and collect all taxes and other payments payable thereunder."

Also included within the department are boards of review for each of the four taxation districts.

#### Organization of the Department<sup>1</sup>

The following summarizes the department's organization.

**Office of the Director of Taxation.** The Director of Taxation has overall management control of the department. He is appointed by and reports directly to the Governor.

**Administrative Services Office.** This office provides fiscal, personnel, and other administrative services to other organizational units of the department.

**Income Technical Office.** The Income Technical Office is responsible for the administration of income and miscellaneous taxes. It offers administrative interpretations of tax laws, conducts training programs on matters related to income and miscellaneous tax laws, and acts as the principal source for answers to questions on income and miscellaneous tax problems.

**Systems and Procedures Office.** The Systems and Procedures Office provides continuous analysis of technical systems work, computer knowledge for the mechanization of routine tax processing functions, and data processing operations for streamlining tax document production. It conducts management and organizational studies to achieve greater productivity from its systems and develops the data processing systems utilized by the department for tax planning and preparation of statistical reports.

**Tax Research and Planning Office.** The Tax Research and Planning Office conducts tax research and planning. It provides statistical information and projections on tax yields, tax impact, and

1. Descriptions drawn from the relevant portions of the Hawaii Revised Statutes and the following documents: Legislative Reference Bureau, *Guide to Government in Hawaii*, 8th edition, August 1984, pp. 89-91, and Department of Taxation, *Annual Report, 1983-84*, October 1, 1984, pp. 2-9.



economic conditions as they relate to taxes. The office also assists the Director of Taxation in developing and supporting proposed tax legislation changes.

**Tax Compliance Division.** The Hawaii tax laws are administered and enforced by the Tax Compliance Division on a statewide basis. The functions of the division are performed by the following two branches:

1. *Audit Branch*, which administers a comprehensive and uniform system for assessment of all income and miscellaneous taxes, provides assistance and information to taxpayers, and audits tax returns.

2. *Enforcement Branch*, which collects all taxes and fees as required by law, maintains accounting records of all collections, and prepares monthly reports of tax collections.

**Tax Services and Processing Division.** The Tax Services and Processing Division performs all functions relating to the processing and controlling of tax documents, and renders taxpayer services to the public.

**Boards of Review.** There is a Board of Review for each of the four taxation divisions. Each board consists of five members appointed by the Governor with the advice and consent of the Senate. Each Board of Review hears informally all disputes between the assessor and any taxpayer who has filed a notice of appeal. The boards are empowered to decide all questions of fact and all questions of law, except questions involving the Constitution or laws of the United States. They may allow or disallow exemptions and increase or

lower any assessment, but may not declare an assessment illegal or void.

The decisions of each Board of Review may be appealed to the Tax Appeal Court. Alternatively, any taxpayer may, at the taxpayer's option, take the matter directly to the court.

**Units Assigned for Administrative Purposes.** Two organizational units are assigned to the department for administrative purposes. They function autonomously but receive administrative support from the department.

1. *Council on Revenues.* The Council on Revenues prepares revenue estimates of the state government for each fiscal year of the six-year state program and financial plan. Reports of the estimates and any revisions thereto are reported to the Governor and Legislature. The Governor is required to consider the estimates in preparing the budget, recommending appropriations and revenues, and controlling expenditures, while the Legislature must consider the estimates in appropriating funds and enacting revenue measures. The council consists of seven members, three of whom are appointed by the Governor for four-year terms and two each of whom are appointed by the President of the Senate and the Speaker of the House of Representatives for two-year terms.

2. *Tax Review Commission.* A Tax Review Commission is required by the Constitution to conduct a systematic review of the State's tax structure, using such standards as equity and efficiency. The first Tax Review Commission is scheduled to submit a report for consideration by the 1985 Regular Session of the Legislature.

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## PART II

### FINDINGS AND RECOMMENDATIONS

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## Chapter 3

### SYSTEMIZATION AND DOCUMENTATION OF THE GENERAL EXCISE TAX

This chapter presents our findings and recommendations on the systemization and documentation of the general excise tax law by the Department of Taxation.

#### Summary of Findings

1. The department's staff is relying on incomplete records of authoritative information in the administration of the general excise tax law.

2. The department is not providing sufficient public information to assist the taxpayer in complying with the tax law or to ensure uniform application of the tax among taxpayers.

#### Systemizing Tax Law Interpretations

The department looks to a variety of sources for substantive rules, policy statements, and interpretations in administering the general excise tax. As shown in Table 3.1, these sources take various forms and are issued with varying degrees of formality, publicity, and reliability.

Rules, regulations, rulings, releases, memorandums, and bulletins all represent statements issued by the department. The use of different titles in publishing tax information causes some confusion in determining appropriate authoritative sources.

Table 3.1

#### General Excise Tax Authoritative Information

<i>Source</i>	<i>Number Issued</i>
Hawaii Revised Statutes, Chapter 237	—
Rules and Regulations of the Department of Taxation, Title 18, Chapter 237	8 regulations and 1 rule
Court Decisions of Tax Appeal and Supreme Court	238 decisions since 1970
Attorney General Opinions	401 opinions since 1935
Tax Information Releases	39 releases (27 in effect)
Letter Rulings	Not quantified*
Income Technical Office Memorandums	19 memos
General Excise Tax Memorandums	6 memos
Rulings of the Director of Taxation	7 written rulings
Tax Assessments	500 assessments per year since 1980 (approximate)
Administrative Directives	3 directives
Information Bulletins	1 bulletin

\*Over 2,000 letters have been issued by the department since 1963; however, private tax rulings are not differentiated from general correspondence.

The terms "rules" and "regulations" are used interchangeably. Under Chapter 91 of the Hawaii Revised Statutes, a rule is defined as "an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency." Under this definition, then, a rule has the following characteristics:



1. It resembles a statute in that it applies to taxpayers generally, although the fact that a rule is directed at a particular situation does not detract from its general applicability;

2. It has future effect; and

3. It implements law or policy (legislative regulations), interprets law (interpretative regulations), or describes organization or procedure or practice requirements (procedural regulations).

The distinction between a rule or regulation and a ruling is important. Unlike a regulation, which has general applicability, a ruling applies law and policy to specific facts and particular taxpayers, much as the decision of a court in a case. Rules and regulations are adopted by the department in formal rulemaking procedures prescribed by Chapter 91, HRS, while rulings are informal statements of position issued by the department. Rules and regulations are to be given the greatest force and effect by the department.

Tax Information Releases are issued to call attention to what the department believes to be a well-established interpretation or principle of law. The primary purpose of a release is to provide general information which the department feels will assist the business community and general public in the application of law. General Excise Tax Memorandums and information bulletins also represent public information released by the department.

The constantly increasing sources of information require careful compilation, good organization, and continuous updates to provide the department with reliable files of authoritative sources to effectively administer the tax law. This information must be available to employees throughout the department to insure consistent

application of the tax law among all taxpayers through information services, enforcement, and technical guidance.

The department's current filing system of authoritative information is decentralized. Each division or branch has established its own reference materials and filing system. Our review disclosed that reference materials were outdated, incomplete, and not well organized. Our findings included the following:

1. Reference manuals used by Taxpayer Services and the Income Technical Office have not been updated since 1980.

2. The index of court cases filed in the Income Technical Office is incomplete for the years 1965 to 1968.

3. The index of Attorney General Opinions maintained by the Income Technical Office is not current.

4. Authoritative information is not filed by subject matter at the Income Technical Office, hindering the research process on technical issues.

5. The Income Technical Office's correspondence file does not differentiate between private rulings and general correspondence requiring cumbersome file maintenance for routine letters.

6. The field audit branch has established its own file of tax guidelines to supplement available authoritative sources.

The Income Technical Office acts as the principal source on technical questions relating to the tax law and interpretations. However, it may not be attuned to troublesome areas of interpreting the law as it does not have adequate information to summarize those areas where tax



assessments are most frequent. Job descriptions for the Income Technical Office include performing a review of a representative sample of tax assessments to keep in touch with the manner in which the department is handling new or critical technical issues; however, this is currently not being done. This situation allows for the following:

1. The Income Technical Office making private rulings without adequate knowledge of how issues are being handled for assessments.

2. Field audit branch being unaware of assessments that may be contrary to administrative position.

When there is no control over the compilation and maintenance of authoritative information, there is a danger of using outdated and incomplete records in obtaining information. The lack of a centralized filing system for authoritative information results in duplication of effort on the part of the various branches and divisions in generating their own resources and in locating all applicable authoritative literature. The omission of a subject matter index causes delays in identifying appropriate authoritative sources and errors in determining all available resources.

*Recommendations. To improve the systemization of the tax law and interpretations, we recommend the following:*

1. Centralize the compilation and maintenance of all authoritative information, preferably with the Income Technical Office.

2. Include tax assessments as part of the central file of tax law interpretations.

3. Include only private rulings in the central file of tax law interpretations and maintain a separate file of general correspondence.

4. File all information both chronologically by source and by subject matter to facilitate identification of obsolete interpretations and to ensure identification of all applicable resources.

5. Automate the filing system for efficiency and ease of access.

6. Maintain all files on a current basis.

7. Classify official position of the department with respect to the various statements and releases issued. Reissue past publications of General Excise Tax Memorandums and information bulletins to eliminate any confusion regarding authoritative source.

## Providing Public Information

The department is responsible for developing interpretations to promote uniform application of the tax law. The general excise tax law is a broad statute designed by the Legislature to be carried out by interpretations in the form of rules and regulations. Other interpretations currently issued by the department providing guidance in application of the law include the following:

1. Tax Information Releases—official statements of the department similar to regulations but without benefit of public hearing or required Attorney General review.

2. Private rulings—letter determinations in response to taxpayer inquiry regarding application of the law.

3. Tax assessments—additional taxes determined by audit.

Besides the regulations, only the Tax Information Releases are public



information. Private rulings and assessments remain confidential information. It is the department's responsibility to review private rulings and assessments to determine if there is sufficient public interest to warrant publication of interpretations involved in the determinations. To date, the department has promulgated eight regulations substantively compiled in Title 18, adopted one rule amending Title 18 and issued 39 Tax Information Releases. The issuance dates of the regulations, rules, and releases are shown in Table 3.2.

Table 3.2  
General Excise Tax  
Rules, Regulations, and Releases

<i>Date Issued</i>	<i>Regulation</i>	<i>Rule</i>	<i>Tax Information Release</i>
Prior to 1966	5	—	1
1966–1970	—	—	15
1971–1975	2	—	8
1976–1980	1	—	8
1981–1984	—	1	7
Total	8	1	39
Obsolete	—	—	12
In Effect	8	1	27

The Income Technical Office has the specific function of developing tax interpretations for the department. The most active period for publishing interpretations by the department was the five-year period from 1966 to 1970. The department's current development efforts have resulted in the publication of only one rule and one regulation since 1975. It issued two Tax Information Releases in 1984 but none in 1983.

The taxpayer's need for authoritative information pertaining to the general excise tax is heightened due to the self-assessment

nature of the tax. One measure of the effectiveness of the guidance provided by the department is taxpayer compliance with the law in the self-assessment process.

Although official statistics are not maintained, field audit officials estimate that over 80 percent of the audits of general excise tax returns result in additional assessments. This rate seems high even though the returns referred to field audit have a higher expected rate of noncompliance than would random returns. This level of noncompliance suggests weaknesses in administration of the tax either through lack of guidance in the self-assessment process or deficient enforcement in encouraging taxpayer compliance.

To determine the adequacy of the existing tax law and interpretations in providing guidance to the taxpayer, we examined a sample of assessments and private rulings. We reviewed the key issues involved and the available authoritative sources for interpreting the law. From our sample, we identified several issues where public information was insufficient to assist the average taxpayer in complying with the law or to ensure consistent application of the tax among all taxpayers. The results of our review were as follows:

1. **Intermediary services** qualify for the lower 0.5 percent tax rate but this activity is not clearly defined in the law, by regulations or in a Tax Information Release. Clearly the department relies on the 1972 Hawaii State Supreme Court decision in the State of Hawaii v. Busk to interpret intermediary services. While the Supreme Court in 1982 handed down another intermediary services decision in the State of Hawaii v. Pacific Laundry, there is continued uncertainty in the application of the law, because there is still no explicit definition of intermediary services.



2. **Reimbursements** are exempt from taxation when they represent a flow of property or service from a third party without additional monetary consideration for making such costs or advances. The department is relying on the 1969 Supreme Court decision in the State of Hawaii v. Foodland and the 1975 decision in the State of Hawaii v. Aloha Motors to provide interpretations on this issue. The department issued an information bulletin in 1968 providing some guidance in this area, but it has not issued any position statement subsequent to the two major court decisions. To date, no regulations have been promulgated to clarify the law.

3. **Nonprofit activities** "as such" qualify for tax exemption while nonprofit activities with the primary purpose to produce income do not. Legislative intent is not clear in the language of the law, especially as it relates to fund raising. With the support of the 1983 Supreme Court decision in the State of Hawaii v. Queens Medical Center, the department has taken a strong position in assessing additional taxes on not-for-profit activities. The department, however, has not issued any public information to assist the taxpayer in complying with the tax laws since the court precedent was established over a year ago.

4. **Foreign corporations** engaging in business in the State are subject to the general excise tax. One-fifth of the assessments in our sample and a significant percentage of the correspondence we examined pertained to the taxability of out-of-state companies. The department has not issued a Tax Information Release providing specific guidance to foreign companies despite the volume of inquiries and assessments.

5. **Industry guidelines** have been provided by the department through private

rulings but no public information has been issued for the following industries:

a. **Advertising.** The department recognizes the agency relationship for advertising agencies, taxing only net commissions rather than gross amount billed to clients. The reimbursement of media costs are exempted from taxation despite the additional monetary consideration paid in commissions to the agencies.

b. **Travel.** The department does not allow a reduction of the supplier's tax base for commissions paid to travel agents or tour companies. The difference between the published rate and the rate contracted by the travel agent is deemed to be commission.

c. **Computer services.** The department recognizes computer software as tangible personal property and thereby eligible for the lower wholesale tax rate.

Private rulings made without public dissemination of interpretations provided to single taxpayers foster inconsistent application of the law.

While the courts have established precedence in dealing with several of these issues under specific fact situations, the average taxpayer is really not equipped to understand the fine distinctions cited by the courts. It remains the responsibility of the department to develop interpretations that can be applied by taxpayers under varying situations to ensure consistent application of the law for all taxpayers.

The Attorney General is currently involved in a project to determine which areas of the law require additional interpretation through regulations. His focus is primarily on legal deficiencies. He has no direct contact with taxpayers to determine the areas of the law causing



compliance problems. The department is in the best position to tap taxpayer need for authoritative information from its contact with the taxpayer through inquiries and assessments.

*Recommendations.* To increase the effectiveness of the administration of the tax laws, the department needs to provide more guidance to the taxpayer through public information. Development of public information is the specific responsibility of the Income Technical Office. To be more responsive to the taxpayers' need for public information, we recommend the following:

1. The department should issue regulations to clarify the ambiguity of the law. Examples of areas of concern include:

- . Intermediary services
- . Reimbursements
- . Tax-exempted activities of nonprofit organizations

2. The department should publish Tax Information Releases to promote consistent applications among taxpayer groups, such as:

- . Nonprofit organizations
- . Foreign companies
- . Advertising agencies
- . Travel agencies
- . Computer services

3. The department should have a continuing system to ensure that its interpretations are abreast of current circumstances and concerns. Such a system should include the periodic review of a representative number of tax assessments to identify complex technical issues and issues with a high rate of noncompliance and the monitoring of taxpayers inquiries to identify unclear areas of the law requiring additional interpretations, preferably by quantifying private rulings by subject matter.

## Chapter 4

### FINANCIAL ACCOUNTING AND INTERNAL CONTROL

This chapter contains our findings and recommendations on the Department of Taxation's accounting practices and procedures.

#### Summary of Findings

We find that:

1. The department has failed to correct several of the conditions noted in our 1975 audit of the department including the following:

a. Sufficient controls over tax payments made through the mail are lacking.

b. There are substantial delays in depositing tax receipts, thereby resulting in significant lost interest earnings.

c. Tax documents and files are not adequately secured.

2. The department does not have an effective audit selection system.

3. The department is not complying with statewide accounting policies encouraging the use of petty cash funds and it is not making adequate use of such funds.

#### Failure to Improve Conditions Noted in Previous Report

In 1975, our office issued a report on the financial audit of the department in

which a number of deficiencies in the financial accounting and internal control systems were noted. That report, Report No. 75-5, also offered recommendations and suggestions for improvement, many of which the department attempted to implement. In several cases, however, the department reverted to its original system and procedures when the recommendations were, for various reasons, not considered to be feasible. In addition, other recommendations were considered not feasible by the department and no attempt was made to implement them. Unfortunately, the department failed to take other adequate steps to address those problems outlined in our previous report. As a result, several of the deficiencies noted in 1975 still exist today.

**Insufficient controls over mailed-in receipts.** The department collected almost \$1.3 billion in taxes during the year ended June 30, 1984 as part of its tax collection responsibilities. That responsibility includes not only the collecting of money but also the safeguarding of the money from loss, theft, burglary, or misappropriation. To accomplish this, the department is responsible for maintaining a system of internal controls over the revenue collection process; that is, a plan of organization and all of the coordinate methods and measures adopted within the department to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed laws and policies. In our 1975 report, we pointed out that internal controls



over mailed-in receipts were deficient and, unfortunately, they continue to be deficient ten years later.

As in 1975, all mail received by the department is first sorted in the mailroom. Mail specifically addressed to individuals or offices are forwarded directly to those addressed unopened, even if the mail is likely to contain tax payments, as is the case with mail addressed to the enforcement branch and field audit branch. All other mail are opened and sorted, by tax type, by the mail clerks. From the mailroom, tax receipts are then forwarded to the cashiering section except for payments such as those not accompanied by a return or where the payment disagrees with the return, which are first routed to the documents preparation section for research.

A sound system of internal controls dictates that accounting control be established at the point of initial receipt; that is, in the mailroom, to minimize the possibility of loss or misappropriation. Under the procedure described above, accounting control is not established over mail receipts until processed by the cashiers. There is no system to account for tax payments received by the mailroom, especially those routed to departmental units other than cashiering. It is conceivable that a tax payment could easily be lost or misappropriated without detection.

In our previous report, we recommended that the department establish accounting controls over mailed-in tax payments in the mailroom. Ideally, a listing of all mail receipts should be prepared daily by mailroom personnel and periodically used to verify that all receipts have been deposited. However, because of the volume

of transactions handled by the department, we recommended that the department establish a "batching" process whereby receipts and accompanying returns are sorted and batched by tax type, a total of the payments in the batch is taken, and the total recorded in a logbook. The batch would then be kept intact throughout the collection and cashiering process. Although the department agrees there is a weakness in the accounting controls of the tax collection system, nothing further has been done about the situation.

*Recommendation. We recommend that the department establish accounting controls over all mailed-in tax payments upon first receipt in the mailroom.*

**Delays in depositing receipts.** Since tax collections are not available for use by the State until they are deposited into the State Treasury, any delay in depositing receipts prevents the State from either utilizing the funds or earning interest on them. It is essential, therefore, that the department process and deposit collections in a timely and efficient manner. Since our previous report, when it was not unusual for days and even weeks to elapse between the initial receipt and subsequent deposit of tax collections, some improvements have been made by the department.

According to the department's 1983 report to the Governor, tax payments are now processed and deposited within 40 hours of initial receipt. The department's 40-hour claim is deceiving, however, as it is limited to tax payments going through the normal tax collection process. Not included are delinquent tax payments addressed to the enforcement branch where it normally takes anywhere from two days to a week to



process. During one day of our fieldwork, we noted some 533 delinquent payments totaling over \$377,000 waiting to be processed, some received as long as two months ago. Almost \$38 million in delinquent payments was collected in fiscal year 1984, all of which was first processed by the enforcement branch before being deposited. Another factor not considered in the 40-hour time frame is weekends. Thursday and Friday receipts may not necessarily be deposited until the following Monday. Finally, the 40-hour time frame represents an average. During peak periods, when a substantial portion of the taxes is collected, the processing time slows down considerably.

Our assessment of the tax collection process is that the department is currently expediting the deposit of the "normal" mailed-in tax payment. Nonetheless, the State is still losing hundreds of thousands of dollars annually in interest earnings. An accurate determination of the interest lost to the State cannot be determined since no accounting is made of the receipts until they are processed by the cashiers. However, based on the State Treasury's effective interest rate in 1984 of 8.7 percent and assuming each dollar collected by the department is not deposited for at least two days, we estimate the State lost some \$600,000 in interest earnings in fiscal year 1984.

In our 1975 report, we recommended that the department study alternatives to the present tax payment handling system. One of the alternatives was the lockbox system. Under this system, an agreement is entered into between a bank and the State to enable taxpayers to mail payments and accompanying documents directly to a post office box to which only the bank has access. The bank would then credit the receipts to the State's account and forward the returns to the department. Department

officials felt the access to the returns by the bank's personnel would present confidentiality problems and thus, the recommendation was not implemented.

The other system that was recommended in our 1975 report, which was also not implemented, was a depository system similar to the depository system used by the Internal Revenue Service (IRS) for collecting federal income and social security taxes for decades. Under this system, general excise taxpayers and employers withholding state income taxes would be issued deposit cards. The cards would contain the taxpayers name and tax identification number and would provide a space for the taxpayer to enter the amount of the payment and the type of tax or assessment being paid. The taxpayer, after filling in the amount and tax type, would deposit his payment and card with the bank from which the check was drawn. The banks would deposit all tax collections to the credit of the State and would make a daily accounting to the department of the amount collected, from whom and for what type of tax. This information could be recorded by the banks on a magnetic tape which could easily be read into the department's computer files. The taxes collected could be monitored by the department on a daily basis and transfers to the banks which service the State's warrants could be made when necessary. Like the federal system, the taxpayers would also be required to file a return detailing the computation of the taxes for the period, the amounts deposited, and any additional amounts due. This return can be submitted directly to the department on a quarterly basis.

A system such as this has many benefits to the department and State. Most importantly, the funds will no longer be susceptible to loss or misappropriation and the State will have immediate access to the



funds and its earnings. The department will no longer have to concern itself with nonsufficient funds payments or incomplete checks as these will be screened by the banks at the time of deposit. The paper flow at the department will be reduced considerably under the depository system and those persons who formerly handled the daily receipts could be better utilized for other more meaningful tasks.

*Recommendation. We recommend that the department implement a depository system for general excise tax and state income withholding tax payments, including interest and penalty assessment payments.*

**Inadequate security over tax documents and files.** Numerous documents and files in the department's central office are critical to the operations of the department. In our 1975 report, we pointed out that many of these documents are exposed to destruction by fire. Of particular concern was recently filed income tax returns which are stored on open shelves. Once destroyed, reconstruction of these documents would be difficult, if not almost impossible, to accomplish. The department has done nothing to date to correct this deficiency.

*Recommendation. We recommend that the department review security measures for safeguarding valuable tax records, documents and files and provide suitable means by which they may be protected from destruction by fire.*

### Audit Selection System

The general excise tax system is based on a self-assessment principle where all businesses are trusted to accurately declare their tax liability. There is also a certain amount of trust placed on the system by businessmen. Businessmen depend on the department to ensure that the general

excise tax system is being fairly administered. In this respect, they expect the department to adequately review and audit taxpayers to ensure compliance with tax laws. As the general excise tax system can only be effective when all businessmen trust they operate in a fair environment, it is vital that the department maintain an effective auditing system. The loss of the businessmen's trust in the system, coupled with a small risk associated with filing false returns, can lead to cynicism about filing honest returns and an eventual breakdown in the self-assessment system.

An effective random audit system is essential for fostering voluntary compliance, but the department has not established such a system. Instead, businesses are selected for field audits through referrals either from the enforcement branch, office audit section or the public. Usually, annual returns requesting refunds or individual taxpayers filing rental income schedules without noting general excise tax numbers are also selected for field audits. However, the department has never attempted to quantify the potential underpayment of taxes attributable to the limited audit coverage. Underpayment of taxes can occur for a variety of reasons including ignorance of the tax laws and interpretations, simple errors in entering data on tax returns, or fraud. In all of these cases, audit selection practices which only concentrate on obvious underpayments and do not randomly select taxpayers for audits cannot be totally effective.

The IRS has developed an audit selection system that has proven to be effective. Under its system, audits are performed on randomly selected tax returns after which the results are evaluated and statistics are developed as to the likelihood of finding assessments based on certain characteristics of the returns or taxpayers.



With this system, the IRS is able to identify not only tax deficiencies but also taxation issues as they arise that need to be addressed with additional interpretations or perhaps new regulations. This system also helps keep taxpayers honest as the chances or threat of being audited are greater in a random system.

***Recommendation.** We recommend that the department establish a random audit selection process. Under this system, the department would maintain statistics on the outcome of the randomly selected audits and certain characteristics of the taxpayer such as industry and type of revenues reported. Criteria can then be developed which would be used in selecting future audits. The random selection process should be repeated periodically to detect new trends or tax issues.*

#### Utilization of Petty Cash

In 1981 the Legislature raised the maximum petty cash available to each department from \$5,000 to \$25,000. At about the same time, the Department of Accounting and General Services instituted a policy requiring that all low dollar value purchases to paid with petty cash funds. These actions were intended to speed up vendor payments and increase the overall efficiency of the statewide vendor payment process.

The department has petty cash funds at each district office other than Oahu as shown in Table 4.1. Even though it is by far the largest district, the department does not have a petty cash fund available for low dollar purchases for the Oahu district.

Table 4.1  
Department Petty Cash Funds

<i>District</i>	<i>Petty Cash Fund</i>
Oahu	\$ —
Maui	100
Hawaii	100
Kauai	50
TOTAL	\$250

Because of the low dollar amounts of each office's petty cash fund, only very minor purchases can be made with petty cash. Furthermore, these petty cash funds are maintained in currency and thus cannot be used to make payments through the mail. A review of department purchases revealed many purchases under \$25 which were processed through the Department of Accounting and General Services for payment by state warrant. This is costly, both in terms of processing costs by the State and delays in payments to vendors.

***Recommendation.** We recommend that the department institute the petty cash policy as required by the Department of Accounting and General Services. To facilitate this process, the department should request and maintain larger petty cash balances in checking accounts. The checking accounts will provide the department with:*

1. *The capability of making payments through the mail,*
2. *Security over the larger fund balances and*
3. *An alternate method of expediting rush payments.*





## Chapter 5

### FINANCIAL STATEMENTS AND ACCOUNTANTS' OPINION

This chapter presents the results of the examination of the financial statements of the Department of Taxation for the fiscal year ended June 30, 1984. It contains the opinion of Peat, Marwick, Mitchell & Co. (Peat Marwick) regarding the fairness and accuracy of the department's financial statements. It also displays various financial statements of the general fund and trust and agency funds administered by the department, together with explanatory notes.

#### Summary of Finding

In the opinion of Peat Marwick, the financial statements present fairly the financial position of the department at June 30, 1984 and the results of its operations for the 1983-84 fiscal year.

#### Accountants' Opinion

Peat Marwick filed the following report on the financial statements with the Legislative Auditor:

"To the Legislative Auditor  
State of Hawaii  
Honolulu, Hawaii:

We have examined the combined financial statements of the Department of Taxation, State of Hawaii, as of and for the year ended June 30, 1984, as listed in the accompanying table of contents. Our

examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, except as stated in the following paragraphs.

The Department of Taxation does not maintain its own fixed assets records and the "General Fixed Assets" balances presented in the combined financial statements referred to above were obtained from the fixed assets records of the State of Hawaii. Accordingly, we were unable to satisfy ourselves as to the "General Fixed Assets" balances amounting to \$1,109,723. Therefore, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the "General Fixed Assets" account group which is included within the combined balance sheet—all funds as of June 30, 1984.

The Department of Taxation does not maintain detailed accrued vacation records and the "Accrued Vacation Payable" balances presented in the combined financial statements referred to above were based on estimates made by the Department of Taxation. Accordingly, we were unable to satisfy ourselves as to the "Accrued Vacation Payable" balances amounting to \$1,202,212. Therefore, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the "General Long-Term Debt" account group which is included within the combined balance sheet—all funds as of June 30, 1984.



In our opinion, except that, as explained in the preceding paragraphs, we do not express an opinion on the financial statements relating to the general fixed assets and general long-term debt account groups, the aforementioned combined financial statements present fairly the financial position of the Department of Taxation, State of Hawaii, at June 30, 1984 and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Our examination was made for the purpose of forming an opinion on the combined financial statements taken as a whole. The supplementary information included in Schedules 1 and 2 is presented for purposes of additional analysis and is not a required part of the basic combined financial statements. Such information has been subjected to the auditing procedures applied in the examination of the basic combined financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic combined financial statements taken as a whole.

/s/Peat, Marwick, Mitchell & Co.

PEAT, MARWICK, MITCHELL & CO.  
Certified Public Accountants

Honolulu, Hawaii  
October 9, 1984"

## Descriptions and Definitions

**Descriptions of financial statements and schedules.** The following is a brief description of the financial statements examined by Peat Marwick. The financial statements and schedules are attached at the end of this chapter.

1. *Combined Balance Sheet—All Fund Types (Exhibit A).* This statement presents the assets, liabilities, and fund equity of all the funds used by the department on an aggregate basis.

2. *Combined Statement of Appropriations, Expenditures and Changes in Fund Balances—Governmental Fund Type—General Fund (Exhibit B).* This statement presents the appropriations, expenditures, and changes in fund balance for the general fund used by the department on an aggregate basis.

3. *Combined Statement of Appropriations, Expenditures and Changes in Fund Balances—Budget and Actual—General Fund Budget Basis (Exhibit C).* This statement presents a comparison of budgeted and actual appropriations and expenditures for the general fund accounts used by the department.

4. *Schedule of Net Tax Collections—Agency Fund (Exhibit D).* This schedule presents the tax collections net of tax refunds collected by the department on behalf of the State of Hawaii general fund, the counties, and other state departments.

5. *Combining Schedule of Appropriations, Expenditures and Changes in Fund Balance—General Fund Programs (Exhibit E).* This schedule presents the appropriations, expenditures, and changes in fund balance for the general fund programs of the department.

**Definition of Terms.** Technical terms are used in the financial statements and in the notes to the financial statements. The more common terms and their definitions are as follows:



1. *Allotted appropriations.* Authorization to incur obligations and to make expenditures pursuant to the appropriation made by the Legislature.

2. *Appropriation.* An authorization granted by the Legislature permitting a state agency, within established fiscal and budgetary controls, to incur obligations and to make expenditures. Appropriations are of two types: (a) funds which are available for use until completely expended; and (b) funds which lapse if not expended by or encumbered at the end of the fiscal year.

3. *Encumbrance.* An obligation in the form of a purchase order or contract which is chargeable to an appropriation, the incurring of which sets aside the appropriation for the amount of the obligation.

4. *Expenditure.* The actual disbursement of funds for the payment of goods delivered or services rendered, the obligation to pay for such goods or services having been incurred against authorized funds.

5. *Transfer—lapse.* The balance of fund authorized, which is unexpended and uncommitted at the end of the prescribed time period. The balance reverts to the designated fund and is available for appropriation by the Legislature in the ensuing fiscal year.

6. *Other current expenses.* Expenditures other than for personal services.

7. *Personal services.* Salaries and wages paid to employees.

8. *Reserve.* An account used to earmark a portion of the fund balance to indicate that it is not available for expenditure.

## Notes to Combined Financial Statements

Explanatory notes which are pertinent to an understanding of the financial statements and financial condition of the funds administered by the department are discussed below.

**Summary of significant accounting policies.** The accounting policies of the department conform to generally accepted accounting principles as applicable to governmental units. The following is a summary of the more significant policies:

1. *Basis of presentation—fund accounting.* The accounts of the department are organized on the basis of funds or account groups, each of which is considered a separate accounting entity. The operations of each fund are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, and fund balance. The various funds are summarized by type in the financial statements. The following fund types and account groups are used by the department.

a. *Governmental fund types.* Governmental funds are those through which the acquisition, use, and balances of the department's expendable financial resources and the related liabilities are accounted for. The measurement focus is upon determination of changes in financial position, rather than upon net income determination.

The general fund is the general operating fund of the department. It is used to account for all financial resources except for those required to be accounted for in another fund. The general fund programs presented are a part of the state general fund and are limited to only those appropriations and obligations of the department.

b. *Fiduciary fund types.* Fiduciary funds are used to account for assets held by the department as an agent for other funds.



The agency funds are used to account for the tax collections of the department on behalf of the state general fund, other state departments, and the county governments. A description of the agency funds of the department is presented below:

- (1) **Undistributed Tax Collections.** This fund is used to account for tax collections and taxes receivable prior to remittance to the state general fund.
- (2) **Payments Under Protest and Litigated Claims.** These funds are used to account for disputed or litigated tax assessments.
- (3) **Sale of Properties for Delinquent Taxes.** This fund is used to account for surplus funds from the sale of levied property in excess of taxes, penalties, and interest.

c. *Account groups.* Account groups are used to establish accounting control and accountability for the department's general fixed assets and long-term debt.

- (1) **General Fixed Assets Account Group.** This group of accounts is established to account for all fixed assets of the department.
- (2) **General Long-Term Debt Account Group.** This group of accounts is established to account for all long-term indebtedness of the department.

2. *Basis of accounting.* The modified accrual basis of accounting is followed by the governmental funds and agency funds. Under the modified accrual basis of accounting, revenues are recorded when susceptible to accrual, usually when the appropriations are allotted. Expenditures are recorded when the liability is incurred, if measurable.

3. *Encumbrances.* Encumbrance accounting, under which purchase orders and contract commitments for the expenditure of funds are recorded in order to reserve that portion of the applicable appropriation, is employed in the governmental funds. Open encumbrances are reported as reservations of fund balances since the commitments will be honored when the goods or services are received. Encumbrances do not constitute expenditures or liabilities.

4. *General fixed assets.* General fixed assets have been acquired for general governmental purposes. Assets purchased are recorded as expenditures in the governmental funds and capitalized at cost in the general fixed assets account group.

No depreciation has been provided on general fixed assets, nor has interest been capitalized.

5. *Total data.* The total data are the aggregate of the fund types. No consolidating or other eliminations were made in arriving at the totals; thus they do not present consolidated information.

**Budget basis of accounting.** The budgets are prepared on a basis other than generally accepted accounting principles (GAAP). The actual results of operations are presented on a budgetary basis in the Combined Statement of Appropriations, Expenditures and Changes in Fund Balances—Budget and Actual—General Fund Budget Basis to provide a meaningful comparison of actual results with budget.

The major differences between the budget and GAAP bases are that encumbrances are recorded as the equivalent of expenditures (budget) as opposed to a reservation of fund balance (GAAP).



Adjustments necessary to convert the results of operations for the year ended June 30, 1984 and fund balances at June 30, 1984 from the GAAP basis to the budget basis are as follows:

	<i>General</i>	
	<i>Excess (Deficiency) of Revenues Over Expenditures and Other Uses</i>	<i>Fund Balances at End of Year</i>
GAAP basis	\$ 13,235	\$ 854,020
Increase (decrease):		
Expenditures of amounts encumbered during the year ended June 30, 1983	658,055	658,055
Reserved (GAAP) at June 30, 1984, but recognized as expenditures for budget purposes	(854,020)	(854,020)
Budget basis	<u>\$ (182,730)</u>	<u>\$ 658,055</u>

**Fixed assets.** A summary of changes (unaudited) in general fixed assets shown on Exhibit A follows:

<i>Balance at July 1, 1983</i>	<i>Additions</i>	<i>Deletions</i>	<i>Balance at June 30, 1984</i>
\$1,087,117	\$33,706	\$11,100	\$1,109,723

**Employees' Retirement System.** The department is included in the Employee's Retirement System (ERS) of the State which covers substantially all employees of the State, as well as the counties of the State. The department's contribution to the ERS for the year ended June 30, 1984 was \$451,736 which includes amortization of the unfunded accrued liability over a 38-year period. The department's policy is to fund pension cost accrued.

Data concerning the actuarial present value of accumulated plan benefits, vested plan benefits, and net assets available for benefits which are relevant to the department are not available since such determinations are made on a systemwide basis and not for individual participating departments.

**Accumulated vacation.** A summary of changes (unaudited) in accrued vacation shown on Exhibit A follows:

Balance, July 1, 1983	\$1,234,709
Net decrease in accumulated vacation	( 32,497)
Balance, June 30, 1984	<u>\$1,202,212</u>

Employees are credited with vacations at a rate of 168 hours per calendar year. Accumulation of such vacation credits is limited to 720 hours at calendar year-end and is convertible to pay upon termination of employment.



STATE OF HAWAII  
DEPARTMENT OF TAXATION

Combined Balance Sheet - All Fund Types

June 30, 1984

<u>Assets</u>	Governmental fund type <u>General</u>	Fiduciary fund type <u>Agency</u>	<u>Account groups</u>		<u>Total</u>
			<u>General fixed assets (unaudited)</u>	<u>General long-term debt (unaudited)</u>	
Cash on hand	\$ -	11,852,634	-	-	11,852,634
Cash held in State treasury	854,020	103,172,868	-	-	104,026,888
Taxes receivable	-	28,730,473	-	-	28,730,473
Fixed assets	-	-	1,109,723	-	1,109,723
Amount to be provided for general long-term debt	-	-	-	1,202,212	1,202,212
	<u>\$ 854,020</u>	<u>143,755,975</u>	<u>1,109,723</u>	<u>1,202,212</u>	<u>146,921,930</u>
<u>Liabilities</u>					
Due to State General Fund	-	40,681,342	-	-	40,681,342
Protested payments and litigated claims	-	102,793,137	-	-	102,793,137
Sale of properties for delinquent taxes	-	281,496	-	-	281,496
Accrued vacation payable	-	-	-	1,202,212	1,202,212
Total liabilities	-	<u>143,755,975</u>	-	<u>1,202,212</u>	<u>144,958,187</u>
<u>Fund Equity</u>					
Investment in general fixed assets	-	-	1,109,723	-	1,109,723
Fund balance - reserved for encumbrances	<u>854,020</u>	-	-	-	<u>854,020</u>
Total fund equity	<u>854,020</u>	-	<u>1,109,723</u>	-	<u>1,963,743</u>
	<u>\$ 854,020</u>	<u>143,755,975</u>	<u>1,109,723</u>	<u>1,202,212</u>	<u>146,921,930</u>

STATE OF HAWAII  
DEPARTMENT OF TAXATIONCombined Statement of Appropriations, Expenditures  
and Changes in Fund Balances -  
Governmental Fund Type - General Fund

Year ended June 30, 1984

Allotted appropriations		\$ 8,931,086
Expenditures:		
Personal services	\$ 6,058,021	
Other	<u>2,667,532</u>	<u>8,725,553</u> ✓
Excess of allotted appropriations over expenditures		205,533 ✓
Transfer - lapse to State General Fund		<u>(192,298)</u>
Excess of allotted appropriations over expenditures and transfer		13,235 ✓
Fund balance, July 1, 1983		<u>840,785</u>
Fund balance, June 30, 1984		\$ <u><u>854,020</u></u> ✓



STATE OF HAWAII  
DEPARTMENT OF TAXATION

Combined Statement of Appropriations, Expenditures  
and Changes in Fund Balances - Budget and Actual -  
General Fund Budget Basis (note 2)

Year ended June 30, 1984

	<u>Budget</u>	Actual on a <u>budgetary</u> <u>basis</u>	Variance - favorable (unfavorable)
Allotted appropriations	\$ <u>9,011,405</u>	<u>8,931,086</u>	<u>(80,319)</u> ✓
Expenditures:			
Personal services	6,172,174	6,042,795	129,379
Other	<u>2,839,231</u>	<u>2,878,723</u>	<u>(39,492)</u>
	<u>9,011,405</u> ✓	<u>8,921,518</u> ✓	<u>89,887</u> ✓
Excess of allotted appropriations over expenditures	- ✓	9,568 ✓	9,568 ✓
Transfer - lapse to State General Fund	<u>-</u> ✓	<u>(192,298)</u>	<u>(192,298)</u> ✓
Excess (deficiency) of allotted appropriations over expenditures and transfer	-	(182,730) ✓	(182,730) ✓
Fund balance, July 1, 1983	<u>-</u>	<u>840,785</u>	<u>840,785</u> ✓
Fund balance, June 30, 1984	\$ <u><u>-</u></u> ✓	<u><u>658,055</u></u> ✓	<u><u>658,055</u></u> ✓



STATE OF HAWAII  
DEPARTMENT OF TAXATION

## Schedule of Net Tax Collections - Agency Fund

Year ended June 30, 1984

General excise and use tax, and license fee	\$ 639,630,187
Individual income taxes	399,215,528
Unemployment insurance	76,296,605
Public service company tax	59,559,375
Fuel tax and permit	54,909,051
Corporate income tax	40,291,450
Tobacco tax and license	19,948,572
Inheritance and estate tax	6,651,792
Franchise tax	547,143
Real property tax	100
Liquor tax and permit	<u>(209,040)</u>
	<u>\$ 1,296,840,763</u> ✓

STATE OF HAWAII  
DEPARTMENT OF TAXATION

Combining Schedule of Appropriations,  
Expenditures and Changes in Fund Balance - General Fund Programs

Year ended June 30, 1984

	Supporting services - revenue collection	Income assessment and audit	Property tax assessment	Tax collections enforcement	Tax services and processing	Tax review commission	Total
Allotted appropriations	\$ <u>1,914,195</u>	<u>3,281,779</u>	-	<u>1,407,419</u>	<u>2,077,386</u>	<u>250,307</u>	<u>8,931,086</u>
Expenditures:							
Personal services	903,502	2,531,246	-	1,334,842	1,288,431	-	6,058,021
Other	<u>1,296,131</u>	<u>650,474</u>	-	<u>72,843</u>	<u>578,441</u>	<u>69,643</u>	<u>2,667,532</u>
	<u>2,199,633</u>	<u>3,181,720</u>	-	<u>1,407,685</u>	<u>1,866,872</u>	<u>69,643</u>	<u>8,725,553</u>
Excess (deficiency) of allotted appropriations over expenditures	(285,438)	100,059	-	(266)	210,514	180,664	205,533
Transfer - lapse to State general fund	<u>(129,437)</u>	<u>(5,136)</u>	-	<u>(140)</u>	<u>(462)</u>	<u>(57,123)</u>	<u>(192,298)</u>
Excess (deficiency) of allotted appropriations over expenditures and transfer	(414,875)	94,923	-	(406)	210,052	123,541	13,235
Fund balance, July 1, 1983	<u>812,685</u>	<u>22,592</u>	<u>4,600</u>	<u>908</u>	-	-	<u>840,785</u>
Fund balance, June 30, 1984	\$ <u><u>397,810</u></u>	<u><u>117,515</u></u>	<u><u>4,600</u></u>	<u><u>502</u></u>	<u><u>210,052</u></u>	<u><u>123,541</u></u>	<u><u>854,020</u></u>



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**PART III**

**RESPONSE OF THE AFFECTED AGENCY**

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## COMMENTS ON AGENCY RESPONSE

On November 23, 1984, copies of a preliminary draft report of this financial audit were transmitted to the Governor, the presiding officers of the Legislature, and the Department of Taxation. A copy of the letter of transmittal to the department is included here as Attachment 1.

As is our practice, we invited the department to comment on the recommendations made in the report. The department responded by letter dated December 7, 1984, included here as Attachment 2, but the department's more substantive response is to be found in its enclosure to the letter. The enclosure consists of the preliminary draft report with the department's response to various sections of the report written on the report itself. Because it is not practical to reproduce the preliminary draft report here, we are reproducing only the department's response, extracted from the enclosure. Each item in the department's response is preceded by some identifying reference to this report, so that the department's response can be read in context.

## GENERAL OBSERVATIONS ON THE RESPONSE

Most of the recommendations made in this report related to conditions of long standing. They existed when we audited the department in 1975. They continue to exist today. Unfortunately, it appears from the department's response that they will continue to exist unless the department reconsiders its position.

The department's inaction is especially true of two conditions. In 1975 and in this report, we stressed the need to apply accounting control over tax payments when they are first received by the department to minimize the possibility of loss or misappropriation. Related to this matter, we emphasized in 1975 and again in this report the need to establish a more efficient system for the deposit of tax revenues so that state interest earnings can be maximized. However, no improvements are likely to be forthcoming unless the department can be persuaded or directed to take corrective action.

## SPECIFIC COMMENTS

### Chapter 3—Systematization and Documentation of the General Excise Tax

1. *To our finding, on page 9, that the department is not providing sufficient public information to assist the taxpayer in complying with the tax law or to ensure uniform application of the tax among taxpayers, the department responds:*



"The Technical Office, in cooperation with our Taxpayer Services Branch, provides news releases, speakers to civic and business leagues, television and radio programs in order to provide the public with information to comply with Hawaii's tax laws."

2. *On page 9, we have included a table (Table 3.1) listing the sources of general excise tax authoritative information. This table was included merely for informational purposes and does not have a direct bearing on any of our findings and recommendations. However, to this table, the department responds:*

"The Technical Office is reviewing the information set forth in this table and questions the validity of these figures, such as our records indicate that there are 68 Tax Information Releases and 42 Income Technical Memorandums still in effect as compared to 27 releases and 19 memorandums mentioned in this report. We are presently attempting to substantiate the number issued of court decisions of tax appeal and supreme court, attorney general opinions, and tax assessments."

Our comment is that the department's figures are larger because as the title to Table 3.1 clearly indicates, our table shows only those authoritative sources which pertain directly to the general excise tax. Further expenditure of effort by the department to substantiate or invalidate the figures would serve no purpose.

3. *On page 10, we state that the department's filing system of authoritative information was decentralized; that reference materials are outdated, incomplete and not well organized; and that, specifically, reference manuals used by Taxpayer Services and the Income Technical Office have not been updated since 1980. To this, the department responds:*

"The Technical Office maintains a centralized filing system of all authoritative information and it also provides a library with various source references. The Technical Office has an on-going procedure to review and disseminate authoritative information to all districts.

"Most reference manuals have been updated. We question the comment 'have not been updated since 1980' since it appears to be a misstatement of fact."

Our comment is that while the department claims to have all authoritative information centralized in the Technical Office, the field audit branch, as we state in our report, has established its own file of tax guidelines to supplement the Technical Office's information. These field audit report guidelines are considered authoritative, as assessments are oftentimes based on these guidelines. As to the status of the reference manuals, during the course of our fieldwork, we reviewed the reference manuals of the



department. Based on that review and on discussions with departmental personnel, we maintain that the reference manuals have not been updated since they were prepared in 1980.

4. *To our recommendation on page 11 that the department centralize the compilation and maintenance of all authoritative information, preferably with the Income Technical Office, the department responds:*

"The Income Technical Office (Technical Office) has begun the task of centralizing and maintaining all authoritative information."

Our comment is that this response differs from the preceding response on the same subject. While the preceding response indicates that the department already "maintains" a centralized system, this response indicates that the task of centralizing "has begun."

5. *To our recommendation on page 11 that the department include tax assessments as part of the central file of tax law interpretations, the department responds:*

"The Technical Office, with the cooperation of the Compliance Division, is studying the implementation of this procedure."

6. *To our recommendation on page 11 that the department include only private rulings in the central file of tax law interpretations and maintain a separate file of general correspondence, the department responds:*

"The Technical Office has begun the implementation of this procedure."

7. *To our recommendation on page 11 that the department file all information both chronologically by source and by subject matter to facilitate identification of obsolete interpretations and to ensure identification of all applicable resources, the department responds:*

"The Technical Office has begun the implementation of this procedure."

8. *To our recommendation on page 11 that the department automate the filing system for efficiency and ease of access, the department responds:*

"The automation of the filing system is part of the Department of Taxation's computerization program."

9. *To our recommendation on page 11 that the department maintain files on a current basis, the department responds:*

"The Technical Office has implemented this procedure."

10. *To our recommendation on page 11 that the department classify the official position of the department with respect to the various statements and releases issued, and reissue past publications of General Excise Tax Memorandums and information bulletins to eliminate any confusion regarding authoritative source, the department responds:*

"The department is in the process of reissuing publications on issues which have continually caused confusion as to authoritative source."

11. *On page 12, we have included a table (Table 3.2) summarizing the number of rules, regulations, and releases pertaining to the general excise tax which have been issued by the department over the years. To this table, the department responds:*

"We question the validity of these figures since our records indicate that 110 Tax Information Releases were issued, 42 are obsolete and 68 are still in effect. We are presently attempting to substantiate the figures regarding the regulations."

Our comment is similar to our comment at Item 2. Further efforts by the department to substantiate the figures would be pointless.

12. *To our recommendation on page 14 that the department issue regulations to clarify ambiguities in the general excise tax law, including such areas as intermediary services, reimbursements, and tax-exempted activities of nonprofit organizations, the department responds:*

"The Deputy Attorney General assigned to the department, with input from the department, is reviewing and preparing rules for release."

13. *To our recommendation on page 14 that the department publish Tax Information Releases to promote consistent applications among such taxpayer groups as nonprofit organizations, foreign companies, advertising agencies, travel agencies, and computer services, the department responds:*

"The Technical Office is in the process of promulgating and revising tax information releases on these subject matters."

14. *To our recommendation on page 14 that the department develop a continuing system to ensure that its interpretations of the general excise tax law are abreast of current circumstances and concerns, the department responds:*

"The Technical Office has implemented an internal information exchange program to monitor and identify areas of the law which require additional interpretation."



## Chapter 4—Financial Accounting and Internal Control

1. *On pages 15-16, we discuss the weaknesses of the department's procedures in collecting tax revenues, as we did in 1975, and recommend that the department establish accounting controls over all mailed-in tax payments upon first receipt in the mailroom. Such controls are basic to any revenue receiving operation and are needed to minimize the possibility of loss or misappropriation. To our discussion and recommendation, the department responds:*

"Through its reorganization in 1981, the Department of Taxation has attempted to increase early controls by situating the three processing units in close proximity to one another and securing the area.

"Sorting by tax type for batching purposes would be extremely difficult because of the large volume of multiple payment transactions.

"A log of payments maintained in the Receiving and Sorting would only be useful if it can be balanced to a collection total obtained in Monetary Control. This requires that batches remain intact until cashiered. Documents and payments are presently subject to examination to ensure that checks are negotiable and returns are processible. If checks are non-negotiable, (not signed, wrong payee, etc.) the entire batch can not be processed until the error is rectified, or adjustments made to the log.

"Also, walk-in traffic and cash payments would not be included in the Receiving and Sorting log. Attempting to keep registers dedicated to over-the-counter transactions only, in order to adjust the log totals, would be inefficient due to the fluctuating nature of walk-in traffic.

"The recommendation, if established, would result in more delays in depositing tax receipts into the bank."

Our comment is that although the department offers many reasons as to why our batch processing recommendation would not be feasible, neither in 1975 nor in answer to our current report does the department refute the fact that internal controls over the cash receipt process are deficient and lacking. The situating of three receipt processing units in close proximity to one another is, as the department states, only an "attempt" at establishing early controls. We do not consider this to be effective action to preclude the loss or misappropriation of tax payments, especially those payments routed to departmental units other than cashiering.

We cannot see why the department has difficulty with our recommendation to sort payments by tax type, as we understand this is



already being done by the mail clerks. The mail clerks could, just as easily as the cashiers, screen payments for negotiability, which would resolve the department's concerns of having to adjust batch totals. By adopting a batching process, the cashiers' workload will be substantially reduced as they will have to register only one transaction where they previously registered, say, 50. The resulting reduction in workload and demand on the registers will enable the department to dedicate one register exclusively to walk-in tax payments, thus alleviating the department's concerns in this area.

Finally, we disagree with the department's assessment that the recommendation, if implemented, would result in further delays in depositing receipts into the bank. The time savings in registering tax receipts will more than compensate for the time required to batch and log receipts.

2. *On pages 16-18, we discuss the current inefficient system and delays in depositing tax receipts and the resultant lost interest earnings to the State. On page 16, we stated that the department reports that an average of 40 hours elapses from the time of receipt to the time tax payments are deposited, and that even this time frame is "deceiving" because it takes much longer to process and deposit delinquent tax payments. To this discussion, the department responds:*

"This statement is not deceptive except when taken out of context. The 40 hours applies to the objectives of the Tax Services and Processing Division which does not control the processing payments applied to delinquent accounts.

"We realize that processing of payments applied to delinquent accounts takes longer, but this is due to the requirements that a return for each period must be filed. One (1) payment may necessitate the manual preparation of twelve (12) bills (one for each month of the year). To expedite the deposit process in this regards, we will look into the feasibility of creating a suspense account to credit said account."

3. *On page 17, we state that despite the department's efforts to expedite "normal" mailed-in tax payments, the State is still losing hundreds of thousands of dollars annually in interest earnings because of the delays in making tax revenue deposits. We estimated that the State lost some \$600,000 in interest earnings in fiscal year 1984. To this condition, the department responds:*

"We acknowledge that interest loss due to the significant volume peaking during the tax season and the limited resources available to handle such volume.

"The Department has implemented various methods in handling the tax season volume peaking; such as double shifting the cashiers and receiving and sorting sections, as well as hiring temporary employees. This has reduced some of the deposit turn-around time.



"However, we question the validity of the interest calculations since it's based on questionable assumptions."

4. *On pages 17-18, we present the basis for our recommendation that the department implement a depository system similar to the depository system used for decades by the Internal Revenue Service to collect federal withholding and social security taxes. Under such a depository system for state taxes, general excise taxpayers and employers withholding state income taxes would make deposits with their banks, and the banks would deposit all tax collections to the credit of the State and make a daily accounting to the department of the amount collected, from whom, and for what type of tax. Such a system would greatly benefit the State and the department: funds would no longer be susceptible to loss or misappropriation; the State would have immediate access to its funds and its earnings; and the paper flow at the department would be reduced considerably. To our recommendation and its supporting discussion, the department responds:*

"Deposits are reported daily to the Department of Budget and Finance before 9:00 a.m. under present conditions. The information is used to plan investments. Coordination of reporting receipts would be a key factor if the depository method is adopted.

"The deposit card system would not be applicable for our general excise and withholding reporting form since the general excise requires various statistical information of the type of gross receipts. The department has in the past attempted to reduce or eliminate such categories of gross receipts statistics. The taxpayer also may have multiple gross receipt types subject to different tax rates. This would then necessitate a larger format of reporting such as the present general excise tax form. Timeliness of reporting receipts and the breakdown for allocation is very critical. Allocation of penalty and interest charges and updating of the system would be affected, as well as the Statement of Tax Operations, due on the 10th working day following the end of the month.

"The department will not compromise the confidentiality of tax returns to third party."

Our comment is that the department's response does not deal with the substance of the recommendation. It merely offers superficial reasons why a depository system would not be suitable to the department. We do not understand why the department cannot use its resourcefulness to adapt a depository system similar to that used by the Internal Revenue Service for many years and make it effective and efficient for State use. Too much is at stake, not the least of which are hundreds of thousands of dollars in lost annual interest earnings, for the department to overlook the benefits of our recommendation. We urge the department to reconsider its position.



5. *To our recommendation on page 18 that the department review security measures for safeguarding valuable tax records, documents, and files and provide suitable means by which they may be protected from fire, the department responds:*

"The department submitted a request to the Department of Accounting & General Services to install a Halon Fire Extinguishing System in the File Maintenance Section. However, since the department will be moving to State Office Building No. 2 in 1986, we were precluded from making improvements to the present building. The request was also made and denied for the new building. The department will resubmit its request for a system to safeguard documents.

"As a backup system, the department is considering microfilming all documents received by the Receiving & Sorting Section. A test program for individual income tax returns was initiated during the 1984 tax season. The objectives were to: (1) develop a means of inventory control over individual income tax returns received by the department, (2) test the capabilities of microfilming and computer equipment, and (3) to determine the needs and resources of the department. This test program has been expanded to include all net income returns received during the 1985 season. With the development of the department's Comprehensive Net Income Tax Program, it will microfilm the essential tax documents."

6. *To our recommendation on page 19 that the department implement an effective random audit system to foster voluntary compliance with the general excise tax law, the department responds:*

"The department feels that strong tax information system and taxpayer education system are more effective tools at this time when budget constraints mandate a reduction/no change situation in work force. Although we are in the process of developing a random selection program for GEW and are presently receiving a report which stratifies General Excise accounts into different gross receipts categories, we feel that these reports are more beneficial to management in the planning process at this time. The Comprehensive Net Income Tax System when implemented in January of 1986 will be able to randomly select audits. This selection process along with the Revenue Adjustment Reports from the IRS audit selection system will be the primary tools available to our Audit Branch."

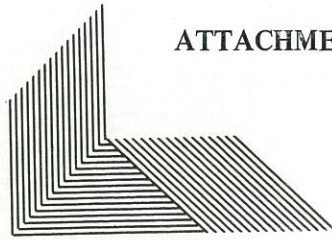
7. *To our recommendation on page 19 that the department establish and use petty cash funds as required by state policy, the department responds:*

"We agree and the department is in the process of setting up a petty cash fund for Oahu."



ATTACHMENT 1

THE OFFICE OF THE AUDITOR  
STATE OF HAWAII  
465 S. KING STREET, RM. 500  
HONOLULU, HAWAII 96813



CLINTON T. TANIMURA  
AUDITOR

November 23, 1984

*COPY*

Mr. Herbert M. Dias, Director  
Department of Taxation  
State of Hawaii  
Honolulu, Hawaii 96813

Dear Mr. Dias:

Enclosed are two preliminary copies, Nos. 4 and 5, of our report on the *Financial Audit of the Department of Taxation*. We call your attention to the recommendations affecting your department which are made in Chapters 3 and 4 of the report. If you have any comments on the recommendations, we ask that you submit them in writing to our office by December 7, 1984, for inclusion in the final report.

The Governor and the presiding officers of the Legislature have been provided with copies of this preliminary report.

Since the report is not in final form and there may be changes to it, access to this report should be restricted to those officials whom you might wish to call upon to assist you in the review of the report. Public release of the report will be made solely by our office and only after the report is published in its final form and submitted to the Legislature.

We appreciate the assistance and cooperation extended to us.

Sincerely,

Clinton T. Tanimura  
Legislative Auditor

Enclosures

ATTACHMENT 2

GEORGE R. ARIYOSHI  
GOVERNOR



HERBERT M. DIAS  
DIRECTOR OF TAXATION

WALLACE AOKI  
DEPUTY DIRECTOR

STATE OF HAWAII  
DEPARTMENT OF TAXATION  
P.O. BOX 259  
HONOLULU, HAWAII 96809

December 7, 1984

The Honorable Clinton T. Tanimura  
Legislative Auditor  
Office of the Auditor  
State of Hawaii  
485 S. King Street, Room 500  
Honolulu, Hawaii 96813

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STATE OF HAWAII

Dear Mr. Tanimura:

Thank you for the opportunity to review and comment on your preliminary report on the Financial Audit of the Department of Taxation.

Due to the limited time to respond, our comments are not as detailed as we had wanted them to be. Certain aspects of the report are very helpful and we are taking steps to correct these matters. However, certain of your findings did not fairly state our progress to correct certain deficiencies subsequent to your 1975 report. Our comments on Chapters 3 and 4 are attached. These include only the pages with our comments.

We will be happy to meet with you and your staff to further discuss this matter.

Very truly yours,

HERBERT M. DIAS  
Director of Taxation

Enclosures

cc: Honorable George R. Ariyoshi