Financial Audit of the Department of Taxation

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

Conducted by

The Auditor
State of Hawaii
and
Deloitte & Touche LLP

Submitted by

THE AUDITOR
STATE OF HAWAII

Report No. 94-20
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Foreword

This is a report of the financial audit of the Department of Taxation for the fiscal year July 1, 1993 to June 30, 1994. The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the State Auditor to conduct post audits of all departments, offices, and agencies of the State. The audit was conducted by the Office of the Auditor and the certified public accounting firm of Deloitte & Touche LLP.

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

Marion M. Higa
State Auditor

Table of Contents

List of Exhibits

List of Schedules

Chapter 1
Introduction

This is a report of our financial audit of the State of Hawaii, Department of Taxation. The audit was conducted by the Office of the Auditor and the independent certified public accounting firm of Deloitte & Touche LLP (Deloitte & Touche).

The audit was conducted pursuant to Section 23-4, Hawaii Revised Statutes, which requires the 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.

Background

In the Hawaii State Government Reorganization Act of 1959 (Act 1, Second Special Session Laws of Hawaii 1959), the Legislature created the Department of Taxation. Section 26-10, Hawaii Revised Statutes, describes the department's responsibilities:

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

Organization of the Department

The department is headed by the director of taxation. The Office of the Director plans, directs, and coordinates the various activities of the department within the scope of laws and established policies and regulations. The department is organized into offices and divisions. Those offices and divisions covered under this audit are described below.

Offices

Five offices provide a variety of technical, accounting, and administrative support to the department.

- Technical Review Office provides technical staff services to the director of taxation in planning and developing systems, policies, and programs for administration of the income and miscellaneous tax functions in the department, for use by all district offices. In addition, it represents the department on tax matters at various official meetings with the public, practitioners, and other professional and government organizations.

- Administrative Services Office assists other divisions within the department with budgeting, accounting, personnel, purchasing, and other functions.

- Systems and Procedures Office plans, develops, and supports the department on all matters pertaining to computerization and automation.

- Tax Research and Planning Office plans, organizes, directs, and coordinates tax research and planning for the department.

- Technical Training and Development Office plans, organizes, directs, and coordinates technical training and development programs for the department.

Divisions

Three divisions perform a variety of processing, auditing, and collection functions on behalf of the State of Hawaii.

- Tax Services and Processing Division performs all functions relating to the processing and controlling of documents.

- Audit Division maintains a comprehensive and statewide tax compliance program.

- Collection Division enforces tax laws and regulations relating to the collection of delinquent taxes.

Other agencies

The audit did not include the following three agencies that are attached to the Department of Taxation for administrative purposes:

- Council on Revenues prepares revenue estimates for the State on a quarterly basis.

- Natural Disaster Claims Commission receives, processes, and decides on allocations of tax relief for losses due to damage or destruction of real or personal property resulting from a natural disaster.

- Tax Review Commission conducts a systematic review of the State's tax structure to ensure that it meets standards of equity and efficiency.

Objectives of the Audit

1. Report on the fair presentation of the combined financial statements of the department.

2. Assess the adequacy, effectiveness, and efficiency of the department's systems and procedures for financial accounting, internal control, and financial reporting; and recommend improvements.

3. Ascertain whether 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.

4. Ascertain the extent to which recommendations contained in Chapters 3 and 4 of the State Auditor's Report No. 85-3, *Financial Audit of the Department of Taxation for the Fiscal Year Ended June 30, 1984*, have been implemented.

Scope and Methodology

We audited the financial records and transactions and the related systems of accounting and internal controls of the department for the fiscal year July 1, 1993 to June 30, 1994. Included in our audit were all fund types and account groups except for the general fixed assets account group. We also reviewed those transactions, systems and procedures for compliance with applicable laws and regulations.

The audit examined the accounting, reporting, and internal control structures to identify deficiencies and weaknesses and to make appropriate recommendations for improvements. We also examined the forms, records, and accounting and operating procedures.

The accountants' opinion as to the fairness of the combined financial statements presented in Chapter 3 is that of Deloitte & Touche. The audit was conducted from July 1994 through September 1994 in accordance with generally accepted government auditing standards.

Chapter 2

Internal Control Practices

Internal controls are steps instituted by management to ensure that objectives are met and resources are safeguarded. This chapter presents our findings and recommendations on the financial accounting and internal control practices and procedures of the Department of Taxation. We are pleased to note that the department has implemented most of the recommendations made in our 1985 report. The department has not considered our prior recommendation on using a depository system to reduce delays in depositing receipts.

Summary of Findings

We find that the department could improve its ability to collect taxes by strengthening its internal control and administrative practices and resources. More specifically, we find that:

1. Procedures for collecting unpaid taxes should be strengthened.

2. Delinquent tax collections should be deposited in a more timely manner.

3. A depository system for certain tax payments should be established.

4. Vacancies in the Collection Division and the Audit Division should be filled.

5. A new income tax computer system is needed.

6. Responses to letter ruling requests should be more timely.

7. A formal training program should be implemented.

8. Inactive agency accounts should be closed.

Procedures for Collecting Unpaid Taxes Should Be Strengthened

One of the department's primary responsibilities is to collect taxes on a timely basis. Often, taxpayers do not file the required tax returns or do not pay the amount of taxes owed. The department has procedures to identify nonfilers and to follow up on delinquent taxpayers, but they need to be strengthened.

Identification of nonfilers

The department's Collection Division uses several methods to identify taxpayers who have not filed the required returns. These methods include investigating complaints from the public; utilizing other taxpayer information, such as general excise tax licenses issued; and following up on information obtained from the department's Audit Division and other state agencies. One significant approach that the department could use more effectively is information from its own computer systems. It could use its comprehensive net income tax system and the general excise, withholding, and transient accommodations tax system to identify taxpayers who have filed one type of return but not the other required returns, or who have stopped filing the required returns. However, the two computer systems are not programmed to perform such a function. Currently, the department performs this procedure manually, which amounts to a highly ineffective use of limited resources that restricts the number of nonfilers that could be identified.

Payment plan approvals

The department's computer systems readily identify taxpayers who do not remit payments with their tax returns. The Collection Division sends billings for these delinquent taxes. If no payments are received after a period of time, the Collection Division contacts the taxpayer to set up repayment options which include a payment plan for paying back taxes. The department has guidelines for setting up payment plans and for obtaining approvals for the plans. However, we noted several instances where the division had not obtained and/or documented the required approvals. Failure to follow procedures and obtain approval for payment plans may lead to payment plans that do not comply with the department's established guidelines and may result in inequities among taxpayers.

Monitoring of taxpayer's financial condition

When the department is unable to reach a resolution with a taxpayer on delinquent taxes, the department has several legal options available, including levying assets or filing a lien against personal property.

Section 231-25, Hawaii Revised Statutes (HRS), authorizes the department to levy and sell property belonging to a taxpayer to pay for delinquent taxes. Section 231-33, HRS, states that any state tax that is unpaid will be considered a debt due to the State and will constitute a lien in favor of the State upon all property of the taxpayer. Section 231-33(g), HRS, states that a lien may be foreclosed in a court proceeding.

The department's general practice is to levy or seize bank accounts, accounts receivable, or inventory of a taxpayer and to file liens or claims against the taxpayer's property. While the department normally files liens, it has not enforced collections through foreclosure proceedings.

Instead, it has chosen to allow taxpayers to continue operations. The last foreclosure proceeding initiated by the department took place in 1981.

The department allows the delinquent taxpayer or business to continue operating, hoping that the business will improve so that the taxpayer can pay the delinquent taxes owed. If the business fails, then the department hopes to receive a distribution of the assets sufficient to cover the delinquent taxes. However, allowing a business to continue puts the collection of unpaid taxes at additional risk because operations may continue to be unprofitable and any assets that could be used to satisfy tax liens would be used up in the operations.

The department should reconsider its practice of not instituting foreclosure proceedings. In addition, it could reduce the risk of not collecting on delinquent taxes by monitoring the financial condition of the taxpayer to determine if operations are profitable enough to pay past due taxes. By closely monitoring these operations, the department could quickly determine if it should initiate foreclosure proceedings instead of allowing the business to continue operating at a loss.

Recommendations

We recommend that the department strengthen the procedures used to collect unpaid taxes by:

1. Re-programming the department's computer systems to identify taxpayers who have not filed the required tax returns;

2. Documenting the approvals obtained for the payment plans of delinquent taxpayers; and

3. Re-examining its practice of not initiating foreclosure proceedings and actively monitoring the financial condition of taxpayers to determine when liens should be enforced through foreclosure proceedings.

Delinquent Tax Collections Should Be Deposited in a More Timely Manner

The State does not have the use of tax collections until they are deposited into the State Treasury. Any delay in depositing receipts prevents the State from either using the funds or earning interest on such funds. Delays also increase the possibility that receipts may be lost or misplaced. Proper internal controls over cash receipts require that they be deposited on a timely basis. The department's current tax collection procedures result in delays in the processing and depositing of delinquent tax collections.

On August 23, 1994, we counted 173 delinquent payment checks totaling approximately $86,000 which were more than two weeks old, some as much as seven months old. This is an improvement over our prior audit when we counted 533 payments totaling $377,000 held by collectors. However, delinquent payments should be deposited when they are received, not when they are ultimately processed against proper accounts.

The department assigns delinquent tax accounts to collectors on its staff. Notices from the department to delinquent taxpayers include a colored self-addressed return envelope containing the collector's code. When the colored envelopes are received, the department forwards them unopened to the collector for follow up. Because of the volume of delinquent payments and the limited number of collectors assigned to delinquent accounts, collectors do not always open the envelopes to process the payments. And, because delinquent payments may relate to several types of taxes, the collector may take a long time to ascertain the appropriate accounts to credit and to process the check for deposit.

The department should open the envelopes when they are received, make photocopies of the checks requiring additional investigation, deposit the checks promptly, and credit the payments to a suspense account. Collectors could use the photocopies to determine the appropriate application of payments to taxpayer accounts. Once the correct taxpayer accounts are determined, credit for the payment should be transferred from the suspense account to the correct taxpayer accounts.

This process would also provide the department with control over delinquent payments that are not applied to taxpayer accounts in a timely manner. Details of the suspense account balance would give the department information which would allow it to investigate old balances on a timely basis.

Recommendation

We recommend that the department make photocopies of delinquent tax checks requiring additional investigation, deposit the checks promptly, and credit the payments to a suspense account.

A Depository System For Certain Tax Payments Should Be Established

In our prior audit report (Report No. 75-5, *Financial Audit of the Department of Taxation, Fiscal Year Ended June 30, 1974*), we had recommended that the department consider using a depository system for general excise tax and state income withholding tax payments, including interest and penalty assessments. Mail-in payments take time to process and moneys cannot earn interest until deposited. Interest earnings would increase hundreds of thousands of dollars if a depository system were used.

In our 1985 report, we recommended that the department *implement* a depository system for the same reasons. A depository system is a reasonable, safe, effective alternative to manually processing mail-in receipts.

Under a depository system, deposit cards would be issued to general excise taxpayers and employers withholding state income taxes. The cards would contain the taxpayer's name, tax identification number, and 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 required information, would deposit the 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 account daily to the department on the amount collected, from whom, and for what type of tax.

The U.S. Internal Revenue Service uses a similar system. Deposit information is transferred easily from banks to the department via magnetic tape or some other acceptable form of communication. As in the federal system, state taxpayers could also be required to file, directly with the department, a return detailing the computation of taxes for the period, the amounts deposited, and any amounts due.

The department has ignored our prior recommendation. In its response to our 1985 report, the department's reasons for not using a depository system were superficial. A depository system for general excise and state withholding taxes would improve the timeliness of deposits and free up valuable staff time now devoted to opening these tax payments and processing the receipts for deposit.

In view of shrinking resources and public concern about the size of government, the department should make every effort to utilize its resources in the most effective way. A depository system for general excise and state withholding taxes would help accomplish this. Our prior recommendation is still valid, and we believe the department should pursue the use of a depository system for tax payments.

Recommendation

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

Vacancies Should Be Filled

At June 30, 1994, unpaid taxes amounted to $154 million. Increased collection activities result in increased collections. The department has vacancies in its Collection Division and Audit Division. Filling these vacant positions should contribute to improved tax collections.

Vacancies in the Collection Division

One function of the Collection Division is to contact delinquent taxpayers to arrange for payment of the taxes due. The department's experience has been that delinquent tax collections increase with increased timeliness and frequency of taxpayer contacts by the Collection Division. In FY1993-94, when the department added 11 additional collectors to the Collection Division, delinquent tax collections rose from $66 million in FY1992-93 to $87 million in FY1993-94. Not all of the increased collections can be attributed to increased staffing of the division; however, it is reasonable to conclude that the additional collections exceeded the cost of the additional staff.

At June 30, 1994, the Collection Division had a total of 15 vacancies statewide, including 11 on Oahu alone. Of the 15 vacancies, the department expects 12 to be kept vacant in FY1994-95 due to budgetary restrictions. If these vacancies were filled, the department should be able to increase collections of delinquent taxes in excess of the additional compensation costs.

Vacancies in the Audit Division

The state tax system is based on the concept of voluntary compliance and self assessment. All taxpayers are expected to declare their tax liability accurately. For the system to operate effectively, confidence in the compliance rate must be high. The department tests compliance by auditing taxpayer returns.

The Audit Division is responsible for auditing tax returns submitted by taxpayers. However, the division is hindered by the high number of vacancies, especially at the more experienced levels. At the end of FY1993-94, the division had six vacancies in its Field Audit Section. The department expects five of the positions to be kept vacant in FY1994-95 due to budgetary restrictions.

While the purpose of audits is to ensure compliance, audits often result in additional taxes assessed of taxpayers. If these vacancies were filled, the increased number of audits could result in increased assessments that would defray the cost of the additional salaries and benefits.

Recommendation

We recommend that the department be allowed to fill the vacancies in its Collection and Audit Divisions.

The Income Tax Computer System Is Too Limited

The department's income tax computer system can perform basic functions, but it is limited in several respects.

The Comprehensive Net Income Tax (CNIT) system, which was implemented in 1986, processes and accumulates income tax return information. However, the system is not very efficient. For example, adjustments to tax return information must be manually prepared, keypunched by the data processing department, written to computer tape, and finally transmitted to the main frame computer. Edit listings must then be generated to verify that the adjustments were posted correctly. In some situations this process must be repeated several times to change a single amount.

The system also cannot interface with (1) the department's other computer system which handles general excise, withholding, and transient accommodations taxes, and (2) the system used by the U.S. Internal Revenue Service. It also lacks the ability to compile taxpayer data in a manner that could facilitate the selection of tax returns for audit.

These limitations prevent the department from efficiently comparing data among the different computerized tax systems or compiling data from the CNIT system based on certain key attributes. For example, the department could identify discrepancies and make additional assessments if the computer system could compare gross income reported on income tax returns and general excise tax returns. Additionally, audit selection would be facilitated if the computer system were able to compile a listing of taxpayers with certain pre-determined attributes, such as gross income.

Recommendation

We recommend that the department consider acquiring a new income tax computer system to increase the efficiency and effectiveness of processing income tax returns and selecting income tax returns for audit.

Response to Letter Ruling Requests Should Be More Timely

A key responsibility of the department is to provide taxpayers with timely information so that they can prepare accurate tax returns. Letter rulings are one method that the department uses to provide taxpayers with information. Letter rulings are informal statements of position issued by the department on the application of laws and policies to the specific facts submitted by the taxpayer.

We were informed by the department that it takes approximately 15 days to issue a letter ruling in response to a taxpayer's letter. However, based on a sample of letter rulings issued in FY1993-94, we found that the time the department takes to issue a letter ruling ranged from 4 to 343 days, with an average of 64 days.

In addition, requests for letter rulings are backlogged. At August 31, 1994, 702 requests for letter rulings had not been answered. Of these, 541 had been received prior to January 1994, with several dating as far back as 1991. The department does not intend to answer 348 of these old requests unless taxpayers specifically file follow-up requests.

In addition, the department does not issue letter rulings in a logical or prioritized manner. Instead of issuing them in the order that the requests are received, the department generally issues them based on the demands and pressures placed on it by the taxpayers.

As letter rulings have an impact on the accuracy of tax returns being filed, the State would benefit from more timely responses to letter ruling requests. The technical review office limits the time it spends on letter rulings since it places a higher priority on its other functions of preparing legislative proposals, revising tax forms, and reviewing tax exemption forms. The department should reassess these priorities and devise a priority system that includes responding to letter ruling requests.

Recommendations

We recommend that the department assess the relative importance of preparing letter rulings as compared to the department's other functions. It should also devise a fairer system of responding to requests for letter rulings.

A Formal Training Program Should Be Implemented

To examine tax returns effectively, the department's auditors must be proficient in auditing techniques and knowledgeable about tax laws. The department should ensure the audit proficiency and tax knowledge of its auditors by providing proper training on a continuing basis.

Currently, all new auditors receive a basic training program. After that program, however, much of the training is on an informal, unstructured basis. The department may use its personnel to conduct classes, bring in outside instructors, or send some of its employees to external classes. In FY1993-94, auditors received training on current tax topics, microcomputer proficiency, and interpersonal or communication skills. They received little training on advanced auditing techniques or complex tax issues.

The department has 81 auditors with varying levels of experience. A more structured training program, such as one that matches course content with the participants' levels of experience, would enhance the department's ability to examine more complex tax issues and increase assessments.

In addition, the department has no individual designated as a training officer who is responsible for the development and coordination of a training program. The department has established a technical training and development office, but the office currently is unfunded.

Recommendations

We recommend that the department develop a formal training program to increase its auditors' proficiency and tax knowledge on a continuing basis. In addition, we recommend that the department designate an individual as the training officer to be responsible for developing and coordinating the department's training program.

Inactive Agency Accounts Should Be Closed

The department has several agency accounts totaling approximately $183,000 that have had no activity since 1989 and earlier. These funds should be remitted to their rightful owners. However, the department does not have any records that identify the owners of the assets or the reasons for the deposits. The department should seek advice on how to close these accounts legally and transfer the balances to their rightful owners or to the general fund.

Recommendation

We recommend that the department contact the Department of the Attorney General to determine the procedures for closing the inactive agency accounts.

Chapter 3

Financial Audit

This chapter presents the results of the financial audit of the State of Hawaii, Department of Taxation for the year ended June 30, 1994. It includes the independent auditors' report and reports on the internal control structure and compliance with laws and regulations. It also displays combined financial statements of all fund types and account groups included in the scope of the audit, together with explanatory notes.

Summary of Findings

In the opinion of Deloitte & Touche LLP (Deloitte & Touche), based on their audit, except for the general fixed assets account group, the combined financial statements present fairly, in all material respects, the financial position of the department at June 30, 1994, and the results of its operations for the year then ended in conformity with generally accepted accounting principles.

Deloitte & Touche noted no matters involving the internal control structure and its operation that they considered to be material weaknesses as defined in the report on the internal control structure. They also noted, with respect to items tested, that the department has complied, in all material respects, with laws and regulations applicable to the department.

Independent Auditors' Report

To the Auditor
State of Hawaii

We have audited the following combined financial statements of the State of Hawaii, Department of Taxation:

Combined balance sheet—all fund types and account groups, June 30, 1994 (Exhibit A);

Combined statement of revenues, expenditures and changes in fund equity—all governmental fund types, year ended June 30, 1994 (Exhibit B);

Combined statement of revenues and expenditures - budget and actual (budgetary basis)—all governmental fund types, year ended June 30, 1994 (Exhibit C).

These combined financial statements are the responsibility of the management of the State of Hawaii, Department of Taxation. Our responsibility is to express an opinion on these combined financial statements based on our audit.

Except as discussed in the following paragraph, we conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the combined financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In accordance with the terms of our engagement, our audit of the combined financial statements did not include the financial activities of the department's general fixed assets account group, which had total assets of $3,739,517 as of June 30, 1994.

As discussed in the notes to the combined financial statements, the combined financial statements referred to above present only the activities of the department and are not intended to present fairly the financial position and results of operations of the State of Hawaii, in conformity with generally accepted accounting principles.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to audit the financial statements of the general fixed assets account group as discussed in the second preceding paragraph, such combined financial statements present fairly, in all material respects, the financial position of the State of Hawaii, Department of Taxation at June 30, 1994, and the results of its operations for the year then ended in conformity with generally accepted accounting principles.

Our audit was made for the purpose of forming an opinion on the combined financial statements taken as a whole. The following combining fund financial statements, which are also the responsibility of the management of the State of Hawaii, Department of Taxation, are presented for purposes of additional analysis and are not a required part of the combined financial statements of the State of Hawaii, Department of Taxation:

Combining balance sheet—agency funds, June 30, 1994 (Schedule I);

Combining statement of changes in assets and liabilities—agency funds, year ended June 30, 1994 (Schedule II).

Such additional information has been subjected to the auditing procedures applied in our audit of the combined financial statements and, in our opinion, is fairly presented in all material respects when considered in relation to the combined financial statements taken as a whole.

/s/ Deloitte & Touche LLP

Honolulu, Hawaii
September 27, 1994

Independent Auditors' Report on the Internal Control Structure Based on the Audit of the Combined Financial Statements

To the Auditor
State of Hawaii

We have audited the combined financial statements of the State of Hawaii, Department of Taxation, as of and for the year ended June 30, 1994, and have issued our report thereon dated September 27, 1994. Our report on the combined financial statements was qualified as we were unable to audit the financial activities of the department's general fixed assets account group.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free of material misstatement.

In planning and performing our audit of the combined financial statements of the State of Hawaii, Department of Taxation for the year ended June 30, 1994, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the combined financial statements and not to provide assurance on the internal control structure.

The management of the State of Hawaii, Department of Taxation, is responsible for establishing and maintaining the internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of combined financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories:

Accounting Applications:

- Receivables
- Cash receipts
- Purchasing and receiving
- Cash disbursements
- Payroll

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the combined financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

This report is intended for the information of the Auditor, State of Hawaii and management of the State of Hawaii, Department of Taxation. However, this report is a matter of public record and its distribution is not limited.

/s/ Deloitte & Touche LLP

Honolulu, Hawaii
September 27, 1994

Independent Auditors' Report on Compliance Based on the Audit of the Combined Financial Statements

To the Auditor
State of Hawaii

We have audited the combined financial statements of the State of Hawaii, Department of Taxation as of June 30, 1994 and for the year then ended, and have issued our report thereon dated September 27, 1994. Our report on the combined financial statements was qualified as we were unable to audit the financial activities of the department's general fixed assets account group.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free of material misstatement.

Compliance with laws, regulations and contracts applicable to State of Hawaii, Department of Taxation is the responsibility of the management of the State of Hawaii, Department of Taxation. As part of obtaining reasonable assurance about whether the combined financial statements are free of material misstatement, we performed tests of the department's compliance with certain provisions of laws and regulations. However, the objective of our audit was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests indicate that, with respect to the items tested, the State of Hawaii, Department of Taxation complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that the department had not complied, in all material respects, with those provisions.

This report is intended for the information of the Auditor, State of Hawaii and management of the State of Hawaii, Department of Taxation. However, this report is a matter of public record and its distribution is not limited.

/s/ Deloitte & Touche LLP

Honolulu, Hawaii
September 27, 1994

Descriptions and Definitions

This section describes the combined financial statements audited and provides definitions of technical terms used in this chapter.

Descriptions of financial statements and schedules

The following is a brief description of the combined financial statements and supplemental schedules audited by Deloitte & Touche. Combined financial statements and supplemental schedules are attached at the end of this chapter.

Combined balance sheet—all fund types and account groups (Exhibit A). This statement presents assets, liabilities, and fund equity of all fund types and account groups used by the department on an aggregate basis.

Combined statement of revenues, expenditures and changes in fund equity—all governmental fund types (Exhibit B). This statement presents revenues, expenditures, and changes in fund equity for all governmental fund types used by the department on an aggregate basis. Revenues include state appropriations mandated by various appropriations acts of the State Legislature.

Combined statement of revenues and expenditures - budget and actual (budgetary basis)—all governmental fund types (Exhibit C). This statement summarizes revenues and expenditures by source and type on the budgetary basis and compares such amounts to the budget as adopted by the State Legislature.

Combining balance sheet—agency funds (Schedule I). This schedule presents assets and liabilities of the agency funds of the department.

Combining statement of changes in assets and liabilities—agency funds (Schedule II). This schedule presents changes in assets and liabilities of the agency funds of the department.

Definition of terms

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

Appropriation. An authorization granted by the State Legislature permitting a state agency, within established fiscal and budgetary controls, to incur obligations and to make expenditures.

Allotment. An authorization by the director of finance to a state agency to incur obligations and to make expenditures pursuant to the appropriation made by the State Legislature.

Encumbrance. An obligation in the form of a purchase order or contract which is chargeable to an appropriation.

Expenditure. The incurrence of a liability for goods delivered or services rendered.

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

Notes to the Combined Financial Statements

Explanatory notes which are pertinent to an understanding of the combined financial statements and financial condition of the funds included in the scope of the audit are discussed in this section.

Financial statement presentation

Reporting entity. The Department of Taxation is a department of the State of Hawaii (State). The department's financial statements reflect only its activities. The state comptroller maintains the central accounts for all state funds and publishes comprehensive financial statements for the State annually, which includes the department's financial activities.

The combined financial statements of the department have been prepared in conformity with generally accepted accounting principles as applied to governmental units. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

GASB Statement No. 14, "The Financial Reporting Entity," established standards for defining and reporting on the financial reporting entity. This statement requires that the combined financial statements of the department include the fund groups of organizations for which the department is financially accountable and other organizations for which the nature and significance of their relationship are such that exclusion would cause the combined financial statements of the department to be misleading. Accordingly, such organizations have been included in the department's combined financial statements.

Fund accounting. The financial activities are recorded in individual funds classified by type and described in the following sections, each of which is deemed to be a separate accounting entity. The financial position and operations of each fund are accounted for in separate self-balancing accounts which represent the fund's assets, liabilities, equity, revenues and expenditures.

Account groups are financial reporting devices designed to provide accountability for certain assets and liabilities that are not recorded in the funds because they do not directly affect net available financial resources.

Governmental fund types. Financial resources which are not accounted for in other funds are accounted for in the general fund. The measurement focus of governmental funds (general and special revenue funds) is on current financial resources. The budget adopted by the State Legislature provides the basic framework within which the resources and obligations of the general fund are accounted for. The general fund of the department is a part of the State's general fund, and the general fund reported on the combined financial statements is limited to and reflects only the appropriations, expenditures, and obligations of the general fund account used by the department, and the general fund allotments received by the department.

Financial resources obtained from specific revenue sources and used for restricted purposes are accounted for in the special revenue fund.

Fiduciary fund type. The agency funds are used to account for receipts and disbursements of amounts collected by the department in a custodial capacity.

Account groups. The general fixed assets account group is used to account for all fixed assets of the department. The general long-term debt account group is used to account for accrued vacation payable.

Summary of significant accounting policies

Basis of accounting. The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. All governmental funds are accounted for using a current financial resources measurement focus. With this measurement focus, only current assets and liabilities generally are included on the combined balance sheet. Operating statements of these funds present increases (i.e., revenues) and decreases (i.e., expenditures) in net current assets.

The modified accrual basis of accounting is used by all governmental fund types and agency funds. Under the modified accrual basis of accounting, revenues are recognized when susceptible to accrual (i.e., when they become measurable and available). "Measurable" means that the amount of the transaction can be determined. "Available" means collectible within the current period or soon enough thereafter to be used to pay liabilities of the current period. Expenditures are recorded when the related fund liability is incurred.

Encumbrances represent commitments related to unperformed contracts for goods or services. Encumbrance accounting, under which purchase orders, contracts and other commitments for the expenditure of resources are recorded to reserve that portion of the applicable appropriation, is utilized in the governmental funds. Encumbrances outstanding at year end are reported as reservations of fund balances and do not constitute expenditures or liabilities because the commitments will be honored during the subsequent year.

Cash. Cash includes all cash and time certificates of deposit with original maturities of three months or less.

Fixed assets. Fixed assets acquired by purchase are recorded at cost. Donated fixed assets are valued at the estimated fair market value on the date received. Maintenance, repairs, minor replacements, renewals and betterments are charged to operations as incurred. Major replacements, renewals and betterments are capitalized. No depreciation is provided for assets included in the general fixed assets account group.

Accrued vacation payable and sick leave. Department employees' accrued vacation payable is expected to be liquidated with future expendable resources and therefore is accrued in the general long-term debt account group. Sick leave is not convertible to pay upon termination of employment and is recorded as an expenditure when taken.

Due to State funds. Due to State funds represents funds that are to be remitted to the State for distribution to the State general fund, highway fund, airport fund, employment security fund, and various other funds.

Fund balances. Fund balances are reserved for encumbrances and a continuing appropriation. Encumbrances represent outstanding commitments which are generally liquidated in the subsequent year.

Total columns on combined financial statements. The total columns on the accompanying combined financial statements are captioned "Memorandum Only" to indicate that they are presented only to facilitate financial analysis. Information in these columns does not purport to present financial position or results of operations of the department in conformity with generally accepted accounting principles. Such data is not comparable to a consolidation. Interfund balances and transactions have not been eliminated.

Budgeting and budgetary control

The budget of the department is a detailed operating plan identifying estimated costs and results in relation to estimated revenues. The budget includes (1) the program, services and activities to be provided during the year, (2) the estimated revenues available to finance the operating plan, and (3) the estimated spending requirements of the operating plan. The budget represents a process through which policy decisions are made, implemented and controlled. Revenue estimates are provided to the State Legislature at the time of budget consideration and are revised and updated throughout the year. Amounts reflected as budgeted revenues in Exhibit C are those estimates as compiled and reviewed by the department. Budgeted expenditures are derived primarily from the General Appropriations Act of 1993 (Act 289, Session Laws of Hawaii of 1993), as amended, and from other authorizations contained in the State Constitution, the Hawaii Revised Statutes, and other specific appropriations acts in various Session Laws of Hawaii.

All expenditures of these appropriated funds are made pursuant to the appropriations in the biennial budget, as amended by subsequent supplemental appropriations.

The general and special revenue funds have legally appropriated annual budgets.

The final legally adopted budget in Exhibit C represents the original appropriations, transfers, and other legally authorized legislative and executive changes.

Budgetary control is maintained at the appropriation line item level as established in the appropriations act. The governor is authorized to transfer appropriations within a state agency; however, transfers of appropriations between state agencies generally require legislative authorization. Records and reports reflecting the detail level of control are maintained by and are available at the department. During the year ended June 30, 1994, there were no expenditures in excess of appropriations at the legal level of budgetary control.

To the extent not expended or encumbered, general fund appropriations generally lapse at the end of the year for which the appropriations are made. The State Legislature specifies the lapse dates and any other contingencies which may terminate the authorizations for other appropriations.

The budgets adopted by the State Legislature for the general and special revenue funds are presented in Exhibit C. The department's annual budget is prepared on the modified accrual basis of accounting with several differences, principally related to (1) encumbrance of purchase orders and contract obligations, and (2) accrued revenues and expenditures. These differences represent departures from generally accepted accounting principles (GAAP). A reconciliation of the budgetary to GAAP bases operating results for the year ended June 30, 1994 follows:

	General Fund	Special Revenue Fund
Excess of revenues over expenditures - actual (budgetary basis)	$ 992,282	$ 49,795
Reserved for encumbrances	2,533,227	
Expenditure for liquidation of prior year encumbrances	(2,292,524)	
Net accrued expenditures	148,211	
Excess of revenues over expenditures - actual (GAAP basis)	$ 1,381,196	$ 49,795

Agency funds

The department collects taxes on behalf of the State and counties. These collections are reflected in the department's agency funds. Taxes receivable are recorded for net income, public service company and franchise taxes when returns are filed without the required remittances. Taxes collected in advance are recorded for estimated payments received for public service company and franchise taxes.

General excise, transient accommodations, liquor, tobacco, and other miscellaneous taxes are recorded when cash is received. At June 30, 1994, delinquent general excise, transient accommodations, liquor, tobacco, and other miscellaneous taxes were $58,654,000 (unaudited).

Unpaid taxes include taxes receivable, taxes which are considered uncollectible, and other delinquent taxes. At June 30, 1994, unpaid taxes were as follows:

Taxes receivable	$	44,755,000
Allowance for uncollectible taxes		50,845,000
Delinquent general excise, transient accommodations, and other taxes		58,654,000
Total unpaid taxes	$	154,254,000

Cash

The director of finance is responsible for the safekeeping of all moneys paid into the State Treasury. The director of finance may invest any moneys of the State which, in the director's judgment, are in excess of amounts necessary for meeting the immediate requirements of the State. Legally authorized investments include obligations of, or guaranteed by, the U.S. Government, obligations of the State, federally-insured savings and checking accounts, time certificates of deposit, and repurchase agreements with federally-insured financial institutions.

The State maintains a cash pool which is used by various state departments and agencies including the department. The department's portion of this cash pool is indicated on the combined balance sheet as "Cash in State treasury."

For demand or checking accounts and time certificates of deposit, the State requires that the depository banks pledge collateral based on the daily available bank balances. The use of daily available bank balances to determine collateral requirements results in the available balances being under-collateralized at various times during the year. All securities pledged as collateral are held either by the State Treasury or by the State's fiscal agents in the name of the State.

Information regarding the carrying amount and corresponding bank balances of the cash pool (which includes the department's "Cash in State treasury") and collateralization of the cash pool balances is included in the Comprehensive Annual Financial Report of the State of Hawaii.

Employee benefits

Employees' Retirement System of the State of Hawaii

All eligible employees of the State and counties, including employees of the department, are required by Chapter 88 of the Hawaii Revised Statutes to become members of the Employee Retirement System (ERS), a cost-sharing, multiple-employer public employee retirement plan. The ERS provides retirement benefits as well as death and disability benefits.

Prior to June 30, 1984, the plan consisted of only a contributory option. In 1984, legislation was enacted to add a new noncontributory option for members of the ERS who are also covered under Social Security. Police officers, firefighters, judges, elected officials, and persons employed in positions not covered by Social Security are precluded from the noncontributory option. The noncontributory option provides for reduced benefits and covers most eligible employees hired after June 30, 1984. Employees hired before that date were allowed to continue under the contributory option or to elect the new noncontributory option and receive a refund of employee contributions. All benefits vest after five and ten years of credited service under the contributory and noncontributory options, respectively.

Total department payroll for the fiscal year ended June 30, 1994, was approximately $11,865,000, and pension contributions to the ERS approximated 13% of payroll costs. Information on covered payroll, actuarially determined contribution requirements, and actual contributions to the ERS is not available on a departmental basis. In addition, the ERS does not make separate measurements of net assets available for benefits and pension benefit obligations for the department. Total pension benefit obligation at June 30, 1993 (the latest date available), for the ERS as a whole, determined through an actuarial valuation performed as of that date, was $6.5 billion. The ERS' net assets available for benefits on that date (valued at market) was $5.0 billion, leaving an unfunded pension benefit obligation of $1.5 billion.

Post-retirement health care and life insurance benefits

In addition to providing pension benefits, the State provides certain health care and life insurance benefits to all employees who retire from the State on or after attaining age 62 with at least 10 years of service or age 55 with at least 30 years of service under the noncontributory option, and age 55 with at least 5 years of service under the contributory option. Contributions are based upon negotiated collective bargaining agreements, and are funded as accrued. Information on the department's share of the total State post-retirement health care and life insurance benefits expense is not available.

Non-imposed employee fringe benefits

Payroll fringe benefit costs of employees of the department funded by state appropriations (general fund) are assumed by the State and are not charged to the department's operating funds. These costs, totaling $3,399,080 for the year ended June 30, 1994, have been reported as revenues and expenditures of the department's general fund.

Furniture and equipment (unaudited)

The following is a summary of changes in furniture and equipment for the year ended June 30, 1994:

Balance at July 1, 1993	$ 3,519,095
Additions	376,142
Retirements	(155,720)
Balance at June 30, 1994	$ 3,739,517

Accrued vacation payable

The changes in accrued vacation payable for the year ended June 30, 1994 were as follows:

Balance at July 1, 1993 (unaudited)	$ 2,254,428
Net increase in accrued vacation	12,211
Balance at June 30, 1994	$ 2,266,639

Commitments and contingencies

Leases

The department leases various office equipment under noncancelable operating leases expiring through 1997. Future minimum lease commitments at June 30, 1994, were as follows:

Year ending June 30,	
1995	$ 16,300
1996	10,300
1997	4,500
Total	$ 31,100

Accumulated sick leave

Sick leave accumulates at the rate of one and three-quarters working days for each month of service without limit, but may be taken only in the event of illness and is not convertible to pay upon termination of employment. However, an employee who retires or leaves government service in good standing with 60 days or more of unused sick leave is entitled to additional service credit in the ERS. At June 30, 1994, accumulated sick leave approximated $6,380,000.

Insurance coverage

Insurance coverage is maintained primarily at the state level. The State is substantially self-insured for all perils including workers' compensation. Expenditures for workers' compensation and other insurance claims are appropriated annually from the State's general fund.

Litigation

The department is a party to various legal proceedings. Although the department and its counsel are unable to express opinions as to the outcome of the litigation, it is their opinion that any potential liability arising therefrom will not have a material adverse effect on the financial position of the department because any judgments against the department are judgments against the State and would be paid by legislative appropriation of the State's general fund and not by the department.

EXHIBIT A

STATE OF HAWAII, DEPARTMENT OF TAXATION

COMBINED BALANCE SHEET - ALL FUND TYPES AND ACCOUNT GROUPS
JUNE 30, 1994

	Governmental Fund Types		Fiduciary Fund Type	Account Groups		
ASSETS	**General**	**Special Revenue**	**Agency**	**General Fixed Assets (Unaudited)**	**General Long-Term Debt**	**Total (Memorandum Only)**
Cash in State treasury	$2,771,706	$2,551	$14,933,307			$17,707,564
Cash on hand	6,000		17,260,175			17,266,175
Cash in bank	24,025					24,025
Taxes receivable			44,754,673			44,754,673
Furniture and equipment				$3,739,517		3,739,517
Amount to be provided for retirement of general long-term debt					$2,266,639	2,266,639
TOTAL	$2,801,731	$2,551	$76,948,155	$3,739,517	$2,266,639	$85,758,593

EXHIBIT A (Continued)

STATE OF HAWAII, DEPARTMENT OF TAXATION

COMBINED BALANCE SHEET - ALL FUND TYPES AND ACCOUNT GROUPS (Continued)
JUNE 30, 1994

	Governmental Fund Types		Fiduciary Fund Type	Account Groups		
LIABILITIES, FUND EQUITY AND OTHER CREDIT	General	Special Revenue	Agency	General Fixed Assets (Unaudited)	General Long-Term Debt	Total (Memorandum Only)
LIABILITIES:						
Vouchers payable	$ 238,479					$ 238,479
Accrued vacation payable					$2,266,639	2,266,639
Taxes collected in advance			$30,875,906			30,875,906
Due to State funds	30,025		31,432,553			31,462,578
Due to counties and other			12,966,378			12,966,378
Protested tax payments			1,491,394			1,491,394
Other			181,924			181,924
Total liabilities	268,504		76,948,155		2,266,639	79,483,298
FUND EQUITY AND OTHER CREDIT:						
Investment in general fixed assets				$3,739,517		3,739,517
Fund balances:						
Reserved for encumbrances	2,533,227					2,533,227
Reserved for continuing appropriations		$2,551				2,551
Total fund equity and other credit	2,533,227	2,551		3,739,517		6,275,295
TOTAL	$2,801,731	$2,551	$76,948,155	$3,739,517	$2,266,639	$85,758,593

See accompanying notes to combined financial statements.

EXHIBIT B

STATE OF HAWAII, DEPARTMENT OF TAXATION

COMBINED STATEMENT OF REVENUES, EXPENDITURES AND CHANGES IN FUND EQUITY - ALL GOVERNMENTAL FUND TYPES
YEAR ENDED JUNE 30, 1994

	Governmental Fund Types		Total (Memorandum Only)
	General	Special Revenue	
REVENUES:			
State allotted appropriations	$17,236,154	$500,000	$17,736,154
Non-imposed fringe benefits	3,399,080		3,399,080
Total revenues	20,635,234	500,000	21,135,234
EXPENDITURES:			
Personnel	14,914,047	450,205	15,364,252
Other	4,339,991		4,339,991
Total expenditures	19,254,038	450,205	19,704,243
EXCESS OF REVENUES OVER EXPENDITURES	1,381,196	49,795	1,430,991
OTHER CHANGES IN FUND EQUITY - Lapsed appropriations	(1,006,194)	(49,795)	(1,055,989)
EXCESS OF REVENUES OVER EXPENDITURES AND OTHER CHANGES IN FUND EQUITY	375,002		375,002
FUND EQUITY, JULY 1, 1993 (Unaudited)	2,158,225	2,551	2,160,776
FUND EQUITY, JUNE 30, 1994	$ 2,533,227	$ 2,551	$ 2,535,778

See accompanying notes to combined financial statements.

EXHIBIT C

STATE OF HAWAII, DEPARTMENT OF TAXATION

COMBINED STATEMENT OF REVENUES AND EXPENDITURES - BUDGET AND ACTUAL (BUDGETARY BASIS) - ALL GOVERNMENTAL FUND TYPES YEAR ENDED JUNE 30, 1994

	General Fund			Special Revenue Fund		
	Actual (Budgetary Basis)	Budget	Variance Favorable (Unfavorable)	Actual (Budgetary Basis)	Budget	Variance Favorable (Unfavorable)
REVENUES - State allotted appropriations	$17,236,154	$17,236,154	$ -	$500,000	$500,000	$ -
EXPENDITURES:						
Personnel	11,650,907	12,640,459	989,552	450,205	500,000	49,795
Other	4,592,965	4,595,695	2,730			
Total expenditures	16,243,872	17,236,154	992,282	450,205	500,000	49,795
EXCESS OF REVENUES OVER EXPENDITURES	$ 992,282	$ -	$992,282	$ 49,795	$ -	$49,795

See accompanying notes to combined financial statements.

SCHEDULE I

STATE OF HAWAII, DEPARTMENT OF TAXATION

COMBINING BALANCE SHEET - AGENCY FUNDS
JUNE 30, 1994

	Tax Collections	Transient Accommodations Tax Payable to Counties	Fuel Taxes Payable to Counties	Protested Tax Payments	IRS Refund Intercept Account	Other	Total
ASSETS							
Cash in State treasury	$ 293,611	$6,491,107	$6,050,184	$1,491,394	$425,087	$181,924	$14,933,307
Cash on hand	17,260,175						17,260,175
Taxes receivable	44,754,673						44,754,673
TOTAL	$62,308,459	$6,491,107	$6,050,184	$1,491,394	$425,087	$181,924	$76,948,155
LIABILITIES							
Taxes collected in advance	$30,875,906						$30,875,906
Due to State funds	31,432,553						31,432,553
Due to counties and other		$6,491,107	$6,050,184		$425,087		12,966,378
Protested tax payments				$1,491,394			1,491,394
Other						$181,924	181,924
TOTAL	$62,308,459	$6,491,107	$6,050,184	$1,491,394	$425,087	$181,924	$76,948,155

STATE OF HAWAII, DEPARTMENT OF TAXATION

COMBINING STATEMENT OF CHANGES IN ASSETS AND LIABILITIES - AGENCY FUNDS YEAR ENDED JUNE 30, 1994

	Balance, July 1, 1993 (Unaudited)	Additions	Deductions	Balance, June 30, 1994
ASSETS				
Cash in State treasury	$ 7,806,111	$3,440,283,725	$3,433,156,529	$14,933,307
Cash on hand	15,993,114	3,204,248,549	3,202,981,488	17,260,175
Taxes receivable	41,852,221	2,894,239,729	2,891,337,277	44,754,673
TOTAL	$65,651,446	$9,538,772,003	$9,527,475,294	$76,948,155
LIABILITIES				
Taxes collected in advance	$26,495,313	$ 121,725,992	$ 117,345,399	$30,875,906
Due to State funds	31,664,076	6,404,212,996	6,404,444,519	31,432,553
Due to counties and other	5,478,765	133,289,768	125,802,155	12,966,378
Protested tax payments	1,831,368	945,994	1,285,968	1,491,394
Other	181,924			181,924
TOTAL	$65,651,446	$6,660,174,750	$6,648,878,041	$76,948,155

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Department of Taxation on November 10, 1994. A copy of the transmittal letter to the department is included as Attachment 1. The department's response is included as Attachment 2.

The department generally concurs with our findings and recommendations. It concurs in substance with our recommendation to implement a depository system for general excise tax and state income withholding tax payments. It believes that an electronic funds transfer system would be more efficient and is exploring that option. We are pleased that the department recognizes the need to improve its tax receipts systems and encourage it to pursue the electronic funds transfer system. It also will deposit all delinquent tax payments in a more timely manner. Further, it concurs that it should be allowed to fill vacancies in its Collection and Audit Divisions. It also will revise its system for preparing letter rulings, is considering the acquisition of a new income tax computer system, and will implement a formal training program for its auditors. It will contact the attorney general for guidance on closing inactive agency accounts.

The department neither concurs with, nor disputes, our recommendation that it reexamine its practice of not initiating foreclosure proceedings and more closely monitor the financial condition of taxpayers to determine when liens should be enforced through foreclosure proceedings. Instead, it states that it initiates foreclosure proceedings if warranted, but contends that foreclosure proceedings and additional monitoring require an inordinate amount of collector hours and produce only marginal increases in revenue. We are unable to confirm this claim because the department had not conducted foreclosure proceedings that we could evaluate.

ATTACHMENT 1

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

MARION M. HIGA
State Auditor

(808) 587-0800
FAX: (808) 587-0830

November 10, 1994

COPY

The Honorable Richard F. Kahle, Jr.
Director
Department of Taxation
Keelikolani Building
830 Punchbowl Street
Honolulu, Hawaii 96813

Dear Mr. Kahle:

Enclosed for your information are three copies, numbered 6 to 8 of our draft report, *Financial Audit of the Department of Taxation*. We ask that you telephone us by Tuesday, November 15, 1994, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit them no later than Wednesday, November 23, 1994.

The Governor and presiding officers of the two houses of the Legislature have also been provided copies of this draft report.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

Marion M. Higa

Marion M. Higa
State Auditor

Enclosures

JOHN WAIHEE
GOVERNOR

RICHARD F. KAHLE, JR.
DIRECTOR OF TAXATION

GEORGINA M. YUEN
DEPUTY DIRECTOR

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

November 23, 1994

The Honorable Marion Higa
State Auditor
Office of the Auditor
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917

Dear Mrs. Higa:

Thank you for the opportunity to review and respond to the Financial Audit of the Department of Taxation prepared by your office. We are pleased to note that the auditor has found the Department's financial internal control structure and operations to be in compliance with applicable laws and regulations. We believe that the audit report fairly describes the Department's success in correcting past deficiencies. We appreciate your observations and recommendations, which coincide with the Department's view of what must be done to further the Department's mission of fostering greater voluntary compliance with the State's tax laws. We acknowledge your office for providing us with an impartial evaluation that firmly supports and actively promotes the Department's own objectives. The comments which follow address the specific audit recommendations in Chapter 2 of the report.

Page 7, Recommendation #1: We recommend that the Department strengthen the procedures used to collect unpaid taxes by reprogramming the Department's computer systems to identify taxpayers who have not filed the required tax returns.

We concur. The Comprehensive Net Income Tax system (CNIT) system has proven to be costly and very difficult to modify or reprogram because of its age, complexity, design, and language. The newer General Excise, Withholding, Transient Accommodations Tax system (GTWZ) system is easier to modify and reprogram. The Department is currently exploring the development of compatible computerized tax systems that include improved nonfiler features. In the interim, the Department will continue to utilize data obtained from its own computer systems, the Department of Commerce and Consumer Affairs, and the Internal Revenue Service (IRS), since budgetary restrictions especially on personnel resources limit the Department's ability to improve the computer systems' nonfiler activities.

Page 7, Recommendation #2: We recommend that the Department strengthen the procedures used to collect unpaid taxes by documenting the approvals obtained for the payment plans of delinquent taxpayers.

We concur. The Collection Division has reminded its staff about the importance of appropriate documentation of payment plan approvals and will provide its staff with additional written procedures on payment plans.

Page 7, Recommendation #3: We recommend that the Department strengthen the procedures used to collect unpaid taxes by reexamining its practice of not initiating foreclosure proceedings and actively monitoring the financial condition of taxpayers to determine when liens should be enforced through foreclosure proceedings.

The Department's philosophy is to use all of the collection tools at its disposal, including foreclosure action, as necessary to collect the delinquent taxes owed to the State of Hawaii. Payment plans, levies, and liens have proven to be the most effective collection tools, especially during years of restricted personnel resources and budgetary funding.

The Department continues to incur restrictions and reductions in its personnel and budgetary resources and must nevertheless still produce the greatest amount of tax revenues for the expended dollars. Taxpayers' financial conditions are monitored upon the establishment or default of payment plans. Foreclosure proceedings and additional monitoring of taxpayers' financial conditions are very work intensive, marginal in revenue production, and require an inordinate amount of collector hours. Foreclosure proceedings will continue to be employed by the Collection staff when warranted.

Page 8, Recommendation: We recommend that the Department make photocopies of delinquent tax checks requiring additional investigation, deposit the checks promptly, and credit the payments to a suspense account.

We concur. The Department believes that the primary reason for the untimely deposit of delinquent tax payments is one of workload versus personnel resources. The audit report notes an improvement from the prior audit in the number of unprocessed delinquent payments more than two weeks old (a 70% decrease); progress occurred notwithstanding that the number of payments made had swelled. The report did not note the increase of 11 staff positions assigned to process delinquent tax payments. Unfortunately, current budget restrictions require the elimination of at least 9 of these positions.

The Department will develop a dedicated check processing work group to process all delinquent tax payments. This group will use the photocopy/suspense account proposal for delinquent tax payments requiring additional research or investigation.

Page 9, Recommendation: We again recommend that the Department implement a depository system for general excise tax and state income withholding tax payments, including interest and penalty assessments.

We concur with the substance of the recommendation that the State increase its revenues from interest earned on funds deposited earlier. We agree that although the Department has improved its processing (receipt, process, and deposit) time, we have been unable to eliminate the float between the date payments are mailed to the Department and the date they are processed. Nevertheless, a direct depository system remains without merit and is an out-of-date method of processing tax receipts.

Direct depository systems are fast becoming obsolete; there are unnecessarily high costs attached to using third party banks as direct depositories and the float still exists. For example, the City and County of Honolulu contracts for its real property tax payment processing. The charge is about $0.34 per transaction, which may or may not be accompanied by a tax payment, and there is no assurance that all transactions will be processed on the day received. The U.S. Treasury is charged $0.10 per check for its depository system, there is a separate charge for handling the depository cards, and the funds do not get credited until the following day.

Alternatively, most state tax agencies are currently using or are considering implementing the electronic transfer of funds (EFT). EFT reduces the float because funds are transferred electronically from bank to bank through a clearing house, on the same day. In addition to allowing quicker access to funds, EFT carries lower transaction costs than a direct depository system and reduces manual processing time and errors. EFT transactions also may include information that replaces the filing of withholding and estimated tax returns.

The report notes that the Internal Revenue Service (IRS) employs a direct depository system. In fact, the IRS is changing its system to EFT. All states, including the State of Hawaii, and other large taxpayers must make their withholding and payroll tax payments using EFT in 1995.

The Department surveyed other states in 1993 on processing and payment methods. Among the states that responded, 7 utilize a lockbox or depository system, and of these, 3 also are using EFT. As of March, 1994, 36 states require some payments by EFT, and other states indicate that they are considering EFT for tax collections. None of the states yet require EFT payments for all taxes or taxpayers, since, as in Hawaii, a relatively small number of taxpayers account for a large percentage of tax revenues. The experience of the other states leads us to believe that the Department should require taxpayers to utilize EFT, starting with those taxpayers making large payments for any type of tax.

We have initiated discussions with State Treasury staff and the present state depository about adopting EFT. The cost to the State for EFT transactions will vary with the options that may be made available to taxpayers. The cost for transactions would be minimal. Developing the requirements for the interface of EFT information with the Department's computer systems may require a consultant.

Legislation is required before the Department can implement either a direct depository system or EFT system. The start up time for both systems is essentially the same. Computer system changes and notification to taxpayers also are necessary. The Department will submit legislation to the 1995 legislature authorizing the implementation of EFT payments.

Page 10, Recommendation: We recommend that the Department be allowed to fill the vacancies in its Collection and Audit Divisions.

We concur. We note that the discussion of vacancies states that as of June 30, 1994, unpaid taxes amounted to $154 million. We believe that this figure, which also is set forth in a chart on page 26 of the report, must be clarified. The Department recognizes close to twenty percent of the $154,254,000 shown on the chart as "total unpaid taxes" as representing accrued taxes, such as public service company and franchise taxes, which are reported by taxpayers but may not yet be due. The Department emphasizes that these taxes are not delinquent accounts.

We note that the discussion of vacancies due to budgetary restrictions does not reflect the fact that both the Collection and Audit Divisions not only are required to maintain vacancies, but that each division must give up 9 of these vacancies (a total of 18 positions) for deletion from the budget in 1995. Further, the discussion does not reflect that the 1995 budget deletes positions in other areas of the Department: 9 positions in the Tax Services and Processing Division and 2 positions in the Systems and Procedures Office, respectively.

The discussion also does not reflect the impact of early retirements resulting from Act 212, SLH 1994, on the divisions or the Department as a whole. At this time, it appears that the Department will lose 10 to 15 persons to retirement, only 30 percent of whom may be replaced. The continued effect of budget restrictions on the Department in all areas, not just the Collections and Audit divisions, at some time, will have an impact on state revenues.

Page 11, Recommendation: We recommend that the Department consider acquiring a new income tax computer system to increase the efficiency and effectiveness of processing income tax returns and selecting income tax returns for audit.

We concur. The Department is not only considering the possibility of acquiring a new comprehensive net income tax (CNIT) computer system, but also the possibility that the present GTWZ computer system may be altered to accept the current CNIT information. More importantly, it must be noted that the CNIT system must be replaced no later than the year 1998; the clock in the current CNIT system will not make calculations for the year 2000 and beyond.

To determine the appropriate direction for the Department's computer system(s), it will be necessary to hire consultants to assist the Department and personnel of the Information and Communications Services Division (ICSD) of the Department of Budget and Finance. Presently and for the foreseeable future, a problem exists in obtaining funding. It is the opinion of the Department that initial funding, and perhaps part of the total funding for the new system, may be obtained by allowing the Department to roll its unexpended appropriation balance into a fund to be used for this purpose. In this manner, an initial funding appropriation will not be required to proceed.

Page 12, Recommendation: We recommend that the Department assess the relative importance of preparing letter rulings as compared to the Department's other functions. It should also devise a fairer system of responding to requests for letter rulings.

We concur. Since 1985, the workload, including walk-in traffic and telephone calls, of the Technical Review Office (TRO), with only one addition to the staff, has grown significantly. In 1990 and 1991, respectively, TRO acquired the responsibility of reviewing applications for conveyance tax exemptions and applications for withholding certificates. Both functions are required and time constrained, by statutory due dates for withholding taxes from real property sales and by the public's need to record documents immediately at the Bureau of Conveyances. Thus, these functions are of necessity, high in the priority of tasks. During the legislative session, TRO concentrates on preparing testimony and reviewing tax measures. Since 1985, the number of tax measures for which testimony has been prepared has increased substantially, almost 87 percent, and the number of letter rulings has increased by 56 percent.

Recognizing the need to reduce the backlog of correspondence, TRO recently implemented a program, which allows the tax specialists to concentrate on correspondence by relieving them on a rotating basis of responsibilities other than their own specific letter ruling and correspondence assignments. By eliminating interruptions, production should increase. TRO also is initiating a monthly report for letter rulings and correspondence to monitor response time and is evaluating the adoption of a "first-in, first-out" policy. These actions will improve letter ruling responses within current budgetary constraints.

Page 13, Recommendation #1: We recommend that the Department develop a formal training program to increase its auditors' proficiency and tax knowledge on a continuing basis. In *addition, we recommend that the Department designate an individual as the training officer to be responsible for developing and coordinating the Department's training program.*

We concur. The Governor approved the Department's plan to establish a Training Office in July, 1991. The Department designated 3 positions for transfer to the new Training Office. In order to be filled, the positions first had to be reclassified and were sent to the Department of Personnel Services (now Department of Human Resources (HRD)) in September, 1991. In 1993, budget restrictions were imposed, and because these positions had been vacant for more than a year, the positions were deleted from the Department's budget (and later returned by the legislature). In 1994, funding again was restricted for the positions designated for the Training Office, and HRD asked departments to withdraw requests for reclassification of restricted positions. The positions now are slated to be deleted in 1995. To date, the Department has lost 3 positions to budgetary restrictions, and the training officer remains unclassified and unfilled. The Department will initiate action to designate a training officer and staff when state budgetary restrictions are eased.

The Department recognizes that although the Training Office cannot be established right now, the Department's auditors would benefit from more formal training. Accordingly, the Department is in the process of developing a formal training program in the Audit Division. First, the specific areas of expertise and needed training levels will be identified. Thereafter, training modules in the identified audit topics will be provided in a variety of ways: after receiving training in an audit topic, some auditors may serve as instructors for other auditors, supervisors may teach some of the courses, and the Department may contract with outside professionals, including trainers from out-of-state, to impart some of the advanced auditing techniques, as allowed by the Department's budget.

Page 13, Recommendation #2: We recommend that the Department contact the Department of the Attorney General to determine the procedures for closing the inactive agency accounts.

We concur and have contacted the Office of the Attorney General for advice in this matter.

Thank you for presenting the Department with many opportunities for further efficiencies.

Sincerely,

RICHARD F. KAHLE, JR.
Director of Taxation