

TO: MTC Strategic Planning Steering Committee
FROM: Early Audit Closure Project Team
SUBJECT: Final Report
DATE: July 10, 2013

Background

The Steering Committee assigned our team to conduct a project to develop a process for MTC auditors to make early determinations that joint audits lack the potential for material audit adjustments. We started that work in January 2013. This report describes our work product and outlines the next steps to be taken.

Project Description

This project involved creating a process and standards for MTC auditors to use during joint audits. The auditors will be able to make a determination that there is little or no potential for material audit adjustments for a state or states after commencement of an audit, but before the development of a complete audit report and without the need to prepare full audit schedules. The determination would end the audit process for the affected states. Our team included representatives from participating states and MTC audit staff. The complete project proposal is attached as an appendix to this report.

Problems: When a large number of states participate in an audit, the MTC auditor must prepare a complete audit report, including detailed schedules, for each participating state even if the proposed assessments or refunds are likely to be very small for one or more of the participating states. The current practice of preparing a complete audit report for each state regardless of the results of the audit adds a substantial amount of time to the audit process for little additional return. The auditor is not available to start a new audit until all reports are complete.

Expected outcomes from the project: We had the following goals for the project –

- Develop a process by which MTC auditors can make an early determination that an audit has limited or no potential for material audit adjustments, close the appropriate audit years and communicate those actions to affected states.
- Develop standards for making an early determination that an audit has limited potential for material audit adjustments.

Results

We have developed a policy and procedure for MTC auditors to use to close audit years after making a determination that one or more tax years lack potential for material audit adjustments. The process establishes criteria for such determinations, and sets out the steps that must be followed for documentation and approval of the determination and closure. The process also sets out the process for communicating about the determination with affected states and taxpayers. We reviewed our draft procedure with input from the MTC Audit Committee and taxpayer representatives.

Next Steps

The proposed policy and procedure should be reviewed and accepted by the Audit Committee. After that, the MTC audit staff will need to make some changes in internal procedures to fully implement the

new process. These will include changes in work paper formats and new formats for communication with states and taxpayers.

In order to evaluate the usefulness and effectiveness of this new policy and procedure, the following information should be gathered once the procedure is implemented –

- Frequency of use – how many times the early determination and closure process is used each year.
- Nature of determinations – which criteria the determinations were based on.
- Time savings – estimate of time saved by the auditor due to the early determination and closure of audit years.

After three or four years, the states and MTC audit staff should be surveyed about their perception of the efficiency and effectiveness of the new policy and procedure.

Respectfully submitted,

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Appendix

Policy and Procedure: Early Closure of Audit Years Due to Lack of Material Adjustments

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Purpose: The goals of the process for early closure of audit years after a determination of lack of material adjustments are to:

1. Develop procedures by which MTC's staff can identify audit activities that present little or no potential benefit to participating states or affected taxpayers;
2. Create a system to communicate that information to appropriate parties in a prompt and efficient manner; and
3. Enable MTC audit staff to work efficiently and to optimize the use of audit resources to provide greater benefit to participating states and taxpayers.

Policy: After sufficient review and as soon as prudently possible, an MTC auditor may determine that an audit lacks potential for material adjustments, and close out some or all of the tax returns under audit, if, after initial review of the returns or of the taxpayer's records, the auditor concludes that:

1. There is little likelihood of an error with respect to the return(s); or
2. The potential net assessment or refund for a particular state for the period under audit would be less than \$1,000, and there is no significant issue or material adjustment for the period under audit or that would affect other tax years of the taxpayer, whether or not those years are included in the audit period (The auditor may use estimates to determine if a potential adjustment meets this guideline); or
3. The amount of work needed to fully document proposed adjustments for a tax year or state, or for the entire audit outweighs the potential benefit to the state(s) or taxpayer(s).

Required documentation:

1. For a determination that one or more tax years for the taxpayer lack potential for material adjustments, for a particular state or states, the auditor must document the reason(s) for the determination in the audit workpapers and include a discussion in the audit narrative.
2. For a determination that the audit should be closed due to lack of material adjustments, the auditor shall document the reasons for closing the audit and issue a written report to the participating states.

Necessary approvals: The following levels of approval are required for early closure under this policy and procedure before the audit is closed and the taxpayer is notified:

1. For an early determination that there is no potential for material adjustments with respect to one or more tax years for the taxpayer, for a particular state or states, the Audit Director must approve the determination and closure of the audit for the affected tax years.

2. For a determination that the entire audit should be closed because there is no potential for material adjustments, the states participating in the audit must be informed of the determination and approve closure of the audit, or decide on other appropriate action that will be taken.

NOTE: The auditor, audit supervisor or Audit Director, in their discretion, may seek input from the affected states or the Audit Committee on any early determination of limited or no audit potential.

Notice to affected taxpayer(s):

1. If any years under audit are closed under this policy and procedure, written notice shall be given to the taxpayer concerning the return(s) for which the determination has been made. The notice shall describe the nature and effect of the determination on the audit status of the tax return, including whether or not the return remains open for subsequent review or adjustment by a state or states (example: net operating loss that could be adjusted during a later audit).
2. If an early closure under this policy and procedure affects a potential refund of taxes paid, the auditor shall notify the taxpayer of the nature of the potential refund and whether it may be necessary for the taxpayer to file amended returns in the affected states.
3. The written notice of an early closure under this policy and procedure must be given to the taxpayer at the time the audit schedules and audit adjustments are provided to the taxpayer. If appropriate, and after the auditor has consulted with any affected state(s), notice of the early closure may be given to the taxpayer before the audit is concluded.

NOTE: For purposes of improving the audit nominating process, the Audit Director shall notify the Audit Committee of any closure of an audit without adjustments.