



# Secretary of State Audit Report

## Department of Revenue Tobacco Compliance Unit

### Summary

#### PURPOSE

The purpose of this audit was to determine if the Department of Revenue was managing its Tobacco Compliance Unit resources in a manner that maximized compliance oversight and tobacco tax collections.

#### BACKGROUND

Tobacco plays an increasingly important role in financing Oregon state operations. Revenue from tobacco taxes and Tobacco Master Settlement Agreement funds totaled \$325 million in fiscal year 2003.

The department's Tobacco Compliance Unit (TCU), a part of the legislatively created Tobacco Task Force, is responsible for identifying and collecting tobacco taxes.

#### RESULTS IN BRIEF

The department can more effectively deploy and manage the Tobacco Compliance Unit's (TCU) resources in support of the Tobacco Task Force's mission.

By comparing TCU operations to best practices for inspection programs, we found that improvements were needed in the following areas:

- Identifying the population of retailers to be inspected,
- Planning and documenting on-site inspections,
- Reviewing and monitoring program operations and outcomes, and

- Identifying and collecting floor tax obligations from tobacco distributors and retailers.

#### RECOMMENDATIONS

We recommend that the department:

- Make better identification of the population of cigarette retailers subject to inspection a priority;
- Develop a more systematic and rigorous inspection program;
- Develop policies and procedures covering all key TCU operations;
- Establish performance goals for the program and each employee classification; and
- Collect the taxes, penalty, and interest identified as unpaid by this audit.

#### AGENCY'S RESPONSE

*The Department of Revenue agrees with the findings and recommendations in this report. We appreciate the cooperation of the Secretary of State auditors (SOS) with the department's internal auditor and program management during the audit. The conclusions and recommendations provided are very helpful and provide good insight into this growing program. The advice is especially welcome during the legislatively mandated expansion of the Tobacco Compliance Task Force and the department's Tobacco Compliance Unit (TCU).*

### Introduction

Tobacco plays an increasingly important role in financing Oregon state operations. During fiscal year 2003, revenue from

tobacco taxes totaled \$243 million and Tobacco Master Settlement Agreement

funds were estimated at \$82 million.<sup>1</sup>

<sup>1</sup> The Tobacco Master Settlement Agreement November 23, 1998

# Background

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Increased tobacco taxes in Oregon and other states have escalated the potential for profit from illegal sales of tobacco products. The 2001 Legislative Assembly created the state's Tobacco Task Force to improve tobacco vendors' compliance with tobacco laws and provide education. Another reason was to ensure compliance with the Tobacco Master Settlement Agreement, which requires that states receiving such funds exercise due diligence in regulating tobacco products. The organization and approach of the Tobacco Task Force is unique among the states. The Task Force includes staff from the Department of Revenue (department), the Department of Justice, and the Oregon State Police. The

department's staff assigned to the Task Force is known as the Tobacco Compliance Unit (TCU). Their primary responsibility is identifying and collecting tobacco taxes. At the time of our audit TCU had been in operation for just over one year as part of the Task Force.

The department has chosen to emphasize inspections of tobacco vendors as the primary compliance tool. The department inspects both tobacco distributors and retailers. Inspectors examine cigarette packages to determine if taxes have been paid—an affixed Oregon tax stamp evidences payment. They also determine whether taxes have been paid for other tobacco prod-

ucts by comparing product inventory with distributor invoices.<sup>2</sup> These inspections generate information for TCU tax audits and investigative leads for Oregon State Police and Department of Justice Task Force members.

With the passage of House Bill 2094 by the 2003 legislature, even more is required of TCU inspectors than ever. Inspectors are now required to identify and seize cigarettes produced by manufacturers who are not in compliance with Oregon master settlement agreement law.

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<sup>2</sup> Other Tobacco Products are defined by ORS 323.500 (10). They include among others: cigars, snuff, and chewing tobacco but not cigarettes.

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## Audit Results

The department can more effectively manage TCU resources in a manner that maximizes compliance oversight and tobacco tax collections.

Our audit included a review of best practices for regulatory programs and identified a number of components key to an inspection program's success.<sup>3</sup> By comparing and contrasting TCU's operations to best practices, we found that improvements could be made in the following areas:

- Identification of the population of tobacco retailers;
- Planning and documenting inspections of tobacco retailers; and
- Review and monitoring of program outcomes.

### Identifying the Population of Oregon Tobacco Retailers

We found that the TCU has yet to identify the complete population of Oregon tobacco retailers subject to inspection. Identifying the population to be inspected is an essential step in establishing an efficient and effective inspection program.

The only list of retailers that the TCU uses is contained in its inspection database. Our analyses of the department's inspection database led us to conclude, however, that it was not adequate to serve as a basis for planning inspections. We found the database to be cumbersome and incomplete.

The TCU has been using its on-site compliance inspections as the primary means of developing a list of tobacco retailers. In the field, inspectors recorded their activities in hard copy for later transfer to the inspection database. We identified the following problems with this approach:

- The TCU's listing of known tobacco retailers was growing only as quickly

as inspections were completed and the results were input to the database. Information about identified but un-inspected stores is not entered into the database. During our audit, we obtained lists of three major convenience store chains. Of 325 listed stores, 89 (28 percent) were not listed in the TCU database. TCU currently has no effective means of recording information on these unlisted stores.

- The database does not link subsequent inspections to the original entry. The database generates a new entry for each inspection. Our review indicated that some retailers had been inspected as many as four times thus generating four entries. Consequently, assembling a history of inspections for a particular entity is difficult, given the current configuration.
- Further, in attempting to do our own analysis of the database, we found that a general lack of uniformity in data entry made analysis of the database using our query tools difficult.

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<sup>3</sup> "Best Practices for Carrying Out a State Regulatory Program", National State Auditors Association, 2003.

## Audit Results (continued)

Since Oregon does not require central registration or licensing of tobacco resellers, the department is without a source of information that is common among states we contacted. Lacking this source of information, the department has been left to its own devices to develop a comprehensive list of those subject to Oregon tobacco tax requirements. To date, the department has been unable to develop such a comprehensive list.

**We recommend** that the department make identification of the population of cigarette retailers subject to inspection a priority. The department should consider:

- Evaluating the feasibility of requiring tobacco retailers to identify themselves to the department.
- Developing a database, or improving the existing inspection database, to allow the TCU the ability to identify, record, and analyze elements of the inspection program critical to its success.
- Other options that would allow the department to effectively identify the population subject to inspection.

### Agency Accomplishments

Department managers reported that improving the inspection database has been made a priority. They planned to have a new database in place in early 2004.

#### AGENCY'S RESPONSE

*Management agrees. TCU management has made identification of the population of cigarette and tobacco retailers a top priority. It initiated development of a new database to maintain information about tobacco retailers. The department plans to more completely identify the population of cigarette retailers subject to inspection by December 2004.*

### Planning and Documenting On-Site Inspections

The TCU inspection process is the department's primary tool for ensuring re-

tailers' compliance with tobacco tax regulations. In addition to providing opportunities to educate retailers, and having a deterrent effect, inspections are also the major source of audit leads, which may result in the collection of unpaid tobacco taxes. At the time of our audit, 50 tobacco audits were completed, in process, or scheduled, and 42 (84 percent) of these were the result of inspector-generated leads.

Our testing, combined with a comparison to best practices, indicated that improvements were needed in TCU operations in the areas of inspection planning and documentation of completed inspections. Specifically, we felt that the department's approach lacked systematic planning including consideration of risk, results of prior inspections, and efficiency of routes that could result in more efficient and effective use of time in the field.

### Inspection Planning Could Be Improved

A rigorous inspection program should systematically align available resources with the population to be inspected in a way that would achieve the desired results in the most effective, efficient, and economical way. After gaining an understanding of the department's current practices, and reviewing existing documentation of completed inspections, we concluded that the inspection program could benefit from a more systematic approach in line with best practices.

Specifically, our analysis of completed inspections for five outlying communities found that inspections in these areas appeared to have primarily focused on stores located along the main highways. Additional analysis identified a number of retailers in these communities that sell tobacco products, located off the main highways, that had never been inspected. This pattern of inspections seemed to indicate a general lack of systematic planning.

We also tested this best practice theory by planning and conducting a two-day, 400-mile, inspection trip in conjunction with a TCU inspector. Our planning included analytical review of prior inspections recorded in the database, identification of additional retailers through research, and advance telephone calls to confirm these identified retailers sold tobacco products. We added an element of a risk based approach by giving more weight to particular types of proprietorships, ones that had not previously been inspected and that we considered to be at higher risk of non-compliance. Our route was planned to maximize use of time in the field.

We conducted inspections at 21 stores in the two days and this generated one potential audit lead.<sup>4</sup> By comparison, TCU data showed that during fiscal year 2003 inspectors were reported to have conducted an average of 19 inspections per week.<sup>5</sup> Further, our analysis found that inspectors generated less than one audit lead per month on average.

We attributed a large part of the difference in productivity to our advance planning. Much of this advance work would not have been necessary had the population of tobacco retailers been better identified and more complete.

### Documentation of Inspections Could Be Improved

TCU inspection activities were inconsistently documented in hard-copy files and in the inspection database. Further, we found that inspectors' review of re-

<sup>4</sup> We were not able to independently evaluate the audit potential in additional cases. Requested documents mailed in by retailers were received, reviewed, and discarded by a TCU employee before we could evaluate them.

<sup>5</sup> Our calculation excluded February 2003 because of temporary staff layoffs.

## Audit Results (continued)

tailer invoices was poorly documented, and copies of requested documents were not retained for later review. We noted that there were no written procedures concerning the recording of inspection results to guide inspectors on best or desired practices.

Supervision and monitoring of the program's operations is much more difficult without the availability of complete and accurate documentation of inspections.

**We recommend** that the department develop a systematic and rigorous inspection program that considers the following:

- Prior inspection results, routing efficiency, and retailers' risk of non-compliance.
- Strategic deployment of inspection resources.
- Revising its inspection forms to include provisions for recording all information required for the improved inspections database.
- Developing document retention policies for those documents determined by the department to be necessary for the execution and oversight of the Other Tobacco Product inspection program.

### **Agency Accomplishments**

As of November 2003, the department was in the process of hiring additional inspectors and intended to assign some to offices outside of Salem.

### **AGENCY'S RESPONSE**

*Management agrees. TCU management has taken steps to develop a more systematic and rigorous inspection program. It has established an initial strategic deployment plan of inspection resources. All inspection forms have been revised to include information required for the improved database. Retention policies will be completed by March 2004. TCU will put processes in place to track inspection results, to*

*monitor efficiencies in daily or weekly inspection routes, and to better evaluate compliance risks by May 2004.*

### **Review and Monitoring of Program Outcomes**

Our audit involved a limited review of certain aspects of the tobacco tax program. Specifically, we reviewed the charging and collecting of interest and penalties on delinquent floor tax payments, the collection of the floor tax obligations from distributors and retailers, and the accuracy and completeness of inspection reports and the inspection database.

Our testing identified several examples of program errors that probably should have been prevented or detected, and subsequently corrected, by TCU staff or management, or both. Specifically, we found:

- An employee waived penalty and interest charges without proper documentation of good and sufficient cause in violation of department rules.
- A computer program failed to record penalties and interest due for late tax reports. This allowed approximately \$16,000 to go uncharged during our audit period.
- The results of the November 2002 floor tax collections were not closely reviewed. We found that some cigarette distributors and retailers had failed to report to the department, and others appear to have under-reported the amount of tax due. Our limited review identified up to \$318,700 in unpaid floor taxes during our audit period.
- Data entry errors in automated tobacco tax records appear to have occurred at a high rate. Of 51 records we reviewed, 11 (22 percent) required correcting entries.
- Inspection reports were not always complete, and many were missing.

These problems probably could have been prevented or identified earlier with an adequate supervisory and monitoring structure in place. An effective structure includes clear policies, procedures, and lines of responsibility covering all key operations. The TCU was operating with few written policies and procedures, and in at least one instance without clear lines of responsibility. This absence of formal guidance and clarity of responsibility appeared to be a contributing factor in many of the areas our audit identified for improvement.

### **Establishing Program Goals and Outcomes**

It is difficult to determine the effectiveness and efficiency of a program in the absence of performance goals and measures. During the 2001-2003 biennium, the program's only significant goal was generation of \$8.6 million in additional revenue. While the program met the target, we found that the TCU did so without developing the basic structure required for effective program oversight.

Best practices require that a systematic process exist for measuring program results. This process usually involves reporting of measurable program outputs. Developing such standards in conjunction with comprehensive policies and procedures will enable program management to fairly evaluate staff performance. Further, having standards in place will facilitate identification of employee training needs.

**We recommend** that the department:

- Develop policies and procedures covering all key TCU operations. These policies should clearly define supervisors' responsibilities.

### **AGENCY'S RESPONSE**

*Management agrees. Policies and procedures covering all key TCU op-*

## Audit Results (continued)

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erations will be completed by June 2004.

- Establish performance goals for the program and each employee classification similar to goals established for other programs in the department. Goals could include frequency of inspections, inspections per inspector, dollars identified through audit, audits closed periodically, and possibly audit leads generated.

### AGENCY'S RESPONSE

*Management agrees. TCU management has established initial performance goals for auditors. Performance goals for the program and each employee classification will be completed by May 2004.*

- Ensure that supervisors and staff receive adequate training in their areas of responsibility.

### AGENCY'S RESPONSE

*Management agrees. TCU will ensure that supervisors and staff receive adequate training in their areas of responsibility.*

- Take steps, where cost effective and reasonable, to collect the taxes, penalty and interest identified as unpaid by this audit.

### AGENCY'S RESPONSE

*Management agrees. TCU will take steps, where cost effective and reasonable, to collect the taxes, penalty and interest identified as unpaid by this audit. TCU plans to complete this action by July 2004.*

### Agency Accomplishment

As of October 2003, policies and procedures were being written. Recruitment and hiring of new staff was underway. Department managers reported that one additional TCU supervisory position had been established.

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## Objectives, Scope and Methodology

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The purpose of this audit was to determine if the Department of Revenue was deploying its resources in a manner that maximized compliance oversight and tobacco tax collections.

We interviewed key program managers and Task Force staff members to gain an understanding of program operations. We researched state statutes and rules and performed a survey of other states' tobacco tax compliance programs.

We obtained access to the department's online records in order to review the program's electronic records.

We requested and received a download of information from the

TCU's inspection database. Our intent was to plan and conduct inspections and contrast our results with those of the program's inspectors. During validation testing of the inspections data, we discovered inconsistencies among the number of inspections reported to management, the inspections database and supporting documentation. Further testing found that supporting documentation was missing. As a result, we determined that we could not rely upon this data for the use we had originally intended. We conveyed our concerns about the reliability of this data to the department.

We accompanied one program inspector on an inspection trip. Later, we

planned an inspection trip and conducted inspections in cooperation with a second program inspector.

We also reviewed the work of the program's auditor. We examined audit files of both completed and in process audits. Further, we examined records of audit leads provided by inspectors and the auditor's pending cases.

We conducted our fieldwork during the period April 2003 through October 2003. We conducted our work according to generally accepted government auditing standards.



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*The courtesies and cooperation extended by the officials and staff of the  
Department of Revenue were commendable and much appreciated.*

*This report, which is a public record, is intended to promote the best possible  
management of public resources. Copies may be obtained by mail at:*

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