

ALASKA STATE LEGISLATURE

LEGISLATIVE BUDGET AND AUDIT COMMITTEE

Division of Legislative Audit



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SUMMARY OF: A Special Report on the Department of Revenue, Oil and Gas Tax Audit Process, June 20, 2014

PURPOSE OF THE REPORT

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted a performance audit of the Department of Revenue's (DOR) oil and gas tax audit process. This audit evaluates the effectiveness of DOR's oil and gas production tax audit group (audit group) by comparing audit processes used for relevant tax structures and by comparing the current process to industry best practices. Impediments to the audit process were identified and recommendations for improvements were made. The audit also examined DOR staff's professional qualifications and assessed whether resources were sufficient to address the audit backlog.

REPORT CONCLUSIONS

In summary, the audit concluded that under Petroleum Production Tax (PPT) and Alaska's Clear and Equitable Share (ACES), fewer tax return audits were conducted, and audits took an average of 2.5 times longer to complete than under the Economic Limit Factor. Despite fewer completed audits, PPT and ACES audits continued to cover a significant portion of annual tax liabilities and resulted in \$488 million in assessments for the 2006 and 2007 tax years.

The audit found that oil and gas auditors were qualified to perform audit functions and auditors met the minimum education and experience requirements for their positions. However, productivity and effectiveness could be improved by implementing a formal training program.

As of March 31, 2014, the audit group had a backlog of 55 tax return, 023 credit, and 025 credit audits. While DOR's backlog of credit audits can be addressed by current resources, it is unclear if DOR will be able to address the backlog of tax return audits. DOR management is confident of its ability to address the backlog. However, our audit does not support management's level of confidence. Given the number of planned audits and the impediments to the audit process identified as part of this audit, there is a risk that DOR will not be able to meet its audit mandate. This risk can be mitigated by implementing improvements to the audit process.

Overall, the audit concluded that the audit group's processes do not follow best practices applied by the auditing profession and other states in five areas: project management, risk assessment, materiality, audit documentation, and taxpayer communication. Implementing auditing best practices could improve DOR's audit quality and timeliness. (See Recommendation No. 1.)

The Tax Division is implementing the Tax Revenue Management System (TRMS) which could address several findings identified above. However, because the system is in the early development stages and the oil and gas production tax configurations have not been defined, the TRMS' success in addressing these issues is difficult to predict.

FINDINGS AND RECOMMENDATIONS

Recommendation No. 1

The Tax Division director should ensure the procedures for conducting oil and gas audits incorporate best practices.

DOR audit and review procedures do not reflect auditing best practices in the following areas: project management, risk assessment, materiality, audit documentation, and taxpayer communication. Applying best practices may help the audit group comply with the statutory time limit by improving audit efficiency and effectiveness.

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July 18, 2014

Members of the Legislative Budget
and Audit Committee:

In accordance with the provisions of Title 24 of the Alaska Statutes, the attached report is submitted for your review.

DEPARTMENT OF REVENUE OIL AND GAS TAX AUDIT PROCESS

June 20, 2014

Audit Control Number
04-30074-14

This audit evaluates the effectiveness of the Department of Revenue's oil and gas production tax audit group (audit group) by comparing audit processes used for relevant tax structures and by comparing the current process to industry best practices. Impediments to the audit process were identified and recommendations for improvement were made. The audit also examined DOR staff's professional qualifications and assessed whether resources were sufficient to address the current audit backlog.

The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Fieldwork procedures utilized in the course of developing the findings and recommendations presented in this report are discussed in the Objectives, Scope, and Methodology.

A handwritten signature in black ink, appearing to read "K. Curtis".

Kris Curtis, CPA, CISA
Legislative Auditor

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OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with Title 24 of the Alaska Statutes and a special request by the Legislative Budget and Audit Committee, we have conducted a performance audit of the Department of Revenue's (DOR) oil and gas tax audit process.

Objectives

The primary audit objectives were:

- Identify the effectiveness of DOR's audit function in terms of audit coverage, level of assessments, and timeliness when compared to the audit function under the prior tax structure, the Economic Limit Factor (ELF).
- Identify impediments to the process of auditing Petroleum Production Tax (PPT) and Alaska's Clear and Equitable Share (ACES) returns and make recommendations for improvement.
- Examine DOR audit staff's professional qualifications and experience levels and determine if resources are sufficient to fulfill audit requirements.
- Examine the Tax Division's methodology for conducting audits and determine if the agency is following industry best practices.
- Identify the status of audits including any backlog and DOR's plan for addressing the backlog.
- Evaluate whether the use of joint interest billings (JIBs) as part of the audit process is in accordance with Alaska Statutes.

Scope

This audit reports on:

- Tax return and credit audits covering the 2000 through 2005 (ELF) tax years and the 2006 through 2013 (PPT and ACES) tax years completed as of March 31, 2014.
- Tax return and credit reviews completed between January 1, 2013, and March 31, 2014.

- DOR's oil and gas production tax audit group (audit group) qualifications and experience as of March 31, 2014.
- Industry best practices promulgated by the American Institute of Certified Public Accountants (AICPA) and the United States (U.S.) Government Accountability Office (GAO) and applied by the oil and gas audit groups in Texas, North Dakota, Utah, New Mexico, and Colorado.
- The audit backlog as of March 31, 2014.
- The audit group's use of JIBs during the period of April 1, 2006, through March 31, 2014 (under PPT and ACES tax structures).

Methodology

To compare the current PPT and ACES audit coverage, level of assessments, and audit function timeliness with the prior ELF tax structure, we:

- Compared the 2005 ELF, the 2006 PPT, and the 2012 ACES tax laws (Alaska Statutes 43.55) and evaluated how the changes impacted audit functions.
- Compared the standard ELF tax return program with PPT and ACES tax return audit programs and evaluated audit procedures against applicable statutes and regulations.
- Reviewed a list of 2000 through 2006 tax year oil and gas audit settlements.
- Interviewed appeals group representatives to gain an understanding of the appeals process.
- Evaluated the number of audited oil and gas fields by examining audit narratives for ELF and detailed workpapers for PPT and ACES audits.
- Examined tax return and credit audit narratives for the 2000 through 2013 tax years that were completed as of March 31, 2014. Using these narratives, we determined assessments, dollar coverage, number of audits completed for each tax year, and time to complete each audit (measured from the tax return due date to assessment date).

To identify impediments to the process of auditing PPT and ACES returns and make recommendations for improvement, we:

- Reviewed a sample of audits and reviews completed between January 1, 2013, and March 31, 2014. For the sample:

- Six of 35 tax return reviews were selected; five were randomly selected to allow for statistically extrapolated results, and one was judgmentally selected to address a potential risk identified during audit planning.
- Two of five tax return audits were judgmentally selected to ensure our audit examination included the most recent audits of large taxpayers.
- Nine of 174 credit reviews were randomly selected to allow for statistically extrapolated testing results.
- Four of 12 credit audits were judgmentally selected to ensure both 023 and 025 audits were represented. Additionally, the recently completed credit audits were given priority to ensure our audit evaluated the most current audit group's processes.
- Examined audit and review files to determine whether reviews and audits were performed in accordance with state statutes, regulations, internal procedures, and industry best practices. The results of audit procedures can be projected to the universe of completed reviews and audits.
- Reviewed the Tax Revenue Management System (TRMS) proposal and inquired with DOR management, with contractors implementing the system, and with three states using the TRMS (North Dakota, Utah, and Colorado) to gain an understanding of the TRMS design and available features.
- Assessed internal control procedures for ensuring:
 - Each taxpayer's annual return and 023 credit application was reviewed by an auditor.
 - Tax return and credit reviews and audits were examined by another person in accordance with the audit group's procedures. The number of examiners depended on the project type, and sometimes included a peer auditor, a supervisor, an audit master, and the Tax Division director.
 - Division auditors used a written program to conduct audits and review tax returns and credits.

To examine DOR audit staff's professional qualifications and experience levels and determine if resources were sufficient to fulfill audit requirements, we:

- Surveyed DOR's oil and gas tax auditors to obtain information about their education, experience, and professional certifications, and about the percentage of time spent on different work tasks.

- Corroborated survey results regarding the number of years auditors worked in the audit group by reviewing the State of Alaska payroll system.
- Identified minimum qualifications for each oil and gas audit position using Workplace Alaska.
- Verified that auditors met the minimum qualifications for their positions as of March 31, 2014.
- Compared the minimum qualifications for DOR auditors to the minimum qualifications in five comparable state governments (described below) and to comparable State of Alaska positions selected based on pay range and job duties.
- Requested and reviewed auditors' estimated number of hours it took to perform audits and reviews completed between January 1, 2013, and March 31, 2014.

To determine if the agency is following industry best practices, we:

- Examined the audit group's methodology for conducting audits.
- Reviewed the AICPA's *Statements on Auditing Standards* and the GAO's *Generally Accepted Governmental Auditing Standards* to determine best audit industry practices.
- Reviewed information about oil and gas industry and tax audit functions in two countries (Norway and Iceland) and nine states with significant oil and gas production (Texas, North Dakota, California, Oklahoma, Utah, New Mexico, Wyoming, Colorado, and Louisiana).
- Selected the five states most comparable to Alaska¹ (Texas, North Dakota, Utah, New Mexico, and Colorado) using the following criteria:
 - Presence of state oil and gas production audit function;
 - Production tax structure (net versus gross);
 - Number of oil and gas taxpayers;
 - Amounts of oil and gas tax revenues collected; and
 - Ability to obtain information about the audit function.
- Interviewed oil and gas tax audit groups' representatives in the five states listed above to learn about their audit policies, practices, and procedures.

¹Countries were found not comparable.

- Reviewed statutes, regulations, audit manuals, reports, and other pertinent information to corroborate the inquiries with representatives in selected states.

To identify the status of audits, including any backlog and DOR's plan for addressing the backlog, we:

- Identified the audit group's planned tax return and credit audits that comprised the audit backlog as of March 31, 2014.
- Evaluated planned audits against the statutory timeline.
- Inquired with the audit group's management to determine the backlog status and the plan for addressing it.

To evaluate whether using JIBs is in accordance with Alaska Statutes, we:

- Inquired with the audit group's management to identify procedures for using JIBs;
- Reviewed two of four recently issued tax return audits to confirm our understanding of procedures for the use of JIBs;
- Reviewed Alaska Statutes and pertinent regulations for 2006 and 2012 to determine how the intended use of JIBs changed from PPT to ACES.

Additional audit procedures necessary to address the audit objectives included:

- Reviewing Division of Legislative Audit workpapers for financial audits conducted on DOR's oil and gas tax revenues from FY 05 through FY 13.
- Reviewing the *Comprehensive Plan and Feasibility Study* issued by Fast Enterprise, LLC in October of 2010 to support the Tax Division's need for a new tax system.
- Researching GAO reports and audit reports issued in other states to determine impediments identified and recommendations made for oil and gas audit functions.
- Reviewing organizational charts as well as the State of Alaska payroll system and Alaska Data Enterprise Reporting System reports to determine the number of positions filled and vacant in 2005 through 2014 (as of March 31st).
- Inquiring with DOR's network specialist and performing a walkthrough to access the data security.

- Researching the use of the Joint Audit Data Exchange System for performing tax audits.

ORGANIZATION AND FUNCTION

The Department of Revenue's (DOR) Tax Division is charged with collecting 22 state taxes and administering the associated tax laws, which include auditing taxpayers for compliance. The oil and gas production tax audit group (audit group) is one of the Tax Division's three audit groups. The audit group reviews and audits oil and gas production tax returns and tax credit certificate applications for compliance with tax laws. The audit group is also responsible for assessing additional taxes and issuing tax credits for exploration, capital expenditures, and certain losses. Cash purchases of eligible tax credit certificates are also processed by this group.

Exhibit 1

The Number of Available and Filled Positions in the Audit Group for 2005 through 2014		
Year*	Number of Positions	Positions Filled
2005	14	10
2006	21	11
2007	20	13
2008	21	17
2009	21	15
2010	21	19
2011	20	19
2012	20	19
2013	22	18
2014	22	19

*Year is as of December 31st except for 2014 which is as of March 31, 2014.

Each month, the audit group collects information regarding oil and gas sale contracts and invoices, lease expenditure data, joint interest billings (JIB), and production data. This data is used in audits and economic analyses. The audit group also assists in issuing advisory bulletins on oil and gas matters, regulatory interpretations, and in developing and drafting regulations.

As of March 31, 2014, the audit group was staffed with 16 auditors and three tax technicians that provide support to auditors. The 16 auditors are divided between the tax return group (nine auditors) and tax credit group (seven auditors). Exhibit 1 shows available and filled positions for 2005 through 2014. The number of filled positions has remained relatively stable since 2010.

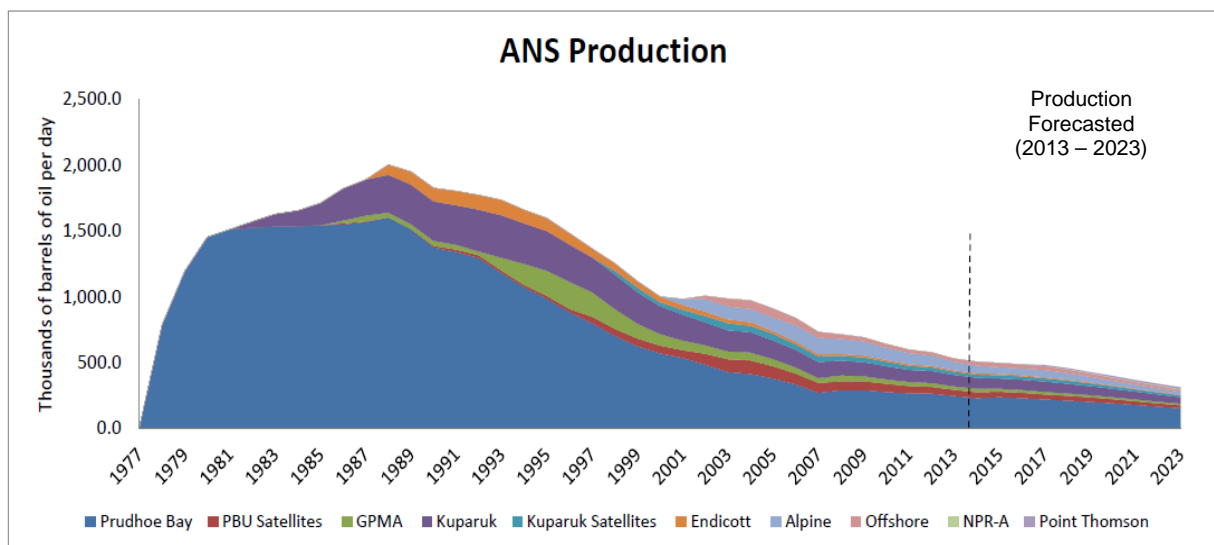
The state accounting system reports audit group personal services expenditures ranged between \$1.9 and \$2.4 million from 2010 through 2013.

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BACKGROUND INFORMATION

Discovery of the Prudhoe Bay oil field on Alaska’s North Slope (ANS) in 1968 established Alaska as a world-class oil and gas producer.² North Slope oil production peaked in 1988, and has been steadily declining since.³ (See Exhibit 2.) Despite the decline, Alaskan oil production still accounted for approximately seven percent of United States (U.S.) domestic production in 2013, according to the U.S. Energy Information Administration. In the same year, Alaska ranked fourth behind Texas, North Dakota, and California in daily oil production.⁴

Exhibit 2



Source: DOR, “Alaska Oil Production History FY 1959-2012 (Average in Thousands of Barrels per Day)”

Oil production and related production tax is important to funding state operations. Thirty-six percent of FY 13 general fund revenues (\$10.3 billion) came from oil and gas production taxes (\$3.7 billion).

The Alaska oil and gas production tax structure has undergone several significant transformations over the last eight years.

A steady decline in oil production prompted state lawmakers to change the oil and gas tax structure in an effort to increase revenues and boost oil and gas production. Changes included several tax credits to incentivize exploration and development of Alaskan oil and gas resources. A brief timeline of these changes is as follows.

²Alaska Oil and Gas Conservation Commission, “Pool Statistics Prudhoe Bay, Prudhoe Oil Pool”.

³Department of Revenue, “Alaska Oil Production History FY 1959-2012 (Average in Thousands of Barrels Per Day)”.

⁴U.S. Energy Information Administration, Crude Oil Production.

- The production tax structure called the Economic Limit Factor (ELF) was in place from 1977 to April 2006. ELF was a gross production value-based tax.
- House Bill 3001, also known as the *Petroleum Production Tax (PPT)*, was signed by Governor Frank Murkowski on August 19, 2006. Most PPT provisions became effective April 1, 2006. PPT changed the Alaska tax structure from a gross production to a net production value-based tax which expanded the tax calculation by allowing deductions for lease expenditures. PPT also modified the alternative tax credit for oil and gas exploration (the 025 credit), and introduced a credit for certain losses and expenditures (the 023 credit) in addition to other credits. (See Exhibit 3 on page 11.)
- House Bill 2001, known as *Alaska's Clear and Equitable Share (ACES)*, was signed by Governor Sarah Palin on December 19, 2007. The majority of ACES became effective on July 1, 2007, although some provisions were retroactive to April 1, 2006. ACES is also a net production value-based tax. ACES increased the tax rate and added more tax credits.
- Senate Bill 236, House Bill 280, and Senate Bill 309, signed in 2010 by Governor Sean Parnell, added new tax credits and amended certain provisions of the ACES tax structure.
- Senate Bill 23, signed on May 30, 2012, further modified the ACES tax structure by changing exploration credits and establishing a tax ceiling for areas outside of Cook Inlet and the North Slope.
- Senate Bill 21, known as the *More Alaska Production Act (MAPA)*, was signed on May 21, 2013, by Governor Sean Parnell. MAPA is a net production value-based tax with an effective date of January 1, 2014, for most provisions. Because the first annual tax returns are not due until March 31, 2015, the audit impact of MAPA is outside the scope of this audit.
- Senate Bill 83, signed on June 26, 2013, added a new section for assigning tax credits.
- Senate Bill 138, signed on May 8, 2014, amended oil and gas production tax, allowed producers to pay taxes with gas, and clarified tax credits.

Appendix A of this report summarizes the differences between the ELF, PPT, and ACES tax structures.

Oil and gas producers and explorers in Alaska may claim multiple tax credits.

Multiple tax credits are offered to producers and explorers⁵ to incentivize exploration and development of Alaskan oil and gas resources. All credits can be claimed on a tax return, and some can be requested using a separate application. While all credits can be used to offset a taxpayer’s tax liability, some can also be sold to other companies or purchased by the Department of Revenue (DOR). DOR’s oil and gas production tax audit group (audit group) refers to tax credits as 019, 023, 024, and 025 credits based on the applicable statute. Exhibit 3 shows credits available under ELF, PPT, and ACES tax laws.

Exhibit 3

Production and Exploration Tax Credits under ELF, PPT, and ACES						
Statutes	Credit Name	Tax Laws			Claimed on Tax Return	Claimed Separately for Cash Payment
		ELF	PPT	ACES		
AS 43.55.019	Education Credit	X	X	X	X	
AS 43.55.023(a)	Qualified Capital Expenditure Credit		X	X	X	X
AS 43.55.023(b)	Carried-Forward Annual Loss Credit		X	X	X	X
AS 43.55.023(i)	Transitional Investment Expenditure Credit		X	X	X	
AS 43.55.023(l)	Well Lease Expenditures Credit			X	X	X
AS 43.55.024(a)	Middle Earth Credit		X	X	X	
AS 43.55.024(c)	Small Producer Credit		X	X	X	
AS 43.55.025(a)(1)-(4)	Alternative Credit for Oil and Gas Exploration	X	X	X	X	X
AS 43.55.025(a)(5)	Cook Inlet Jack-Up Rig Credit			X	X	X
AS 43.55.025(a)(6)-(7)	Frontier Basin Credits			X	X	X

DOR Tax Division’s audit process ensures that oil and gas production taxes collected and tax credits issued are complete and accurate.

Part of the Tax Division’s mission is to ensure that all earned tax revenues are collected and appropriate credits are issued. The Tax Division’s audit group serves as the main check over the accuracy of oil and gas taxes. The audit group is responsible for confirming that taxpayers correctly pay taxes owed, and for approving and issuing tax credit certificates. To ensure compliance, the audit group has four main processes in place: tax return reviews, tax return audits, credit reviews, and credit audits.

⁵Both producers and explorers file annual tax returns and claim credits. However, only producers pay taxes and claim refunds.

Tax Return Reviews

Annual oil and gas production tax returns are due three months after the tax year ends or by March 31st of the next year. Upon receiving the returns, the audit group performs a due diligence desk review for each filed return. Using written desk review procedures, auditors check for common errors in the calculation of the tax and credits claimed on the return. According to AS 43.55.020(h), a taxpayer is entitled to interest if a refund is not received within 90 days of either March 31st following the taxable year or the date the return was filed, whichever is later. To avoid paying interest, the audit group prioritizes reviewing returns that request a refund within the 90-day window.

Tax Return Audits

Auditors use a standard audit program based on the applicable tax law to perform their audits. Under ACES, the audit group has six years from the date the return was filed to assess any additional taxes.⁶ Based on the audit outcome, the taxpayer is either issued a refund, a no change letter, or an assessment notice. Tax return audits result in the highest dollar assessments.

Credit Reviews

Tax credits may be claimed on an annual return or at any time during the operation year. With the exception of the 023 and 025 credits, credits claimed on an annual return are reviewed during the tax return review process or during the tax return audit process if a return is selected for an audit.

Capital expenditure (023) credits not claimed on an annual return go through a due diligence review before a tax credit certificate is issued. According to AS 43.55.023(d), the department is required to grant or deny an 023 tax credit application no later than 120 days after the 023 credit was claimed. Therefore, the audit group works to complete credit reviews within the 120 day window.

Credit Audits

Credit audits are performed on 023 and 025 credits. All 025 exploration credits are audited prior to issuance and a judgmental selection of 023 credits are audited after they have been reviewed and issued. Based on the audit results, the audit group notifies the taxpayer of disallowances for 025 credits or issues an assessment for 023 credits. Credit audits are also subject to the six-year statute of limitations.

⁶Alaska Statute 43.55.075(a).

REPORT CONCLUSIONS

This audit evaluates the effectiveness of the Department of Revenue's (DOR) oil and gas production tax audit group (audit group) by comparing audit processes used for relevant tax structures and by comparing the current process to industry best practices. The audit also examined DOR staff's professional qualifications and assessed whether resources were sufficient to address the current audit backlog.

In summary, the audit concluded that fewer Petroleum Production Tax (PPT) and Alaska's Clear and Equitable Share (ACES) tax return audits were conducted, and audits took an average of 2.5 times longer to complete when compared to the Economic Limit Factor (ELF). Despite fewer completed audits, PPT and ACES audits continued to cover a significant portion of annual tax liabilities and resulted in \$488 million in assessments for the 2006 and 2007 tax years.

The audit found that, although oil and gas auditors are qualified to perform audit functions and auditors met the minimum education and experience requirements for their positions, productivity and effectiveness could be improved by implementing a formal training program.

As of March 31, 2014, the audit group had a backlog of 55 tax return, 023 credit, and 025 credit audits. While DOR's backlog of credit audits can be addressed by current resources, it is unclear if DOR will be able to address the backlog of tax return audits. DOR management is confident of its ability to address the backlog. However, our audit does not support management's level of confidence. Given the number of planned audits and the impediments to the audit process that were identified as part of this audit, there is a risk that DOR will not be able to meet its audit mandate.

Overall, the audit concluded that the audit group's processes do not follow best practices applied by the auditing profession and other states in five areas: project management, risk assessment, materiality, audit documentation, and taxpayer communication. Implementing auditing best practices could improve DOR's audit quality and timeliness. (See Recommendation No. 1.)

The Tax Division is implementing the Tax Revenue Management System (TRMS) which may address several findings identified above. However, because the system is in the early development stages and the oil and gas production tax configurations have not been defined, the TRMS' success in addressing these issues is difficult to predict.

More detailed conclusions are presented on the following pages.

Audit coverage under PPT and ACES has changed in a number of significant aspects when compared to ELF.

While the average number of completed tax return audits decreased from ELF to PPT and ACES, the audit group continued to audit a significant portion of tax liabilities, and the number of oil and gas fields reviewed in each audit remained materially the same. Changes in the tax law resulted in an increased number of completed credit audits as well as an increased amount of information reviewed as part of each audit. The changes in audit coverage are described in detail below.

The average number of completed tax return audits decreased, and the average number of completed credit audits increased.

The average number of tax return audits completed decreased from 10 under ELF to five under PPT and ACES. (See Exhibit 4.)

Although the number of completed audits decreased, it is important to note that the number of producers who paid taxes decreased under PPT and ACES with the introduction of the small producer credit, which reduced the tax liability for some producers to zero. DOR management stated that 100 percent of producers who paid taxes continue to be audited under PPT and ACES. Because DOR management was unable to provide documentation supporting the number of producers that paid taxes between 2000 and 2007, the claim could not be substantiated.⁷

As shown in Exhibit 3 (page 11), there were fewer credits available to producers and explorers under ELF. The passage of PPT and ACES added several new credits that required extra audit effort by the audit group. To address the need, DOR allocated additional resources to credit audits creating a separate credit audit group. As a result, the total number of credit audits completed under PPT and ACES increased to 55 from 10 under ELF. The increase in credit audits under PPT and ACES is reasonable given the increase in available credits under these tax structures.

Exhibit 4

Number of Completed Tax Return Audits under ELF and PPT/ACES		
Tax Year	Completed Audits	Tax Structure
2000	9	ELF
2001	13	
2002	12	
2003	11	
2004	10	
2005	5	
2006	9	
Average ELF	10	
2006	4	PPT/ACES
2007	5	
Average PPT/ACES	5	

⁷According to the Department of Natural Resources, there were between 17 and 31 oil and gas producers in Alaska between 2000 and 2007; however, no information is available on the number of producers who paid production taxes in those years.

The audit coverage expressed in tax liabilities audited increased along with tax payments collected.

There was a significant increase in the audit coverage in dollars from the 2001 through 2007 tax years. The average audit coverage in dollars changed from approximately half a billion a year under ELF to \$2.5 billion under PPT and ACES. The increase in audit coverage generally followed the increase in the collected oil and gas production tax revenues. The audit group continues to audit the significant portion of the collected revenues under PPT and ACES even though the number of audited producers decreased.

The amount of information reviewed as part of each audit and the resulting workload has increased with changes in the tax laws.

A comparison of the standard tax return audit programs for ELF and ACES showed that some audit procedures, such as volume verifications, remained the same. However, new procedures relating to lease expenditure and credit testing were added to PPT and ACES audit programs.

Lease expenditures constitute major deductions from the gross produced value when calculating tax liability. They were first introduced in the PPT tax structure and remained under ACES. This change in the tax structure necessitated an expansion of PPT and ACES audit programs to include the verification of lease expenditures deducted as part of the tax calculation. Auditing lease expenditures has resulted in a significant increase to DOR auditors' workload.

The expansion of capital and exploration credits under ACES allowed credits to be applied against tax liabilities sold to other companies or purchased by the State. The complexity of the tax laws and increase in the number of available credits necessitated the addition of a review of the claimed credits to the audit program.

The coverage of oil and gas fields audited did not change.

ELF tax return audits were performed for specific oil or gas fields, while PPT and ACES audits are performed on specific taxpayers. Despite this change, a review of audit narratives for the 2000 through 2007 tax years showed the fields audited under ELF for selected taxpayers were also audited under PPT and ACES. Overall, audit coverage of production fields has not materially changed.

PPT and ACES tax return audits have taken on average 2.5 times longer to complete than ELF audits.

A comparison of the tax return due dates to the audit completion dates (the date when an assessment letter was issued to a taxpayer) showed a considerable increase in the average

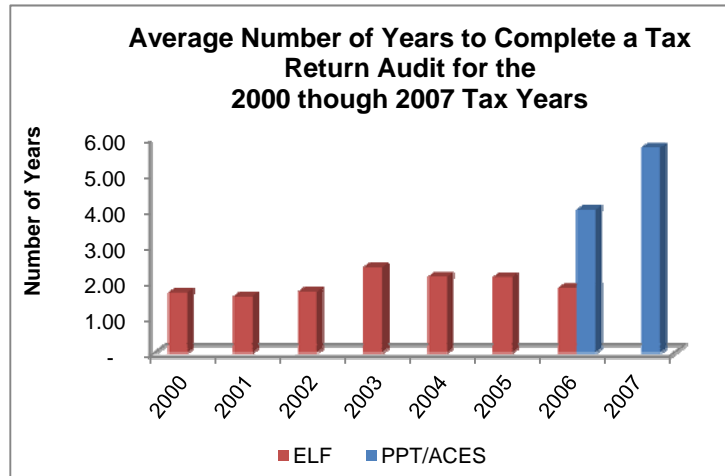
number of years it took to complete a tax return audit.⁸ On average, it took two years to complete an ELF audit and almost five years to complete a PPT or ACES audit. (See Exhibit 5.)

The reported timeframe does not mean that the audits were actively worked on for the entire five years. Typically, audits were not started immediately following receipt of the tax return, or the audits were started and then worked on intermittently.

DOR management reported that PPT and ACES tax return audits took longer to complete because of the complexity of the newly adopted tax laws which was

compounded by the existence of two tax structures in the same year. The 2006 tax year was split between ELF and PPT, and the 2007 tax year between PPT and ACES. Additionally, the ability to start audits was affected by taxpayers submitting multiple amendments to their original returns.

Exhibit 5



In comparison to ELF, audit assessments increased significantly under PPT and ACES; however, collectability is unknown at this time.

Oil and gas audit narratives reviewed showed a significant increase in PPT and ACES tax return audit assessments during the last two years. (See Exhibit 6 on following page.) The total assessments for two years of PPT and ACES audits (\$488 million) were over five times higher than the total ELF assessments for the seven years prior to PPT and ACES (\$92 million).

The number and type of credits available were significantly expanded under PPT and ACES. (See Exhibit 3 on page 11.) The increase in available tax credits resulted in more credit audits and higher total assessments or disallowances.⁹ (See Exhibit 7 on following page for the credit assessment under ELF, PPT and ACES.)

⁸Because DOR oil and gas auditors do not track actual hours spent on an audit, the difference between the return due date and the audit completion date were the only objective pieces of information available to determine the audit timeline.

⁹An *assessment* is an amount that a taxpayer is required to pay back to the State. The assessment is calculated after a credit certificate is issued or the credit is used to offset the tax liability. *Disallowance* is a reduction in the credit amount and is calculated before the credit certificates are issued.

Exhibit 6

Tax Return Audit Assessments for Tax Years 2000 through 2007					
Tax Year	Assessments				Tax Structure
	Tax Due	Interest	Penalty	Total	
2000	\$ 22,566,305	\$ 10,521,878	\$537,059	\$ 33,625,242	ELF
2001	21,235,105	9,954,514	-	31,189,619	
2002	6,211,704	2,983,200	-	9,194,904	
2003	5,349,888	4,640,257	-	9,990,145	
2004	2,288,929	966,001	22,550	3,277,480	
2005	2,246,840	748,116	-	2,994,956	
2006	1,285,449	506,783	-	1,792,232	
Total ELF	\$ 61,184,220	\$ 30,320,749	\$559,609	\$ 92,064,578	
2006	50,421,769	27,511,062	-	77,932,831	PPT/ ACES
2007	181,502,961	228,375,160	-	409,878,121	
Total PPT/ACES	\$231,924,730	\$255,886,222	-	\$487,810,952	

The assessments’ collectability is unknown because taxpayers can contest audit assessments. Taxpayers may appeal an assessment to the appeals section in DOR, then to the Office of Administrative Hearing (OAH) in Department of Administration, and finally to the Alaska Supreme Court. At any point in the appeal process, the taxpayer and DOR may settle on an amount acceptable to both parties.

According to DOR management, even if taxpayers choose to appeal the assessment, they often pay the assessed amounts “*under protest*” to avoid incurring

Exhibit 7

Credit Audit Assessments for Tax Years 2004 through 2013			
Tax Years	Assessment or Disallowance		
	Tax Due or Disallowed	Interest	Total
2004-2005 ELF Total	\$ 3,320,914	-	\$ 3,320,914
2006-2013 PPT/ACES Total	\$70,725,631	\$9,930,336	\$80,655,967

additional interest on the assessment. If at some point the original assessment is reduced through a settlement or administrative or court action, the State will refund the taxpayer the difference along with any accrued interest. The statutory interest rate before January 1, 2014, was 11 percent. Effective January 1, 2014, the statutory interest rate is three percent above the annual federal rate.¹⁰

Because there are no historical collection rates for PPT and ACES, the collectability of the current assessments could not be predicted.

¹⁰Alaska Statute 43.05.225(1)

Oil and gas auditors are qualified to perform audit functions; however, improvements in training are needed.

This audit examined the professional qualifications and experience level of DOR's audit staff. Auditors' qualifications were evaluated by reviewing education, experience, certifications, minimum job requirements, training, and supervision. Detailed conclusions regarding each of these areas are described below.

Auditors have sufficient education and experience to perform assigned functions.

As of March 31, 2014, all 16 auditors have at least a bachelor's degree, and two have master's degrees. Additionally, four auditors are certified public accountants (CPA), and two hold other relevant certifications.

On average, the 16 auditors have seven years of experience in the audit group. The tax return group averages 8.5 years of Tax Division experience, and the credit group averages five years.

In addition to the years of experience in the audit group, the majority of auditors have audit and/or oil and gas experience from their previous employment. The average years of audit experience outside of DOR is 7.3 years, and oil and gas experience outside of DOR is 3.9 years.

The first significant change in the tax code (PPT) was implemented on April 1, 2006, and coincided with significant turnover in the audit group. All but three auditors employed as of March 31, 2014, were hired after the implementation of PPT.

Auditors met the minimum requirements for their positions, and with one exception, the minimum requirements are consistent with the in-state comparables.

As of March 31, 2014, all auditors met the minimum qualifications for their current positions.

Except for the audit master position, DOR's minimum qualifications are consistent with comparable in-state positions. For the highest paying audit master position, no minimums for education or experience were specified, while each of the comparable exempt and partially exempt positions had minimum qualifications listed. The only audit master position description is in AS 39.25.110(42), which states:

Oil and gas audit masters [should be] employed in a professional capacity by the Department of Revenue...to collect oil and gas revenue by developing policy, conducting studies, drafting proposed regulations, enforcing regulations, and directing audits by oil and gas revenue auditors.

Auditors would benefit from a formalized training program.

A survey of the auditors showed that 19 percent disagree with the statement, “*They received appropriate levels of training to perform their duties.*” Survey results are provided in Appendix C of this report.

Four of five comparable states reviewed offered some form of a structured training program to their auditors. While audit group management has begun working on a training program, the program is still in its infancy. A formalized training program may:

- Improve effectiveness by providing auditors with increased knowledge and expertise to carry out their tasks;
- Increase productivity by decreasing the time it takes to learn job duties; and
- Increase standardization which could result in improved work consistency, quality, and efficiency.

DOR uses joint interest billings (JIBs) in accordance with Alaska Statutes.

This audit evaluates whether DOR’s use of JIBs is in accordance with Alaska Statutes. *JIBs* are billings made by an operator to the other working interest owners (non-operators) for the costs of joint exploration, development, and operations. In a JIB arrangement, the operator first records the project’s expenses in total and then allocates the charges to the non-operators as specified in the joint operating agreement. Upon receiving a JIB, a non-operator can audit the JIB for compliance with the joint operating agreement.

In Alaska Statutes, the use of JIBs for oil and gas audits and reviews was first introduced by PPT in 2006. Under PPT, auditors were allowed to rely on JIB audits if joint operating agreement provisions were substantially similar to the statutory definition of *lease expenditures* and if JIBs were effectively audited by non-operators.¹¹

When the PPT law was repealed a year later, statutes that described the use of JIBs were also removed. Under ACES, JIBs are mentioned in AS 43.55.030(f), which states, “*The department may require a producer, an explorer, or an operator of a lease or property to file monthly reports, as applicable, of:...(5) joint interest billings.*”

JIBs are also mentioned in the oil and gas regulations pertaining to the 023 credit (15 AAC 55.320(b)):

Information and documentation that the department will require a producer or explorer to provide in an application for a transferable tax credit certificate

¹¹Alaska Statute 43.55.165(c)-(d).

under AS 43.55.023(d) include; [...] (3) a schedule of the relevant expenditures incurred, identifying any applicable authorizations for expenditure and showing the accounts charged and, in the case of expenditures included in a joint interest billing, the month billed.

Our audit found that JIB audits conducted by nonoperators are not relied upon as material audit evidence by DOR auditors because:

1. Some JIB audits are not performed timely, and waiting for the audit results may lead to the statute of limitations expiring; and
2. JIB audits are performed for compliance with the joint operating agreements. The operating agreement provisions differ from the definition of allowable lease expenditures in Alaska Statutes. Thus, activities allowable under the joint operating agreement may be unallowable under Alaska Statutes.

As of March 31, 2014, the audit group used JIBs as one potential information source for their audits. However, JIBs generally provide little detail about the timing of exploration, development, and production expenditures incurred by an operator. Thus, auditors often requested invoices to determine the allowability of expenditures reported on JIBs.

According to AS 43.55.040(1)-(2), DOR can require additional necessary information and examine all taxpayer books, records, and files to compute the tax amount. Thus, DOR's current use of JIBs is within its statutory authority.

Implementing audit practices generally accepted by the auditing profession and applied in other states could improve the quality and timeliness of DOR's audit work.

While the audit group is not required to follow industry standards, there are some practices that, if implemented, could significantly improve the quality and timeliness of DOR's audit work. Best practices were identified based on a review of the standards promulgated by the American Institute of Certified Public Accountants (AICPA) and the United States Government Accountability Office (GAO), on interviews with representatives from five different states with comparable oil and gas audit functions, and on a review of pertinent supporting documentation. Appendix B of this report compares the audit group in Alaska with comparable audit groups in five other states. We recommend DOR's tax director adopt industry best practices in the following five categories. (See Recommendation No. 1.)

Project Management

The concepts of project management and adequate supervision are fundamental parts of auditing standards promulgated by the AICPA and GAO. Four of five researched states have procedures to actively monitor and control their audit projects.

An examination of DOR credit reviews, credit audits, tax return reviews, and tax return audits showed the following:

- Projects do not have established budgets or timelines (other than the statutory timelines) to complete the work. Auditors do not track their time by project.
- Supervisory reviews are only performed after a project is completed and, sometimes, several months after it is completed. In the case of one audit, the supervisory review was completed eight months after the workpapers were ready for review.
- There is insufficient evidence that auditors followed-up on requests for supporting documentation from taxpayers in a timely manner.

A survey of audit group employees showed that 19 percent disagreed with the statement that projects are managed to ensure performance is effective and efficient. Implementing project management principles would allow audit group management to better monitor audit processes and outcomes, resulting in more efficient and effective audits.

Risk Assessment

The AICPA's *Statement on Auditing Standards* states, "*Risks...are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence.*"

A DOR audit master performs a risk assessment to select taxpayers to examine and identify areas needing specific followup. These risk assessment procedures are not documented in DOR manuals and are done by a single individual. Furthermore, the current audit procedures do not focus the audit work on material and risky areas. Consequently, audit scopes are broad, and immaterial items are reviewed.

All five comparable states apply various risk assessment procedures. While each state's tax structure and audit procedures are unique, a common factor is that risk assessments are performed to select taxpayers for audit and to focus audits on the highest risk areas. If implemented in DOR, risk assessment could help identify material assessments in less time. Documenting the risk assessment procedures helps with standardizing operations and ensures consistency in case of staff turnover.

Materiality

Materiality is a key concept in auditing. According to the AICPA's *Statements on Auditing Standards* and the GAO's *Government Auditing Standards*, materiality is used to determine the nature, timing, and extent of audit procedures.

The audit group does not have procedures for establishing materiality thresholds. Furthermore, materiality determinations are not documented in audit or review workpapers. As a result, audit scopes are broad, and immaterial items are reviewed.

Three of five states apply the concept of materiality in their audits. The remaining two either have a simple tax structure where auditors perform only volume verification or have a materiality level specified in statute.

Establishing and applying a materiality threshold would help the audit group improve efficiency by reducing time spent reviewing immaterial items.

Audit Documentation

AICPA and GAO auditing standards require auditors to prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

- The nature, timing, and extent of the audit procedures performed;
- The results of the audit procedures performed and the audit evidence obtained; and
- Significant findings or issues arising during the audit, the conclusions reached, and significant professional judgments made in reaching those conclusions.

DOR's audit documentation does not provide for effective and efficient operations because documentation cannot be efficiently identified and reviewed. While credit and tax return audit and review files were found to include results and conclusions, the methodologies and significant auditor decisions were not sufficiently documented. The relationship between workpapers and audit programs was not readily apparent. Furthermore, procedures that supported conclusions could not be ascertained without assistance. We also found that paper and electronic files were not consistently organized. Electronic files lacked a standard naming convention and file structure, and certain information was duplicated between the paper and electronic files.

Improving audit documentation could enhance support for audit assessments, help with successfully transitioning projects from one auditor to the next, and reduce the time spent on peer and supervisory reviews.

Taxpayer Communications

DOR tax auditors send taxpayers an engagement letter informing the taxpayer of an audit. However, the engagement letter does not communicate taxpayers' rights and responsibilities under the audit.

All five comparable states have a *Taxpayers' Bill of Rights* which is a document outlining taxpayers' rights and responsibilities under an audit. The Taxpayers' Bill of Rights is given to a taxpayer at the beginning of an audit with the goal of protecting a taxpayer's rights without interfering with a state's responsibility to collect taxes and assess the accuracy of returns.

Thirty-eight percent of auditors surveyed listed the format and timeliness of getting information from taxpayers as an impediment to the audit process under ACES. Adopting a Taxpayers' Bill of Rights or similar communication will help auditors establish an understanding and expectations with taxpayers at the beginning of each audit. Clearly defined expectations could assist in obtaining information from taxpayers more timely and in usable formats.

Lack of standardization impedes the oil and gas audit process.

Sixty-three percent of DOR auditors surveyed listed a lack of consistency in manual processes and/or a lack of automation as impediments to the process of auditing or reviewing ACES and PPT returns and credits. Examined audit and review files showed that audit operations lack standardization in the following areas: audit processes, maintenance of critical historical information, and format of taxpayer documentation.

Audit Processes

The audit group has standardized some of their audit processes, including checklists for completing audits and reviews and templates for verifying tax liabilities and calculating interest liabilities. However, some processes are still performed manually and differ between auditors. There are several areas where procedures could be standardized. For example, auditors could standardize the Microsoft Access queries performed on lease expenditures. Standardizing routine queries would free up audit time for analysis of unique taxpayer-specific risks. Additionally, designing workpaper templates would help reduce the time it takes to create workpapers.

Maintenance of Historical Information

The procedures for retaining and making accessible important historical information are inadequate. While most information exists, it is either scattered between sources, or contained in systems which are problematic to query. Examples of historical information not maintained in an easily accessible format include:

- Lists of audit assessments, settlements, Office of Administrative Hearing judgments, Supreme Court judgments, and the related payments made by taxpayers.
- Master lists of completed audits, audit coverage, and audit assessments.

- Lists of submitted tax returns and related amendments by taxpayer.
- Lists of total oil and gas production tax payments by tax year and total number of oil and gas production taxpayers by tax year.

Maintaining historical information in an accessible and usable format would help management track the audit group's performance, help auditors perform trend analyses and build expectations, and save auditors time in assembling all the necessary information for an audit.

Format of Taxpayer Documentation

In a survey of DOR tax auditors, 25 percent stated that the format of information given by taxpayers often impedes the audit and review processes. Examination of the audit and review files showed that some taxpayers provide information to auditors in a PDF format. Information in this format cannot be readily analyzed without being manually input into Microsoft Excel.

Alaska Statutes give DOR auditors authority to require returns and other information be filed electronically in a form and manner approved by the department. Requiring audit support to be submitted in a standard format would save audit resources. The standardization of audit documentation is further discussed in Recommendation No. 1 in conjunction with the application of industry best practices.

The Tax Division is implementing the TRMS which could address some impediments to efficient and effective audit operations if properly configured.

In FY 13, the Tax Division began the development of the TRMS which will replace multiple automated and manual legacy systems used by the Tax Division. The TRMS is based on an off-the-shelf product called *GenTax* which is currently used by 16 other states.¹² The TRMS is being implemented in phases with corporate income tax and eight other tax types being implemented in April 2014. The oil and gas production tax is scheduled for the second phase sometime in 2015.

Interviews with *GenTax* users in North Dakota, Utah, and Colorado concluded that users were generally satisfied with the product's features as they applied to the oil and gas production taxes.

The TRMS remains in the early stage of implementation, and as of March 31, 2014, the system specifications for oil and gas production taxes had not been developed. Thus, this audit could not predict if the system will adequately address the inefficiencies identified in

¹²States reported to be using *GenTax* are: Alabama, Illinois, Minnesota, North Dakota, Utah, Arkansas, West Virginia, Wisconsin, Georgia, Colorado, Louisiana, Montana, Oklahoma, Mississippi, Idaho, and New Mexico.

this report. In a survey of DOR’s auditors, 63 percent stated that they believe the TRMS implementation will improve audit and review processes.

While DOR’s backlog of credit audits can be addressed by current resources, it is unclear if DOR will be able to address the backlog of planned tax return audits.

Backlog is defined in this report as an accumulation of planned tax return audits and credit audits that have not been completed as of March 31, 2014. Because of the concerns described below, it is unclear whether DOR will be able to address the backlog of planned tax return audits. However, we believe that the credit audit backlog can be addressed with the current resources.

As shown in Exhibit 8, the audit backlog is comprised of 55 tax return, 023 credit, and 025 credit audits. The backlog includes returns filed as far back as 2008.

Because planned audits are associated with different tax years, the audit group has until March 31, 2020, to complete all 55 audits; however, several audits will have to be done each year to avoid exceeding the six year statute of limitations. As of March 31, 2014, none of the audits comprising the backlog have exceeded the six-year statute of limitations.

Exhibit 8

Number of Audits in Backlog by Type as of March 31, 2014			
Audit Type	Audit in Progress	Audit Not Started	Total
Tax Return Audits ¹³	6	24	30
023 Credit Audits ¹⁴	5	10	15
025 Credit Audits ¹⁵	10		10
Total	21	34	55

While it is difficult to predict if DOR auditors will be able to address the tax return audit backlog, our audit identified the following concerns.

- One major taxpayer’s 2007 tax return audit took an estimated 10,540 hours (5.5 years of staff time)¹⁶ to complete. As of March 31, 2014, the same taxpayer’s 2008 audit, which statutorily must be done by March 31, 2015, had yet to be started.
- Based on a survey of audit group employees, auditors estimated that only 49 percent of their time was spent working on audits; while the rest of their time was spent on other activities. (See Exhibit 9.) In 2014, implementation of the TRMS may consume even more audit resources.

¹³DOR management plans to audit the five largest taxpayers every year. There were six returns submitted by each of the five taxpayers for the 2008 through 2013 tax years. Therefore, the backlog is comprised of 30 audits.

¹⁴DOR management consistently audits two taxpayers for the 023 credits and selects additional taxpayers if a credit application review identifies an issue worth following-up during the audit. The 023 tax credits audit span the same period as the tax return audits for 2008 through 2013.

¹⁵All 025 credit applications are audited before a credit is issued, and as of March 31, 2014, ten 025 credit applications were submitted in 2013 and 2014 that are in the process of being audited.

¹⁶The hours are based on the auditors’ estimate.

Considering the historical number of hours taken to complete a credit audit, the smaller scope, and the number of auditors assigned to this function, it is likely the credit audits will be completed within the statutory timeline.

DOR management believes that it has sufficient audit resources to address the backlog without exceeding the six-year statute of limitations. DOR management expects to gain efficiencies on future ACES audits based on the audit group having a better understanding and more experience with ACES since the completion of the 2007 tax year audits. Additionally, to save time, DOR management plans to audit two years of tax returns as part of each audit. With a minimum of five tax returns approaching the six year statute of limitations each year, the additional time necessary to complete two-years of tax returns in one audit increases the risk that some taxpayers' returns will not be audited before the six-year statute of limitations.

Exhibit 9

Percentage of Time Spent by Credit and Tax Return Group on Different Activities		
Activity	Audit Group	
	Credit	Tax Return
Tax Return Audits	0%	49%
Credit Audits	35%	3%
Tax Return Reviews	5%	7%
Credit Reviews	35%	9%
Drafting Regulations	1%	5%
Tax System Development and Implementation	11%	14%
Other (Meetings, Training, Special Projects, etc.)	13%	13%
Total	100%	100%

According to DOR management, implementing the TRMS will further improve DOR audit group efficiency. Implementing the TRMS will not directly address the current backlog since it will only affect the returns submitted starting in 2015. However, automating some processes should allow auditors to allocate more time to conducting audits as opposed to completing tax return review procedures. Additionally, if the legacy system information is effectively converted to the TRMS, auditors may be able to access all prior year information in one location which may also improve efficiency.

Although DOR management is confident of the Tax Division's ability to address the backlog, this audit does not support management's level of confidence. Given the number of planned audits and the impediments to the audit process identified as part of this audit, there is a risk that DOR will not be able to meet its statutory audit mandate. We recommend implementing improvements to audit processes as described in Recommendation No. 1 to help gain efficiencies and overcome impediments.

FINDINGS AND RECOMMENDATIONS

Recommendation No. 1

The Tax Division director should ensure the procedures for conducting oil and gas audits incorporate best practices.

The Department of Revenue's (DOR) audit and review procedures do not reflect auditing best practices in the following areas:

1. *Project Management.* Audit projects lack ongoing monitoring procedures to ensure they are effectively and efficiently managed. Specifically, projects do not have established budgets and timelines; actual project hours are not tracked; supervisory reviews are performed only at the end of a project; and there is insufficient evidence to support that follow-up on taxpayer information requests are performed timely. Lack of sufficient project management may result in excessive time spent on audit and review projects and impede the Tax Division's ability to meet statutory timelines. Four of five comparable states applied some form of continuous project management. It is also a practice generally accepted by the auditing profession.
2. *Risk Assessment.* While some risk assessment procedures are performed, risk assessments are not documented, are performed by a single individual, and do not result in focused audits. Consequently, audit scopes are broad, and immaterial items are reviewed. Additionally, the lack of risk assessment procedures may result in auditors concentrating on low risk areas leaving less time for high risk areas or for other projects. All comparable states implemented risk assessment procedures. Additionally, risk assessment is a requirement for audit engagements under American Institute of Certified Public Accountants (AICPA) and the United States Government Accountability Office (GAO) auditing standards.
3. *Materiality.* DOR's oil and gas production tax audit group (audit group) has no procedures for establishing what is material or immaterial in an audit. As a result, audit scopes are broad, and immaterial items are reviewed – which is an inefficient use of audit time. Three of five comparable states apply materiality, which is also a requirement under AICPA and GAO auditing standards.
4. *Audit Documentation.* DOR's audit documentation does not provide for effective and efficient operations because it does not document methodologies used and significant auditor decisions. Furthermore, documentation is poorly organized and is duplicated between paper and electronic files. The lack of office standards for workpaper documentation forces auditors to develop their own which can be inefficient, impede the successful transfer of a project to another auditor, and require additional time for

peer and supervisory reviews. Having sufficient audit documentation to support the basis for findings and conclusions is a generally accepted auditing standard.

5. *Taxpayer Communication.* The audit group does not clearly communicate to taxpayers their rights and responsibilities under the audit. Not establishing an understanding and expectation with tax payers at the beginning of the audit may contribute to reduced taxpayer cooperation and increased timelines for obtaining information. All five comparable states had a Taxpayers' Bill of Rights.

Alaska Statute 43.55.075(a) establishes a six-year time limit for issuing an audit assessment. Application of best practices, outlined by the AICPA and the GAO and applied in other states, could help the audit group comply with the statutory time limit by improving audit efficiency and effectiveness.

The described best practices were not implemented by the audit group because DOR management believed that current procedures were adequate, and to date, audits have been completed within statutory timelines. While the 2007 tax year audits were completed within the six years, four of five 2007 tax return audits were completed just days before the deadline.

We recommend the Tax Division director ensure the procedures for conducting oil and gas audits incorporate best practices generally accepted by the auditing profession and applied in other states. Specifically, we recommend the following.

1. Improve audit project management by strengthening monitoring procedures.
2. Expand existing risk assessment procedures to incorporate risk determinations specific to each audit and review, and document those procedures.
3. Implement and document an audit materiality threshold.
4. Develop and document standards for comprehensive workpaper documentation.
5. Expand taxpayer formal communications to include the taxpayer's rights and responsibilities when being audited.

APPENDICES

Appendix A – Oil and Gas Production – Tax Law Comparison

Appendix A is a schedule that summarizes and compares key provisions of the three oil tax structures effective during the audit. These include the Economic Limit Factor or ELF (1977 through March 31, 2006), Petroleum Profits Tax or PPT (April 1, 2006, through June 30, 2007), and Alaska’s Clear and Equitable Share or ACES (July 1, 2007, through December 31, 2013).

The *bbls* abbreviation in the appendix means barrels of oil.

Appendix B – Oil and Gas Comparison – States

Appendix B summarizes oil tax provisions and audit practices of five comparable states and Alaska. To define best practices, we selected five states with comparable oil and gas tax audit functions; inquired with representatives of these states; and reviewed pertinent statutes, regulations, audit manuals, reports, and other information to corroborate the inquiries.

Appendix C – Department of Revenue Employee Audit Process Survey

Appendix C includes survey questions sent to DOR oil and gas tax auditors. The survey included two types of questions: closed-ended and open-ended. Five closed-ended questions in a scale format addressed the use of internal manuals, appropriateness of training and supervision, and organization of audit projects. Aggregate responses to these questions are provided. Thirteen open-ended questions addressed employee qualifications, use of audit time, and impediments and improvements to the audit process. Questions are listed, but detailed responses are not included.

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Appendix A

Oil and Gas Production – Tax Law Comparison

	ELF Economic Limit Factor	PPT Petroleum Profits Tax	ACES Alaska's Clear and Equitable Share
Tax Calculated on <i>AS 43.55.011</i>	Gross value	Net value	Net value
Tax Rate ¹ <i>AS 43.55.011 - .015</i> ² <i>AS 43.55.016</i> ³ <i>AS 43.55.011</i>	Separate tax rate on oil ¹ and gas ²	Same tax rate ³ on oil and gas	Same tax rate ³ on oil and gas
Oil Conservation Surcharges ¹ <i>AS 43.55.201</i> ² <i>AS 43.55.300</i>	Response Fund: \$.02 ¹ Prevention Fund: \$.03 ²	Response Fund: \$.01 ¹ Prevention Fund: \$.04 ²	Response Fund: \$.01 ¹ Prevention Fund: \$.04 ²
Tax Calculation Summary <i>AS 43.55.011 - .016</i>	Taxable Volume (bbls) × Taxable Value (\$/bbl) = <u>Gross Value at Point of Production</u> × ELF × 15% (Oil) 10% (Gas) Tax Rate = <u>Production Tax Due</u> - Credits = <u>Annual Tax Due</u> + Conservation Surcharges = <u>Total Tax Due</u>	Taxable Volume (bbls) × Taxable Value (\$/bbl) = <u>Gross Value at Point of Production</u> - Lease Expenditures = <u>Monthly Production Tax Value</u> × 22.5% Base Tax Rate = <u>Base Tax</u> + Monthly Progressivity Tax = <u>Monthly Production Tax Due</u> Sum of Monthly Production Tax Due for the Year - Credits = <u>Annual Tax Due</u> + Conservation Surcharges = <u>Total Tax Due</u>	Taxable Volume (bbls) × Taxable Value (\$/bbl) = <u>Gross Value at Point of Production</u> - Lease Expenditures = <u>Monthly Production Tax Value</u> × 25% Base Tax Rate = <u>Base Tax</u> + Monthly Progressivity Tax = <u>Monthly Production Tax Due</u> Sum of Monthly Production Tax Due for the Year - Credits = <u>Annual Tax Due</u> + Conservation Surcharges = <u>Total Tax Due</u>
Tax Credits ¹ <i>AS 43.55.019</i> ² <i>AS 43.55.023(a)</i> ³ <i>AS 43.55.023(b)</i> ⁴ <i>AS 43.55.023(l)</i> ⁵ <i>AS 43.55.023(d)</i> ⁶ <i>AS 43.55.023(i)</i> ⁷ <i>AS 43.55.024(a)</i> ⁸ <i>AS 43.55.024(c)</i> ⁹ <i>AS 43.55.025(a)</i> ⁽¹⁾⁽⁴⁾ ¹⁰ <i>AS 43.55.025(a)(5)</i> ¹¹ <i>AS 43.55.025(a)(6)&(7)</i> ¹² <i>AS 43.55.028</i> ¹³ <i>AS 43.55.029</i> ¹⁴ <i>AS 43.55.023(f)</i>	<ul style="list-style-type: none"> • Education Credit¹ • Alternative Exploration Credit⁹ Uses: Applied against tax liability.	<ul style="list-style-type: none"> • Education Credit¹ • Qualified Capital Expenditure Credit² • Carried-Forward Annual Loss Credit³ • Transitional Investment Expenditure Credit⁶ • Middle Earth Credit⁷ • Small Producer Credit⁸ • Alternative Credit for Oil and Gas Exploration⁹ Uses: Applied against tax liability, purchased by the State, ¹⁴ and sold to other companies. ⁵	<ul style="list-style-type: none"> • Education Credit¹ • Qualified Capital Expenditure Credit² • Carried-Forward Annual Loss Credit³ • Transitional Investment Expenditure Credit⁶ • Well Lease Expenditure Credit⁴ • Middle Earth Credit⁷ • Small Producer Credit⁸ • Alternative Credit for Oil and Gas Exploration⁹ • Cook Inlet Jack-Up Rig Credit¹⁰ • Frontier Basin Credit¹¹ Uses: Applied against tax liability, purchased by the State, ¹² and sold to other companies. ^{5,13}

Appendix A

Oil and Gas Production – Tax Law Comparison

(Continued)

	ELF Economic Limit Factor	PPT Petroleum Profits Tax	ACES Alaska's Clear and Equitable Share
Statute of Limitations for Audits ¹ AS 43.05.260 ² AS 43.55.075	3 years ¹	3 years ¹ (4/1/06-12/31/06) and 6 years ² (1/1/07-6/31/07)	6 years ²
Penalty ¹ AS 43.05.220 ² AS 43.55.30(d) ³ AS 43.55.40(7)	Delinquent Taxes: 5% ¹ per month and Delinquent Reports: \$25 ² per day	Delinquent Taxes: 5% ¹ per month	Delinquent Taxes: 5% ¹ per month and Delinquent Reports: up to \$1,000 ^{2,3} per day
Interest on Delinquency or Overpayment AS 43.05.225	Greater of: 5% above rate of member banks or 11%	Greater of: 5% above rate of member banks or 11%	Greater of: 5% above rate of member banks or 11%
Reporting ¹ AS 43.55.030(a) ² AS 43.55.030(e) ³ AS 43.55.030(f) ⁴ AS 43.55.040(5) ⁵ AS 43.55.110(e) ⁶ AS 43.55.020(a) ⁷ AS 43.55.025(f) ⁸ AS 43.55.023(a)(2) ⁹ AS 43.55.023(l)(2) ¹⁰ AS 43.55.025(c)(2)	<ul style="list-style-type: none"> • Producers paying tax must file an annual return.^{1,6} • Explorers may have to file a report with the Department of Natural Resources to claim credits.⁷ 	<ul style="list-style-type: none"> • Producers paying tax must file an annual return.¹ • Producers or explorers may have to file a report with the Department of Natural Resources to claim some credits.^{7,8} 	<ul style="list-style-type: none"> • All producers must file an annual return regardless of whether or not tax is due.¹ • Explorers or producers must file an annual statement on expenditures (or adjustments) regardless of whether oil or gas is produced.² • DOR may require monthly information reports from producers, explorers, and operators as applicable.³ • DOR may require reporting of forward-looking information for revenue forecasting purposes.⁴ • DOR may require returns, statements, and reports to be filed electronically.⁵ • Producers or explorers may have to file a report with the Department of Natural Resources to claim some credits.⁷⁻¹⁰

Appendix B

Oil and Gas Comparison – States

T A X I N F O R M A T I O N	Tax Type	Alaska	Texas	North Dakota	Utah	New Mexico	Colorado
		Net	Gross ¹⁷	Gross	Gross ¹⁷	Gross ¹⁷	Gross ¹⁷
	Oil and Gas Tax Rate¹⁸	Oil and Gas Production: 25% (progressive) of value at point of production less deductions	Oil Production: 4.6% and Gas Production: 7.5% of market value	Oil Production: 5% and Oil Extraction: 6.5% of gross value Gas Production: \$0.0833 per MCF (1,000 cubic feet)	Oil and Gas Severance: 3-5% of value at point of production less deductions	Oil and Gas Severance: 3.75% and Oil and Gas Emergency School Tax: 3.15-4% of value at point of production less deductions	Oil and Gas Severance: 2-5% of gross income
	Available Deductions	Lease expenditures Transportation costs Royalties	Marketing costs	Royalties	Processing costs Transportation costs	Processing costs Transportation costs Royalties	Processing costs Manufacturing costs Transportation costs
	Statutory Audit Deadline	6 years	4 years	3 and 6 ¹⁹ years	6 years	3 years	3 years
	Oil and Gas Returns Filed in 2013	59 by producer and explorer	149,000 ²⁰ by lease	3,312 ²⁰ by producer and purchaser	1,110 by person	7,149 by operator and purchaser	4,040 ²¹ by person
	2013 Oil and Gas Revenues Collected	\$3,734,713,764	\$4,486,093,075	\$2,407,739,572	\$53,164,253	Information unavailable	\$136,083,569
Producers in the State	18	12,487 ²²	300-400	117	Information unavailable	330	

¹⁷While this tax is described as a "gross tax" per statutes, taxpayers are allowed to subtract certain costs (*marketing costs, operating costs, and transportation costs*); therefore, the tax is essentially a net tax.

¹⁸Listed tax rates are general rates per state law; however, exceptions are available allowing a different rate to be applied if an applicant meets the requirements.

¹⁹Returns with a 25 percent change in the tax liability have a six-year statutory timeframe.

²⁰Includes filed amendments; filings are made monthly.

²¹Includes all severance taxes: oil, gas, coal, ore, metallic minerals, and oil shale.

²²The number of producers was determined using the online portal for the State of Texas, Window on State Government, by reviewing data for January 2014.

Appendix B

Oil and Gas Comparison – States (Continued)

		Alaska	Texas	North Dakota	Utah	New Mexico	Colorado
GENERAL	Oil and Gas Severance Tax Auditors	16	10 ²³	2	6 ²⁴	13	10 ²⁴
	Audits Completed in 2013	9 desk audits (1 tax return and 8 credit audits)	53 field audits ²⁵	3,312 ²⁶	13 field audits ²⁷ 31 desk audits	50 field audits 100 desk audits ²⁸	32-37 field audits ²⁹
STAFF	Minimum Auditor Qualifications	Bachelor's degree	Bachelor's degree or pertinent experience	Bachelor's degree or 4 years of experience	Bachelor's degree	Bachelor's degree or 4 years of experience	Bachelor's degree and 1 year of experience or 5 years of experience or a master's/PhD degree
	Staff Training Program	No formalized training plan	Initial 3 month intensive training and 40 hour annual training	No formalized training plan ³⁰	80 hours of training every two years per government auditing standards	Oil and gas plant tours; oil and gas accounting classes; annual in-house training.	80 hours of training every two years per per government auditing standards

²³Includes the number of auditors in the Houston office (largest office), not the entire state.

²⁴Some auditors perform federal royalty audits in addition to state tax audits.

²⁵The number of audits includes only the audits completed by the Houston office.

²⁶All returns filed are reviewed, some in more depth than others.

²⁷The number includes federal royalty audits.

²⁸The reported number of audits represents the expectation for the year. Each auditor is expected to perform five field and 10 desk audits. There were a total of 10 auditors in New Mexico, excluding supervisors.

²⁹Approximately 12 severance tax audits and 20 to 25 production and sales volume audits are completed annually.

³⁰Two auditors perform the oil and gas tax audits in North Dakota and have been with the Tax Administration Division for 19 and 26 years; both are CPAs.

Appendix B

Oil and Gas Comparison – States (Continued)

		Alaska	Texas	North Dakota	Utah	New Mexico	Colorado
A U D I T P R O C E S S	Types of Audits Performed	Reviews Desk audits	Field audits	Compliance audits (reviews) Desk audits	Desk audits (reviews) Field audits	Desk audits (reviews) Field audits Compliance audits	Field audits
	Active Project Management	No	Yes	No ³¹	Yes	Yes	Yes
	Taxpayer Bill of Rights	No	Yes	Yes	Yes	Yes	Yes
	Audit Manual	Yes ³²	Yes	No ³⁰	Yes	Yes	Yes
	Audit or Test Plan	Yes	Yes	No ³⁰	Yes	Yes ³³	Yes
	Materiality	No	Yes	No ³⁴	Yes	Established in statutes	Yes
	Risk Analysis	Partially	Yes	Yes	Yes	Yes	Yes
	Automated System to Track Taxes & Audit Work	Partially ³⁵	Integrated Tax System and Agency Workhouse Manager	GenTax System	GenTax System	Oil and Natural Gas Accounting and Revenue Database	GenTax System

³¹Project management was not considered necessary because there are only two individuals working on oil and gas audits, the audits take a short time, and the process is highly automated.

³²Based on the audit group's survey, the audit manual is not widely used by auditors, and some were unaware of its existence.

³³Auditors use a step-by-step audit process listed in New Mexico's Oil and Gas Severance Tax Bureau audit manual which is similar to using an audit program.

³⁴Due to the simple gross tax structure and the automation of audit processes and tax analyses, which allows for 100 percent coverage, materiality is unnecessary.

³⁵The Tax Division uses a Tax Accounting System to track all its tax types. The Division is currently in the process of implementing a TRMS (GenTax) system.

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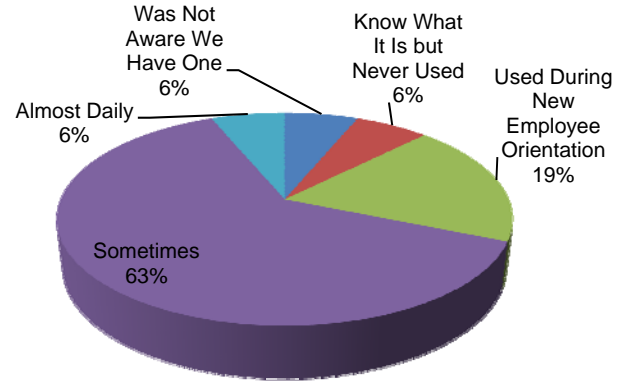
Appendix C

Department of Revenue Auditors' Process Survey

1. During calendar year 2013, how often did you use the Department of Revenue's (DOR) Audit Standards and Management Manual?

Employee Responses	Total Employee Responses	Percent of Responses
Was Not Aware We Have One	1	6%
Know What It Is but Never Used	1	6%
Used During New Employee Orientation	3	19%
Sometimes	10	63%
Almost Daily	1	6%
Total Respondents	16	100%

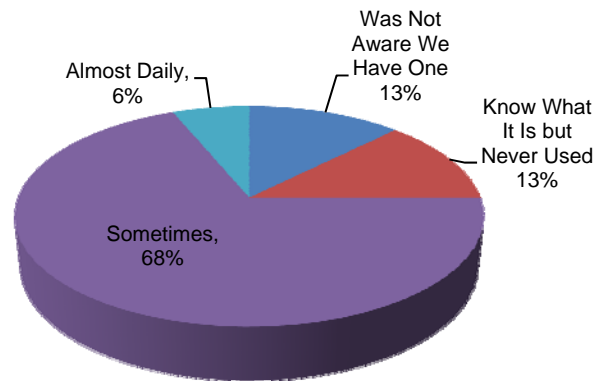
DOR's Audit Standards and Management Manual Use



2. During calendar year 2013, how often did you use DOR's Training and Policy Manual?

Employee Responses	Total Employee Responses	Percent of Responses
Was Not Aware We Have One	2	13%
Know What It Is but Never Used	2	13%
Used During New Employee Orientation	0	0%
Sometimes	11	68%
Almost Daily	1	6%
Total Respondents	16	100%

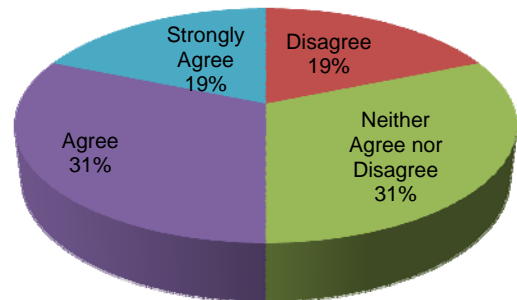
DOR's Training and Policy Manual Use



3. I receive appropriate levels of training to perform my job duties.

Employee Responses	Total Employee Responses	Percent of Responses
Strongly Disagree	0	0%
Disagree	3	19%
Neither Agree nor Disagree	5	31%
Agree	5	31%
Strongly Agree	3	19%
Total Respondents	16	100%

Appropriate Level of Training



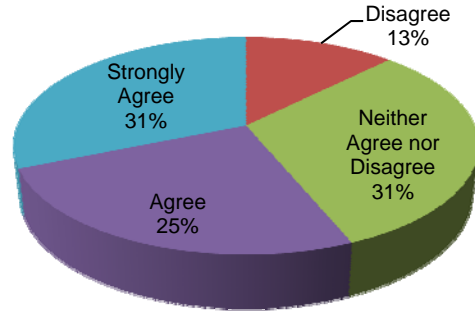
Appendix C

Department of Revenue Auditors' Process Survey (Continued)

4. I receive appropriate levels of supervision to perform my job duties.

Employee Responses	Total Employee Responses	Percent of Responses
Strongly Disagree	0	0%
Disagree	2	13%
Neither Agree nor Disagree	5	31%
Agree	4	25%
Strongly Agree	5	31%
Total Respondents	16	100%

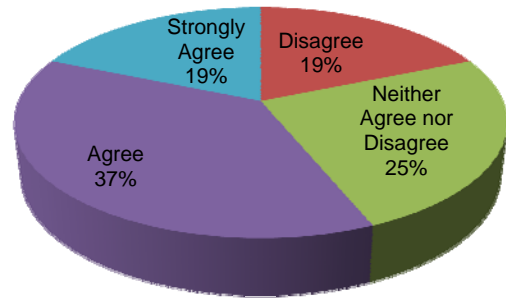
Appropriate Levels of Supervision



5. Audit projects are properly organized and managed to make sure they are performed in an effective and efficient manner.

Employee Responses	Total Employee Responses	Percent of Responses
Strongly Disagree	0	0%
Disagree	3	19%
Neither Agree nor Disagree	4	25%
Agree	6	37%
Strongly Agree	3	19%
Total Respondents	16	100%

Audit Project Organization and Management



Appendix C

Department of Revenue Auditors' Process Survey (Continued)

The survey also included several open-ended questions. The responses to these questions were analyzed and aggregated. The open-ended questions included in the employee survey were the following:

1. What is the highest level of education you have completed?
2. What degrees have you received?
3. What professional certifications do you hold?
4. How long have you been with the Tax Division - Oil and Gas Production Tax Unit (in years and months)?
5. How many years of audit experience do you have outside of the DOR Tax Division?
6. How many years of oil and gas experience do you have outside of the DOR Tax Division?
7. Please estimate the percentage of your time spent on the following activities during calendar year 2013:
 - Tax return audits;
 - Credit audits;
 - Tax return reviews;
 - Credit reviews;
 - Drafting regulations;
 - Tax system development and implementation; and
 - Other.
8. What additional types of training would be helpful to perform your duties? Please list.
9. Would additional supervision be helpful in performing your duties? Please explain.
10. How did DOR management communicate to you that you should be independent from oil and gas companies you audit or review?
11. Please list any impediments to the process of auditing or reviewing ACES and PPT returns or credits. This includes potential inefficiencies or areas of ineffectiveness in the audit or review process.
12. What improvements would you suggest to DOR's oil and gas production tax audit and review process?
13. Please provide any additional comments that may help our audit.

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THE STATE
of **ALASKA**
GOVERNOR SEAN PARNELL

Department of Revenue

COMMISSIONER'S OFFICE
Angela M. Rodell, Commissioner

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RECEIVED

AUG 26 2014

LEGISLATIVE AUDIT

August 26, 2014

Kris Curtis, Legislative Auditor
Legislative Budget & Audit Committee
Division of Legislative Audit
P.O. Box 113300
Juneau, AK 99811-3300

RE: Response to Preliminary Report on the Department of Revenue (DOR) Oil and Gas Tax Audit Process

Dear Ms. Curtis:

Thank you for your agency's review of the department's Tax Division, Oil and Gas Production Tax Audit Group. We appreciate the opportunity to respond to the proposed recommendation contained in your report dated June 20, 2014. The deficiencies identified in your report are itemized and addressed below for the Tax Division.

Recommendation No. 1

The Tax Division director should ensure the procedures for conducting oil and gas audits incorporate best practices.

This recommendation is broken down into five sub-parts: 1) project management; 2) risk assessment; 3) materiality; 4) audit documentation; and 5) taxpayer communication.

DOR's responses to the five subparts of the recommendation:

- 1) Project Management: DOR agrees its oil and gas audit projects need stronger monitoring procedures. The department plans to continue to strengthen its monitoring procedures to ensure that all audit projects are better managed. The Tax Revenue Management System (TRMS) will allow specific projects to be monitored, track hours spent on each audit, and make it easier for supervisory reviews to be conducted in increments through each project. The investment in TRMS will greatly improve our project management procedures.
- 2) Risk Assessment: DOR generally agrees it needs to expand its risk assessment procedures. DOR believes that its oil and gas production tax audit program is unique because it has a very small

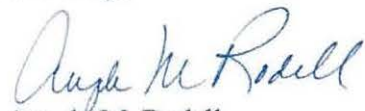
number of taxpayers who actually have a tax liability, and the department audits every taxpayer that has a production tax liability in Alaska (therefore taxpayers are not selected for audit). The department plans to expand upon its risk assessment procedures to include more individuals in the process, and plans to document that process so that is easier for others to understand and follow.

- 3) Materiality: DOR agrees it should implement and document an audit materiality threshold. The department plans to create a procedure for establishing what is and is not material for oil and gas production tax audits in Alaska. The implementation of TRMS will also help the department going forward in this area. TRMS will make it very easy for auditors to identify and sort out line item details that the department considers immaterial.
- 4) Audit Documentation: DOR agrees it needs to continue developing and documenting standards for its oil and gas production tax audit processes, and our implementation of TRMS has already started this process. To operate properly, the new TRMS system requires standardized forms and structured procedures. Our staff have been working diligently with the TRMS contractors to structure and standardize all of our forms, letters, work-paper templates, etc. DOR will continue to refine its processes and procedures as we work through the implementation process.
- 5) Taxpayer Communication: DOR generally agrees that it needs to expand upon its formal communications with taxpayers. The Oil and Gas Production Tax Audit Group deals with very sophisticated taxpayers (some of the largest corporations in the world) who understand their rights and responsibilities under audit. DOR does agree that the engagement letter should be more specific by outlining timelines and expectations, and as outlined in (4) above, we are currently working on an engagement letter to be implemented with TRMS that incorporates these recommendations.

The department is unsure about a “taxpayer bill of rights” as that may be something that needs to be set forth in statute or regulation, and we plan to explore that further. The department plans to re-work its formal communications with taxpayers to ensure better communication of their rights, responsibilities, and expectations during the audit process.

We believe that we have addressed all of the findings and recommendations presented in your June 20, 2014 report, and will continue to work on improving in this area. If you or your staff have additional comments or questions, please do not hesitate to contact us.

Sincerely,



Angela M. Rodell
Commissioner

Cc: Michael Pawlowski, Deputy Commissioner, DOR
Matthew R. Fonder, Director, Tax Division
Brandon Spanos, Deputy Director, Tax Division
Dan DeBartolo, Director, Administrative Services Division, DOR