
OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: May 7, 2010

IBA Report Number: 10-39

Audit Committee Docket Date: May 10, 2010

Item Number: 6

Analysis Related to a Proposal to Transfer the City Treasurer's Revenue Audit Program to the Office of the City Auditor

OVERVIEW

In his FY 2010 Budget Recommendations Memorandum dated April 30, 2009, Councilmember Young requested that the Mayor and City Auditor review and take action on transferring the functions of the Treasurer's Revenue Audit Program (RAP) to the Office of the City Auditor. On March 17, 2010, the Budget and Finance Committee adopted a motion requesting the IBA analyze considerations surrounding the RAP transfer proposal. The Committee requested the IBA's analysis be presented to the Audit Committee. In reviewing the proposed FY 2011 budget for the City Auditor on April 12, 2010, the Audit Committee also requested analysis of the proposal to transfer the City Treasurer's RAP to the Office of the City Auditor.

In response to this direction, the IBA has independently met with the City Treasurer and the City Auditor to discuss their perspectives regarding the revenue audit function. Additionally, we surveyed other major cities in California and in the nation. This report provides an overview of the RAP, presents City Treasurer and City Auditor perspectives related to the proposed transfer, discusses the organizational location of the revenue compliance audit function in other cities, and offer final comments for Audit Committee consideration.

FISCAL/POLICY DISCUSSION

Revenue Audit Program

Until 2006, the RAP was a work unit within the Office of the City Auditor and Comptroller. In June of 2006, the previous City Auditor and management agreed to move the RAP from the

Office of the City Auditor and Comptroller to the Office of the City Treasurer. The previous City Auditor and Comptroller believed 1) synergies could be achieved by consolidating these revenue audits with the City Treasurer collections function, 2) revenue compliance audits better matched with the revenue collection function and 3) it would be difficult for the Office of the City Auditor and Comptroller to independently audit the revenue audit group while simultaneously managing the function particularly if revenue and performance auditors were rotated between audit types. The decision to transfer the RAP to the City Treasurer took place before the City acted to separate the City Comptroller and City Auditor functions to create greater audit independence.

As noted above, the RAP currently operates within the Office of the City Treasurer. It is comprised of 6.00 FTEs including 1.00 Principal Accountant (who manages the group and performs audits), 3.00 Accountant IIIs and 2.00 Accountant IIs. The Principal Accountant reports to a Financial Operations Manager who in turn reports to a Treasury Operations Manager. The Treasury Operations Manager reports directly to the City Treasurer. The proposed FY 2011 budget (total salaries and fringe benefits) for 6.00 RAP FTEs is approximately \$630,000.

Between FY 2004 and FY 2008, the RAP was staffed with between 4.00 and 8.00 FTEs although some of these positions were periodically vacant or dedicated to managing the group. As noted in a memorandum from the City Treasurer to the Chief Financial Officer dated May 15, 2009 (Attachment 1), RAP audits have resulted in annual revenue recoveries between \$1.2 million and \$2.5 million between FY 2004 and FY 2008. Due in part to 2.00 positions being vacant throughout FY 2009, revenue recoveries declined to \$789,000 in the last fiscal year. The majority of RAP's annual revenue recovery results from revenue compliance audits of hotels, with a lesser amount attributable to audits of lease or franchise agreements.

Revenue compliance audits focus on whether or not revenues owed to the City have been calculated and paid correctly. According to the City Treasurer, "a typical revenue audit involves reviewing financial statements and general ledgers, testing detailed accounting records for accuracy and reliability; confirming compliance with governing sections of the Municipal Code and lease or franchise agreements; and making recommendations to administering departments based on audit findings." RAP staff currently performs the following types of revenue compliance audits:

- Transient Occupancy Tax (approximately 311 hotels in City subject to audit)
- Percentage Leases with businesses on City owned property (approximately 101 leases)
- Franchise Agreements - SDG&E, waste haulers (3), cable companies (2), other (2)
- Business Tax Payments – under certain circumstances
- Special requests by City departments for unique agreements with City revenue elements

The managing Principal Accountant for the RAP indicates that approximately 60% of staff time is spent performing TOT revenue audits. A very small percentage of staff time (< 5%) is spent on audit appeal hearings. While the program places a higher priority on high revenue hotels, it also endeavors to audit all hotels on a two to three year cycle. Hotels are not required to maintain records after three years; however, they can still be audited and found to be deficient in their payments to the City after three years.

City Treasurer Comments Regarding the Proposed Transfer of the RAP

In discussing the contemplated transfer of the RAP with the City Treasurer and the Principal Accountant, the following perspectives were shared:

1. If the City Auditor were to perform revenue compliance audits, he would not be able to independently audit this revenue collection process which is a management responsibility. As the City is currently organized, the City Auditor can independently audit the RAP or any other City Treasurer revenue billing/collection process for effectiveness or efficiency.
2. City Charter Section 39.2 requires the City Auditor to follow Government Auditing Standards which require all audits to adhere to very specific audit protocols and procedures (stipulated in what is known as the Yellow Book). These procedures were developed for, and are more pertinent to, performance audits which are the focus of the City Auditor. They are not as applicable to revenue compliance audits. Organizations like the Internal Revenue Service, Franchise Tax Board or the State Board of Equalization conduct revenue compliance audits and are not subject to Yellow Book standards. The concern is that added, unnecessary audit procedures would be more cumbersome and result in a less efficient RAP.
3. All of the current RAP staff possess degrees in accounting; half of the staff either are or are about to become Certified Public Accountants. Additionally, RAP staff possesses significant experience performing revenue compliance audits. Accounting expertise and experience is needed to effectively perform revenue compliance audits. While these skill sets could be transferred to the Office of the City Auditor, they should not necessarily be considered interchangeable with City Auditor staff whose training and experience tends to be oriented toward conducting performance audits.

City Auditor Comments Regarding the Proposed Transfer of the RAP

In discussing the contemplated transfer of the RAP with the City Auditor and the Managing Performance Auditor, the following perspectives were shared:

1. The City Treasurer bills and collects revenue for the City. As they report to management, there may be a conflict for the RAP to audit a process they are charged with administering. The City Auditor believes there is greater independence and transparency when an office that is independent of management conducts the revenue compliance audits. For example, the City Auditor publicly presents an annual audit work plan that does not allow for discretionary audit decisions which the City Auditor notes may not be the case for revenue audits under management.
2. The Office of the City Auditor conducts all audits in accordance with Government Accounting Standards (Yellow Book). The Yellow Book requires audit documentation, standards and audit protocols that have been designed to protect the integrity of the resulting audits. These standards would enhance the process and quality of revenue compliance audits. The application of Yellow Book audit standards should not result in a less efficient RAP.

- Transferring the RAP into the Office of the City Auditor will develop synergies and efficiencies. It is envisioned that the program would report directly to the City Auditor and his senior performance audit managers who have considerable audit experience. The City Auditor's staff is experienced in conducting audits in accordance with Government Accounting Standards. Additionally, City Auditor staff receives specialized training and discusses innovative approaches to auditing with their peers in the audit profession. This information would be shared with RAP staff in a more synergistic environment entirely dedicated to auditing.

Revenue Compliance Audit Responsibilities in Other Cities

In researching where responsibility for revenue compliance audits is located in other cities we found that most cities have finance/revenue related departments performing this function. These same cities also have independent audit offices that primarily perform performance audits but may perform other types of revenue audits. Our research indicates that revenue compliance field audits are more typically performed, or overseen, by finance/revenue related departments. The following cities were contacted:

<u>City</u>	<u>Revenue Compliance Audits Performed By</u>	>>>>>>	<u>Reports To</u>	<u>Independent Audits Performed By</u>
Los Angeles	Office of Finance		Management	Elected City Controller
San Jose	Finance Department		City Manager	Appointed City Auditor
San Francisco	Elected Treasurer		Public	Appointed Controller
Fresno	Controller		City Manager	Budget Director
Long Beach	Elected City Auditor		Public	Elected City Auditor
Oakland	Finance & Mgmt Agency		Management	Elected City Auditor
Chicago	Department of Revenue		Management	Council Finance Cmte.
Philadelphia	Revenue Department		Management	Elected City Controller
San Antonio	Finance Department		City Manager	Appointed City Auditor
Phoenix	Finance Department		City Manager	Appointed City Auditor
Dallas	Financial Services Dept		City Manager	Appointed City Auditor
Detroit	Finance Department		Management	Appointed City Auditor

With the exception of Long Beach whose elected City Auditor administers a contract for the provision of revenue compliance audits, we did not identify a city whose revenue compliance audits were entirely performed or overseen by the independent City Auditor. The Principal Accountant for RAP provided the IBA with recent data he gathered indicating that the ten largest cities in the nation (based on population) have finance/revenue related departments performing or overseeing revenue compliance audits; however, we were only able to confirm this for eight of the top ten cities prior to the release of this report.

Additional IBA Comments for the Audit Committee

After discussing the contemplated transfer with involved City departments and staff in other cities, the IBA offers the following comments for Audit Committee consideration:

1. Based on comments received from the City Treasurer about her City Charter specified duties, the IBA preliminarily discussed the contemplated transfer of RAP with the Office of the City Attorney. The City Attorney's Office has some concern that such a transfer may be subject to certain legal implications that the Audit Committee should consider. We recommend that the Audit Committee request an opinion from the Office of the City Attorney with regard to any legal implications related to a proposed transfer. We would also note that the proposed transfer may also be subject to a meet and confer process with MEA.
2. While there are similarities in the nature of all audit work, there are a few notable differences between the City's revenue compliance and performance auditors. These differences include:
 - Revenue compliance audits are external to the organization while performance audits are more typically internal organizational audits.
 - The scope/audit approach and nature of the duties involved.
 - Auditor education/training/experience as it best relates to each audit type.
 - Current differences in employee classification: RAP employees are classified/represented whereas City Auditor employees are unclassified/unrepresented.
 - Compensation: performance auditors currently receive significantly higher compensation than revenue compliance auditors, including salary and benefits.

While these differences do not preclude consolidation of the two work units, they could impact staff integration and interchangeability as it relates to the possibility of creating efficiencies by consolidating audit operations.

3. Based on information provided by the City Treasurer, approximately 120 hotel audits since 2005 had audit periods of more than three years. As hotels are not required to maintain audit records after three years, the City's audit (and potential revenue recovery) position is weakened (not eliminated) after three years. Audit cycles exceeding three years are typically attributable to insufficient budgeted staff, staff vacancies and/or competing revenue audit needs.
4. Using revenue recovery data provided by the City Treasurer for FY 2004 through FY 2008 (based on the number of RAP staff actually performing audits), we roughly estimate that RAP's revenue recovery to auditor expense ratio ranged from 2.4:1 to 6.2:1 for each dollar spent over the five year period. The RAP brings in significantly more revenue than it costs; however, this does not mean that this revenue recovery ratio could not be further enhanced. Understanding that the amount of revenue recovered may vary from year to year based on factors not tied to the audit process, the IBA recommends that a historical revenue recovery ratio be validated and used as one go-forward benchmark for evaluating work unit performance wherever the function is located.

5. The City Auditor and the City Treasurer each make reasonable audit independence arguments. Both assert the other cannot independently audit a work process they are responsible for; however, the IBA believes either argument can be mitigated. If the City Treasurer retains revenue compliance audits, the City Auditor can audit their operation at any time and make process recommendations with respect to the timing, selection and execution of audits. If the City Auditor were to assume revenue compliance audits, the Audit Committee could request that an outside audit firm be retained to periodically perform an independent audit of this function.

CONCLUSION

In response to direction from the Budget & Finance and Audit Committees, the IBA has provided information related to a contemplated transfer of the City Treasurer's RAP to the Office of the City Auditor. We have described the nature of the RAP function and its organizational placement at the City. Additionally, we have surveyed other major cities to report which departments typically perform the revenue compliance audit function within each organization. Finally, we have provided additional comments for Audit Committee consideration.

While there are notable differences in the nature of the work performed by revenue compliance and performance auditors, we believe the work units could be consolidated if the City Council determines that greater operating and revenue efficiencies can be achieved. We have suggested ways to ensure that the revenue compliance audit function can be objectively performed and independently audited for efficiency and effectiveness irrespective of where responsibility for the function is assigned within the organization.

As noted in this report, the IBA recommends the Audit Committee request an opinion from the Office of the City Attorney regarding any legal implications related to a proposed transfer of the RAP.

The IBA believes that a determination as to where the revenue compliance audit function is located within the organization should be based solely on operating efficiency and effectiveness. The City's current organizational structure for this function is similar to that of almost all major cities. We would suggest a recommendation to transfer the RAP only be made if the Audit Committee is convinced that the City Auditor can develop and realize significant operating efficiencies that could not otherwise be achieved by the Office of the City Treasurer.

[Signed]

Jeff Kawar
Fiscal & Policy Analyst

[Signed]

APPROVED: Andrea Tevlin
Independent Budget Analyst

Attachment 1




THE CITY OF SAN DIEGO

M E M O R A N D U M

DATE: May 15, 2009

TO: Mary Lewis, Chief Financial Officer

FROM: Gail R. Granewich, City Treasurer 

SUBJECT: Revenue Audit Program – Quarterly Report
and Response to FY 2010 Budget Discussions

Quarter Ending March 31, 2009 – Audits Completed

During the third quarter of Fiscal Year 2009, the Office of the City Treasurer's Revenue Audit Program completed 26 audits, totaling \$279,606 in audit deficiencies. The 26 audits included 20 tax-related audits and 6 lease audits, including:

Transient Occupancy Tax/Business Tax Audits

- W San Diego
- 500 West Hotel
- Doubletree Del Mar
- Ramada San Diego North
- Two (2) non-compliant vacation rental properties

Lease Audits

- Ace Parking operations at Qualcomm Stadium
- Canyonside Stables, LLC
- Crystal Pier Motel, Inc.
- Seaforth Sportfishing Corp.
- Wave House Belmont Park
- Rancho Santa Fe Polo Club

Quarter Ending March 31, 2009 – Recoveries

During the third quarter of Fiscal Year 2009, the City received \$200,006 in recoveries on performed audits, including \$57,636 received by the Office of the City Treasurer's Delinquent Accounts Collection Division.

Current Quarter (Ending June 30, 2009)

Major TOT and lease audits expected to be completed during the current quarter include:

- Residence Inn Mission Valley
- Holiday Inn Mission Valley
- Sheraton Suites San Diego
- Sheraton Suites Shelter Island
- San Diego Visitor Information Center
- SDSU Football use of Qualcomm Stadium
- KenCal Ownership (Hyatt Islandia)
- NextG Networks (Use Permit)

2009 Fiscal Year-to-Date Totals

Revenue audits completed and recoveries through the third quarter ending March 31, 2009:

Table A

Type	Audits Completed	Audit Hours	Audit Deficiencies	Recoveries
TOT	71	2,652	\$537,142	\$382,035
Lease/Franchise	15	1,707	\$199,472	\$168,937
Requested (BT)	5	14	\$4,940	\$3,160
Total	91	4,373	\$741,554	\$554,132

As a reminder, of the 65 revenue audits completed during the first and second quarters of this fiscal year, some of the more significant audits included:

Transient Occupancy Tax/Business Tax Audits

- Western Inn Old Town
- Bahia Hotel
- Studio 819
- Staybridge Suites Sorrento Mesa
- Holiday Inn Express
- US Grant Hotel
- Hotel Occidental
- Staybridge Suites Carmel Mountain
- Embassy Suites La Jolla
- Holiday Inn on the Bay

Lease Audits

- San Diego Chargers Football Company
- Wesco Sales Corp.
- Paradise Café II
- San Diego Bowl Game Association
- The Lodge at Torrey Pines
- Catamaran Hotel (and two associated operations)

Staffing Updates

The Revenue Audit Program continued to operate with two open positions during the third quarter. Requests to fill these positions were approved and one vacancy was filled in late April, the other is expected to be filled by early June.

Response to Councilmember Young's Fiscal Year 2010 Budget Recommendation

In a memorandum dated April 30, 2009, Councilmember Anthony Young requested "the Mayor and City Auditor to review and take action on transferring the functions of the Revenue Audit and Appeals division of the City Treasurer's office into the Office of the City Auditor." He further indicated that savings would result from this consolidation and that the revenue audit function should be under the Independent Auditor.

This section of the report provides background on the Revenue Audit Program and results from the prior five (5) years.

Background

The Office of the City Treasurer's Revenue Audit Program has been performing audits of revenue-generating businesses within the City limits since the mid-1960s. Originally, the program was part of the Audit Division within the department of the Auditor and Comptroller. In June of 2006, and consistent with City Charter §45, the Revenue Audit Program was transferred under the oversight of the City Treasurer. City Charter §45 states in part:

The Treasurer shall issue notices for and collect...miscellaneous taxes, fees, assessments, licenses and privilege charges as may from time to time be assigned to him or her. He or she shall maintain a continuous inspection of the records and accounts of such taxes, licenses and privilege charges in order to effectuate their collection.

As indicated in **Table B** below, many other large jurisdictions place the revenue audit function within its main revenue receiving department.

Table B

Municipality	Location of Revenue/Tax Audit Function	Municipality	Location of Revenue/Tax Audit Function
Los Angeles	Office of Finance	Phoenix	Finance Department
Chicago	Revenue Department	San Antonio	Finance Department
Houston	Finance Department	San Jose	Finance Department
Philadelphia	Revenue Department	San Francisco	Treasurer and Tax Collector

The transfer of the Revenue Audit Program to the Office of the City Treasurer also cleared the way for the Office of the City Auditor to be established as a separate, independent department focused on the operations of the City as set forth in City Charter §39.2. The operations, focus, procedures and audit techniques of the revenue audit function differ from the City Auditor's role and responsibility. Revenue auditors focus on whether or not revenues paid to the City have been made correctly, whereas internal auditors focus on overall efficiencies and controls of an organization.

The move to the Office of the City Treasurer has in fact streamlined revenue audits. The Revenue Audit Program now exists within the department which, as required by City Charter, administers the City's tax codes and receives lease and franchise fee payments on behalf of administering departments.

As referred to in City Charter §45, the City Treasurer's Revenue Audit Program exists to "...maintain a continuous inspection of the records and accounts..." of the taxes, rents and fees paid to the City. These include the Transient Occupancy Tax paid by all hotels, motels and property management companies within the City; rent payments made by all of the City's percentage rent lessees; and franchise fees paid by all waste haulers, cable companies and utilities operating within the City limits. Audits are also done on certain business tax payments on an as-needed basis only, due to the high rate of compliance in the department's FTB Compliance Program.

A typical revenue audit involves reviewing financial statements and general ledgers; testing detailed accounting records for accuracy and reliability; confirming compliance with governing sections of the Municipal Code and lease or franchise agreements; and making recommendations to administering departments based on audit findings.

Over the past five years, through detailed and thorough revenue auditing and analysis, the Revenue Audit Program has brought in the following recoveries:

Table C

Year	No. of Audits	Audit Hours	Recoveries	FTEs
2008	98	4,706	\$1,367,209	5
2007	136	5,648	\$2,474,149	5
2006	118	6,099	\$1,704,618	5
2005	165	8,603	\$1,530,616	6
2004	174	8,601	\$1,194,404	6

The main types of revenues audited by this program and included in the summary results in **Table C** are:

Transient Occupancy Tax

The City imposes a Transient Occupancy Tax of 10.5% on hotel guests for the privilege of occupying a room in a hotel, motel, RV park, or vacation rental within the City limits. Operators of these establishments have the responsibility to collect the tax and remit it to the City. Revenue audits are performed on the payments made by these operators. These audits also include a review of the recently adopted Tourism Marketing District fee of 2%, assessed on revenues of hotels with 70 or more units.

Authority to Audit: SDMC §35.0121

Number in Audit Population: 308

Frequency of Audits: Every Two to Three Years

Table D

Fiscal Year	No. of Audits	Audit Hours	Total Recoveries
2008	86	3,378	\$846,661
2007	95	3,787	\$2,095,083
2006	73	3,154	\$638,127
2005	106	3,855	\$435,839
2004	115	5,211	\$621,097

Percentage Lease Agreements

The City has a number of lease agreements with businesses operating on City owned land. The bulk of these lease agreements exist at Mission Bay and the San Pasqual Valley. The lease agreements are administered by the City's Real Estate Assets Department. Additionally, the City has a few tenant agreements with businesses operating within Qualcomm Stadium. Revenue audits are performed on each of these lessees and permittees as well.

Authority to Audit: Within Individual Lease Agreements
Number in Audit Population: 87
Frequency of Audits: Every Two to Four Years

Table E

Fiscal Year	No. of Audits	Audit Hours	Total Recoveries
2008	11	1,133	\$350,150
2007	25	1,471	\$237,783
2006	29	2,411	\$257,750
2005	44	4,448	\$991,314
2004	40	2,954	\$516,192

Franchise Agreements

Franchise Fee payments are made to the City by utility companies, waste haulers and cable companies operating within the City limits. Revenue audits are performed on each of these franchisees.

Authority to Audit: Within Individual Franchise Agreements
Number in Audit Population: 18
Frequency of Audits: Every Three to Four Years

Table F

Fiscal Year	No. of Audits	Audit Hours	Total Recoveries
2008	1	195	\$170,398
2007	2	323	\$112,116
2006	3	481	\$760,241
2005	3	242	\$86,044
2004	4	314	\$35,432

Revenue auditing has a specialized focus, requiring specific training and accounting expertise. Revenue Audit Manager, Douglas Enger, is a Certified Public Accountant and has worked exclusively conducting revenue audits for the City of San Diego for 12 years.

Mary Lewis
May 15, 2009
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The total recoveries achieved by the Revenue Audit team over the past five years show that the Revenue Audit Program is providing an outstanding return to the City under the Office of the City Treasurer where the Charter required focus on revenue is paramount. I have a high performing, well qualified team. I do not believe that relocation of the revenue audit function under the City Auditor would result in additional efficiencies, cost savings or an increase in revenue.

cc: Elizabeth Correia, Financial Operations Manager
Douglas Enger, Revenue Audit Manager