THE CITY OF SAN DIEGO

DATE: April 1, 2011

TO: Honorable Members of the Audit Committee

FROM: Eduardo Luna, City Auditor

SUBJECT: **Revenue Recovery Auditing**

In January 2011, the Office of the City Auditor presented the Audit Committee with preliminary information regarding Revenue Recovery Auditing. The Audit Committee took action to request the City Auditor work with the City Administration to identify options for moving forward with Recovery Audits.

The City Auditor met with City Administration to discuss Recovery Audits and this memorandum summarizing opportunities to expand the City's current revenue recovery efforts.

Background

In ensuring revenue collection, the City currently engages in internal-type, external-type, and taxpayer audits to varying degrees. However, the City can engage in additional revenue recovery efforts.

Revenue Recovery Auditing

Revenue Recovery Audits focus on identifying missed opportunities to collect revenue. They may be considered Taxpayer Audits, but focus more on picking up where government revenue collection efforts stop. Currently, the City engages outside firms to collect on past-due bills that remain uncollected after the City's best efforts to collect. Additionally, the City engages outside services to perform sales/use tax and property tax audits. There are other areas where the City can benefit by dedicating effort to Revenue Recovery Auditing.

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Our office met with the City Administration to identify some areas where the City can improve upon these types of activities. The following appear to be areas where the City plans to or may consider engaging in Revenue Recovery activity.

- **Accounts Payable** – audits performed to identify activity such as overpayments, payments for services not rendered, duplicate payments, and to identify unutilized credits from vendors.
    - According to the City Administration, the City anticipates engaging outside assistance to conduct an accounts payable review tentatively by June 2012. The Comptroller will be assessing and updating the Master Vendor File in preparation for the Accounts Payable review.
- **Reverse Sales Tax** – audits to identify where the City paid taxes where it is exempted.
    - Currently, the City does not regularly review sales tax payments to identify Reverse Sales Tax issues. California regulations exempt the City from paying sales taxes on certain purchases for items resold to customers. In July 2009, the City Auditor identified an $80,500 reverse sales tax finding on water additive chemical purchases. We believe there is added benefit to continuing efforts to identify areas where the City paid sales tax exempted by California regulations.
- **Municipal (Superior) Court** – audits that determine opportunities to collect on assessed fines not transferred to local governments.
    - The City currently does not regularly assess the extent to which it receives all revenue generated through the Superior Courts. Currently, the State Controller's Office conducts periodic revenue distribution audits to ensure distributions to the state occur in compliance with state law. These audits do, to some extent, address allocations to cities. However, the audits occur only once every four or more years and do not appear to address Municipal Code-specific violations. While our Revenue Audit in March 2010 made two recommendations to the City Treasurer's Office regarding this type of revenue, we believe the City can benefit by attempting to identify cost-effective external resources to audit court revenue more frequently.

Revenue Recovery Audit Costs

The City may need to solicit third party firms through the procurement process depending on the type of services. There are a number of third party firms which specialize in revenue recovery services with a wide range of services. The compensation structure ranges from flat fees to contingencies. With contingencies, there is no cost unless actual revenue is collected. When the firm identifies and collects on revenue, the firm receives a percentage of the recovery as their form of compensation. In some cases, governments are concerned that contingencies would result in abnormally high payments to third party firms. To mitigate these contingencies, agencies negotiate caps in the maximum payments to the firms.

Conclusion

While the City currently conducts revenue recovery, there are more opportunities to consider. We believe the three areas of accounts payable, reverse sales tax, and municipal court revenue offer the potential for cost-effective returns if the City engages outside firms to conduct contingency-based auditing services.