



THE CITY OF SAN DIEGO

DATE: May 7, 2010
TO: Honorable Members of the Audit Committee
FROM: Eduardo Luna, City Auditor
SUBJECT: Revenue Audit and Appeals Division

As requested by the Audit Committee during the April 2010 meeting, we have evaluated a proposal to consolidate Revenue Audit positions from the City Treasurer's Office into the Office of the City Auditor. This discussion includes the number of new auditors that would be absorbed in the Office of the City Auditor and whether audit efficiencies or enhanced revenue recoveries could be achieved.

We believe that if the City Auditor's Office is requested to absorb the Revenue Audit positions, we would be able to leverage our considerable audit expertise, training, and resources to increase the number of audits conducted and enhance the audit methodologies utilized by the Revenue Audit Division.

Background

The Revenue Audit Division of the City Treasurer conducts mandatory revenue audits in order to identify deficiencies and maximize recovery. The Revenue Audit Division conducts audits of Transient Occupancy Tax (TOT), Franchises, and Percentage Based Leases. In FY 2010, these revenue sources totaled over \$150 million. As of May 1, 2010, the Division is comprised of one principal accountant and five accountants with a FY 2011 proposed budget of \$714,199. Between FY 2006 and FY 2009, the Revenue Audit Division averaged 118 audits, 7,775 audit hours, and \$1.8 million in recoveries per year.

Exhibit I: Basic Performance Statistics of Revenue Audit Division

Table with 6 columns: Metric, FY 2006, FY 2007, FY 2008, FY 2009, Average. Rows include Number of Audits, Audit Hours, and Total Recoveries.

Source: Simpler Payroll Data, Chief Financial Officer, and Revenue Audit Division database.



Most Revenue Audit Division audit activities involve auditing TOT payees as shown in the exhibit below.

Exhibit II: Breakdown of Audits Performed

Audit Type	FY 2006	FY 2007	FY 2008	FY 2009
Business Tax	13	14	0	8
Franchise	3	5	1	1
Lease	29	25	11	18
TOT	73	95	86	91
Total	118	139	98	118

Source: Revenue Audit Division database

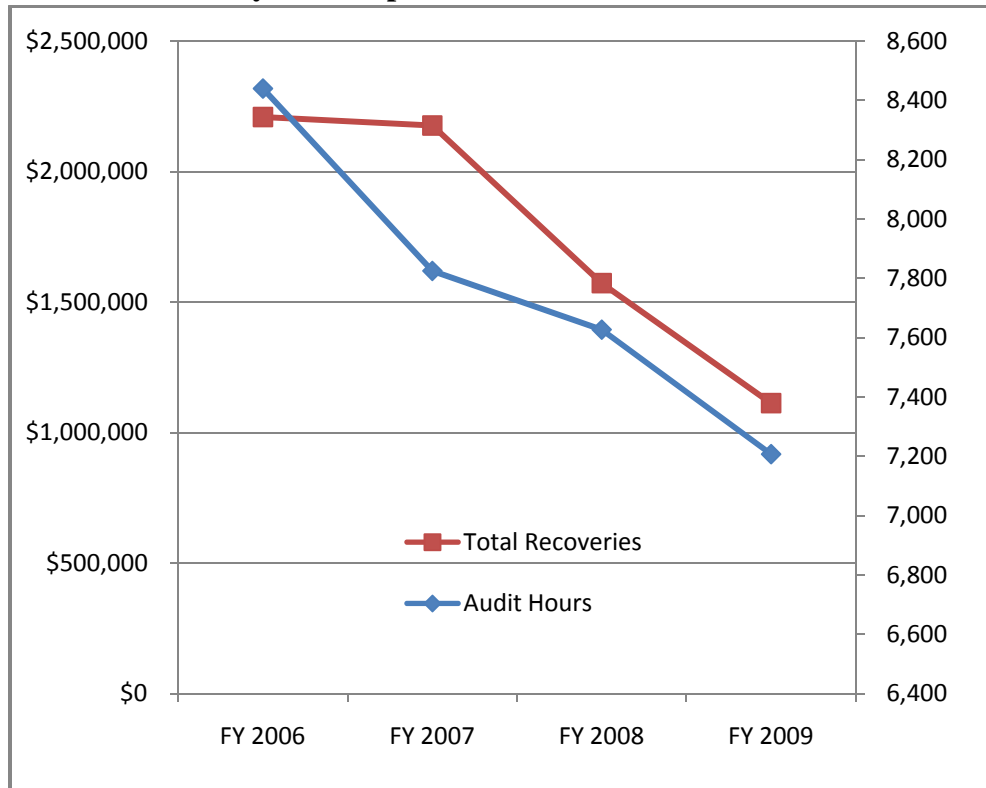
In FY 2009, the Revenue Audit Division performed 118 audits in which 91 (77 percent) were TOT audits. This pattern continued for FY 2006 through FY 2008.

Treasurer Revenue Audit Division Effectiveness

Audit organization effectiveness can be measured by several elements, including audit revenue recoveries, how audit staff hours are employed, and the completion of a target audit work plan. In our review of the Revenue Audit Division, we found that audit effectiveness has decreased in these areas. From FY 2006 through FY 2009, the total revenue recoveries have declined by about 50 percent and audit hours engaged have steadily declined as well.

According to the data we reviewed, between FY 2006 and FY 2009, the Revenue Audit Division recoveries declined from \$2.2 million to \$1.1 million, and there has been a corresponding decline in the number of audit hours spent during the same period. The following exhibit shows the substantial decrease in audit recovers and audit hours incurred for each of the past four fiscal years.

Exhibit III: Multiyear Comparison of Audit Recoveries and Audit Hours



Source: Simpler Payroll Data, Chief Financial Officer, and Revenue Audit Division database

As indicated earlier, Revenue Audit Division audit activities entail auditing Franchises, Leases, and TOT payees. The Revenue Audit Division's key performance measure is to generally audit all payees within two to three years. For TOT audits, missing this performance metric may limit the City's ability to effectively audit. According to the San Diego Municipal Code, TOT payees are required to maintain documentation for a period of only three years. Since TOT audits represent the majority of the audit activities for the Revenue Audit Division, this requirement is an important consideration. Missing the three year window increases the risk auditors will not have access to records necessary to audit.

Based on our review of the Revenue Audit Division data, as illustrated in the following exhibit, we found that the Revenue Audit Division has not met their performance target for auditing Franchise, Lease, and TOT payees.

Exhibit IV: Percent of Audits Conducted During Past Three Fiscal Years

Audit Type	Number of Audit Entities	Percent Audited in Last Three Fiscal Years
Franchise¹	25	76
Lease	90 / 113²	60 / 48
TOT³	324	84

Source: Revenue Audit Division, Real Estate Assets Department, and Environmental Services Department

As shown above, the Revenue Audit Division has only audited 76 percent of Franchises, 60 percent of percentage-based leases, and 84 percent of TOT payees. While missing their performance goal, the Revenue Audit Division has risked limiting their ability to collect on delinquent accounts past the previous three fiscal years.

Office of the City Auditor Planned Efficiencies

In the event that the Revenue Audit Division is transferred to the Office of the City Auditor, we would focus on using our considerable audit expertise, training, and resources to achieve greater efficiencies. We would accomplish this by reevaluating audit methodologies, increasing the amount of audit hours dedicated to revenue audit, and enhancing auditor capabilities with additional training. With 5 accountant FTE positions, and one supervisor, the City Auditor would budget at least 7,800 audit hours, which is higher than the level that has occurred over the past two fiscal years.

In addition, we would assess the current status of the revenue audit program in terms of audits pending and completed within the three year time period. We would establish an audit work plan that would ensure that all Franchise, Leases, and TOT payees are audited within a three time period. We would assign priority to conducting revenue audits of those payees that had not been audited within three years.

¹ This includes three cable video franchises (Time Warner, AT&T, Cox Communications), gas and electric franchise (SDG&E), and twenty-one refuse haulers.

² The Revenue Audit Division is delegated with auditing responsibility for the City's approximately 90 leases that are percentage-based. However, the Citywide Revenue Audit Report noted that there is a discrepancy between the number of percentage leases provided by the Real Estate Assets Department (READ) and the number noted by the Revenue Audit Division—113 versus 90. We recommended that READ should work with the Revenue Audit Division to develop an indicator in the information system used to by the Division ensure an accurate lease audit population.

³ As of July 27, 2009, there were 227 hotels and 97 motels with active accounts in the City's TOT system, in addition to vacation rentals, bed & breakfast properties, management companies, RV parks, and apartment complexes registered as operators. The figure listed includes only hotels and motels, as they constitute the largest portion of TOT accounts.

We would assess the Revenue Auditors audit methodology to audit TOT, franchise fees, and lease holders. Our goal would to incorporate advanced audit analytical techniques and assessing risk in revenues to maximize potential recoveries. Utilizing techniques to identify potential audit recoveries would allow us to audit more efficiently. We would assess the current staff's capabilities and focus the 80 hours of professional development required every two years for auditors performing audits in accordance with Government Auditing Standards to enhancing skills that would increase the efficiency and effectiveness of revenue audit services.

Government Auditing Standards Ensure Independence, Objectivity, and High Standards

Under the City Charter, the City Auditor's Office follows Government Auditing Standards, the prominent auditing standard for local government audit organizations. Organizational independence is a key issue affecting the organization's ability to perform work and report in an objective manner. Standards specifically state that impairments result when an audit function is organizationally located within the reporting line of the areas under audit or when the auditor is assigned or takes on responsibilities that affect operations of the area under audit. In the current reporting structure under the City Treasurer, the Revenue Audit Division both reports and takes on responsibilities which may impact operations of the area under audit. Therefore, under Government Auditing Standards, the Revenue Audit Division is impaired. As currently situated, the Revenue Audit Division would not be able to fully comply with Government Auditing Standards.

If the Revenue Audit Division is moved into the City Auditor's Office, the City Auditor would be able to ensure revenue audits are performed in accordance to Government Auditing Standards. Government Auditing Standards require high standards for planning, assessing audit risk, proper supervision, reporting, and obtaining sufficient and appropriate evidence to support findings. Collectively, the Standards ensure the audit process adequately plans and completes audits in a comprehensive manner.

Other Issues for Consideration

There are additional benefits of transferring the Revenue Audit Division to the Office of the City Auditor which include audit oversight and flexibility to audit other revenue sources. In the Office of the City Auditor, the revenue audit function would be overseen by a leadership and management team with a combined 50 years of audit experience, with professional certifications in Public Accounting, Internal Auditing, and Fraud Examination. The City Auditor's Office offers the expertise not only in accounting, but in audit specialties which the Revenue Audit Division does not appear to maintain.

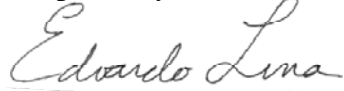
Another benefit of housing the Revenue Audit Division in the Office of the City Auditor would be to coordinate current City Auditor activities with activities performed by Revenue Auditors. For example, the integration of six more Revenue Auditors with performance auditors would provide the opportunities to audit other revenue sources, such as property taxes and court penalties. The latter two revenue categories were identified in the recent Revenue Audit (Report 10-016) as needing additional auditing.

We note that we compiled this information from current available data sources and did not audit the information or conduct a performance audit of the City Treasurer's Revenue Audit Division.

Conclusion

The City Auditor's Office appreciates the support received from the Audit Committee, City Council, and the Mayor for increased audit resources. If the Revenue Audit Division is integrated into the City Auditor's Office, we will move quickly to ensure a smooth transition, and meaningfully increase the audit efficiency of the current Revenue Audit Division.

Respectfully Submitted,



Eduardo Luna
City Auditor

cc: Honorable Mayor Jerry Sanders
Honorable City Council Members
Jay M. Goldstone, Chief Operating Officer
Mary Lewis, Chief Financial Officer
Gail Granewich, City Treasurer
Jan Goldsmith, City Attorney
Andrea Tevlin, Independent Budget Analyst