



## THE CITY OF SAN DIEGO

DATE: January 5, 2011

TO: Honorable Members of the Audit Committee

FROM: Eduardo Luna, City Auditor

SUBJECT: **Revenue Recovery Auditing**

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Councilmember Carl DeMaio requested the Office of the City Auditor prepare a brief memorandum describing Revenue Recovery Auditing and its potential benefits to the City of San Diego. The purpose of this memorandum is to provide background information on some of the types of revenue recovery audits available to local governments and potential costs associated with conducting these activities.

### *Background*

According to the Government Finance Officer Association, revenue collection administration plays one of the most important functions of government – ensuring the collection of revenue owed. In performing this function, the following three types of audits can be useful in ensuring the collection function performs optimally.

- **Internal-type Audits** – audits performed to improve internal controls, testing the accounting system, and evaluating the efficiency and effectiveness of programs and activities.
- **External-type Audits** – financial audits conducted annually by the external financial auditor which provide reasonable assurance that financial statements are not materially misstated.
- **Taxpayer Audits** – compliance-related audits to ensure that a taxpayer is in full compliance with applicable tax and regulatory requirements.

The City currently engages in all three types of audits to varying degrees. However, the City may benefit from exploring more external resources to perform Revenue Recovery audits, a form of Taxpayer Audits.

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### *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.

Our office solicited other local government audit organizations to identify revenue recovery opportunities undertaken by their jurisdictions or performed by their audit functions. The responses identified several areas worthy to consider. These include the following:

- **Accounts Payable** – audits performed to identify activity such as overpayments, payments for services not rendered, duplicate payments, and to identify unutilized credits from vendors.
- **Reverse Sales Tax** – audits to identify where the City paid taxes where they are exempted. For example in July 2009, the Office of the City Auditor issued a Wastewater audit which identified \$80,500 in tax paid on water additive chemicals purchases which were exempted from taxation by California regulations.
- **Municipal Court** – audits that determine opportunities to collect on assessed fines not transferred to local governments.
- **Business Licenses** – audits to identify businesses not paying taxes or obtaining proper licenses. This may include understating the size of businesses to reduce tax liability.
- **Health Benefits** – audits of benefits eligibility and the recovery of costs associated with ineligible benefit payments.
- **Property Tax/Tax Increment** – audits of secured and unsecured parcel data to identify errors and omissions responsible for revenue escaping the City and Redevelopment Agencies.

### *Revenue Recovery Audit Costs*

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.

For example, the Medicare System contracts with third parties to audit ambulance service billings to ensure ineligible services are not billed to Medicare. Medicare recovers the costs reimbursed for ineligible expenses and pays a contingency fee to the third party firms. With contingency fees, the system does not pay if the system does not see actual revenue recovery.

The City of San Jose, California contracted with a third party firm to provide revenue recovery audits of accounts payable vendor disbursements and invoices. The firm was compensated on a contingency basis of 18 percent with a maximum of \$100,000 per claim. The scope of services included identifying overpayments and payment errors, unrecorded purchase returns, unapplied cash, and rebate returns due to the City. One of the value-added benefits of this arrangement was that the firm would be responsible for providing a current master vendor file with current vendor contact information to the City. With the constant changing nature of vendors, the cost to San Jose to perform this value-added activity would have been significant.

The City of Augusta, Georgia contracted with a tax recovery professional to perform a reverse sales tax audit of City utility projects. The audit resulted in the City identifying about \$1 million in tax payments to the State of Georgia where the City was exempted from paying state tax. The tax professional received a small percentage of the revenue recovery as compensation.

A northern California community college district contracted with a firm to perform a health benefit eligibility audit. The cost was a flat fee and resulted in the district identifying over 20 deceased dependents of employees for which the district continued to pay medical benefits. The district provides fully-funded health care to employees and dependents; as a result, the finding resulted in a reduction of cost and reduction in the actuarialized unfunded postemployment liability cost.

### *Conclusion*

While the City currently conducts revenue recovery, there are more opportunities to consider. In doing so, the City should evaluate the cost benefit of expanding these beneficial recovery activities. Our office can work with the Chief Financial Officer to identify additional revenue recovery opportunities, while not duplicating current efforts.