

Office of the City Auditor

INFORMATION CALENDAR

November 9, 2004

To: Honorable Mayor and
Members of the City Council
From: Ann-Marie Hogan, City Auditor
Subject: Business License Tax Program Audit Report For Fiscal Year 2004

INTRODUCTION

The attached Business License Tax Program Audit Report identifies the Business License tax revenue identification efforts and accomplishments of the Auditor's Office during fiscal year 2004.

In the past, the Auditor's annual Business License Tax Program Audit Report included our accomplishments in Business License revenue identification as well as audit findings and recommendations resulting from conditions observed during the course of our audit work. Beginning in fiscal year 2002, we changed the scope of our program, eliminating the on-going audit of Finance's Business License Tax operations.

Finance is continuing to periodically report to Council regarding the implementation status of past audit recommendations. As we do with other audits, at some future date we will conduct a follow-up audit of Business License Tax operations.

CURRENT SITUATION AND ITS EFFECTS

Business License Tax Program audits resulted in 17 businesses being billed a total of \$125,070 during fiscal year 2004. \$133,038 was collected during the fiscal year, including \$82,981 from prior year billings.

Since inception of the program in 1982, auditors have identified revenues totaling \$4,537,588. Additionally, since non-compliant businesses will often pay the correct tax after the audit, the identified revenue is not a one-time windfall, but generally becomes part of the future revenue stream.

For each \$100,000 identified by audit, about \$18,000 in additional revenue can be expected for each future year, as long as the audited businesses continue to generate consistent sales. This would result in over \$22,000 annually in addition to the one time revenue of \$125,070.

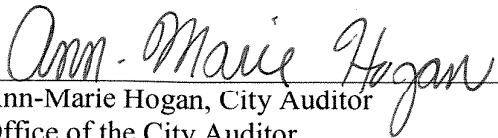
POSSIBLE FUTURE ACTION AND FISCAL IMPACTS

The auditors intend to continue to allocate staff resources to identify underreporting and unlicensed businesses. Although future reductions to the audit budget will affect the number of staff hours devoted to revenue audits, continuous improvement of audit techniques, and the installation of more sophisticated audit software, should enable the auditors to continue to provide audit services with, on average, significant benefits compared to costs.

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Approved:

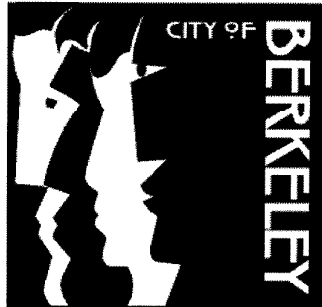


Ann-Marie Hogan, City Auditor
Office of the City Auditor

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CITY CLERK DEPT

City of Berkeley



Office of the City Auditor
Ann-Marie Hogan, City Auditor

Business License Tax Program Audit Report

For Fiscal Year Ending June 30, 2004

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Presented to Council November 9, 2004

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BUSINESS LICENSE TAX AUDIT PROGRAM REPORT

For the Fiscal Year Ended June 30, 2004

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I. PURPOSE AND OBJECTIVE

The purpose of this report is to present the results of the City Auditor's Business License Tax Audit Program for fiscal year 2004.

The objective of the Business License Tax Audit Program was to recover Business License revenues that the City would not otherwise receive because persons and businesses doing business in Berkeley under-paid the tax due.

II. SCOPE AND METHODOLOGY

During fiscal year 2004, the auditors reviewed businesses for Business License tax compliance for calendar years 2001, 2002, and 2003. The businesses selected for review included various types of businesses suspected of underreporting. The auditors primarily used Audit Command Language (ACL) software to compare the sales data for individual businesses reflected in sales tax records with self-reported gross receipts in the City's Occupational License (OL) database. The businesses that reported gross receipts to the State for sales tax purposes that were significantly higher than the gross receipts reported to the City for Business License tax were selected for audit. Also during fiscal year 2004, some of the audits initiated in the previous fiscal year were completed.

Business owners selected for audit were requested to provide documentation about their gross receipts, such as income tax returns, sales tax returns, and/or financial statements. Based on the information provided, when underreporting of gross receipts was found, business owners were billed for unpaid Business License taxes plus penalties and interest, as provided for in Berkeley Municipal Code (BMC) Section 9.04.110 and 9.04.120.

Prior to fiscal year 2002, the City Auditor's annual Business License Tax Program Audit report included our accomplishments in Business License revenue identification as well as audit findings and recommendations resulting from control weaknesses or system deficiencies observed during the course of our audit work. For the time being, we have limited the scope of our audit to focus on Business License tax compliance. However, we will continue to monitor and report on the implementation status of our earlier recommendations through our own follow-up reporting to the City Manager and to Council, as we do with other audits.

Audit work was performed in accordance with Generally Accepted Government Auditing Standards for an attestation review. Audit work was limited to those areas specified in the scope and methodology section of this audit.

III. BACKGROUND

The Business License tax requirement is codified in BMC Chapter 9.04. It was enacted solely for revenue purposes and, as such, is not meant to be a regulatory function. Authority and administration of the Business License tax has been assigned to the Customer Service Division of the Finance Department.

The City's accounting system, FUNDS, reports that the actual amount of Business License tax, penalties, and interest revenue for fiscal year 2004 was \$11,063,515. During fiscal year 2004, the City Auditor's Office identified revenues amounting to \$125,070. Staffing for the Business License tax audit was planned at 1.5 full-time equivalent (FTE), and later reduced to .5 FTE in February 2004.

In December of each year, the Finance Department sends a Business License tax renewal form (Tax Declaration) to all business license holders listed in the City's OL database. Taxpayers are instructed to fill-in their gross receipts information, calculate the tax, and return the form to the Finance Department with payment. Newly established businesses are required to obtain a Business License within 15 days of commencing business.

BMC section 9.04.035 requires all persons/entities engaged in business within Berkeley to obtain a license and to pay an annual license fee. Business License tax is generally assessed on a business's prior year gross receipts generated within Berkeley. In some instances, the tax is a fixed fee, or is assessed based on gross payroll. All licenses are effective on January 1 and expire on December 31. A license renewal is delinquent if payment is not received on or before February 28 of each year.

If full payment is not received by April 1 for license renewals, or within 60 days following the commencement of business for newly established businesses, a penalty of 50 percent of the license tax is added. Interest accrues at the rate of 1 percent each month on the unpaid taxes and penalties, and will continue to accrue until paid.

IV. SUMMARY OF PROGRAM RESULTS

A. Audits Initiated

During fiscal year 2004, the City Auditor's Office limited the persons and entities they selected for audit to only those engaged in business in Berkeley during calendar years 2001, 2002, and 2003. Emphasis was on whether business owners accurately reported gross receipts to the City of Berkeley, rather than unlicensed and delinquent businesses (businesses with old licenses).

Twenty businesses were identified and reviewed for underreporting. The same owner or company owned some of these businesses. Of these, eleven were billed for underpayment of taxes, one was in compliance (closed), and eight were still in the process of being audited, as of June 30, 2004. In addition to the 20 audits initiated during fiscal year 2004, there were 76 audit cases that were carried over from fiscal year 2003.

Industry Classification Categories	Underreporting
Business and Repair	2
Construction Contractors	1
Manufacturing	3
Retail	12
Wholesale	2
Total # of Audits Initiated in FY 2004	20

B. Audit Assessments

During fiscal year 2004, 17 businesses were assessed (billed) a total of \$125,070 for unpaid taxes, penalties and interest. The same owner or company owned some of these businesses. Total dollars assessed during fiscal year 2004 included assessments from six audit cases initiated in prior fiscal years and billed in fiscal year 2004. Audit cases initiated in prior years resulted in the assessment of \$7,153 in unpaid taxes, penalties and interest. Ten audit cases were initiated and billed during fiscal year 2004, accounting for \$117,917 of the \$125,070 in unpaid taxes, penalties and interest.

Business License Tax Program Audit For FY 2004

Composition of FY 2004 Audit Assessment Totals	Amount Assessed
Unpaid Business License taxes*	\$67,520
Penalty Assessments*	\$34,777
Interest Charges	\$22,773
TOTAL	\$125,070

Note: Audits resulting in an underpayment or overpayment of taxes, penalties and interest totaling \$50 or less were closed without a billing or refund, pursuant to BMC 7.20. The dollar threshold is based on the rationale that the costs to process a billing or refund are at least \$50. Total: 4

*The auditors identified Business Improvement District Taxes (BID) during the audit and included the revenue with Business License taxes and penalties. The amount of unpaid BID taxes was \$1,872 and the penalties were \$1,884.

Industry Classification Category	Underreporting	Delinquent	Total # of Assessments
Refuse Hauler	1*	0	1
Business and Repair	1	0	1
Rental	1*	0	1
Retail	10	0	10
Professionals	3*	1*	4
TOTAL	16	1	17

*Prior year audits

Summary of FY 2004 Audit Activity	Prior Years	FY 2004	Total
Audits Carried Over	76	0	76
Add: Audits Initiated	N/A	20	20
Less: Audits Dropped	3	1	4
Less: Closed with Billed Assessments	6	11	17
SUBTOTAL	67	8	75
Less: Audits Referred to Finance	64	0	64
TOTAL # Audits Carried Over to FY 2005	3	8	11

C. Audits Dropped

Based on our review of auditee documentation and information available in City records, four audit cases were dropped (closed without a billing) for the following reasons:

- 2 In Compliance
 - 1 Business closed
 - 1 No material underpayment/overpayment of tax
- Total: 4

D. Audits Referred to Finance

During fiscal year 2004, 64 audits were referred to Finance-Customer Service for follow up because the business owners were non-compliant with City regulations, primarily because there was no response or the auditor was unable to obtain adequate documentation to perform an audit.

E. Business License Tax Appeals

Businesses can appeal a tax bill resulting from audits to the Hearing Officer in the City Manager’s Office, in accordance with BMC Section 9.04.270. Four businesses (two owned by the same individual) appealed their audit cases. Two of them resulted in revised billings. Of the two revised billings, one was a refund of \$561 due to additional information presented at the hearing. The other resulted in a Hearing Officer waiver of penalties and interest totaling \$8,150 due to confusion over the City’s implementation of current SIC codes. Revised billings for both were issues fiscal year 2005. Note: More information about the issue of revised SIC codes can be found in the City Manager’s report to Council on October 19, 2004, item number 25.

F. Projected Business License Tax Revenue

In fiscal year 2004, the City Auditor’s Office budgeted 1.5 FTE auditors to perform Business License tax audits. Revenue of at least \$125,000 per assigned auditor was projected, or \$187,500 (1.5 FTE x \$125,000) for the 1.5 FTE. However, during the year, staffing for the Business License tax audit program was reduced to .5 FTE. The actual FTE for the fiscal year, including supervisory time, was 1.09 FTE. The General Audit division spent \$133,261 less than what was budgeted for fiscal year 2004. During fiscal year 2004, for every dollar spent on salaries, fringe benefits, and the administration of the Business License tax Program, the auditors identified and billed approximately \$1.30 in Business License tax, penalties, and interest. The auditors believe that, in future years, revenue targets will continue to be met or exceeded, based on past experience, current staff capabilities, and the planned implementation of newly acquired technology for more effective revenue identification.

<u>Total Revenue</u>	<u>Auditor Salaries*</u>	<u>Ratio</u>
\$125,070	\$93,034	1.3 : 1
<p>*Auditor Salaries = auditor salaries + supervisory salaries + fringe benefits divided by .80 to account for vacation, sick leave, training, and other administrative use of time.</p>		

G. Collections

Total payments received during fiscal year 2004 from Business License tax audits were \$133,038. Of this, \$82,981 was collected from prior fiscal year billings. In August 2004, accounts receivable from prior years on three accounts totaling \$17,834 was written off because they were deemed uncollectible. As of June 30, 2004, the accounts receivable balance for the Business License Tax Audit Program was \$72,621.

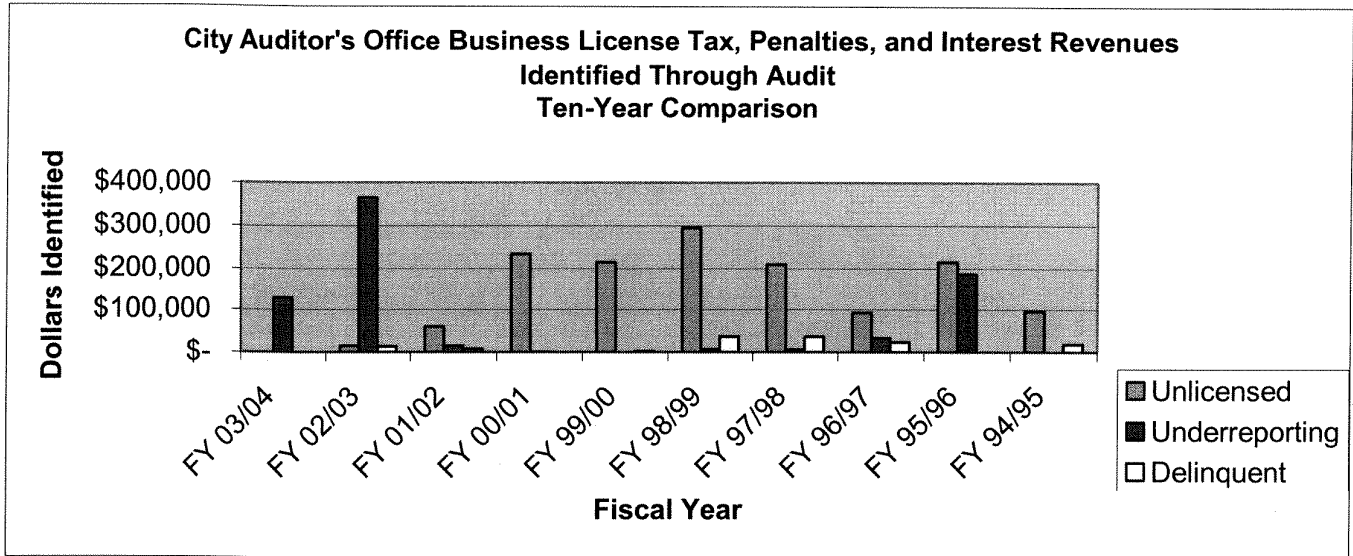
H Cumulative Statistical Information

The Business License Tax Program audit function in the City Auditor's Office continues to show a good rate of return for the staff time invested.

**City Auditor's Office
Business License Tax, Penalties and Interest Revenues
Identified through Audit**

Period	Unlicensed Businesses		Under-reporting Of Gross Receipts		Delinquent License		TOTAL	No. Of Hours Spent	% Of FTE @ 80% Productive Time*
FY 03/04	0	0	16	124,536	1	534	125,070	1,806	1.09
FY 02/03	8	15,162	31	364,782	8	13,351	393,295	3,457	2.08
FY 01/02	54	59,701	8	15,020	1	7,653	82,374	2,236	1.34
FY 00/01	115	233,571	2	934	0	0	234,505	1,915	1.15
FY 99/00	112	214,361	0	0	2	1,875	216,236	1,553	0.93
FY 98/99	186	295,323	5	7,283	3	36,591	339,197	2,536	1.52
FY 97/98	152	209,723	9	6,466	14	36,175	252,364	835	0.50
FY 96/97	25	91,798	16	32,468	15	23,769	148,035	783	0.47
FY 95/96	60	215,249	59	186,901	0	0	402,150	689	0.41
FY 94/95	45	95,189	0	0	13	18,474	113,663	522	0.31
TOTALS	757	\$1,430,077	146	\$738,390	57	\$138,422	\$2,306,889	16,332	

* Productive Time is calculated based on 2,080 work hours per year @ 80% (Hours Spent/(2,080 x 80%) The 80% figure is used so that the cost of the hours spent includes an allowance for sick leave, vacation days, holidays, and training and other administrative uses of time.



V. CONCLUSION

During the last ten years, the City Auditor's Business License Tax Audit Program has identified 960 businesses that owed the City \$2,306,889 in Business License taxes, penalties, and interest. Since inception of the program in 1982, the revenues identified from the City Auditor's Office Business License tax audits have totaled \$4,537,588. Once a business obtains a license, it usually continues to pay in succeeding years. Therefore, the identified revenue is not a one-time windfall, but becomes a part of future revenue streams. Our reporting of revenue identified, and our performance target per auditor, addresses the first year's revenue only; about 54% is unpaid tax, while 46% is penalties and interest. Unpaid tax generally includes unpaid tax for the last three years audited. Accordingly, for each \$100,000 in tax identified by audit, about \$18,000 (\$54,000 / 3 years) in tax for each succeeding year can be expected, as long as the audited businesses are generating consistent gross sales.

This year's focus on auditing underreporting businesses was due to the Auditor's Office change in Business License Tax data sources. Using ACL and sales tax data from the STARS system, auditors were able to adopt a more effective approach to identify businesses that underreported gross receipts. This new approach allowed the auditors to test and analyze gross receipts reported to the City effectively, and the auditors were able to isolate businesses that were likely to owe the highest unpaid taxes. The auditors will continue to explore new opportunities to improve the methodology for identifying underreporting businesses, increasing the revenues generated through the audit process.

