



Office of the City Auditor

INFORMATION CALENDAR

May 13, 2003

To: Honorable Mayor and
Members of the City Council

From: Ann-Marie Hogan, City Auditor

Subject: Business License Tax Program Audit Reports For Fiscal Year 2002 and the First Three
Quarters of Fiscal Year 2003

INTRODUCTION

The two attached Business License Tax Program Audit Reports identify the Business License tax revenue identification efforts and accomplishments of the Auditor's Office during the last year and nine months. One report covers activity during fiscal year 2002 and the other activity during the first three quarters of fiscal year 2003. 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. We have now changed the contents of our report, excluding the audit findings and recommendations. This will allow us to report more timely to Council on our own work plan and accomplishments, while continuing to monitor the implementation status of our earlier recommendations through follow-up reporting to the City Manager and to Council, as we do with other audits.

SUMMARY

New revenue resulting from our Business License Tax Program audits totaled \$82,374 for fiscal year 2002 and \$382,710 for the first three quarters of fiscal year 2003. Since inception of the program in 1982, the auditors have identified revenues totaling \$4,401,933. Additionally, since non-compliant businesses will often pay the correct tax after the audit, the identified revenue is not a one-time windfall, but often becomes part of the future revenue stream.

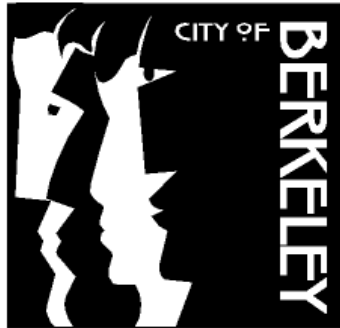
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Office of the City Auditor

City of Berkeley



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

Business License Tax Program Audit Report

For the Fiscal Year Ending June 30, 2002

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Presented to Council May 13, 2003

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BUSINESS LICENSE TAX PROGRAM AUDIT REPORT
For the Fiscal Year Ending June 30, 2002
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I. PURPOSE AND OBJECTIVES

The purpose of this report is to present the results of the City Auditor's Business License Tax Audit Program for fiscal year 2002.

The objectives of the Business License Tax Audit Program were to:

- Identify persons/entities engaged in business in Berkeley that have not obtained the required license.
- Ascertain if licensed businesses have accurately reported their gross receipts and paid the appropriate license fees.

II. SCOPE AND METHODOLOGY

During fiscal year 2002, the auditors reviewed businesses for Business License tax compliance for calendar years 1999, 2000, and 2001. The businesses selected for review included:

- 1) Physicians selected from physician listings.
- 2) Business establishments located within the City's Districts 7 & 8 that appeared unlicensed.
- 3) Delinquent Business License taxpayers (had not renewed their Business License) who had not responded to renewal notices from Finance.

Additionally, some of the audits initiated in the previous fiscal year, including audits of underreporting City construction contractors, were completed during fiscal year 2002.

Entities subject to the Business License tax were selected and traced to the City's business license database to determine whether they were registered as a licensed business. Businesses that were not in the database were presumed unlicensed. Licensed businesses were subjected to audit if their Business License tax appeared to be delinquent or if it appeared that their gross receipts used to calculate the tax had been underreported.

Business owners selected for audit were requested to provide information about their gross receipts. We requested and accepted as documentation income tax returns, lease agreements, and/or financial statements. Based on the information provided, we billed these businesses for unpaid Business License taxes, penalties, and interest as provided for in Berkeley Municipal Code (BMC) Chapter 9.04.

The City depends largely on the accurate disclosure of information by the reporting entity. Because of this, Business License revenues collected may or may not reflect the true facts of the taxpayer's business.

In the past, 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 conditions observed during the course of our audit work. We have now changed the contents of our report, excluding the audit findings and recommendations. This will allow us to report more timely to Council on our own work plan and accomplishments. 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.

With the exceptions noted above, our work was performed in accordance with Government Auditing Standards as prescribed by the Comptroller General of the United States and was limited to those areas specified in the Scope and Methodology section of this report.

III. BACKGROUND

The Business License tax requirement is codified in the Berkeley Municipal Code (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 by BMC 9.04.070. The City's accounting system, FUNDS\$, reports that the actual amount of 2002 Business License tax, penalties, and interest revenue was \$9,873,702.

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, a penalty of 50 percent of the license tax is added. Interest at the rate of 1 percent per month, on the amount of the fees and penalties continue to accrue, until paid. Newly established businesses are required to obtain a Business License, within 30 days of commencing business.

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

In 1982, the Auditor's Office collaborated with the Finance Department and began a citywide systematic audit of business licenses. Based on the adopted budget for fiscal years 2000 and 2001, Finance formed a temporary Business License Project Team (Special Project) consisting of two Field Representatives and one Office Assistant to increase efforts to identify and collect Business License taxes. Business License tax revenue was anticipated to offset the cost of funding Special Project.

IV. SUMMARY OF PROGRAM RESULTS

A. Audits Initiated

During fiscal year 2002, the City Auditor's Office reviewed physicians and businesses located in districts 7 and 8 to determine whether they were unlicensed. We also performed follow-up work on businesses that were sent several renewal notices from Finance-Customer Service to determine the status of their non-renewal.

A.1 Unlicensed Physicians

We obtained two sources of physician listings and reviewed information regarding 127 physicians to determine whether they appeared to be in compliance with the business license tax requirements. Out of the 127 physician cases reviewed, 62 resulted in issuance of audit notification letters. The notification letters initiate the audits and request the businesses to provide documentation for the audit.

Of the 62 physician cases audited, 2 owed tax and were billed, 57 were in compliance, 2 are in the process of being audited, and 1 would not provide documentation for the audit and will be referred to Finance for follow-up. Audit results indicate that the vast majority of physicians doing business in Berkeley are in compliance with the Business License Tax requirements.

A.2 Unlicensed Businesses in Districts 7 & 8

The auditors reviewed 748 businesses located within the street boundaries of Districts 7 and 8. Each business was reviewed for compliance with the Business License tax requirements. The auditor verified compliance by crosschecking the business name with the City's Occupational License (OL) database system.

Of the 748 businesses reviewed, 138 were sent audit notification letters.

Of the businesses audited, 52 owed tax and were billed, 55 were in compliance, 10 are in the process of being audited, and 21 would not provide documentation for the audit and will be referred to Finance for follow-up. The 52 unlicensed businesses represent 7% of the businesses sampled; if all of the non-responding and "in progress" auditees are also determined to be unlicensed, an unlicensed rate of 11% would be assumed.

A.3 Businesses With Renewal Notices From Finance

Businesses identified as having been sent five or seven renewal notices from Finance were reviewed for lack of compliance with the Business License tax requirements due to non-renewal. An OL system report identified 313 businesses that had been sent five renewal notices and 144 businesses that had been sent seven renewal notices, for a total of 457 businesses. The auditors reviewed 145 of these businesses, of which 34 were sent audit notices.

Of the 34 businesses audited, 1 owed tax and was billed, 1 was in compliance, 18 are still in the process of being audited, and 14 would not provide documentation for the audit and will be referred to Finance for follow-up.

B. Audit Assessments

During fiscal year 2002, 63 businesses were assessed (billed) a total of \$82,374 for unpaid taxes. The billings were comprised of the following:

| Particulars | Amount |
|-------------------------------|------------------|
| Unpaid Business License taxes | \$ 52,251 |
| Penalty Assessments | 19,840 |
| Interest Charges | 10,283 |
| TOTAL | \$ 82,374 |

| Categories | Unlicensed | Under-reported | Delinquent | Total # of Assessments |
|--|------------|----------------|------------|------------------------|
| Business, Personal & Repairs | 14 | | | 14 |
| Construction Services (Carry over from FY 01) | | 8 | | 8 |
| Grocer | 1 | | | 1 |
| Professional | 33 | | | 33 |
| Rental Property | | | 1 | 1 |
| Retail | 6 | | | 6 |
| Total | 54 | 8 | 1 | 63 |

C. Audits Dropped

Based on our review of auditees' documentation and information available in City records, 124 audit cases were dropped for the following reasons:

- 12 Businesses closed/moved out of Berkeley
- 55 Business License under a different name
- 7 Exempt from Business License
- 13 Miscellaneous, such as undeliverable audit notices
- 32 Employee, not a business
- 5 Immaterial difference

D. Business License Tax Appeals

Businesses can appeal a tax bill resulting from the audit to the Hearing Officer in the City Manager's Office, in accordance with BMC Section 9.04.270. There were three appeal hearings associated with audit cases during fiscal year 2002. One was a fiscal year 2002 audit case (billed in FY 2002) and two were fiscal year 2001 audit cases. All three appellants requested that their penalties, interest, or both be waived because they had been unaware Berkeley had a Business License tax. There were no tax, penalties, and interest waived for any of the appellants.

E. Projected Business License Tax Revenue

In fiscal year 2002, the City Auditor's Office was budgeted about 1.5 FTE to perform business license tax audits. Revenue of at least \$125,000 per assigned auditor was projected (\$187,500). Revenue identified did not meet the \$187,500 target.

Position vacancies, including the Audit Manager as well as staff auditors, were significant during fiscal year 2002. This impacted both revenue-generating audits and completion of the larger audit work plan. The division spent \$131,555 less than what was budgeted for the year. Some of this money was used to balance expenses in Payroll Audit, and most was returned to the City to balance overages in other departments. The Auditor's Office was fully staffed by the end of the fiscal year. 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.

During the last eight years, for every dollar spent on salaries, fringe benefits, and administration of the Business License Tax Program, the auditors identified and billed approximately \$4 in Business License tax, penalties, and interest.

| <u>Total Revenue</u> | <u>Auditor Salaries</u> | <u>Ratio</u> |
|----------------------|-------------------------|--------------|
| \$1,788,524 | \$470,424 | 4:1 |

F. Collections

Total payments received during fiscal year 2002 from Business License tax audits were \$86,599. Of this, \$70,620 was collected based on fiscal year 2002 billings, and \$15,979 was collected based on prior years' billings.

As of June 30, 2002, the accounts receivable balance for the Business License tax audit program was \$38,216.

G. Cumulative Statistical Information

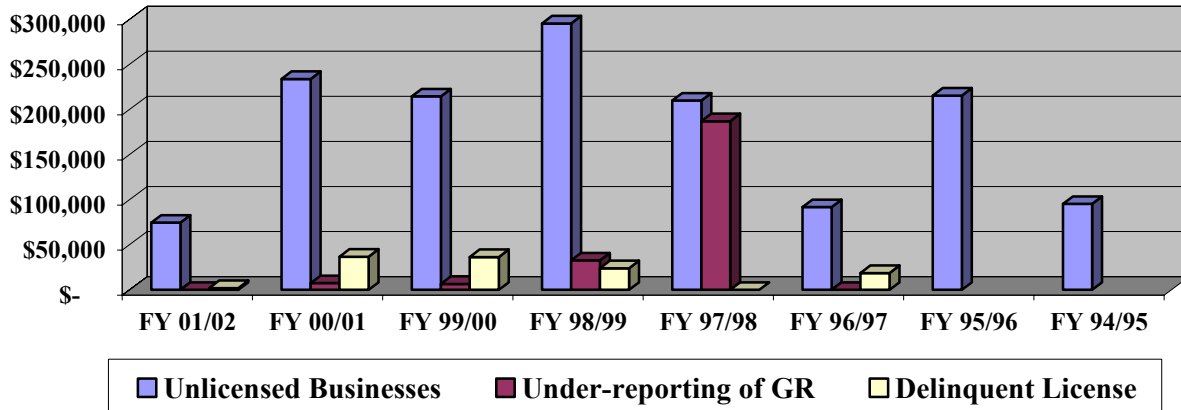
The Business License Tax Program audit function in the City Auditor's Office continues to show a high rate of return for the staff time invested.

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

| Period | Unlicensed | | Under-reporting | | Delinquent | | TOTAL | No. of Hours Spent | FTE* @ 80% Productive Time |
|---------------|------------|--------------------|-------------------|-------------------|------------|------------------|--------------------|--------------------|----------------------------|
| | Businesses | | of Gross Receipts | | License | | | | |
| 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 | 749 | \$1,414,915 | 99 | \$ 249,072 | 48 | \$124,537 | \$1,788,524 | 11,069 | |

* Productive Time is calculated based on 2080 hours @ 80% (Hours Spent/(2080 x 80%))

**City Auditor's Office
Business License Tax, Penalties, and Interest Revenues Identified
Through Audit
Eight-year Comparison**



V. CONCLUSION

During the last eight years, the City Auditor's Business License Tax Audit Program has identified 896 businesses that owed the City \$1,788,524 in Business License tax, 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 \$4,019,223. 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 60% is tax, while 40% 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 \$20,000 (\$60,000 / 3 years) in tax for each succeeding year can be expected, as long as the audited businesses are generating consistent gross sales.

This year, we primarily reviewed three groups of auditees; unlicensed physicians, unlicensed businesses in City Districts 7 and 8, and businesses that had not renewed their license after Finance had sent them five or more notices.

This year's focus on auditing unlicensed businesses identified significantly fewer instances of noncompliance than anticipated, particularly among physicians. However, results from our geographic sample (Districts 7 and 8) indicate that a substantial number of Berkeley businesses continue to operate without paying tax.

Results of audits of City contractors, which were initiated in the previous fiscal year but finalized in 2002, indicated that a significant percentage of businesses were understating their gross receipts in reporting to the City. The auditors will continue efforts to identify these underreporting businesses in the future. This may result in a significant future increases in revenue.



Office of the City Auditor

Date: April 25, 2003
To: Honorable Mayor and
Members of the City Council
From: Ann-Marie Hogan, City Auditor
Subject: 3rd Quarter Report on the City Auditor's Business License Tax Function

Effective for the fiscal year ending June 30, 2002, our office severed our report on our accomplishments in Business License revenue identification from the report dealing with the conditions observed and outstanding audit findings related to Finance – Customer Service. Instead we will substitute periodic reports to Council on planned and actual revenue recovery, and will deal with the Finance - Customer Service issues in our follow-up activities. Future audits in the area will be considered, but will not be an annual event. This is the report covering the City Auditor's Business License Tax Audit Program activity for the first nine months of the current fiscal year (through March 31, 2003).

The objectives of the City Auditor's Business License Tax Program are: 1) to identify and assess unlicensed businesses and 2) to evaluate the accuracy of reported gross receipts of licensed businesses and associated license fees. The Business License requirement is codified in the Berkeley Municipal Code Chapter 9.04. It was enacted solely for revenue purposes and, as such, is not meant to be a regulatory function.

**City Auditor's Office
Business License Tax Revenues Identified**

| Period | Unlicensed Businesses | Underreporting Businesses | Delinquent License | Total Revenue Identified |
|--------------------------------------|-----------------------|---------------------------|--------------------|--------------------------|
| July 1, 2002 – March 31, 2003 | \$15,162 | \$354,198 | \$13,350 | \$382,710 |
| July 1, 2001 – June 30, 2002 | 59,701 | 15,020 | 7,653 | 82,374 |
| July 1, 2000 – June 30, 2001 | 233,571 | 934 | -- | 234,505 |
| July 1, 1999 - June 30, 2000 | 214,361 | -- | 1875 | 216,236 |
| July 1, 1998 – June 30, 1999 | 295,323 | 7,283 | 36,591 | 339,197 |

As of March 31, 2003, the auditors identified revenue totaling \$382,710 and the City collected outstanding receivables totaling \$153,021. We reviewed 255 businesses and 102 were sent audit notification letters. We primarily focused on businesses that underreported their gross receipts. We audited 82 businesses for underreporting, including 60 dentists and 6 larger businesses. We also audited 20 businesses to determine why their Business License was delinquent. Fifty-four audit cases were closed, the majority of which were dentist cases. In addition, the City placed liens on three rental properties.

Each year, full time equivalent (FTE) employees assigned to conduct Business License tax audits are projected to generate \$125,000 each in one-time Business License tax revenue. For the first nine months of fiscal year 2003, 2.3 FTEs worked on Business License tax audits, and identified \$382,710 in revenue. This is \$167,085 above the 3rd quarter goal of \$215,625 ($\$125,000 \times 2.3 \text{ FTE} \times \frac{3}{4} \text{ FY}$), or 77% above the projected amount for each auditor. For the final quarter of the year, resources devoted to revenue identification were reduced, because of a temporary transfer of staff to another department, in order to implement the fiscal year 2003 reduction of one FTE in the Auditor's Office.

During the last nine years, the City Auditor's Business License Tax Program identified 941 businesses that owed tax for an increase in total Business License tax revenue of \$2,171,234. Since inception of the program in 1982 through March 31, 2003, the revenues identified from the City Auditor's Office Business License audits total \$4,401,933. 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. A more complete analysis of future revenue streams is contained in the accompanying report for the previous fiscal year.