

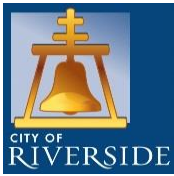
# PERFORMANCE AUDIT

Finance Department

**Business License Tax  
Administration &  
Collections**

**May 2, 2016**

Office of the City Manager  
Internal Audit Division  
Cheryl Johannes, Internal Audit Manager



## Internal Audit

### Objective of Review

- Assess the efficiency/effectiveness of administrative processes/ procedures in order to maximize business license tax revenue/collections; and
- Ensure adequacy of internal control activities.

### Background

There are over 20,000 businesses with active licenses operating within the City. Business license taxes are a source of revenue for the City's General Fund. City business license tax revenue is budgeted at \$6.5 million in FY2015/16, which is 2.5 percent of the City's projected General Fund Revenue. Effective management of the business license tax revenue collection effort is critical to ensure stable revenues are available to support police, fire, parks, and other public services.

Per Municipal Code 5.04 – Taxes, Licenses and Regulations, businesses operating within the City are required to have an active business license (or an exemption); renewed annually. The amount of the annual business license tax is based on the type of business, number of employees and gross annual receipts. Three business improvement districts (BIDs) within the City require an additional tax equal to the annual business license tax, which is due and payable at the time of a new and renewed business license (MC 3.46, 3.48 and 3.49). Business license taxes are self-assessed and self-reported.

## PERFORMANCE AUDIT ~ Summary

### Finance Department

#### Business License Tax Administration and Collections

We found that the Business License Tax Division has established adequate administrative practices and internal controls to carry out the requirements of Municipal Code 5.04; the Division successfully migrated to a new business license software application/system, HdL PRIME.<sup>1</sup>

There is opportunity to increase business license tax revenue and improve collections on delinquent accounts, enhance customer service, and ensure the City collects the tax revenue it is owed from businesses, specifically by:

- Implementing an Administrative Processing Fee to support enhancements to the business license tax system (HdL), increasing functionality and customer service;
- Reducing the delinquency notice timeline from 180 days to no more than 150 days (or less);
- Prioritizing collection efforts based on customer segments – size of the business based on gross receipts, amount owed, payment history, etc. ; and
- Implementing a Business License Tax “audit program” to ensure businesses are remitting the proper amount of license tax and that taxes are administered in a fair and uniform manner throughout the business community.

<sup>1</sup> HdL's PRIME Business License Tax software agreement was approved by the City Council December 18, 2012.

## OBJECTIVE, SCOPE and METHODOLOGY

In accordance with the Internal Audit Work Plan for FY 2015-16, we have completed a performance audit of the Finance Department's Business License Tax Division ~ Administration and Collections. The objective of the review was to:

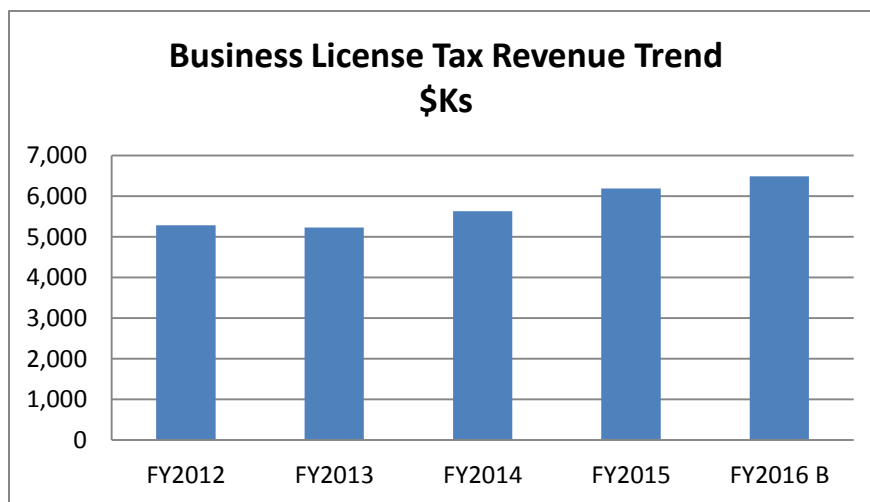
- Assess the efficiency/effectiveness of administrative processes/ procedures in order to maximize business license tax revenue/collections; and
- Ensure adequacy of internal control systems/activities.

We relied upon the following to assess the administrative operations and accomplish our objectives:

- Riverside [Municipal Code 5.04](#);
- Policies/procedures specific to business license tax administration;
- City's financial system, IFAS;
- HdL PRIME, business license software and system generated reports; and
- Various external sources for "best practices" and performance benchmarks.

We reviewed current Division policies/operating procedures; interviewed management to obtain information about actual practices within the Division; reviewed system reports to determine the status, aging and amount of business license accounts delinquent; randomly selected and reviewed business license accounts in HdL PRIME to test accuracy of fees applied to the new applications/renewals and to determine the efficiency and consistency of collection efforts on a sample basis; reviewed hardcopy documentation to determine the efficiency and adequacy of identifying unlicensed businesses on a sample basis; and, performed a benchmarking (best practices) analysis with other California cities.

## BACKGROUND



Source: IFAS

Business license taxes are a source of revenue for the City's General Fund. City business license tax revenue (G/L Object 101-320000) is budgeted at \$6.5 million in FY 2015-16, or 2.5 percent of the City's

General Fund revenue.<sup>1 2</sup> Effective management of the business license tax revenue collection effort is critical to ensure stable revenues are available to support police, fire, parks, and other public services.

Per [Municipal Code 5.04 – Taxes, Licenses and Regulations](#), businesses operating within the City are required to have an active business license (or an exemption); the license is to be renewed annually. Business license taxes are self-assessed and self-reported.

The amount of the annual business license tax is based on the type of business, number of employees and gross annual receipts. Three business improvement districts (BIDs) within the City require an additional tax equal to the annual business license tax, which is due and payable at the time of a new and renewed business license (MC 3.46, 3.48 and 3.49); BID taxes are remitted to the corresponding district for the promotion of these commercial areas.

At the time of our review, the HdL system was reporting just over 20,000 active accounts<sup>3</sup> (some of these accounts were delinquent). Refer to Appendix A for monthly activity for the period of our review.

### **STAFFING of the Division**

The Business License Tax Division within the Finance Department includes a Supervisor in addition to a staff of seven (7) Business Tax Representatives. Responsibilities include business license application processing and collections, entering application information into the software system (HdL), reviewing and processing business license tax appeals, monitoring delinquent business accounts, generating reports for management on request, and providing customer service at the Division's 6<sup>th</sup> floor counter/over the phone/via email.

### **DELINQUENT ACCOUNTS and COLLECTIONS**

In addition to notices being issued automatically by the HdL system, Senior Business Tax Representatives are responsible for making collection phone calls, performing site/business visits and issuing notices and citations in an effort to collect outstanding license taxes.

Per [Municipal Code 1.17](#), Admin Citations are issued to business accounts that are 150 days delinquent. Once efforts have been exhausted by the Division, delinquent business accounts are transferred to SEQUOIA Financial Services<sup>4</sup> for collection services. Accounts may be referred to Small Claims Court. No other penalties, such as business closure for non-payment, are allowed under the existing Municipal Code.

Businesses that operate in the City of Riverside but have their main business location/address in another city are required to obtain a City business license and pay the appropriate business tax. The majority of these businesses apply for a business license when contracting directly/indirectly with the City for services. As these licenses come up for annual renewal it has been the Division's policy to include the account in the delinquent account/renewal notice process. The out-of-town businesses delinquent

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<sup>1</sup> As of March 31, 2016 actual revenue collected for fiscal year 2015-16 totals \$5 million, or 77% of budget (source:IFAS).

<sup>2</sup> This amount (and the graph above) does not include taxes collected on behalf of the three business improvement districts (BIDs).

<sup>3</sup> Our review did not include HdL PRIME data integrity.

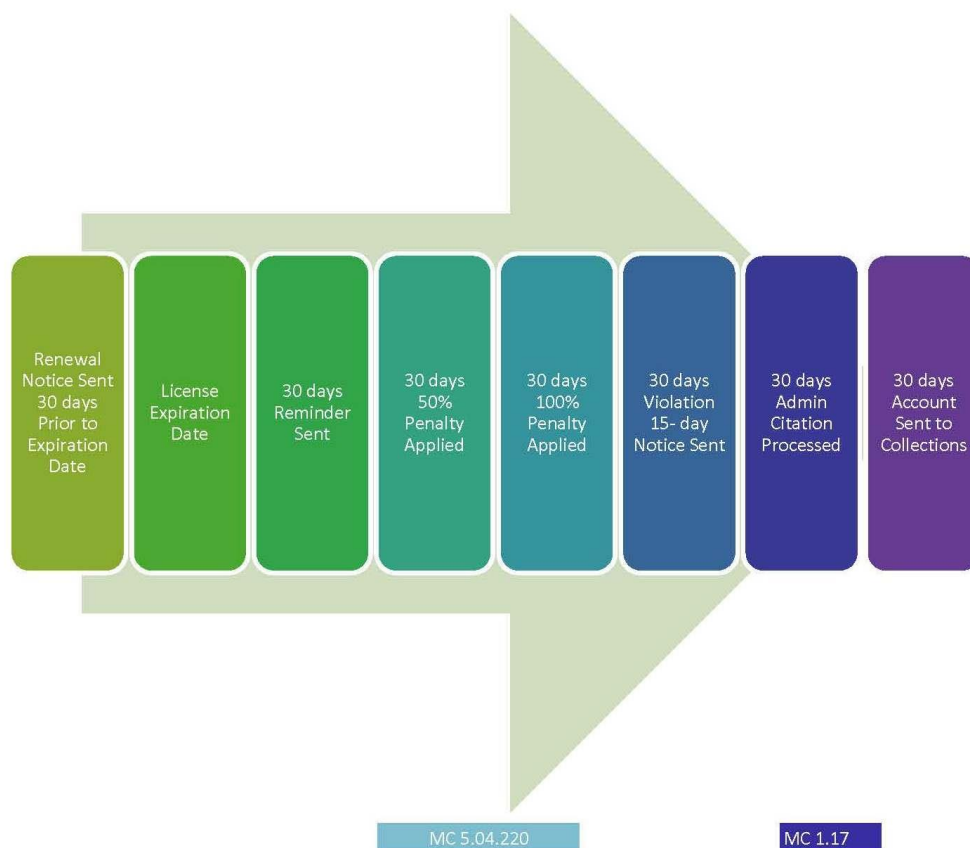
<sup>4</sup> The current debt collection services contract with SEQUOIA was approved by the City Council, Nov. 18, 2014.

account balances become part of the total amount past due in the HdL system; the City's delinquent account notification process is followed.

**- *Timeline to collect on delinquent accounts is lengthy.***

The delinquent account collectability rate can vary depending on a number of factors including economic conditions, the level of business/taxpayer compliance, staffing efforts, and the effectiveness of collection tools and methods.

Business licenses are valid for one year after the issuance date. Thirty (30) days prior to the license expiration date, a renewal notice is generated by the HdL system; mailed to the account/business owner. Businesses with an account balance not paid within 30 days after the due date/expiration date are sent a reminder notice that payment has not been received. Thirty (30) days after the reminder notice a delinquent notice with a 50% penalty of the total amount due is mailed. If the account continues to be delinquent an additional 30 days, another penalty is applied, at the maximum of 100% of the amount due, per Municipal Code [5.04.220](#). At that time the 100% penalty is applied the account is 90 days delinquent. An account does not go to the collections agency until it is 180 days past due. The flowchart below illustrates the delinquent business license tax notice process/timeline.



The City entered into an agreement with SEQUOIA Financial Services for collection services. Monthly, the Division submits accounts to SEQUOIA for collection services. Since March 2015, the Division has referred 242 accounts to SEQUOIA, with a total collectable amount of \$125,254. As of November 2015, the agency had collected \$25,293 (a collection rate of 20%).

- ***Unlicensed businesses represent significant uncollected revenue.***

Efforts to identify unlicensed businesses such as field reviews of street activity, reviews of yellow pages and trade documents, and shared information from Fire Inspections and Public Utilities have been successful. More emphasis and resources are needed to compare business tax information provided by the CA Board of Equalization (BOE) with the accounts in HdL to identify unlicensed businesses in the City. The current method of comparing BOE data to HdL accounts is manual and only performed by the Division Supervisor.

The data and chart below reflects the positive efforts by the Division at the time of our review in researching various data sources for unlicensed businesses.

| <b>RESIDENTIAL AND COMMERCIAL NEW RENTAL REVENUE</b> |                 |                   |                         |            |
|------------------------------------------------------|-----------------|-------------------|-------------------------|------------|
| August 1, 2012 - July 31, 2015                       |                 |                   |                         |            |
|                                                      | <b>Accounts</b> | <b>Revenue</b>    | <b>Discovery Source</b> |            |
| Apartment Rentals                                    | 104             | \$ 45,535         | BT Research             | 924        |
| Business Rentals                                     | 205             | \$ 268,881        | Fire Inspections        | 31         |
| Multi Residential Rental*                            | 672             | \$ 339,413        | Utilities               | 9          |
|                                                      |                 |                   | Code                    | 17         |
| <b>Total</b>                                         | <b>981</b>      | <b>\$ 653,829</b> | <b>Total</b>            | <b>981</b> |

\*Represents 2395 Parcels

Source: HdL and Business License Tax management

## CONCLUSION

Implementation of the new HdL PRIME system has enabled the Division to manage almost every aspect of the business license tax process more efficiently. Management utilizes the system to effectively monitor account activity, perform reconciliations, and generate reports. The system is a significant improvement from Permits Plus.

The “tax gap” is the difference between business license taxes owed to the City and taxes voluntarily paid, and is a measure of business/taxpayer compliance. Closing this gap is important, not just from a revenue producing point of view but as a means of promoting fairness within the taxing system. When some businesses/taxpayers do not pay owed taxes an additional burden is placed on businesses/taxpayers who fully comply.

According to tax experts, it is unrealistic to expect 100 percent compliance with tax laws, thereby eliminating the “tax gap”. Full compliance may never be achieved because of unintentional misapplication of tax law, inability to pay the taxes due, intentional fraud, or willful non-compliance by those who do not apply/file for a business license.

Some common principles can improve the success of the business license tax function. These principles include collecting and using good management information, requiring more complete documentation from businesses/taxpayers, increasing “tax audit” efforts, and focusing efforts on the most important compliance problems.

| PRINCIPLE                                                                                                                                                                                                                                                                            | POTENTIAL IMPROVEMENTS                                                                                                                                                  |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <p><b>Good information is critical to identifying compliance problems.</b><br/>A taxing organization must systematically estimate the extent of noncompliance and establish a reliable and relevant system of management information.</p>                                            | <p>Monitor and track collection and compliance performance; update administration and collection policies and procedures.</p>                                           |
| <p><b>Focus on compliance efforts where they will do the most good.</b><br/>Efforts should be directed toward identifying the largest compliance problems.</p>                                                                                                                       | <p>Increase and prioritize efforts to locate unlicensed businesses.<br/>.</p>                                                                                           |
| <p><b>Deal with compliance problems quickly.</b><br/>The longer it takes to reach a taxpayer, the less success in correcting the compliance problem.</p>                                                                                                                             | <p>Prioritize delinquent accounts for collection; improve management reports; increase presence and visibility of staff in the field.</p>                               |
| <p><b>More visible tax information promotes higher compliance.</b><br/>Documentation for items such as gross receipts makes errors less likely. Good records and documentation increases compliance and leads to better results when an application (new or renewal) is audited.</p> | <p>Require more documentation for some business accounts; implement an “audit program” to identify patterns of noncompliance, and support enforcement of the codes.</p> |
| <p><b>The simpler the rules, the better.</b><br/>The simpler the tax code, the more certain the results in applying it.</p>                                                                                                                                                          | <p>Periodically review City Code and administrative rules for simplification.</p>                                                                                       |

## **OBSERVATIONS and BEST PRACTICES**

### **Policies and Procedures**

Written policies and procedures codify management's criteria for executing an organization's operations. Developing and documenting policies and procedures is the responsibility of management; documentation should exist for business processes, personnel responsibilities to promote uniformity in executing and recording transactions. In addition, thorough and concise policies and procedures serve as effective training tools for employees.

If written policies and procedures do not exist, are inaccurate, incomplete, or simply not current, the following could result:

- Inaccurate and unreliable financial records due to inappropriate recording of transactions
- Inconsistent practices among employees and/or department/division
- Processing errors due to a lack of knowledge
- Inability to enforce employee accountability

### **Best Practices**

- Document all significant business practices, processes, and policies.
- Make the policies and procedures available to all personnel.
- Ensure they are accurate, complete, and current at all times.
- Revise policies and procedures for changes in processes and/or systems. This is particularly important when new systems are developed and implemented or other organizational changes occur.
- Communicate significant changes to all affected personnel immediately to ensure they are aware of any revisions to their daily duties and responsibilities.

At the time of our audit, the majority of documented policies and procedures addressed processing business license applications and transactions in HdL. According to the supervisor, "desk" policies and procedures are currently being updated and/or drafted. We encourage the Division to complete the policies and procedures and review annually in order to keep current with changes in practices.

### **Efficiency and Effectiveness**

Operations are considered effective when they are functioning as intended. If, for example, two individuals are both responsible for executing the same function within a process, a duplication of efforts would exist. This is an inefficient and ineffective use of time and resources.

Inefficiency and ineffectiveness may result in a lack of resource availability and may cause a business function to be unable to meet its objectives. Frequently, this results in added operational costs to the organization. Those costs could be measured in additional overtime needed to accomplish goals and objectives, unmet targets, lost productivity, or the inability to accept additional responsibility. Accordingly, inefficiencies result in the inability to be effective in attaining objectives.

The Division uses site visits, telephone calls, payment plans, reviews State databases for unlicensed businesses, delinquent collection efforts in addition to standard billing and delinquency follow-up notices.



## Best Practices

In an effort to promote operational efficiency and effectiveness, the Division should consider the following:

- Analyze business processes and identify and eliminate any duplicated efforts.
- Streamline processes by reducing any non-valued added procedures.
- Identify any processes that have been done merely because “that’s the way we’ve always done it.” Determine if those processes are still needed. If they are, identify methods that would allow steps to be completed either more timely or effectively.
- Strive to process documents and/or transactions in a minimum required time to increase the efficiency and effectiveness.
- Employ a cost-benefit methodology when analyzing and developing new processes. If the costs outweigh the benefits, then consider eliminating the procedures or significantly reducing the number of steps needed to complete the process.
- Look for more innovative ways to accomplish goals and objectives.
- Automate where possible.

## **Technology Enhancements**

HdL software appears to have some reporting limitations. Information such as accounts receivable balances and aging is not a standard capability. While the application/form for a new business license is available [online](#), the application cannot be *processed* online to create an invoice/amount due that can then be *paid* online via a credit card by the customer/applicant. The application must be mailed or emailed to the Division; after review, the Division inputs the data from the application into HdL. The system generates an invoice for the license tax due; the invoice is sent to the customer/applicant. Remittance for the new license must be via a credit card or paid directly at the Division counter.

Technology enhancements would provide enhanced customer service and improve efficiencies in the Division.

## **FINDINGS and RECOMMENDATIONS**

Based on our review and discussions with the Finance/Division management, we have noted the following findings and recommendations that warrant management’s consideration and response:

- |                                                                                                                                                          |
|----------------------------------------------------------------------------------------------------------------------------------------------------------|
| <b>1. Additional funds are needed to enhance HdL PRIME. Enhancements could provide greater customer service while improving the efficiency of staff.</b> |
|----------------------------------------------------------------------------------------------------------------------------------------------------------|

The City does not apply an administrative processing fee to the business license tax application. In our review of ten (10) California city business license tax divisions we found only two other cities that do not include an application administration processing fee for new and/or renewed business licenses. (Refer to APPENDIX B)

The application processing fee varies by city, ranging from \$5 to \$60 per application. Due to limited funds, enhancements to HdL have not been initiated. Additional funds from the implementation of an *Application Processing Fee* could be utilized to enhance the online application process and improve customer service while also reducing/eliminating the manual tasks of processing applications in order to create an invoice, mail the invoice, update the HdL system, etc. With over 20,000 business licenses,

there is the potential to collect a significant amount of additional tax revenue per year with the implementation of an *Application Processing Fee*.

**Recommendation 1:**

*Determine and apply with City Council approval a reasonable Application Fee to business license tax applications annually (new and renewal) in order to fund future technology improvements that will enhance customer service and improve efficiencies.*

**Management Response:**

Management concurs; we believe that an administrative fee is warranted especially compared to what others in the State are doing and our City's needs. There are technological deficiencies and staffing deficiencies that limit our ability to enhance our customer service and the efficiencies of the division. A study would need to be conducted to determine the appropriate dollar amount of such a charge, but management believes we can do that internally in collaboration and consultation with the business community.

**2. Reducing the number of notices and number of days for delinquent accounts to settle outstanding balances before accounts are referred to collections could improve the revenue stream.**

Industry best practices suggest a collections schedule should involve immediate release of invoice, a courtesy reminder prior to the due date, a call or notice after the due date, two late notices and a final demand. Cutting days or weeks off the average delinquency notice time can make an important difference in cash flow/revenue and collection efforts.

**Recommendation 2:**

*Reduce the timeline (number of days) from 180 days to no more than 150 days (or less) before a delinquent account is forwarded to the collections agency, while still maintaining compliance to related Municipal Codes.*

**Management Response:**

Management concurs; management intends to fully review the delinquent account policies and practices to provide greater effectiveness and fairness to the businesses and to the City. Certain changes may require Municipal Code revisions as well. Management plans to review and make changes in the next fiscal year.

**3. Prioritizing delinquent accounts for collection could provide the greatest recovery potential.**

Currently delinquent accounts are not prioritized for collection. Prioritizing collection efforts based on some criteria such as business license tax amount or frequency of delinquencies would help staff focus on accounts with the greatest recovery potential among the hundreds of delinquent accounts.

**Recommendation 3:**

*Prioritizing collections solely on an aging report is not recommended, as it assumes the most overdue invoices pose the most risk, which is not always the case considering customers with larger balances usually generate a larger risk. Develop a process/procedure using available delinquency data to prioritize collection efforts. Segment customers based on size of the company (gross receipts), amount owed and payment history.*

**Management Response:**

**Management concurs; will begin implementing this recommendation.**

**4. Business license audit efforts could result in additional revenue for the City/General Fund.**

The City's Municipal Code Section 5.04.130 authorizes designated employees of the City to examine, audit, and inspect books and records of any person engaged in business within the City of Riverside, for the purpose of ascertaining the correct amount of business taxes required to be paid. The City of Riverside through the Finance Department does not enforce verification of business license application information, such as annual gross receipts or number of employees. Since business taxes are self-assessed and self-reported, it is necessary for the City to verify the accuracy of the reported tax.

Several California cities have successfully implemented a Business Tax Audit Program through their Finance Department or City Auditor's Office – City of Orange, Santa Monica, Los Angeles, and Berkeley. Under a systematic approach, "business tax auditors" would develop a method for selecting, reviewing and analyzing relevant information. If mistakes are identified, they can be addressed by adjusting the business license tax amount and invoicing the account for any differences (or refund account for over-payment). With this customer-focused approach, the business tax audit provides businesses with an enhanced understanding of the business license tax laws so that in the future they can more accurately self-assess taxes and better comply with City business license regulations.

**Recommendation 4:**

*Gross sales receipts have a significant impact on the amount of business license tax liability, and afford opportunity for under-reporting by business owners. We recommend the Finance Department establish a Business Tax Audit Program. We realize this recommendation will require a certain set of core competencies of "tax auditors", training and perhaps additional staffing resources and budgetary allowances.*

**Management Response:**

**Management concurs; implementation of auditing components in the business tax collection process is a desirable goal. Management sees auditing in two aspects- field review/auditing and desk auditing. Management has included additional cost-covered staffing in the next budget to begin this process. In addition, we will need to work with Human Resources and the employee unions to affect changes in job descriptions to add auditing functions to current position classifications. Management already has an initial plan and hopes to implement it within next fiscal year.**

A draft of the performance audit report was reviewed with Finance Department management and the Business License Tax Division supervisor prior to finalization. The assistance and cooperation from the Finance Department during the audit is greatly appreciated.

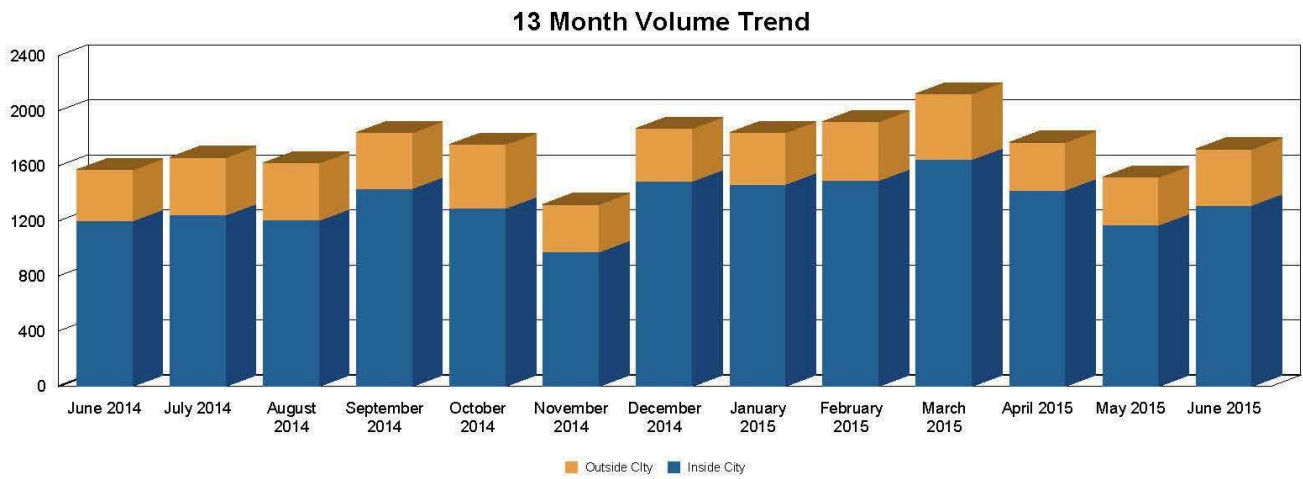
We respectfully request that in one year, management provide a status of the progress made in implementing the recommendations detailed in this report.

- Cheryl Johannes, Internal Audit Manager

## APPENDIX A

### Management - Payment Transaction Trend Analysis

Date entered for report: June 30, 2015. Rate Class for report: All Rate Classes



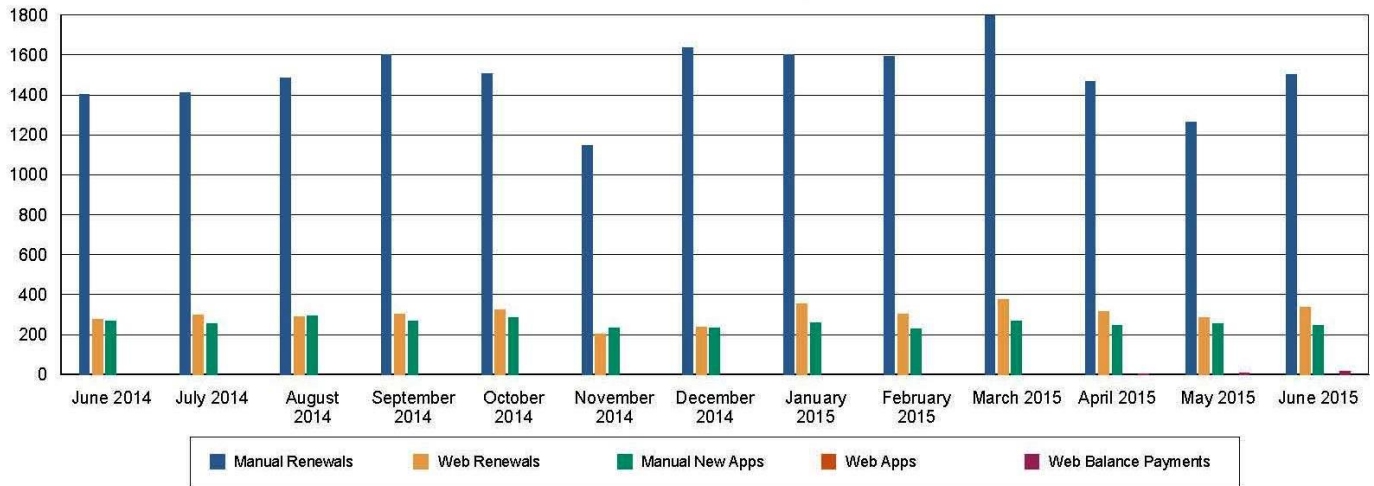
| June 2014 | July 2014 | August 2014 | September 2014 | October 2014 | November 2014 | December 2014 | January 2015 | February 2015 | March 2015 | April 2015 | May 2015 | June 2015 | Total  |
|-----------|-----------|-------------|----------------|--------------|---------------|---------------|--------------|---------------|------------|------------|----------|-----------|--------|
| 370       | 417       | 416         | 406            | 464          | 345           | 383           | 375          | 427           | 477        | 347        | 347      | 409       | 5,183  |
| 1,203     | 1,246     | 1,207       | 1,438          | 1,294        | 978           | 1,491         | 1,468        | 1,496         | 1,649      | 1,426      | 1,173    | 1,316     | 17,385 |
| 1573      | 1663      | 1623        | 1844           | 1758         | 1323          | 1874          | 1843         | 1923          | 2126       | 1773       | 1520     | 1725      | 22568  |

## APPENDIX A (continued)

### Management - Manual and Web Activity Comparison

Date entered for report: June 30, 2015. Rate Class for report: All Rate Classes

#### 13 Month Activity



| June 2014 | July 2014 | August 2014 | September 2014 | October 2014 | November 2014 | December 2014 | January 2015 | February 2015 | March 2015 | April 2015 | May 2015 | June 2015 | Total |
|-----------|-----------|-------------|----------------|--------------|---------------|---------------|--------------|---------------|------------|------------|----------|-----------|-------|
| 1402      | 1411      | 1485        | 1600           | 1508         | 1145          | 1636          | 1600         | 1595          | 1798       | 1469       | 1263     | 1502      | 19414 |
| 278       | 297       | 289         | 300            | 325          | 201           | 238           | 356          | 300           | 376        | 315        | 285      | 335       | 3895  |
| 267       | 256       | 293         | 268            | 265          | 235           | 234           | 257          | 230           | 268        | 247        | 254      | 248       | 3342  |
| 0         | 0         | 0           | 0              | 0            | 0             | 0             | 0            | 0             | 0          | 0          | 0        | 0         | 0     |
| 0         | 0         | 0           | 0              | 0            | 0             | 0             | 0            | 0             | 0          | 2          | 9        | 18        | 29    |
| 1947      | 1964      | 2067        | 2168           | 2118         | 1581          | 2108          | 2213         | 2125          | 2442       | 2033       | 1811     | 2103      | 26680 |

## APPENDIX B

### Comparison of Cities with Application Processing Fees for Business Licenses

| City             | Application Processing Fee \$ | Tax Base       | Date Renewable                          |
|------------------|-------------------------------|----------------|-----------------------------------------|
| Bakersfield      | \$5 (N & R)                   | Gross receipts | Annually, July 1; new prorated          |
| Anaheim          | \$32 (N & R)                  | Gross receipts | Annual date of issuance                 |
| Santa Ana        | \$31 (N & R)                  | Gross receipts | 3 tax periods; depends on business type |
| Orange           | \$46 (N) \$23 (R)             | Flat Rates     | Annual date of issuance                 |
| Riverside        | \$0                           | Gross receipts | Annual date of issuance                 |
| Stockton         | \$24 (N & R)                  | Gross receipts | Annual date of issuance                 |
| Berkeley         | \$25 (N & R)                  | Gross receipts | Annually, January 1 ; new prorated      |
| Moreno Valley    | \$60 (N & R)                  | Gross receipts | Annual date of issuance                 |
| Corona           | \$0                           | Gross receipts | Annual date of issuance                 |
| Rancho Cucamonga | \$0                           | Gross receipts | Annual date of issuance                 |
| Perris           | \$0                           | Flat Rate      | Annual, January or July                 |

Sources: Internet/ City websites; City Finance and/or Business Tax personnel