



City of Chattanooga

INTERNAL AUDIT

City Hall

Chattanooga, Tennessee 37402

Stan Sewell
Director

Ron Littlefield
Mayor

July 24, 2009

Mayor and City Council
City of Chattanooga
City Hall
Chattanooga, TN 37402

RE: Business Tax Collections, Audit 09-06

Dear Mayor Littlefield and City Council Members:

Attached is the Internal Audit Division's report on Business Tax Collections.

The Treasurer's Office has already taken positive actions in response to our recommendations. We thank the management and staff of the Treasurer's Office for their cooperation and assistance during this audit.

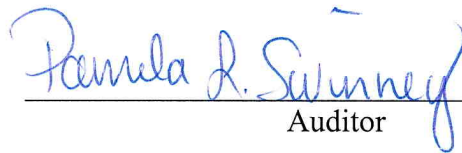
Sincerely,

Stan Sewell, CPA, CGFM
Director of Internal Audit

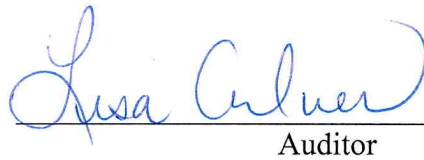
cc: Dan Johnson, Chief of Staff
Gayle Keown, City Treasurer
Daisy Madison, City Finance Officer
Audit Committee Members

**FINANCE DEPARTMENT
TREASURER'S OFFICE
BUSINESS TAX COLLECTIONS
AUDIT 09-06
JUNE 12, 2009**

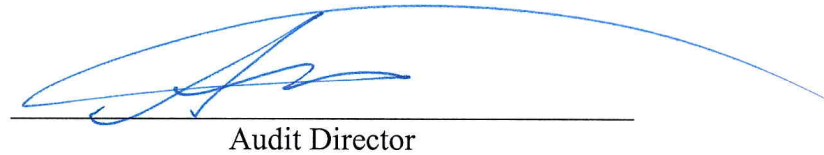
**FINANCE DEPARTMENT
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Auditor



Auditor



Audit Director

**FINANCE DEPARTMENT
TREASURER'S OFFICE
BUSINESS TAX COLLECTIONS
AUDIT 09-06**

INTRODUCTION

The City Treasurer is appointed by the Mayor and City Council. The Treasurer's office is a division of the Department of Finance & Administration. As treasurer and tax collector for the City, this official is responsible for the collection and investment of nearly \$200 million in revenue and other sources of funding that flow through the City. The Treasurer's primary responsibility as tax collector is to maximize collection of property taxes, storm water fees, and business licenses and permits levied by the City Council.

The City of Chattanooga is permitted to collect a tax on the privilege of conducting a business in the corporate city limits. This is based upon the rules and regulations established by the Tennessee Code Annotated 67-4-701 through 67-4-729. Chattanooga City Code Section 2-108 assigns the responsibility of issuing all licenses and permits required under the City Code to the City Treasurer.

STATISTICS

The following figures are from the City's Comprehensive Annual Financial Report for Year Ended June 30, 2008 and represent actual tax, license and fee collections.

| | <u>FY08</u> | <u>FY07</u> |
|-----------------------------------|--------------------|--------------------|
| Gross Receipts Tax | \$3,931,405 | \$3,773,167 |
| Business Licenses | \$153,130 | \$152,025 |
| Fees for Business Licenses | \$ 59,615 | \$59,525 |

STATEMENT OF OBJECTIVES

This audit was conducted in accordance with the Internal Audit Division's 2009 Audit Agenda. The objectives of this audit were to determine if:

1. Businesses were properly classified to obtain the appropriate tax.
2. Proper internal controls are in place for the cash collections process.
3. Delinquencies were properly monitored and documented.

4. The City should devote more resources to business tax audits as a routine and standard practice.

STATEMENT OF SCOPE

Based on the work performed during the preliminary survey and the assessment of risk, the audit period covered the operations and procedures related to the Treasurer's Office business tax collections that occurred from March 2008 to current.

STATEMENT OF METHODOLOGY

We reviewed the written policies/procedures and interviewed staff to gain an understanding of the business tax collections process by the Treasurer's Office. In addition, we reviewed the Internal Control and Compliance Manual for Tennessee Municipalities, the State of Tennessee rules and regulations, and the Chattanooga City Code.

When utilized to draw general conclusions, the sample size and selection were statistically generated using a desired confidence level of 90 percent, expected error rate of 5 percent, and a desired precision of 5 percent. When our intention was to make projections about the entire population, the statistical samples were selected using a desired confidence level of 95 percent, expected error rate of 5 percent, and a desired precision of 5 percent. Statistical sampling was used in order to infer the conclusions of test work performed on a sample to the population from which it was drawn and to obtain estimates of sampling error involved. When appropriate, judgmental sampling was used to improve the overall efficiency of the audit. Source documentation was obtained from the Treasurer's Office. Original records as well as copies were used as evidence and verified through physical examination.

To achieve the audit's objectives, reliance was placed on computer-processed data contained in the Treasurer's office business tax system (BUSL). We assessed the reliability of the data contained in the BUSL system and conducted sufficient tests of the data. Based on these assessments and tests, we concluded the data was sufficiently reliable to be used in meeting the audit's objectives.

STATEMENT OF AUDITING STANDARDS

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. In addition, we abide by the standards of professional practice established by the Institute of Internal Auditors.

AUDIT CONCLUSIONS

Based upon the test work performed and the audit findings noted below, we conclude that:

1. Businesses were properly classified to obtain the appropriate tax.
2. Weaknesses exist in the internal controls for business tax cash collections.
3. Delinquent accounts are not adequately monitored or documented.
4. The City should perform routine desk and field audits as a standard practice.

SEPARATE CASH DRAWERS

In accordance with Internal Control Compliance Manual for Tennessee Municipalities, Title 3, Chapter 1, Section 6, “Each cashier should be assigned a separate cash drawer that is accessible only to that cashier.” However, based on staff interviews and observation, all collections are processed on one computer with all employees using the same user id and password. Therefore, collection discrepancies cannot be traced to one individual.

RECOMMENDATION 1

We recommend the Treasurer’s Office assign a separate cash drawer for each employee who receives funds. Further, we recommend the Treasurer’s Office (assisted by the IS Department) assign a unique user id and password for each cashier. Also, each cashier should be provided a daily transaction listing for daily reconciliation of cash collections.

AUDITEE RESPONSE

We have discussed with our Information Services analyst that unique user id and passwords should be set up for each cashier. We will be ordering separate cash drawers for each cashier for both our systems in order to comply with your recommendation. IS will also work to provide the daily transaction listing for each user.

LICENSE FORMS NOT PRE-NUMBERED

The Internal Control and Compliance Manual for TN Municipalities Title 3 Chapter 2 Section 3 states “collections of the business tax, regulatory license fees, and permit fees are recorded on pre-numbered forms.” During the audit we examined the license forms used and noted the Treasurer’s Office is not in compliance.

RECOMMENDATION 2

We recommend the Department use pre-numbered license/permit forms. We further recommend the written procedures manual be updated to include a daily reconciliation of the number of licenses issued to the number of pre-printed forms issued.

AUDITEE RESPONSE

We are also working with Information Services on this issue. We will need to replace current dot matrix printer which uses duplex forms. This will allow us to order pre-numbered forms which will require a new printer in order to comply. Since more than 10,000 forms are currently in stock, our Business Tax Supervisor will manually pre-number the forms in order to reconcile the number used daily. Written procedures will be updated to reflect this process.

SEGREGATION OF DUTIES

The Internal Control and Compliance Manual for TN Municipalities Title 1 Chapter 2 Section 2 states “when possible, different persons should be responsible for the authorization, recordkeeping (posting), custodial (cash and materials handling), and review procedures, to prevent manipulation of records and minimize the possibility of collusion.”

During staff interviews we learned all staff has the ability to collect funds and place an account in “suspense” status without supervisory approval. Suspense status is equivalent to the “write-off” of an uncollectible account. If an account is placed in suspense, then the account will no longer appear on the delinquent reports or generate annual business tax returns.

We obtained a listing of businesses coded as “suspense” and pulled a statistical sample of 50 accounts using a 90% confidence level. We reviewed the available supporting documentation to determine if the delinquent accounts were adequately monitored and approved by a supervisor prior to being placed into “suspense”. We found that 31 (or 62%) of the sampled items had no written documentation of collection efforts. The 19 sampled items with supporting documentation had no documented supervisor review or approval. Of the 50 items sampled only 7 had been placed in the “suspense” status by a supervisor.

RECOMMENDATION 3

We recommend the Treasurer's Office develop a formal written procedure which includes documentation, review and approval of delinquent accounts placed into "suspense" status. Also, we recommend BUSL access rights be modified to allow only the supervisory level the capability to change an account to or from a "suspense" status. Due to the ease and opportunity available for abuse, embezzlement and/or fraud, we further recommend consideration be given to a notification or approval from the Finance Officer or an individual independent from the Treasurer's Office prior to any write-offs (transfers to suspense).

AUDITEE RESPONSE

Information Services has also been contacted to delete employee access and limit to a supervisor in order to place a business in "suspense" status. Many of the accounts in suspense can be inactivated after seven (7) years after all collection efforts have been exhausted. Measures have already been taken to document all actions taken on an account prior to suspense status.

EXPAND WRITTEN POLICIES/PROCEDURES

The Treasurer's office has developed several written procedures for the collection and issuance of business tax license and various permits. We reviewed the written policies and procedures and conducted interviews with staff.

We noted that the written policy and procedures are not comprehensive. Currently, the written policies do not address the delinquent collection process and review procedures. Also, the Treasurer's Office has a policy to adjust any overpayments up to \$5.00 to interest expense. This policy has not been included in the written policy manual. We also noted the Treasurer's office receives new business listings from Hamilton County and the State of Tennessee that is reviewed for businesses possibly located within City limits. The staff has used the reports to locate City businesses; however, a documented procedure including a follow-up process and supervisor review to provide assurance that the new accounts are added is not in place.

Written policies and procedures enhance internal controls of the office and provide both current staff and new hires with guidance in performing their job duties consistently.

RECOMMENDATION 4

We recommend management expand their current written policies and procedures to be comprehensive of all processes performed by the staff. The policies and procedures should

address the steps of the process, retainage of supporting documentation, and supervisory review/approval.

AUDITEE RESPONSE

Our written policies and procedures are being updated and will be submitted for review. The delinquent collection process, in addition to the follow-up process for prospective new businesses, will also be included in this update for our written policy manual.

PERFORMANCE OF FIELD AUDITS NEEDED

Per T.C.A. Section 67-4-722(a) the county clerk or city tax collecting official has the legal right to inspect the books and records of a taxpayer. If the City exercises this right, all revenues generated from the field audit would be maintained by the City (**including the State portion**) as stated in T.C.A. 67-4-724(a)(1).

We performed two statistical sample tests to determine if the City would benefit by investing additional resources to conduct field audits and analytical reviews. The methodology and sample result of the test work performed is detailed below.

Comparison of State Revenues to City Revenues Reported by Businesses

We obtained a listing of current business tax accounts with the City for class 1 and class 2 businesses. The population included 3,490 business accounts. The total number of active business account for all four classes totals 12,481. The two classes used in the sample represent only 28% of all registered business accounts. A statistical sample was pulled with a 95% confidence level. We obtained the business tax returns and the Tennessee sales tax returns (FYE 2008) for a sample of 72 business accounts and compared the gross sales reported to the City to gross sales reported to the State.

Of the 72 accounts reviewed, we noted 14 business returns that reported a total of \$865,372.37 more gross sales to the State than to the City. Business tax due for the unreported sales discovered in the sample was \$771.10. When projected to the population we estimate unpaid taxes in the amount of \$37,376.76 from underreported revenues.

We reviewed the deductions taken on the business tax returns and compared to the deductions claimed on the sales tax returns. We found two (2) business tax returns with deductions of \$81,299.03 that were not substantiated by the sales tax return. The business tax due for the disallowed deductions in the sample was \$121.92. When projected to the population we estimate unpaid taxes in the amount of \$5,909.66 from invalid deductions.

Last, we reviewed the business tax rates used on the business tax returns for accuracy (based upon information obtained from the sales tax returns). We noted one (1) business that paid

business tax at the wholesale rate (a reduced rate) when in fact they should have paid both wholesale and retail tax. The additional business tax due for the improper tax rate usage was \$161.75. When projected to the population, we estimate unpaid taxes in the amount of \$7,840.50 from improper tax rates.

It is important to note that our total projection of \$51,126.92 (sum of \$37,376.76, \$5,909.66, and \$7,840.50) in unpaid taxes is based on a review of only two of the four tax classes representing only 28% of registered businesses for one tax year. Further, since our review was limited to information available on the State sales tax returns, we would expect to find additional unreported revenues, unallowable deductions, and tax rate errors had field audits been performed.

Non-reporting Businesses

We obtained a listing of current business tax accounts with the State of Tennessee for class 2 businesses. The population included 4,644 business accounts. A statistical sample was pulled with a 95% confidence level. We verified the businesses selected in the sample were registered and paying business tax with the City. It is important to note that our sample of 72 accounts is based on a review of only one of the four tax classes and for only one year.

Based on our review of accounts in the sample selected, we determined two (2) businesses had not registered with the City. The business tax due for the unregistered businesses in the sample was \$31,632.52 (penalty and interest not included). The unregistered accounts represent 2.78% of the sample population indicating a projection of 129 unregistered business accounts in the population. We noted one potential outlier (\$31,455.29 of the additional tax liability) in our sample that may skew the results of our sample; therefore, we did not monetarily project the results to the population. However, we did contact the unregistered business (the outlier noted above) and have received payment for tax, penalty and interest of \$75,875 for tax periods July 1, 2005 through June 30, 2008 prior to the completion of our field work.

RECOMMENDATION 5

We recommend the Treasurer's Office devote resources to perform in-house reviews, analysis and field audits. Should the Treasurer's Office lack the necessary staff to devote to these duties, it appears the additional revenues generated would warrant the hiring of an additional employee.

AUDITEE RESPONSE

We agree with your recommendation that additional audits and reviews of business taxes are needed. After reviewing the statistical data and information provided on businesses we have

determined although the business tax employees verify gross receipts returns for obvious errors (Examples: Incorrect tax rates, deductions taken in error, incorrect credits being deducted, etc.), they are unable to fully utilize the state records due to lack of manpower. While researching the auditor's samples, we did determine, while statistically the samples were correct, several of the businesses were filing on different tax periods (or reporting sales on different locations) and some rates were over/under reported on prior year's or on the next year's tax returns.

Given the current level of staffing we will continue to randomly review and compare sales tax records in addition to striving to collect the maximum gross receipts taxes required by State of TN Business Tax Act.

SUBSEQUENT EVENTS

Subsequent to our field work and prior to the release of our report, the State of Tennessee, through HB 2275/SB 2318, has transferred primary responsibility for administering the business tax from the local governments to the state. Due to this development, some of the recommendations given in our audit report may now be unnecessary in part or in whole.