



CITY OF COLORADO SPRINGS OFFICE OF THE CITY AUDITOR

05-128 SALES TAX PERFORMANCE AUDIT

OCTOBER 6, 2006

Public Report

Jeff Litchfield, CPA CIA CFE
City Auditor

Denny Nester, CPA CIA
Assistant City Auditor





Office of the City Auditor

Date: October 6, 2006
To: Honorable Mayor and Members of City Council
Re: 05-128 Sales Tax Performance Audit

We have completed a performance audit of the Sales Tax Division of the City of Colorado Springs.

As background information, the Sales Tax Division shared the results of one of our findings with you prior to the release of our audit. The finding related to the issuance of refunds to certain non-profit organizations. Because of the interest generated when the Sales Tax Division shared this finding, we prepared and released a report on that one finding (June 16, 2006) and that finding is reproduced in this report as Finding 1 and an updated response from the City has been included.

The purpose of this audit was to evaluate whether the Sales Tax Division of the Finance Department was accomplishing its goals and objectives in an efficient and effective manner. We also evaluated whether reliable information was being maintained. The audit included a review and evaluation of procedures, practices and controls related to the Sales Tax Division on a selective basis. Our fieldwork covered the period ending December 2005.

As always, please let me know if you have any questions.

Sincerely,

A handwritten signature in purple ink that reads "Jeff Litchfield".

Jeff Litchfield
City Auditor

Cc: Lorne Kramer, City Manager
Mike Anderson, Assistant City Manager
Terri Velazquez, Finance Director
Shelli Morgan, Sales Tax Manager

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Introduction

AUTHORIZATION

We completed a performance audit of the Sales Tax Division of the City of Colorado Springs. This audit was originally on the 2007 audit plan as project 07-165 but was moved forward at the request of City Staff. We conducted this audit under the authority of Chapter 1, Article 2, Part 7 of the Colorado Springs City Code, and more specifically parts 703 and 705, which state:

1.2.703: ENSURE PUBLIC ACCOUNTABILITY:

The City Auditor shall ensure that administrative officials are held publicly accountable for their use of public funds and the other resources at their disposal. The City Auditor shall investigate whether or not laws are being administered in the public interest, determine if there have been abuses of discretion, arbitrary actions or errors of judgment, and shall encourage diligence on the part of administrative officials. (1968 Code §1-10.3; Ord. 76-54; 1980 Code; Ord. 01-42)

1.2.705: DETERMINE EFFECTIVENESS AND EFFICIENCY OF PROGRAMS:

The City Auditor shall determine the extent to which legislative policies are being efficiently and effectively implemented by administrative officials. The City Auditor shall determine whether City programs are achieving desired objectives. The City Auditor shall review the administrative control systems established by the enterprises, department or group managers and by the City Manager, Utilities Executive Director and Memorial Hospital Executive Director and determine whether these control systems are adequate and effective in accomplishing their objectives. (1968 Code §1-10.3; Ord. 76-54; Ord. 01-42)

ORGANIZATION PLACEMENT

The City Auditor's Office of the City of Colorado Springs is structured in a manner to provide organizational independence from the entities it audits. This independence is accomplished by the City Auditor being appointed by and reporting directly to the City Council. The audited entity in this audit (Sales Tax Division) reports to the Finance Director who reports to the City Manager, who is also a City Council Appointee.

SCOPE AND METHODOLOGY

We conducted our audit in a manner that meets or exceeds the Standards for the Professional Practice of Internal Auditing, a part of the Professional Practices Framework promulgated by the Institute of Internal Auditors. Our audit included such tests of records and other supporting documentation as we deemed necessary in the circumstances. We reviewed the internal control structure and compliance tests were performed. Sufficient competent evidential matter was gathered to support our conclusions.

The purpose of this audit was to evaluate whether the Sales Tax Division of the Finance Department was accomplishing its goals and objectives in an efficient and effective manner. We also evaluated whether reliable information was being maintained. The audit included a review and evaluation of procedures, practices and controls related to the Sales Tax Division on a selective basis. Our fieldwork covered the period ending December 2005.

Introduction

BACKGROUND

As a home rule city, Colorado Springs collects sales and use (sales) taxes directly from businesses, instead of relying on the State of Colorado to collect such taxes on their behalf. The Sales Tax Division was established to perform this function for the City.

The Sales Tax Division is responsible for collecting more than \$150 million in taxes each year. In addition to the City Sales and Use Tax, which represents over 60% of the General Fund's revenue, the Division also collects the Public Safety Sales and Use Tax, the Trails, Open Space & Parks Tax and the Lodger's & Auto Rental Tax.

After a recent change in management, the City Auditor's Office was asked to review the performance of the Sales Tax Division and provide recommendations to increase the efficiencies and effectiveness of their operation. This audit was performed in response to that request.

The audit included interviews with personnel of the Sales Tax Division, review of financial records maintained by the Division, and research related to how sales tax offices in other localities are managed.

OVERALL CONCLUSION

We conclude the Sales Tax Division of the Finance Department was accomplishing its goals and objectives in an efficient and effective manner and was maintaining and reporting reliable information. Based upon our review, we identified 11 findings in four general areas: Policy Related, Process Related, System Related, and Staff Related. One finding was previously reported to City Council in a report issued on June 16, 2006. That finding concerned the issuance of refunds to certain non-profit organizations that were not consistent with City Code.

We have made no determination as to which findings are more important than others. Therefore, the findings are not necessarily listed in order of importance.

Findings, Recommendations and Responses

POLICY RELATED CONCERNS:

1. The Sales Tax Division was issuing refunds that were not authorized by the City Code.

Note – This finding was originally released on June 16, 2006.

Chapter 2, Article 7, Part 4 of the Colorado Springs City Code governs Transactions Exempt from City Sales and Use Taxes. The Code governing exemptions for Charitable and Religious Organizations; Governments, and Schools contained language similar to “the purchase price paid or charged on **direct** sales to and **direct** purchase by” (emphasis added). More specifically, the sections are:

2.7.404: CHARITABLE AND RELIGIOUS ORGANIZATIONS:

The purchase price paid or charged on direct sales to and direct purchase by religious, charitable and eleemosynary corporations, in the conduct of their religious, charitable and eleemosynary functions and activities only, provided that a letter of exemption from the City is possessed by the organization. These organizations, however, are required to collect sales tax when taxable sales are made by them. (1968 Code §3-75; Ord. 76-168; Ord. 01-42)

2.7.418: GOVERNMENTS, SALES TO:

The selling price paid or charged on direct sales to and direct purchases by the United States government, the State of Colorado, its departments or institutions, and political subdivisions in their governmental capacity only, and all sales to or purchases by the City are exempt. No commercial, industrial or any other banking institution, organized or chartered by the United States government or by the State of Colorado shall be considered a governmental institution for the purpose of this exemption. (1968 Code §3-75; Ord. 76-168; Ord. 01-42)

2.7.437: SCHOOLS:

The purchase price paid or charged on direct sales to and direct purchases by a school other than a school held or conducted for private or corporate profit in the conduct of its educational functions and activities only are exempt, provided that a letter of exemption from the City is possessed by the school. The school is required, however, to collect sales tax when taxable sales are made by it. (1968 Code §3-75; Ord. 79-179; Ord. 01-42)

Additionally, we reviewed the standard exemption letter for organizations governed by the above sections of the Code and found it to contain the following statement – “The exemption may not be used by construction contractors who may perform contracts for the organization.”

The Sales Tax Division has historically allowed construction contractors working on behalf of these organizations to pay the use or sales tax and then allowed the organization paying for the work to apply for a refund. Since the Code specifically states “direct sales to” and “direct purchase by,” we interpret this to mean purchases “on behalf of” are not eligible for exemption, therefore, purchases by a contractor or other third party do not meet the exemption criteria as outlined in the City Code.

Findings, Recommendations and Responses

Auditor's Recommendation:

We recommend the Sales Tax Division comply with the City Code and stop issuing refunds for transactions that are not "direct" sales or purchases. We further recommend the Sales Tax Division take steps to notify organizations about how they should complete their purchases so as to be eligible for the exemption pursuant to the City Code.

City's Response: (June 16, 2006)

The City of Colorado Springs Sales Tax Division agrees with this recommendation and will no longer accept and process refund requests from charitable and religious organizations, government or schools for the sales and use taxes paid on construction materials. The Sales Tax Division will, however, review and process all refund requests that were received prior to June 13, 2006. Charitable and religious organizations, governments or schools will still be eligible for tax exemption from direct purchases as long as those purchases fall within the requirements of the City Code.

City's Follow-up Response: (September 2006)

The City of Colorado Springs Sales Tax Division agrees with this recommendation. However, upon direction from City Council, the division worked with legal to develop an administrative policy (tax guide) that will allow exempt organizations (those outlined above) to continue to receive refunds. The Sales Tax Division developed a definition of "direct sales". This was sent to all exempt organizations September 1, 2006. The City of Colorado Springs Sales Tax Division also had the City Auditor review the tax guide to ensure that it met their requirements.

Auditor's Follow-up Response: (September 2006)

The City Auditor agrees with and supports the direction provided by City Council and the subsequent actions of the Sales Tax Division.

Findings, Recommendations and Responses

PROCESS RELATED CONCERNS:

- 2. The Sales Tax Division had not developed an effective educational process or training for businesses, who collect, pay, report, and remit sales and use tax.**

Businesses may not comply with their obligations if they are not educated about them. The self-assessing nature of sales/use tax places a clear obligation on the City to educate the businesses who collect the taxes. Businesses are more likely to comply if they know what their obligations are. Any current noncompliance with City Tax Code could be due to businesses not understanding their reporting requirements.

Auditor's Recommendation:

We recommend the Sales Tax Division develop and offer educational courses or training to businesses reporting sales and use tax. These classes should be offered to both new and existing businesses. Addressing the needs of businesses should increase compliance with the Tax Code.

City's Response:

The burden of proof to gather the correct tax information is on the taxpayer. However, the City of Colorado Springs Sales Tax Division agrees that this type of education would be beneficial to the business community. Currently, there is not sufficient staff to develop and administer this type of education.

There are tax guides posted to our website which offers an interpretation of the Code in layman's terms. The Sales Tax Division staff is also always available via email, telephone and in person to answer all questions that arise from the business community.

Findings, Recommendations and Responses

3. The Sales Tax Division did not have a policy and procedures manual.

The Sales Tax Division did not have a formal policy and procedures manual. A policy and procedures manual would help to provide consistency in handling various business operations and activities. A manual would also help ensure that operations are carried out accurately, in an effective and efficient manner. Formal procedures provide for continuity when employee turnover occurs, are useful in training new employees, assign activities to specific individuals and prevent duplication of duties.

Recognizing that decisions of the Sales Tax Division may set a precedent for future decisions, the employees should be provided detailed guidance on how to respond to taxpayers' requests.

The Technicians of the Division had prepared a procedures manual for their activities. Other personnel (Investigators and Auditors) did not have a procedures manual to follow.

Auditor's Recommendation:

We recommend that the Sales Tax Division establish a policy and procedures manual for all areas. The Sales Tax Manager has started this process.

City's Response:

The City of Colorado Springs Sales Tax Division agrees with this finding/recommendation. We agree that this will assist with training and consistency within the division. All areas within the Sales Tax Division (auditors, investigators and technicians) have been required to begin documenting procedures as part of their 2006 performance plans.

The tax guides are also in the process of being reviewed and updated. This will assist staff in responding to various taxability issues.

Findings, Recommendations and Responses

4. The Sales Tax Manager did not review or approve staff decision.

Decisions were being made by staff personnel that should have been approved by a manager. Some of the areas where the Sales Tax Manager or a designated person should be involved include:

- Compiling a yearly audit plan
- Reviewing audit work papers
- Approving assessments, penalties and interest charges prior to issuance of audit reports
- Approval of audit reports
- Account write-offs and refunds

Reviewing these decisions would ensure the propriety and validity of the decisions that were made by staff. It would also ensure that decisions were made consistently by all employees.

Auditor's Recommendation:

We recommend that management controls be developed for the areas mentioned above. The Sales Tax Manager should take an active roll in developing a yearly audit plan. The Manager should review and approve audit work papers. Assessments should also be reviewed prior to the issuance of the approved audit report. The Manager should also ensure that account write-offs and refunds are administered in a fair and consistent manner.

The current Sales Tax Manager has implemented guidelines to address this recommendation.

City's Response:

The City of Colorado Springs Sales Tax Division agrees with this finding/recommendation.

Procedures are currently being developed to bring more consistency to the Sales Tax Division. The manager has already begun reviewing and approving all items noted in the above finding.

Findings, Recommendations and Responses

5. The Sales Tax Division had not established standard documentation requirements.

The Auditors and Investigators did not have specific work paper standards to follow. Without these standards to follow, management may not be assured that the audit working papers contain complete documentation of audit procedures and findings. There is no assurance of consistency between Auditors. The Auditors should have standardized work paper guidelines and the procedures should incorporate using an automated work paper system. Division management may want to consider using some type of computer auditing tool such as ACL to test data and increase efficiency.

Auditor's Recommendation:

We recommend that audit management establish standard documentation requirements for Auditors and Investigators.

City's Response:

The City of Colorado Springs Sales Tax Division agrees that work standards are necessary to ensure efficient operations. Steps are being taken by management to establish these standards.

Findings, Recommendations and Responses

6. Inefficient and ineffective methods were used to identify businesses that did not have sales tax permits.

Means used to identify businesses and individuals with tax liabilities due the City were generally not effective or efficient. Not all business owners may have applied for a sales tax permit. Tax revenue due the City could easily go undetected because of human error. The Sales Tax Division should explore alternative methods of identifying non-filers and bring them into compliance with City Code.

Auditor's Recommendation:

We recommend that the Sales Tax Division review alternative options for identifying businesses that should be remitting sales and/or use tax, but are not. Comparisons with data maintained by other organizations, such as Colorado Springs Utilities or the State of Colorado, may be possibilities.

City's Response:

The City of Colorado Springs Sales Tax Division has looked at other ways to determine the businesses that are new to the community. Previously, a new business list was provided by Springs Utilities showing businesses who established utilities during the month. We were informed by representatives at Springs Utilities that they would not be able to provide us with this report as previously done due to a legal opinion from their legal department.

The Sales Tax Division staff is continuously looking for ways to efficiently ensure compliance.

Findings, Recommendations and Responses

7. Daily activity logs were not being reviewed.

Investigators maintain a manual log of all daily activities including the amount of tax assessments collected. This log was only reviewed by the Investigators. The activity report should be used as a performance tool by management. If mobile computing devices become available in the future, having the report available to management in an electronic format may be beneficial.

Auditor's Recommendation:

We recommend that investigators start compiling time electronically so that it can be reviewed by management and used as a performance tool.

City's Response:

The City of Colorado Springs Sales Tax Division agrees that daily activity logs should be reviewed and procedures have been put into place for this to occur.

Requiring the investigators to compile their time electronically would be inefficient since they spend a majority of their time out in the field. They currently pre-print the log sheets and take them out to the field with them. As they visit businesses they write all pertinent information onto the log. This would require that they come back into the office and re-enter the information into the computer. The Investigators currently do not have laptop computers but this could be something that the Sales Tax Division looks into when computers are replaced.

The Sales Tax Division will continue to look for more efficient ways to conduct business.

Findings, Recommendations and Responses

SYSTEM RELATED CONCERNS:

8. The Sales Tax Computer System was not adequate.

The Sales Tax Computer System was not adequate to capture and provide the level of detail and information needed by the users. The system was outdated and did not have the ability to perform many basic tasks. For example:

- The system did not allow users to record and document interactions with tax payers.
- The system did not have the ability to perform queries or compile data by set criteria.
- The system did not have the ability to print out management reports.
- Only one contractor had the ability to make changes or repair the computer system.
- Several processes could be automated, but the system could not accommodate the additional functions.
- The system did not interface with PeopleSoft.
- The system did not have the ability to provide an e-file option.

The integrity of the sales tax system is questionable. The quality and relevance of information contained in the sales tax database is of concern.

The current Sales Tax Manager has submitted a request for information (RFI) and is in the process of sending out a request for proposal (RFP). The City has budgeted for \$250,000 for the replacement of the system.

Auditor's Recommendation:

The new system should have the capability of performing all the needed functions. The new system should improve the efficiency and effectiveness of the Sales Tax Division related to collections and reporting.

City's Response:

The City of Colorado Springs Sales Tax Division does agree with the City Auditor regarding the system.

An RFP was issued in June 2006. The RFP was cancelled in August 2006 due to poor responses and responses well over our budget. The Sales Tax Division is currently reviewing our options for obtaining a new system within our limited budget.

We also agree that the current budget is not adequate for the necessary system.

Findings, Recommendations and Responses

9. The current Sales Tax System required duplication of effort by staff.

The field staff (Auditors and Investigators) were not given access to make changes in the Sales Tax application system. Therefore, they would document needed changes and pass that documentation to the office staff (Audit Technicians) for entry into the computer system. It appeared that the system utilized by Sales Tax was developed and implemented when mobile computing was not an economically viable option for updating information in the system. Therefore, the current procedures were developed. However, these procedures result in a duplication of effort by the mobile field staff (Auditors and Investigators) and the office staff (Audit Technicians).

Auditor's Recommendation:

When specifying the parameters of a new Sales Tax system, the Sales Tax Division should incorporate the use of mobile computing devices to minimize the duplication of efforts in the future. The use of such devices would require that field staff be given access to update appropriate information. The Division will need to review what access is given to each group of employees to ensure that appropriate segregation of duties is preserved or compensating controls are developed.

City's Response:

The City of Colorado Springs Sales Tax Division agrees with the Auditor's Recommendation. However, this would require funding that is currently not in the budget for the Sales Tax Division.

Findings, Recommendations and Responses

10. Access granted to and changes made by Audit Technicians were not routinely reviewed.

Effective access controls protect automated system information and resources from unauthorized modification, fraud, loss or disclosure by restricting inappropriate access. Creating formalized procedures for granting user access to the system reduces the risk that unauthorized users and users with excessive access rights could gain access where they may intentionally or inadvertently add, alter, or delete sensitive data. The Sales Tax Division did not have formal procedures describing the process and criteria for granting user access to the system. Changes made by Audit Technicians were not routinely reviewed. Exception reports were not generated that would identify unusual transactions that might need to be reviewed. Technicians had unlimited access to all areas within the application system. However, they did not have programming access.

Auditor's Recommendation:

We recommend that management review the access and use of the computer system. This review should include development of exception reports that might identify unusual transactions, which should be reviewed by management. A policy regarding access and use of the system should be established.

City's Response:

These requirements will be looked at with the implementation of a new software system. The current system does not allow for this type of exception reporting. All policies are currently being reviewed and updated as necessary.

Findings, Recommendations and Responses

STAFFING RELATED CONCERNS:

11. The City had not evaluated the impact of adding staff to the Sales Tax Division.

The City should evaluate the cost/benefit relationship of increasing the audit and investigation staff. For the year 2005, four Auditors received assessments totaling over \$2.8 million. Three Investigators resolved over 6,000 assessments and collected over \$2.1 million. The third Investigator was not hired until September 2005. Significant additional revenue recoveries for the City might result if the audit and investigation staff were increased.

Auditor's Recommendation:

We recommend that a cost-benefit analysis be performed on increasing the audit and investigation staff of the Sales Tax Division. The current staff audits less than 1% of sales tax reporters annually. Therefore, it appears likely that the analysis may find additional staffing would be beneficial to the City. If the analysis indicates that there would be significant benefit for the City, the staff should be increased.

City's Response:

The City of Colorado Springs Sales Tax Division has requested additional staff as part of the 2007 budget process.

The City continues to grow at a rapid pace; however the audit staff for the Sales Tax Division has not changed since 2003. The Division currently has four auditors to provide routine compliance audits, audits of "problem" accounts, economic development analysis and taxpayer assistance. There are currently in excess of 10,000 active licenses and in the last two years our Division has performed 58 audits. It is difficult to keep a routine audit schedule and be able to audit problem accounts that come up throughout the year. In addition, auditors must be taken off of audits to assist with economic development project requests.

The City Code addresses a three year statute of limitations on the City. This means that we cannot go back any further than that when we conduct our audits. Without timely audits, there is a potential of lost revenue to the City.

There is also a need for a supervisor in the technician area. This position would provide increased efficiency and effectiveness and would reduce the potential loss in revenue that occurs with inefficient operations.