



AUDIT REPORT

SALES TAX 2004

Austin City Council

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February 2005

Office of the City Auditor
Austin, Texas

Sales Tax Series

03/25/2003 Audit Report “Aspects of Sales Tax Revenue
06/06/2003 Memo on Sales Tax Issues
07/22/2003 Audit Report “Sales Tax: Annexation Timelines”
12/09/2003 Audit Report “Sales Tax: Potentially Non-Permitted Businesses
02/08/2005 Audit Report “Sales Tax Audit 2004”

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City of Austin



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February 8, 2005

To: Mayor and Council Members

From: Stephen L. Morgan, City Auditor

Subject: Audit Report on Aspects of Sales Tax Revenue

I am pleased to present this audit report on aspects of Sales Tax Revenue, which is part of our office's ongoing focus on revenue accountability. The purpose of this audit was to provide assurance that the City of Austin is credited for sales taxes paid by eligible businesses within the City limits by testing the reliability of data from the State Comptroller's Office.

From our testing, we identified several hundred addresses coded non-Austin but appearing within the city limits. Further testing of four zip codes identified hundreds of other businesses that may be missing entirely from the State Comptroller's Office database. The State Comptroller's Office must confirm them and, although the potential monetary impact has not been determined, the effect on City revenue may be minimal.

No recommendations to management are made in this report but issues for further study have been identified. We appreciate the cooperation and assistance we have received from the State Comptroller's Office and the University of Texas McCombs School of Business during this audit.

Stephen L. Morgan, CIA, CGAP, CFE, CGFM
City Auditor



SALES TAX AUDIT 2004

Office of the City Auditor

February 8, 2005

This audit is one of a series conducted by the Office of the City Auditor that examines aspects of sales tax revenue over time for the City of Austin. A previous audit indicated the need for further analysis to determine the reliability of the State Comptroller's Office data associated with the collection of sales tax from eligible businesses for the City of Austin.

BACKGROUND INFORMATION

The State Comptroller's Office (SCO) is responsible for handling the collection and allocation of sales tax revenue for municipalities. Each and every location for a business that offers tax-eligible goods or services is supposed to file for a sales tax permit with the SCO. The SCO collects the state sales tax on certain goods and services, along with a corresponding municipal tax if the transaction occurs within a city. For this service, the City of Austin pays a fee of two percent, which is over \$2 million per year. The SCO provides "zip code drop" reports from their sales tax database of known taxpayers by zip code to help cities double check sales tax records. This data provides such information as name, location, whether the business is located inside a city's limits, and under whose jurisdiction they fall. However, the SCO is prohibited by statute from sharing information on actual dollar payments made by businesses.

Austin's most direct influence in the sales tax allocation process is to ensure all businesses that are physically located within Austin's boundaries are properly identified on the SCO database. While other cities such as Houston and Dallas have done this, Austin had not until 2003. The Office of the City Auditor's Sales Tax Series, conducted in 2003, was our first effort to audit data from the SCO. One recommendation from the series of audits conducted in 2003 called for pursuing access to sales tax data from the State to allow the City to verify that sales tax receipts are properly allocated and distributed.

Some issues identified in the 2003 series of sales tax audits required further consideration, including the potential that data problems might extend beyond just newly annexed areas, and other Austin businesses might still be coded as not located in Austin. The State mostly relies upon taxpayer honesty and accuracy in reporting revenue and identifying the location of a business. The largest cities in Texas have the greatest ability and need to analyze tax revenues yet are not allowed to access the sales tax data. As a result, SCO staff has suggested that cities should periodically help test the limited data that is available.

Objective

The objective of this audit was to determine whether the SCO zip code drops properly credit Austin for businesses selling taxable goods and/or services inside the City limits.

Scope

The scope included 2004 zip code drop data from the SCO as well as 2004 data from a third-party database, ReferenceUSA (RefUSA) for sixteen zip codes from the interior of Austin. Active businesses in four of these zip codes (78757, 78704, 78702, and 78759) were selected for additional testing during the course of the audit.

Methodology

Under the guidance of OCA auditors, audit work was conducted by a student team from the University of Texas. Audit methodology included meeting with the SCO staff, researching state law on sales tax and sales tax exclusions, obtaining SCO zip code drop data and testing for data flaws. All zip codes fully within Austin were subjected to limited testing for data errors. Additionally, four of the interior zip codes were judgmentally selected to test for missing records. This second round of testing was done by comparing the SCO records with an external, independent business database, RefUSA. Two different screening approaches were used. The first screening method identified a number of larger retail businesses with high annual retail sales that would obviously be tax eligible and thus have a potentially large sales tax revenue impact. A second screening method was used for small or unknown businesses and we called to confirm that the businesses in question were offering taxable products and/or services.

This audit was conducted in accordance with generally accepted government auditing standards. We lacked direct access to SCO systems and computers, and financial data necessary to confirm payment allocations were not available under state law. As a result, our work did not distinguish whether data problems were likely due to data reliability issues at the SCO or taxpayer fraud, and there was a limited ability to test for fraud and data reliability.

AUDIT FINDINGS

Data reliability testing of zip codes that are fully within Austin revealed hundreds of small businesses in the SCO database with data errors that may have prevented Austin from receiving full credit for sales tax revenue collected. Further testing of four zip codes identified a couple of hundred other businesses that may be missing entirely from the SCO reports for the zip codes in question. The records flagged as a result of this audit are under review by the SCO to determine how many adjustments need to be made for Austin.

Due to state laws that preclude our access to much of the sales tax data, we have a limited ability to determine the impact of the problems identified, including the dollars associated with any business reporting sales taxes within Austin. While past audit work focused on risk related to newly-annexed areas, this audit work indicates that data reliability controls are also lacking for interior areas of Austin.

Records for 294 businesses in the SCO database had data errors that may have prevented Austin from receiving full credit for tax payments.

Our testing found 268 businesses coded as being outside the City limits even though they were in 16 zip codes that are from the interior of Austin. This coding indicates that they may not be collecting and remitting a municipal portion with their sales tax payments to the State. If they are remitting a municipal portion to the State, Austin is not getting credit for it, and thus the coding indicates a problem exists.

Testing of these interior zip codes also revealed 39 businesses coded as not under Austin's jurisdiction even though they were in zip codes fully within the City limits. The jurisdiction field is used to indicate which municipality is owed the municipal portion of the tax, if any. These businesses may be collecting and remitting a municipal portion with their sales tax payments to the SCO, but they are not sent to Austin. However, 13 of these 39 businesses flagged were also coded as not being located within the City limits, and would thus overlap with the 268 errors noted above.

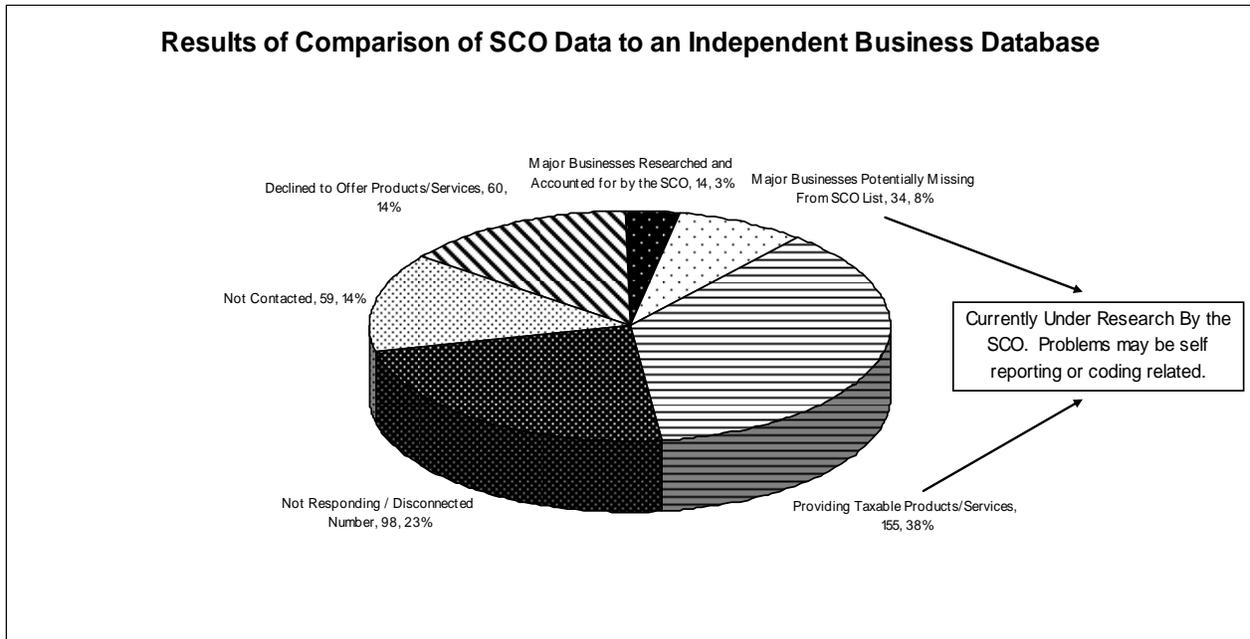
Further testing of four zip codes identified hundreds of other businesses that may be missing entirely from the SCO zip code reports.

From the sixteen zip codes we tested for coding issues above, we matched SCO reporting for four selected zip codes to a reference database that contains currently active businesses, and flagged a number of businesses that appeared to be tax-eligible but could not be found in the SCO reporting. Of these, 48 were well-known businesses that would obviously be tax-eligible if in fact they were found to be in the SCO database. Preliminary research by the SCO staff accounted for 14 of these businesses with the remaining 34 still to be researched by the State to determine if Austin was somehow credited for these under a different name or address.

Beyond the 48 large businesses flagged, an additional 372 (smaller or lesser-known) businesses, also unmatched in the SCO zip code drop report, were identified for further testing to determine if they are indeed in the Austin area and offering tax-eligible goods or services. Businesses offering to provide a taxable good and/or service totaled 155. Businesses declining to offer the tax-eligible good or service requested totaled 60. Businesses that were called but did not respond or had disconnected numbers totaled 98. Businesses that were not called totaled 59. As a result, we could not determine how many of these 157 had been selling tax-eligible goods or services.

For a depiction of testing results, please refer to Exhibit 1 on the next page.

Exhibit 1



Source: OCA testing of SCO and ReferenceUSA business data.

The SCO has begun researching and adjusting some of the records identified above.

The data problems identified have been referred to SCO staff for research. Where money was simply allocated incorrectly, SCO will make adjustments and credit Austin for any past revenues. In addition, SCO is referring to their own enforcement division those businesses whose records could not be explained after further SCO research. SCO has already begun sending demand letters to some of the businesses identified.

It is important to note that the data problems could represent either erroneous information self-reported by businesses or problems the SCO may have had controlling data. Where SCO data is in error, little or no sales activity may have been recorded.

When combined with the fact that a business could have reported sales tax receipts under a different name or location, we cannot say money is owed to Austin for each and every problem record.

Changes to State law would improve accountability.

The recommendation from a previous audit that the City's Governmental Relations Office (GRO) pursue a legislative agenda changing state law to allow the City to verify the proper allocation and distribution of sales tax receipts has not been successfully implemented. However, the GRO has successfully worked to place support for this item into the draft legislative agenda being proposed to Council. In addition, GRO helped support a successful change to a different state law (related to the privacy of audit working papers) that could help gain access to sales tax data in the future.

ISSUES FOR FURTHER STUDY

Should the City expect a higher degree of data reliability for the service fees paid to the State? We found data reliability problems in the State's data coding that point to issues of accuracy. We also found businesses in the RefUSA database that were missing from the SCO data that point to issues of completeness. The data issues raised do not impact a large percentage of the records handled by the State. However, increased screening and or detection on the part of the State could potentially eliminate a number of the coding errors we identified.

Past recommendations may not be sufficient to address the State Comptroller's Office data issues. The focus of the 2003 audit work was slightly different and past recommendations to City management addressed working on legislation to remove privacy barriers and requiring analysis of newly-annexed areas to identify businesses. Our current work, performed in 2004 and discussed in the findings above, suggests problems with State Comptroller's Office data may be ongoing and may not be limited to newly-annexed areas.

Additional accountability from the State for municipal allocations may be needed. State law hinders Austin's ability to assess the impact of and necessity for future audit work. During our 2003 audit work, the State Auditor's Office had indicated that they had not audited or tied out an allocation to a city and did not intend to do so in the near future.

Further, SCO staff indicated that they mostly rely upon taxpayer honesty and accuracy for the location data. Implementation of screening and review controls for addresses, jurisdictions, and city limits may not be viewed by the SCO as cost-beneficial because the issue is revenue neutral to the State (the State receives its share of the tax regardless of location). In fact, SCO staff recommends that cities actively screen their zip code reporting in order to help catch errors. Access to GIS technology and staffing restrictions could also be a limitation at the State level.

Increased attention by the City of Austin may be needed. Due to the discovery of control problems in data from interior city zip codes, our office may continue to audit sales tax collections to the extent we believe we are encouraging SCO to allocate revenue accurately to the City of Austin.

Our future audit work related to sales tax collections may need to examine how City staff reviews sales tax revenue from the State. Additionally, we will continue to support initiatives by larger Texas cities to change legislation that restricts access to SCO data on actual dollar payments made by individual businesses.

Primarily, we found several hundred businesses in the SCO zip code drop data with coding errors that may affect Austin's revenue and this may be the easiest to test in the future. Depending upon the information we receive from the SCO, businesses missing from the State Comptroller's Office zip code drop data but found in the RefUSA database may represent a secondary objective for future work.