

INFORMATION TECHNOLOGY AGENCY COLLECTION OF FRANCHISE FEES

AUDIT REPORT

CITY OF LOS ANGELES

MARCH 8, 1999



**OFFICE OF THE CONTROLLER
RICK TUTTLE, CONTROLLER**

**JAMES P. ARMSTRONG, CPA
DIRECTOR OF AUDITING**

SUBMITTED BY:

**CHING ILAGAN, SENIOR AUDITOR
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OFFICE OF
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LOS ANGELES 90012
(213) 485-5093

March 8, 1999

Mr. John Hwang, General Manager
Information Technology Agency
200 N. Main Street, Suite 1400
Los Angeles, CA 90012

Dear Mr. Hwang:

Our Auditing Division completed a review of the Information Technology Agency's Collection of Franchise Fees and the results are summarized in the attached report.

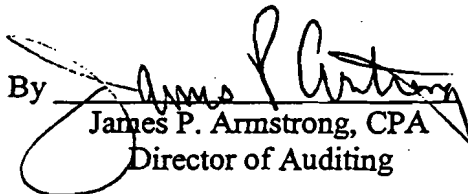
Before we finalized the report, a draft copy was provided to you, and the findings and recommendations in the draft report were discussed with your staff.

Please review the final report and advise the Controller's Office within 30 days on actions taken to implement the recommendations. A follow-up will be conducted during our next audit.

The cooperation extended by your staff during the course of the review was appreciated. If you have any questions, please call Victoria Ancajas, Chief Auditor, at (213) 485-4525.

Very truly yours,

RICK TUTTLE, CONTROLLER

By 
James P. Armstrong, CPA
Director of Auditing

JPA:CI:vca



Mr. John Hwang, General Manager
Information Technology Agency
March 8, 1999
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cc: Hon. Richard J. Riordan, Mayor
Hon. John Ferraro, President, City Council
Hon. Richard Alatorre, Chairperson, Budget and Finance Committee
Hon. Michael Feuer, Member, Budget and Finance Committee
Hon. Rita Walters, Member, Budget and Finance Committee
Hon. Joel Wachs, Chairperson, Governmental Efficiency Committee
Hon. Laura Chick, Member, Governmental Efficiency Committee
Hon. Mark Ridley-Thomas, Chairperson, Information Technology and General
Services Committee
Hon. Mike Hernandez, Member, Information Technology and General Services Committee
Hon. Hal Bernson, Member, Information Technology and General Services Committee
Alan Arkatov, President, Board of Information Technology Commissioners
Kelly Martin, Chief of Staff, Office of the Mayor
Jennifer Roth, Deputy Mayor, Office of the Mayor
Rocky Delgadillo, Deputy Mayor, Office of the Mayor
J. Paul Brownridge, City Treasurer
Keith Comrie, City Administrative Officer
Ronald Deaton, Chief Legislative Analyst
Independent City Auditors

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EXHIBITS

Exhibit I	Franchise Fees Received by Fiscal Year Fiscal Year 1994- 1998	
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REPORT ON INFORMATION TECHNOLOGY AGENCY'S COLLECTION OF FRANCHISE FEES

I. EXECUTIVE SUMMARY

We completed a review of the Information Technology Agency's (ITA) oversight of the collection of franchise fees for the period July 1, 1997 through June 30, 1998. Our review included an evaluation of the ITA's oversight and monitoring procedures to ensure that franchisees comply with other financial requirements of the franchise agreement.

The ITA is responsible for planning, designing, implementing, operating and coordinating the City's information technology systems and networks. In August 1995, the Department of Telecommunications and the General Services Department's Communications Division were consolidated into the ITA. The Board of Information Technology Commissioners is responsible for overseeing the ITA's cable franchise and consumer protection operations.

The ITA's Public/Private Enterprise Bureau administers and regulates all City cable franchises, including the enforcement of rates and adequate service levels and the collection of appropriate franchise fees due to the City.

A. OBSERVATIONS AND CONCLUSION

The ITA has not conducted timely audits of cable companies since 1995 to ensure franchisees pay the appropriate and correct amount of franchise fees to the City. Although cable franchise fees received by the City increased for the last five years, there is no assurance franchisees paid the correct amount to the City. Lack of adequate monitoring by ITA in the collection of cable franchise fees may have resulted in lost revenues. Also, insurance requirements were not properly monitored which may expose the City to possible claims as a result of the franchisees' non-compliance.

B. RECOMMENDATIONS

1. Evaluate and report on the benefits of contracting out the audit of the cable companies or hiring additional auditors to speed up the audit process to timely recover any uncollected franchise fees.
2. Report annually to the Board of Information Technology Commissioners on the status of audits.

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3. Ensure that franchisees comply with the insurance requirements of the franchise agreement by sending written notice to the franchisee at least one month prior to the expiration of the insurance policy.
 4. Maintain copies of current and enforceable insurance policies for franchisees.

C. OBJECTIVES AND SCOPE

The objectives of our review were to determine if:

- a. The ITA adequately monitored the accuracy and timeliness of franchise fee remittances from cable companies.
- b. The ITA adequately monitored the franchisees' compliance with other financial requirements of the franchise agreements.

D. REVIEW TECHNIQUES AND METHODOLOGY

In order to meet our objectives, we:

1. Interviewed ITA staff involved in the receipt and deposit of franchise fees and the monitoring of the franchise agreements.
2. Evaluated the ITA's procedures for collecting and depositing the franchise fees.
3. Evaluated ITA's monitoring procedures designed to ensure that franchisees comply with the requirements of the franchise agreements.
4. Verified if franchise fees were timely received and deposited with the City Treasury.

We did our review between October and December 1998 in accordance with generally accepted Government Auditing Standards.

II. BACKGROUND

City franchise revenues are primarily derived from franchise fees for the construction and operation of cable television infrastructure within the City's right of way. Franchise fees are collected from cable franchise operators or private companies that operate private communication lines.

The Telecommunications Planning and Regulation Division of the Public/Private Enterprise Bureau (PPEB) is responsible for the collection of the franchise fees in accordance with the terms of the franchise agreement. The Division is also responsible for monitoring other financial requirements of the contract including the audit of the franchisees' financial records to ensure that the franchisee remits the correct amount of franchise fees to the City.

Cable television franchise is typically granted for a period of 15 years. In accordance with the franchise agreement, the City requires the franchisee to pay franchise fees equivalent to five percent (5%) of gross revenues during each year of the franchise. The franchise fees are paid quarterly to the City throughout the term of the franchise, not later than 30 days after the end of each calendar quarter.

As of June 30, 1998, six cable companies operate within the City's 13 franchise areas. Franchise area is the geographic area within the City in which the franchisee is entitled to construct, operate and maintain the cable television. One cable company can operate in more than one geographical area. The franchise of the six cable companies will expire in the year 2002.

A City private communications line franchise is typically granted for a period of 10 years. The City charges a standard franchise fee of \$5 per linear foot of communication line per year. As of June 30, 1998, franchise fees received from private communications lines amounted to approximately \$10,000.

Forty percent of all monies collected from cable television franchise holders for franchise fees are deposited into the Liquidated Damages and Lost Franchise Fees Fund (Fund 342). The remaining 60% of the franchise fees collected are deposited into the City's General Fund.

For the last five years, total cable franchise fees received increased by about 25%, from \$12.4 million during fiscal year 1993-94 to \$15.6 million during fiscal year 1997-98 (See Exhibit I).

III. FINDINGS AND RECOMMENDATIONS

FINDING NO. 1: ITA DID NOT ADEQUATELY MONITOR THE ACCURACY AND APPROPRIATENESS OF THE FRANCHISE FEES RECEIVED FROM CABLE COMPANIES WHICH MAY HAVE RESULTED IN LOST REVENUES TO THE CITY.

ITA did not provide adequate management oversight in the collection of cable franchise fees which may have resulted in uncollected franchise fees for the City. Insufficient audits were made to ensure that the City received the correct amount of cable franchise fees in accordance with the terms of franchise agreements.

The City requires payment of franchise fees equivalent to five percent (5%) of the cable company's gross revenues to be paid quarterly throughout the term of the franchise. For the fiscal year 1997-98, the City received approximately \$15.6 million in cable franchise fees.

From December 1991 through December 1995, ITA audited seven franchise agreements. Six other franchise agreements were reportedly never audited from the time the franchise was awarded in 1987. It should be noted that the former Department of Telecommunications consolidated into ITA in August 1995.

The seven franchise audits which covered the period from 1987 through 1993, disclosed underpayment in franchise fees amounting to approximately \$569,000 including penalty and interest.

A similar finding was noted in the Controller's audit report dated October 1990. The Controller's report identified underpayment of \$21,620 in franchise fees from two cable companies and recommended periodic audits of all cable companies.

We obtained and reviewed audit reports prepared by an outside consultant for other municipalities on cable franchise fee remittances. The consultant's findings included several categories of revenues excluded from the calculation of franchise fees and subscribers with miscoded zip codes which resulted in underpayment of franchise fees. The audits disclosed underpayment in franchise fees ranging from \$5,000 to \$300,000 for a three-year period which were reportedly collected by the municipalities.

According to the ITA staff, no audits were conducted because the ITA's Senior Auditor was assigned multiple responsibilities and audits of the cable companies were not given high priority. According to ITA staff, the auditor started an audit in July 1998 and the audit was still on going as of the end of our field work.

The ITA Telecommunications Regulatory Officer stated that he had the same concern about cable companies not remitting the correct amount of franchise fees as a result of a recent Federal court decision impacting the method of calculation of franchise fees. In the Budget Request for

fiscal year 1996-97, ITA requested funding for contractual services for franchise audits. According to ITA staff, the request was rejected during the budget process, and the Department has not requested funding for franchise audits in subsequent budget requests.

Sound management practice and adequate financial control over franchise collections require timely audits of the franchisees to ensure that the City is receiving the correct amounts according to the terms of the agreements.

Without timely audits, the City may not be collecting the correct amount of franchise fees from the cable companies and some categories of revenues may have been excluded from the calculation of franchise fees remitted to the City.

RECOMMENDATIONS:

Evaluate and report on the benefits of contracting out the audit of the cable companies or hiring additional auditors to speed up the audit process to timely recover any uncollected franchise fees.

Report annually to the Board of Information Technology Commissioners on the status of audits.

FINDING No. 2 ITA DID NOT ADEQUATELY MONITOR THE INSURANCE REQUIREMENTS OF THE FRANCHISE AGREEMENTS WHICH MAY RESULT IN POTENTIAL CLAIMS AGAINST THE CITY.

ITA did not ensure that current and enforceable insurance policies are submitted by the franchisees as required by the franchise agreement. Franchisees' failure to maintain the required insurance may result in a material breach of the franchise agreement and could lead to potential claims against the City.

Our review of the insurance policies showed that for the 13 franchises, only eight had insurance documentation on file, seven of which had already expired. Also, one cable company which operates in six franchise areas did not have the insurance coverage for each area as required by the agreement.

The Telecommunications Planning and Regulation Division is responsible for monitoring the insurance requirements of the franchise agreements. Section 12 of the franchise agreement requires the franchisee to provide and maintain continuously throughout the term of the agreement the required insurance for General Liability, Automobile Liability, Workers' Compensation and Employer's Liability.

As a result of our audit, ITA personnel obtained insurance documentation from franchisees. On January 13, 1999, ITA provided us with copies of current and enforceable insurance documentation for all franchisees.

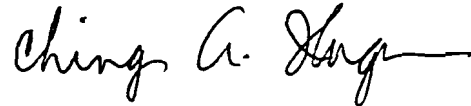
RECOMMENDATIONS:

Ensure that franchisees comply with the insurance requirements of the franchise agreement by sending written notice to the franchisee at least one month prior to the expiration of the insurance policy.

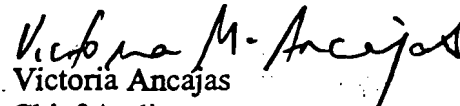
Maintain copies of current and enforceable insurance policies for franchisees.

An exit conference was held on February 24, 1999, at which time the findings and recommendations contained in this report were discussed with the ITA representatives Jesse Juarros, Assistant General Manager; Paul Janis, Telecommunications Regulatory Officer; and, Sharon Stenen, Chief Management Analyst, who concurred with the findings and recommendations.

Respectfully submitted,



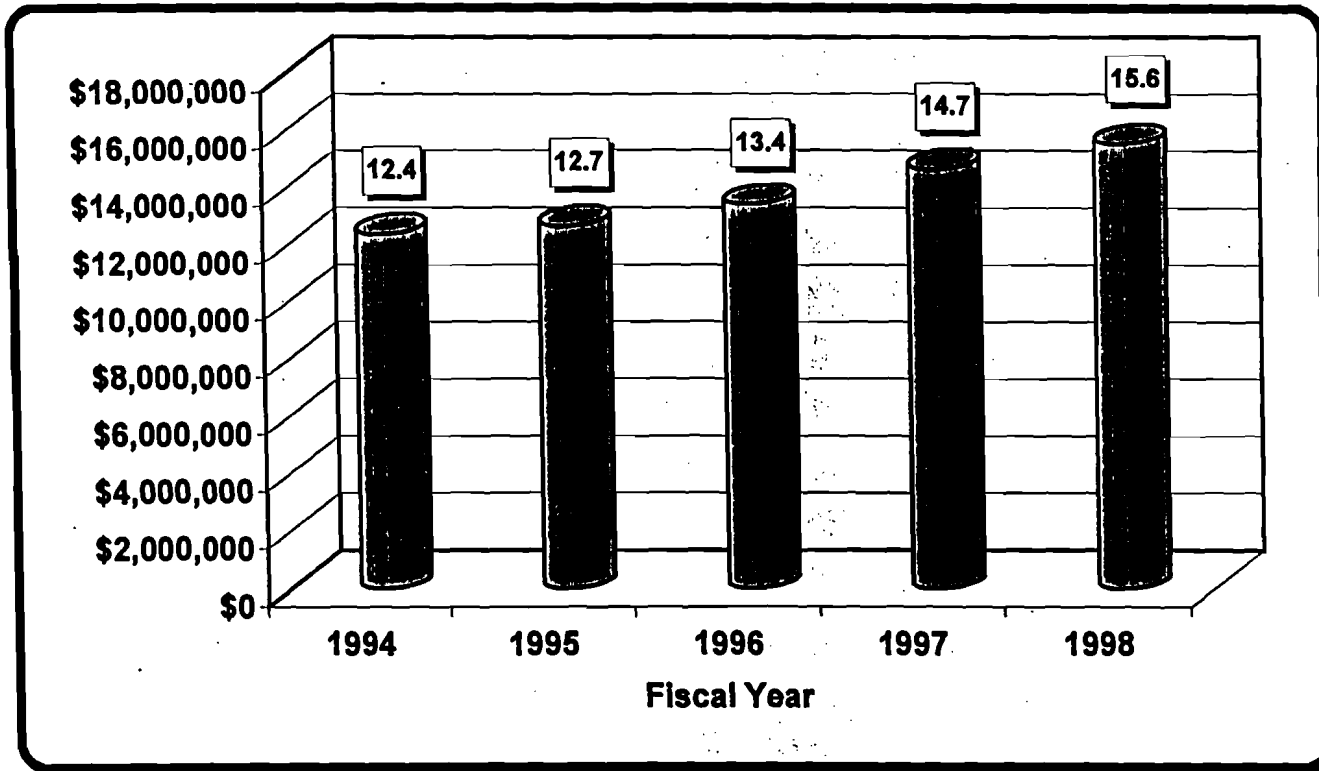
Ching Ilagan
Senior Auditor



Victoria Ancajas
Chief Auditor

December 31, 1998

**Information Technology Agency (ITA)
Franchise Fees Received by Fiscal Year**



Fiscal Year	Amount
1994	\$12,406,497
1995	\$12,688,863
1996	\$13,449,679
1997	\$14,678,959
1998	\$15,567,322

Source: Information Technology Agency, Public/Private Enterprise Bureau