PERFORMANCE AUDIT
OF THE

TAX COMPLIANCE BUREAU

DEPARTMENT OF TREASURY

June 2004

27-140-03

"...The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof."

– Article IV, Section 53 of the Michigan Constitution

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Michigan

Office of the Auditor General

REPORT SUMMARY

Performance Audit

Tax Compliance Bureau

Department of Treasury

Report Number:
27-140-03

Released:
June 2004

The Tax Compliance Bureau consists of two divisions. The Audit Division is responsible for conducting field audits of business taxpayers. The Discovery and Tax Enforcement Division is responsible for conducting special projects to identify businesses and individuals with tax liabilities due the State and performing special reviews to detect fraud related to individual income tax returns.

Audit Objectives:

1. To assess the effectiveness and efficiency of the Audit Division's audit activities.

2. To assess the effectiveness of the Discovery and Tax Enforcement Division's projects for identifying businesses and individuals with tax liabilities due the State.

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Audit Conclusions:

1. We concluded that the Audit Division's audit activities were generally effective and efficient. However, we noted reportable conditions related to cost-benefit evaluation, audit working paper documentation, and collections records for Bureau activities (Findings 1 through 3).

2. We concluded that the Discovery and Tax Enforcement Division's projects for identifying businesses and individuals with tax liabilities due the State were generally effective. However, we noted reportable conditions related to Internal Revenue Service (IRS) data and taxes for nonresident entertainers (Findings 4 and 5).

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Reportable Conditions:

The Department of Treasury needs to evaluate the cost benefit of increasing the Audit Division's field audit staff. The Department may need to seek additional appropriations to increase the Audit Division's field audit staff if its evaluation indicates that there would be significant cost benefit for the State. (Finding1)

The Audit Division did not ensure that its audit working papers contained complete documentation of audit procedures and findings (Finding 2).

The Department's automated accounts receivable system did not provide summaries of collections related to assessments issued by the Tax Compliance Bureau (Finding 3).

The Discovery and Tax Enforcement Division needs to develop additional uses

of the Internal Revenue Service (IRS) data to more effectively identify businesses with tax liabilities due the State (Finding 4).

The Department needs to seek amendatory legislation to require entertainment venues to collect and remit the estimated State taxes due for performances by nonresident entertainers (Finding 5).

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Agency Response:

Our audit report contains 5 findings and 6 corresponding recommendations. The preliminary response prepared by the Department indicated that it agrees with 5 recommendations and that it has complied or will comply with them. The Department's response also indicated that it disagrees with 1 recommendation.

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A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: http://audgen.michigan.gov

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THOMAS H. MCTAVISH, C.P.A.
AUDITOR GENERAL

June 18, 2004

Mr. Jay B. Rising
State Treasurer
Treasury Building
Lansing, Michigan

Dear Mr. Rising:

This is our report on the performance audit of the Tax Compliance Bureau, Department of Treasury.

This report contains our report summary; description of agency; audit objectives, scope, and methodology and agency responses and prior audit follow-up; comments, findings, recommendations, and agency preliminary responses; a schedule of revenue for taxes administered by the Department of Treasury, presented as supplemental information; and a glossary of acronyms and terms.

Our comments, findings, and recommendations are organized by audit objective. The agency preliminary responses were taken from the agency's responses subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

Sincerely,

Thomas H. McTavish, C.P.A.
Auditor General

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DEPARTMENT OF TREASURY

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Description of Agency

The Tax Compliance Bureau's mission* is to increase compliance with State tax statutes while concurrently providing improved customer service by effectively managing the Taxpayer Bill of Rights.

The Bureau consists of the following two divisions:

1. The Audit Division is responsible for conducting field audits of business taxpayers. The Division's functions include selecting taxpayer accounts for audit, auditing books and records of taxpayers to determine whether all taxes have been properly computed and paid, and preparing reports that summarize the results of the audits after completion. The Division's field auditors are located in 13 field offices (7 are located within the State and 6 are located outside the State). For fiscal year 2001-02, the Division's collections for tax deficiencies, penalties, and interest resulting from Division audits totaled approximately $62.5 million. In addition, the Bureau issued assessments* totaling approximately $58.0 million for tax deficiencies, penalties, and interest that resulted from fiscal year 2001-02 Division audits.

2. The Discovery and Tax Enforcement Division is responsible for performing special reviews for all taxes administered by the Department of Treasury (see supplemental information). The Division's functions include conducting special projects to identify businesses and individuals with tax liabilities due the State and performing special reviews to detect fraud related to individual income tax returns. For fiscal year 2001-02, the Division's collections for tax deficiencies, penalties, and interest totaled approximately $94.3 million. In addition, the Bureau issued assessments totaling approximately $15.3 million for tax deficiencies, penalties, and interest that resulted from fiscal year 2001-02 Division activities.

For the fiscal year ended September 30, 2002, the Bureau's expenditures totaled approximately $21.3 million. As of June 30, 2003, the Bureau had 247 employees.

** See glossary at end of report for definition.*

Audit Objectives, Scope, and Methodology and Agency Responses and Prior Audit Follow-Up

Audit Objectives

Our performance audit* of the Tax Compliance Bureau, Department of Treasury, had the following objectives:

1. To assess the effectiveness* and efficiency* of the Audit Division's audit activities.

2. To assess the effectiveness of the Discovery and Tax Enforcement Division's projects for identifying businesses and individuals with tax liabilities due the State.

Audit Scope

Our audit scope was to examine the program and other records of the Tax Compliance Bureau. Our audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Audit Methodology

Our audit procedures, performed from March through June 2003, included examinations of program records and activities for the period October 1, 2000 through June 30, 2003.

We conducted a preliminary review of the Bureau's operations to gain an understanding of its activities and to form a basis for selecting certain operations for audit. This included interviewing Bureau personnel and identifying performance measures* and objectives* that the Bureau used to evaluate its effectiveness. Also, we reviewed applicable laws, management plans, activity reports, and policies and procedures to gain an understanding of management control* related to pertinent Bureau functions.

To accomplish our first objective, we interviewed Audit Division staff and examined various program reports and program performance documentation. We analyzed how the Audit Division determined that it accomplished its mission and met its goals* and objectives. We conducted tests of records related to field audits of taxpayers. Also, we visited two field offices to gain an understanding of field operations and activities.

** See glossary at end of report for definition.*

To accomplish our second objective, we interviewed Discovery and Tax Enforcement Division staff and examined various program reports and program performance documentation. Also, we conducted tests of records related to projects for identifying businesses and individuals with tax liabilities due the State.

Agency Responses and Prior Audit Follow-Up

Our audit report contains 5 findings and 6 corresponding recommendations. The preliminary response prepared by the Department indicated that it agrees with 5 recommendations and that it has complied or will comply with them. The Department's response also indicated that it disagrees with 1 recommendation.

The agency preliminary response that follows each recommendation in our report was taken from the agency's written comments and oral discussion subsequent to our audit fieldwork. Section 18.1462 of the *Michigan Compiled Laws* and Department of Management and Budget Administrative Guide procedure 1280.02 require the Department of Treasury to develop a formal response to our audit findings and recommendations within 60 days after release of the audit report.

The Bureau complied with the 3 prior audit recommendations.

COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

EFFECTIVENESS AND EFFICIENCY OF THE AUDIT DIVISION'S AUDIT ACTIVITIES

COMMENT

Background: The number of Audit Division staff members decreased by 35 in calendar year 2002 because of the State's early retirement program. As of June 2003, the Audit Division had 206 staff members, which included 148 auditors who conducted field audits of taxpayers. The other 58 Division staff members had management, supervisory, or administrative support positions.

The Audit Division, Tax Compliance Bureau, is responsible for conducting field audits of businesses registered with the Department of Treasury. As of June 2003, approximately 514,000 businesses were registered with the Department.

The Audit Division also conducts field audits of unregistered out-of-State businesses that conduct business in Michigan to determine whether they have State tax liabilities. The Audit Division receives referrals from the Discovery and Tax Enforcement Division for out-of-State businesses that have not registered for the single business tax (SBT) and have not responded to letters requesting information on their business activities in the State. As of June 2003, the Audit Division's potential audit population included approximately 1,100 unregistered out-of-State businesses.

Audit Objective: To assess the effectiveness and efficiency of the Audit Division's audit activities.

Conclusion: We concluded that the Audit Division's audit activities were generally effective and efficient. However, we noted reportable conditions* related to cost-benefit evaluation, audit working paper documentation, and collections records for Bureau activities (Findings 1 through 3).

FINDING

1. **Cost-Benefit Evaluation**

   The Department of Treasury needs to evaluate the cost benefit of increasing the Audit Division's field audit staff. The Department may need to seek additional

* *See glossary at end of report for definition.*

appropriations to increase the Audit Division's field audit staff if the evaluation indicates that there would be significant cost benefit for the State.

Historically, the revenue recoveries generated by field audits have significantly exceeded the costs for Audit Division activities. For fiscal year 2001-02, the Audit Division's expenditures totaled approximately $19.3 million and its field audit staff completed audits of approximately 1,900 businesses. For these businesses, the Division completed 3,412 tax audits (including SBT and other business taxes) and determined that tax deficiencies existed in 2,354 (69%) of the tax audits. For these 2,354 audits, Division records indicated that the results were as follows:

Total Tax Deficiencies, Penalties, and Interest	Total Collected at Completion of Audit	Total Amount of Assessments Issued	Number of Field Auditors	Average Amount of Collections Per Field Auditor	Average Amount of Assessments Per Field Auditor
$120,565,083	$62,521,487	$58,043,596*	185	$337,954	$313,749

* Assessments are issued to taxpayers who have not paid taxes upon completion of the audit.

The Audit Division has established an audit selection process to select large corporations and other businesses with potentially high tax deficiencies. Based on the high rate of taxpayer noncompliance for field audits and the current cost benefit of field audits, significant additional revenue recoveries for the State could result if the Audit Division's field audit staff was increased. At our request, the Division evaluated the cost benefit of increasing its field audit staff. The Division's evaluation indicated that there would be significant cost benefit for the State if the Division added 75 field auditors to its staff.

Based on actual prior audit results and considering the learning period for new auditors, the Audit Division estimated that an increase of 75 field auditors may result in an increase of approximately $100 million for tax deficiencies, penalties, and interest in the first three years after the auditors were added. Based on average audit results for fiscal year 2001-02, approximately 52% of this amount would be collected at the completion of audits and assessments totaling approximately 48% of this amount would be issued. The Division also estimated that the costs for 75 additional field auditors would be approximately $18 million in the first three years after the auditors were added.

RECOMMENDATIONS

We recommend that the Department evaluate the cost benefit of increasing the Audit Division's field audit staff.

We also recommend that the Department seek additional appropriations to increase the Audit Division's field audit staff if the evaluation indicates that there would be significant cost benefit for the State.

AGENCY PRELIMINARY RESPONSE

The Department agrees with the recommendation. The Department informed us that in December 2003 supplemental appropriations for increasing field audit staff were recommended by the Department and were approved by the Legislature and Governor. The supplemental appropriations added 42 full-time equated positions to the Audit Division. In addition, the Department plans to increase the scope of compliance activities for the Audit Division.

FINDING

2. Audit Working Paper Documentation

The Audit Division did not ensure that its audit working papers contained complete documentation of audit procedures and findings.

For businesses selected for audit, the Audit Division conducted audits for SBT and for other taxes that were applicable for the businesses. The Division's audits were conducted mainly for SBT, sales tax, and use tax. For SBT audits, the Division determined whether the SBT liabilities were properly computed by reviewing the accounting records and federal tax returns of the businesses. For sales tax and use tax audits, the Division reviewed samples of sales and purchase transactions to determine whether tax liabilities reported by the businesses were proper.

The Audit Division implemented an automated system for its field audit working papers in April 2001. The Division's field audit staff members are required to document in the automated working papers the audit procedures and findings for each tax included in the audit. At the time of our review, the Division had not implemented standards for documentation to be included in the automated working papers.

We reviewed the automated working papers for a sample of 72 audits completed by the Audit Division during the period July 2002 through March 2003. Our sample included 33 SBT audits, 15 sales tax audits, and 24 use tax audits. Our review disclosed:

a. The working papers for 68 (94%) audits did not contain documentation of the auditor's evaluation of the businesses' internal control*.

   The Division's fieldwork standards provide that the audit should include a study and evaluation of the existing internal control for the accrual and reporting of tax liabilities. Without a documented evaluation of relevant controls, the Division has a limited basis for evaluating the appropriateness of the nature, timing, and extent of the detailed audit tests.

b. The working papers for 46 (64%) audits did not contain cross-referencing of the audit findings and conclusions to the supporting working paper sections.

   Cross-referencing enables supervisors and managers to review the working papers more efficiently and facilitates any follow-up required for audit findings after audits are completed.

c. The working papers for 4 (6%) audits did not contain narrative summaries of the audit testing procedures. Also, the working papers for 11 (28%) of the 39 sales tax and use tax audits did not contain documentation of the sampling procedures. For these 11 audits, the Division's standard sampling plan forms had not been completed.

   Proper documentation of the audit testing and sampling procedures provides assurance that the Division conducted audits in accordance with established procedures and accurately projected audit results, including the determination of tax deficiencies.

d. The working papers for 14 (42%) of the 33 SBT audits did not contain supporting detail for calculating the audit adjustment amounts. However, the working papers did contain narrative descriptions of the auditing procedures performed to determine the audit adjustments.

* *See glossary at end of report for definition.*

Maintaining supporting detail for audit adjustments in the working papers facilitates supervisory review and follow-up for audit findings after audits are completed. Supporting detail also provides validation of the accuracy of the adjustments.

The Audit Division informed us that it recognized the need for improved documentation and that it was in the process of developing quality standards for its automated working papers.

RECOMMENDATION

We recommend that the Audit Division ensure that its audit working papers contain complete documentation of audit procedures and findings.

AGENCY PRELIMINARY RESPONSE

The Department agrees with the recommendation. The Department informed us that in December 2003 supplemental appropriations for streamlining audit procedures and findings were recommended by the Department and approved by the Legislature and Governor. The approved supplemental appropriations included a project plan to standardize audit schedules. In addition, standard audit schedules will comply with the generally accepted government auditing standards described in the "Yellow Book," *Government Auditing Standards* (2003 Revision), issued by the General Accounting Office and the Comptroller General of the United States.

FINDING

3. Collections Records for Bureau Activities

The Department's automated accounts receivable system did not provide summaries of collections related to assessments issued by the Tax Compliance Bureau.

The Department's automated accounts receivable system could provide summaries of collections for assessments issued for the Bureau's activities. Records of collections for assessments would help the Bureau to evaluate the effectiveness and efficiency of its activities through analysis of collection performance data over time.

When a taxpayer did not make payment at the completion of an audit conducted by the Audit Division, the Bureau issued assessments for the tax deficiencies, penalties, and interest due. For fiscal year 2001-02, the tax deficiencies, penalties, and interest for audits completed by the Audit Division totaled $120.6 million. The Audit Division collected $62.5 million (52%) and the Bureau issued assessments for $58.0 million (48%) of this amount.

Also, the Bureau issued assessments for tax deficiencies, penalties, and interest for businesses and individuals determined in Discovery and Tax Enforcement Division projects. For fiscal year 2001-02, the tax deficiencies, penalties, and interest for Discovery and Tax Enforcement Division projects totaled $109.6 million. The Discovery and Tax Enforcement Division collected $94.3 million (86%) and the Bureau issued assessments for $15.3 million (14%) of this amount.

The Department's Collection Division is responsible for maintaining the automated accounts receivable system for assessments and collecting the balances due. The Collection Division may not collect the balances due for assessments for various reasons, including bankruptcies and dissolutions of businesses. Also, the assessments may be adjusted at informal conferences at the Department or through appeals to the Michigan Tax Tribunal.

RECOMMENDATION

We recommend that the Department revise its automated accounts receivable system to provide summaries of collections related to assessments issued by the Tax Compliance Bureau.

AGENCY PRELIMINARY RESPONSE

The Department agrees with the recommendation. The Department informed us that the State Treasurer's Accounts Receivable System has the capability to track audit related assessments and provide reports of amounts collected. The audit assessments can be tracked using project codes.

The Department also informed us that the Tax Compliance Bureau will utilize project codes to identify audit-generated assessments. The Bureau will request a standard management report to be produced on a regular basis and evaluate the information.

EFFECTIVENESS OF THE DISCOVERY AND TAX ENFORCEMENT DIVISION'S PROJECTS

COMMENT

Audit Objective: To assess the effectiveness of the Discovery and Tax Enforcement Division's projects for identifying businesses and individuals with tax liabilities due the State.

Conclusion: We concluded that the Discovery and Tax Enforcement Division's projects for identifying businesses and individuals with tax liabilities due the State were generally effective. However, we noted reportable conditions related to Internal Revenue Service (IRS) data and taxes for nonresident entertainers (Findings 4 and 5).

FINDING

4. IRS Data

The Discovery and Tax Enforcement Division needs to develop additional uses of IRS data to more effectively identify businesses with tax liabilities due the State.

The Department annually receives electronic data files from the IRS with information reported on federal business tax returns by businesses with Michigan addresses. The IRS business tax return data contains tax information reported on federal returns that is also reported on SBT returns and is used by business taxpayers to compute the SBT liabilities. The Department receives data from federal income tax returns and federal taxable wages reports filed by Michigan corporations and partnerships.

We reviewed the Department's current application of the IRS data and identified further uses of the data that would enhance the identification of businesses with tax liabilities due the State.

We discussed these further uses of the data with the Department. We were informed by Discovery and Tax Enforcement Division administrative staff that the Division had not yet developed further uses of the IRS business data because of staff limitations and other priorities.

The additional uses of the data that we identified have not been included in this audit report in order to maintain the integrity and security of the Department's current discovery and enforcement process.

RECOMMENDATION

We recommend that the Discovery and Tax Enforcement Division develop additional uses of IRS data to more effectively identify businesses with tax liabilities due the State.

AGENCY PRELIMINARY RESPONSE

The Department disagrees with the recommendation. The Department informed us that although it acknowledges the receipt of IRS data referenced in the finding, it cannot take a position on the finding or recommendation without further data. The resources of the Discovery and Tax Enforcement Division are fully committed to ongoing projects. The Department is unable to determine from the audit report the cost benefit of following the recommendation. The Department has solid statistics that support the present project assignments and the cost benefit of each project. The Department is reluctant to divert committed resources with an established track record before a cost-benefit analysis of that diversion can be determined. As ongoing projects expire, the Department will evaluate the cost-benefit ratio of this project.

FINDING

5. Taxes for Nonresident Entertainers

The Department needs to seek amendatory legislation to require entertainment venues to collect and remit the estimated State taxes due for performances by nonresident entertainers.

Based on actual average performance collections, we estimated that the uncollected taxes due for nonresident entertainer performances tracked by the Discovery and Tax Enforcement Division in fiscal years 2000-01 and 2001-02 totaled approximately $1.7 million.

The Discovery and Tax Enforcement Division has a special project to track performances by nonresident entertainers at large entertainment venues in the State. The Division sends letters to the business managers of the entertainers

informing them of the State tax requirements and provides the business mangers with tax forms to calculate the estimated amounts due for income tax withholding and SBT. The business managers are instructed to remit the estimated taxes due to the Division. For fiscal years 2000-01 and 2001-02, the Division's collections for nonresident entertainer performances totaled $858,650 and $665,395, respectively.

The Discovery and Tax Enforcement Division has been unsuccessful in collecting the taxes due for a significant number of nonresident entertainer performances. For fiscal year 2000-01, the Division was unable to collect any taxes for 370 (49%) of the 760 performances that it tracked. For fiscal year 2001-02, the Division did not collect any taxes for 336 (57%) of the 594 performances that it tracked. In these cases, the Division did not receive any responses from the business managers for the entertainers. The Division has not made any other attempts at collecting these taxes.

Discovery and Tax Enforcement Division staff informed us that several other states have laws that require entertainment venues to collect the estimated taxes due for nonresident entertainer performances by withholding the amounts due from the gross receipts for performances. Based on the high rate of noncompliance identified in the Division's special project, we conclude that a similar legal requirement for State taxes would provide a more effective and efficient method for collecting the State taxes due for performances by nonresident entertainers.

RECOMMENDATION

We recommend that the Department seek amendatory legislation to require entertainment venues to collect and remit the estimated State taxes due for performances by nonresident entertainers.

AGENCY PRELIMINARY RESPONSE

The Department agrees with the recommendation and the finding that amendatory legislation would be necessary to require entertainment venues to collect and remit estimated Michigan income tax withholding and SBT due on performances by nonresident entertainers.

The Department informed us that neither Michigan's Income Tax Act of 1967 (Act 281, P.A. 1967) nor the SBT Act (Act 228, P.A. 1975) requires entertainment venues to collect and remit estimated taxes owed by nonresident entertainers.

The Department believes the recommended legislative change will be unpopular with Michigan-based businesses, especially the entertainment venues, and the businesses will resist the changes. The Department will consider this legislative initiative with other legislative initiatives.

SUPPLEMENTAL INFORMATION

DEPARTMENT OF TREASURY
Schedule of Revenue for Taxes Administered by the Department of Treasury
General Fund and Special Revenue Funds
Fiscal Year Ended September 30, 2002
(In Thousands)

Tax	Amount
Personal income	$ 6,711,089
Sales	6,439,894
Single business	1,983,795
State education (property)	1,583,660
Use	1,306,365
Gasoline	939,721
Tobacco products	669,914
Real estate transfer	253,075
Insurance company	227,081
Industrial facilities	152,322
Diesel fuel	143,393
Telephone and telegraph company	137,343
Inheritance	131,029
Casino game wagering	91,915
MUSTFA environmental	60,264
Gas and oil severance	31,688
Commercial mobile radio service	25,005
Convention hotel accommodation	16,711
Airport parking	13,644
State housing development services	8,031
Aviation fuel	6,699
Trailer coach parks	3,268
Car loaning company	1,634
Intangibles	527
Total	$ 20,938,067

Source: *State of Michigan Comprehensive Annual Financial Report*.

GLOSSARY

Glossary of Acronyms and Terms

assessment	A billing issued for taxes, penalties, and interest due. The Department of Treasury's Collection Division is responsible for maintaining the accounts receivable records for assessments and collecting the balances due.
effectiveness	Program success in achieving mission and goals.
efficiency	Achieving the most outputs and outcomes practical with the minimum amount of resources.
goals	The agency's intended outcomes or impacts for a program to accomplish its mission.
internal control	A process, effected by management, designed to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.
IRS	Internal Revenue Service.
management control	The plan of organization, methods, and procedures adopted by management to provide reasonable assurance that goals are met; resources are used in compliance with laws and regulations; valid and reliable data is obtained and reported; and resources are safeguarded against waste, loss, and misuse.
mission	The agency's main purpose or the reason that the agency was established.
MUSTFA	Michigan Underground Storage Tank Financial Assurance.
objectives	Specific outcomes that a program seeks to achieve its goals.

performance audit	An economy and efficiency audit or a program audit that is designed to provide an independent assessment of the performance of a governmental entity, program, activity, or function to improve public accountability and to facilitate decision making by parties responsible for overseeing or initiating corrective action.
performance measures	Information of a quantitative or qualitative nature used to assess achievement of goals and/or objectives.
reportable condition	A matter that, in the auditor's judgment, represents either an opportunity for improvement or a significant deficiency in management's ability to operate a program in an effective and efficient manner.
SBT	single business tax.