

Office of the Auditor General  
Report on Internal Control, Compliance, and Other Matters

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**State of Michigan**  
**Comprehensive Annual Financial Report**  
State Budget Office

Fiscal Year Ended September 30, 2016

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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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Office of the Auditor General

## Report Summary

*Report on Internal Control, Compliance, and  
Other Matters  
State of Michigan Comprehensive Annual  
Financial Report (SOMCAFR)  
State Budget Office  
Fiscal Year Ended September 30, 2016*

**Report Number:**  
071-0010-17

**Released:**  
March 2017

Generally accepted government auditing standards require an auditor to report on internal control over financial reporting; compliance with provisions of laws, regulations, contracts, or grant agreements that have a material effect on the financial statements; and other matters coming to the attention of the auditor during the completion of a financial audit. We are issuing this report in conjunction with our independent auditor's report on the SOMCAFR dated January 31, 2017.

<b>Findings Related to Internal Control, Compliance, and Other Matters</b>	<b>Material Weakness</b>	<b>Significant Deficiency</b>	<b>Agency Preliminary Response</b>
The Department of Treasury (Treasury) should improve internal control to prevent the issuance of duplicate tax refunds. Also, Treasury should act timelier to resolve duplicate tax refund issues ( <a href="#">Finding #1</a> ).		X	Agree
Treasury and the Office of Financial Management (OFM), within the State Budget Office, should continue to enhance internal control to prevent, or detect and correct, misstatements and ensure the reasonableness and accuracy of the tax accruals ( <a href="#">Finding #2</a> ).		X	Agree
OFM did not ensure that sufficient procedures existed for the transition and oversight of staff responsible for capital asset reporting ( <a href="#">Finding #3</a> ).		X	Agree
The Michigan Department of Transportation, in conjunction with OFM, did not have sufficient internal control in place to evaluate the dates of service when processing payments and liquidating prior year accounts payable estimates ( <a href="#">Finding #4</a> ).		X	Agree. Does not intend to implement recommendation.

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

Office of the Auditor General  
201 N. Washington Square, Sixth Floor  
Lansing, Michigan 48913

**Doug A. Ringler, CPA, CIA**  
Auditor General

**Laura J. Hirst, CPA**  
Deputy Auditor General





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Office of the Auditor General

201 N. Washington Square, Sixth Floor • Lansing, Michigan 48913 • Phone: (517) 334-8050 • [www.audgen.michigan.gov](http://www.audgen.michigan.gov)

**Doug A. Ringler, CPA, CIA**  
Auditor General

March 30, 2017

Mr. Alton L. Pscholka, State Budget Director  
State Budget Office  
George W. Romney Building  
Lansing, Michigan

Dear Mr. Pscholka:

This report on internal control, compliance, and other matters is being issued in conjunction with our financial audit of the *State of Michigan Comprehensive Annual Financial Report* for the fiscal year ended September 30, 2016.

Certain findings included in this report specifically relate to other State agencies. Although the Office of Financial Management, State Budget Office, may not be directly responsible for these functions, we have addressed these findings to you for corrective action, consistent with your responsibility for financial accounting and reporting under Sections 18.1141 and 18.1421 of the *Michigan Compiled Laws*.

The Office of Financial Management provided preliminary responses to the recommendations at the end of our fieldwork. The *Michigan Compiled Laws* and administrative procedures require an audited agency to develop a plan to comply with the recommendations and submit it within 60 days of the date above to the Office of Internal Audit Services, State Budget Office. Within 30 days of receipt, the Office of Internal Audit Services is required to review the plan and either accept the plan as final or contact the agency to take additional steps to finalize the plan.

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

Sincerely,

A handwritten signature in dark ink that reads "Doug Ringler". The signature is written in a cursive style.

Doug Ringler  
Auditor General



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# INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE



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**Doug A. Ringler, CPA, CIA**  
Auditor General

## Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters

Mr. Alton L. Pscholka, State Budget Director  
State Budget Office  
George W. Romney Building  
Lansing, Michigan

Dear Mr. Pscholka:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Michigan principally as of and for the fiscal year ended September 30, 2016 and the related notes to the financial statements, which collectively comprise the State's basic financial statements, and have issued our report thereon dated January 31, 2017. Our report includes a reference to other auditors who audited the financial statements of the:

- State Lottery Fund (a major fund)
- Michigan Unemployment Compensation Funds (a major fund)
- Michigan Employment Security Act - Administration Fund
- Unemployment Obligation Trust Fund
- State Building Authority - Debt Service Fund
- State Building Authority - Capital Projects Fund
- Attorney Discipline System
- State Sponsored Group Insurance Fund
- Michigan Education Savings Program
- Michigan Finance Authority
- Michigan State Housing Development Authority
- Farm Produce Insurance Authority
- Mackinac Bridge Authority
- Mackinac Island State Park Commission
- Michigan Early Childhood Investment Corporation
- Michigan Education Trust
- State Bar of Michigan
- Venture Michigan Fund
- Western Michigan University
- Central Michigan University
- Eastern Michigan University
- Ferris State University
- Grand Valley State University
- Lake Superior State University
- Michigan Technological University
- Northern Michigan University
- Oakland University
- Saginaw Valley State University

This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

### **Internal Control Over Financial Reporting**

In planning and performing our audit of the basic financial statements, we considered the State's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the basic financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control. Accordingly, we do not express an opinion on the effectiveness of the State's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's basic financial statements will not be prevented, or detected and corrected, on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control as described in Findings #1 through #4 that we consider to be significant deficiencies.

### **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the State's basic financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

### **Office of Financial Management's Response to Findings**

Certain findings included in this report specifically relate to other State agencies. Although the Office of Financial Management, State Budget Office, may not be directly responsible for these functions, we have addressed these findings to you for corrective action, consistent with your responsibility for financial accounting and reporting under Sections 18.1141 and 18.1421 of the *Michigan Compiled Laws*.

The Office of Financial Management's preliminary responses to the findings identified in our audit are included in the body of our report. The responses were not subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

### **Purpose of This Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Sincerely,



Doug Ringler  
Auditor General  
January 31, 2017



FISCAL YEAR 2016  
FINDINGS, RECOMMENDATIONS,  
AND AGENCY PRELIMINARY RESPONSES

## **FINDING #1**

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### **Improvements needed to prevent issuance and provide timelier resolution of duplicate tax refunds.**

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The Department of Treasury (Treasury) should improve internal control\* to prevent the issuance of duplicate tax refunds. Also, Treasury should act timelier to resolve duplicate tax refund issues. A duplicate Michigan Business Tax (MBT) refund of \$14.5 million was issued to a taxpayer during fiscal year 2016 that took Treasury nearly three months to resolve once identified.

The duplicate refund did not result in a loss of resources to the State because the taxpayer did not attempt to deposit the warrant. Also, the system identified the additional refund and issued an assessment letter to the taxpayer. Upon further follow-up with Treasury, it is our understanding that the circumstances which led to the duplicate refund were unique and limited to a certain segment of the overall MBT return population. We performed additional testing and did not identify any other duplicate refunds. However, the control deficiency that permitted a duplicate multi-million dollar refund to be issued is a significant deficiency\* in terms of the processing and approval of Treasury tax refunds.

According to Section 205.28 of the *Michigan Compiled Laws*, certain aspects of tax administration, processing, and collection are protected, nonpublic data. As a result, this finding presents a summary of the identified weakness. Treasury possesses the pertinent information related to this improper refund and indicated that it would work with its tax system contractor to prevent this from occurring in the future.

## **RECOMMENDATIONS**

We recommend that Treasury improve internal control to prevent the issuance of duplicate tax refunds.

We also recommend that Treasury act timelier to resolve duplicate tax refund issues.

## **AGENCY PRELIMINARY RESPONSE**

The Office of Financial Management (OFM) provided us with the following response:

*Treasury and OFM agree with the recommendations. Treasury has implemented a change to the tax system that improves controls to prevent and detect duplicate MBT tax refunds. The operating effectiveness of this change has been confirmed through Treasury testing and validation. In addition, training has occurred and Treasury procedures are being reviewed and updated to ensure timely resolution of issues.*

\* See glossary at end of report for definition.

## FINDING #2

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### Continued improvements needed to processes for establishing and monitoring tax receivables and payables.

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Treasury and OFM, within the State Budget Office, should continue to enhance internal control to prevent, or detect and correct, misstatements and ensure the reasonableness and accuracy of the tax accruals.

Our review of tax accruals for fiscal year 2016 disclosed:

- a. Treasury did not properly account for sales tax cash collections received in October 2016 resulting in the improper accrual of \$20.3 million of sales tax collections to fiscal year 2016.

Treasury accrues sales tax collections received in October and November of the succeeding fiscal year that relate to a tax period ending prior to October 1. For prepaid sales tax payments to the State for gasoline and diesel purchases, taxpayers prepare and remit Treasury form 173, which includes the time period covered, the number of gallons purchased, the tax rate, and the corresponding calculation of tax owed and remitted to the State. Treasury manually reviews these forms and compiles the amounts to determine how much should be recognized within the sales tax accrual.

We identified 6 of 10 instances in which Treasury improperly accrued October 2016 collection amounts that the taxpayer reported for a tax period commencing after September 30, 2016. Treasury subsequently confirmed that it had mistakenly accrued all October 2016 collections to fiscal year 2016 and, prior to issuance of the *State of Michigan Comprehensive Annual Financial Report (SOMCAFR)*, recorded adjusting entries to correct the misstatement.

- b. Treasury did not sufficiently evaluate and implement necessary revisions within the Governmental Accounting Standards Board\* (GASB) Statement 34 estimated receivable calculations, resulting in uncertainties during the fiscal year 2016 closing schedule.

During the year-end closing process, Treasury provides information to OFM relating to tax receivable amounts on the accrual basis of accounting. The amounts are derived from complex calculations involving estimated percentages of taxpayer liability expected to be collected by the State at some point in future fiscal years. The estimated percentages are developed using historical tax return data and collection pattern assumptions.

We initially identified issues with Treasury's sales, use, and withholding (SUW) tax summary-level SAP system report needed for the calculation in the fiscal year 2015 year-end closing process. Throughout the spring and

\* See glossary at end of report for definition.

summer of 2016, Treasury indicated that it had developed an understanding of the issues involved, completed various remediation actions, and considered implementation of any remaining programming fixes a priority in advance of the fiscal year 2016 year-end closing period. However, Treasury did not produce the revised report until October 19, 2016 and the figures within that report remained invalid and therefore unusable for the fiscal year 2016 GASB Statement 34 calculations.

During our review of Treasury's revised report, we identified an inconsistency with how the SAP system report logic was accumulating tax information. At our suggestion, and with assistance from the Office of Internal Audit Services, Treasury reexamined the computer program logic used to generate the SAP system report in comparison with the computer program logic used to produce similar SUW reports from its legacy system. From this review, the Office of Internal Audit Services and Treasury identified and ultimately implemented the necessary revisions to the underlying SAP system report logic in late November 2016, resulting in valid figures for the calculations and entries reflected within the *SOMCAFR*.

- c. Treasury had not developed a process to compare and evaluate significant accounting estimates with subsequent activity for several tax accrual components, in accordance with sound business practice. The estimates for the assessed taxes receivable, receivables to be assessed, business taxes payable backlog, and individual income tax payable backlog of the year-end tax accruals are not compared with subsequent activity to assess the reliability of the process used to develop the estimates.

In its approval of accrual methodologies, OFM instructs State departments that it is important to evaluate the reliability of the estimated accruals in the subsequent year and adjust the estimation methodology accordingly.

We first commented on this issue during the fiscal year 2013 *SOMCAFR* audit. OFM and Treasury continue to agree with our prior audit recommendation and, although not addressed for fiscal year 2016, Treasury has developed a renewed interest to address the estimate-to-actual comparison procedures for both receivable and payable components.



**RECOMMENDATION**

We recommend that Treasury and OFM continue to enhance internal control to prevent, or detect and correct, misstatements and ensure the reasonableness and accuracy of the tax accruals.

**AGENCY  
PRELIMINARY  
RESPONSE**

OFM provided us with the following response:

*Regarding part a, Treasury and OFM agree with the recommendation. Treasury staff have been trained on the proper rules for compiling the prepaid sales tax amounts. In addition, the report that Accounting Services will be provided in subsequent fiscal years will contain the file period of the payment, so that Accounting Services staff can ensure that only filing periods prior to October 1 are included in the accrual.*

*Regarding part b, Treasury and OFM agree with the recommendation, but would like to emphasize that, as noted by the auditors, the final GASB 34 Summary Report and related accounting entries were accurate. Treasury will improve internal controls to ensure that it timely evaluates and implements any future changes needed to the GASB 34 Summary Report.*

*Regarding part c, Treasury and OFM agree with the recommendation. Treasury is currently working on developing a methodology to evaluate significant tax accrual estimates with subsequent activity.*

## FINDING #3

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### Improvements needed to OFM's capital asset reporting process.

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OFM did not ensure that sufficient procedures existed for the transition and oversight of staff responsible for capital asset reporting. The individual responsible for these tasks for many years within OFM retired toward the end of the fiscal year 2015 year-end closing process. Because of the timing of the departure, a sufficient transfer of knowledge was not completed that, combined with a lack of comprehensive instructions for a successor to follow, contributed to significant misstatements related to fiscal year 2016 capital asset balances, which were corrected prior to the *SOMCAFR*'s issuance.

Following are four examples of the capital asset issues we identified:

- a. OFM did not ensure that infrastructure balances were properly stated at year-end. While OFM recorded transactions to adjust the infrastructure balances, it did not have sufficient procedures in place to review the accuracy of these transactions or the ending balances. As a result, infrastructure assets reported were initially double-counted, as infrastructure and within the buildings, equipment, and other depreciable assets balance of the government-wide financial statements. Until corrected, this resulted in a \$145.2 million overstatement of capital assets.
- b. OFM did not ensure that it followed up with agencies regarding capital asset acquisition, adjustment, and disposal information. OFM asks each State agency to provide information at year-end regarding all changes to its capital assets. For example, one State agency reported land sales of \$2.5 million and land purchases of \$7.2 million. However, OFM did not account for these items in the initial year-end capital asset balances. Also, the same State agency reported \$10.3 million in land improvements that OFM should have incorporated within the buildings, equipment, and other depreciable assets balance. However, OFM misclassified these land improvements as land acquisitions and reported them within the land and other non-depreciable assets balance of the government-wide financial statements. OFM informed us that this misclassification occurred because it did not clarify with the State agency whether the items reported were additions to land or land improvements, since the same form is used for both activities.
- c. OFM did not ensure that all State agencies provided updated information for each capital asset category. As a result, software development

costs for a major computer system were not initially capitalized by OFM.

- d. OFM did not appropriately account for manual capital asset adjustments made in prior years. OFM uses the AssetMax system to track asset values for the State's capital assets and to calculate depreciation amounts. During prior year-end closing processes, OFM accounted for a number of adjustments manually rather than within AssetMax. During fiscal year 2016, we identified instances in which OFM adjusted ending asset and associated accumulated depreciation balances in order to tie to AssetMax rather than bring the amounts reported in AssetMax to the correct balance. This resulted in an initial understatement of buildings of \$5.7 million and an understatement of accumulated depreciation of \$4.3 million for the government-wide financial statements.

**RECOMMENDATION**

We recommend that OFM ensure that sufficient procedures and oversight exist for capital asset reporting.

**AGENCY  
PRELIMINARY  
RESPONSE**

OFM provided us with the following response:

*OFM agrees with the recommendation and is in the process of cross training staff and updating procedures related to capital asset reporting.*

## **FINDING #4**

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### **Improvements needed to MDOT's financial accounting practices.**

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The Michigan Department of Transportation (MDOT), in conjunction with OFM, did not have sufficient internal control in place to evaluate the dates of service when processing payments and liquidating prior year accounts payable estimates. Consequently, expenditures may have been recorded in the wrong fiscal year.

The State of Michigan Financial Management Guide (Part II, Chapter 14, Section 100) requires agencies to record payables for goods or services received by September 30. Local agencies, MDOT project managers, and external consultants submit estimated accounts payable worksheets for compilation by MDOT staff at the end of the fiscal year. MDOT reverses these payables in the subsequent fiscal year. MDOT's practice is to apply payments made during the current fiscal year against the established payable at the end of the prior fiscal year, which is tracked on an internal spreadsheet, until the payable balance is reduced to zero. The actual work date of service is not taken into consideration. If payments in the current fiscal year are less than the estimated payable established at the end of the prior fiscal year, the remaining payable balance is written off.

MDOT wrote off an average of 16% of the estimated payables established for fiscal years 2015, 2014, and 2013. The write-off percentage is most likely understated because of MDOT's practice of applying payments made during the current fiscal year against the estimated payable regardless of the work date of service.

We initially identified this issue during the fiscal year 2012 *SOMCAFR* audit. In the fiscal year 2015 report on internal control, compliance, and other matters, we reported that MDOT and OFM agreed that evaluation of service dates might improve the precision of payable calculations. Although the service date is available in MDOT's Field Manager System, used for construction projects, MDOT indicated that it did not believe it would be cost effective to revise its current process or that any resulting improvements in precision would be material. Without evaluating service dates, the level of misstatement is not known.

## **RECOMMENDATION**

We recommend that MDOT, in conjunction with OFM, improve internal control to ensure the evaluation of dates of service when processing payments and liquidating prior year accounts payable estimates.

## **AGENCY PRELIMINARY RESPONSE**

OFM provided us with the following response:

*MDOT and OFM agree that comprehensive consideration of the dates of service when processing contractor payments might lead to accounts payable transactions that are more accurate. However, the service dates mentioned in the recommendation are not readily available to central office contractor payment staff and efficient access would require*

*system changes. As a result, MDOT does not intend to implement the recommendation because it believes that the cost of the needed system changes would significantly outweigh the benefits derived from any resulting improvements in precision.*



FISCAL YEAR 2015  
REPORT ON INTERNAL CONTROL,  
COMPLIANCE, AND OTHER MATTERS  
FOLLOW-UP

Below is the status of the reported findings from the 2015 SOMCAFR report on internal control, compliance, and other matters:

Prior Audit Finding Number	Topic Area	Status	Current Finding Number
1a	Tax Accruals - SUW Tax Data Anomalies	Rewritten*	2b
1b	Tax Accruals - SUW Tax Cash Collections Properly Recorded	Complied	Not applicable
1c	Tax Accruals - SUW Tax to Be Assessed Component	Complied	Not applicable
1d	Tax Accruals - MBT Liabilities	Complied	Not applicable
1e	Tax Accruals - HMO and PIHP Use Tax Collections	Complied	Not applicable
1f	Tax Accruals - October Business Tax Cash Collections	Complied	Not applicable
2a	Monitoring of Receivables and Payables - Tax Accruals	Repeated*	2c
2b	Monitoring of Receivables and Payables - Medicaid Accruals	Complied	Not applicable
3	Accuracy of the AIDS Drug Assistance Program Receivable	Complied	Not applicable
4a	MDOT Project Expenditures Charged to the Proper Fund at Year-End	Complied	Not applicable
4b	MDOT Contractor Payments and Liquidating Accounts Payable Estimates	Repeated	4

\* See glossary at end of report for definition.



## **GLOSSARY OF ABBREVIATIONS AND TERMS**

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<b>AIDS</b>	acquired immune deficiency syndrome.
<b>deficiency in internal control over financial reporting</b>	The design or operation of a control that does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.
<b>financial audit</b>	An audit that is designed to provide reasonable assurance about whether the basic financial statements of an audited entity are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.
<b>Governmental Accounting Standards Board (GASB)</b>	An arm of the Financial Accounting Foundation established to promulgate standards of financial accounting and reporting with respect to activities and transactions of state and local governmental entities.
<b>HMO</b>	health maintenance organization.
<b>internal control</b>	A process, effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.
<b>material misstatement</b>	A misstatement in the basic financial statements that causes the statements to not present fairly the financial position or the changes in financial position, and, where applicable, cash flows thereof, in accordance with the applicable financial reporting framework.
<b>material weakness in internal control over financial reporting</b>	A deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the basic financial statements will not be prevented, or detected and corrected, on a timely basis.
<b>MBT</b>	Michigan Business Tax.
<b>MDOT</b>	Michigan Department of Transportation.
<b>OFM</b>	Office of Financial Management.

<b>PIHP</b>	Prepaid Inpatient Health Plan.
<b>repeated</b>	The same problem was noted in the current audit and the wording of the current recommendation remains essentially the same as the prior audit recommendation.
<b>rewritten</b>	The current circumstances and problems noted require that the recommendation be rewritten rather than remain essentially the same.
<b>significant deficiency in internal control over financial reporting</b>	A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.
<b>SOMCAFR</b>	<i>State of Michigan Comprehensive Annual Financial Report.</i>
<b>SUW</b>	sales, use, and withholding.
<b>Treasury</b>	Department of Treasury.
<b>unmodified opinion</b>	The opinion expressed by the auditor when the auditor, having obtained sufficient appropriate audit evidence, concludes that the basic financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.



