



MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT



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

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

Report Number:
271-0140-12

Tax Compliance Bureau

Department of Treasury

Released:
March 2013

The Tax Compliance Bureau's (TCB's) mission is to increase taxpayer compliance with State tax statutes while concurrently providing improved customer service by effectively managing the Taxpayer Bill of Rights. To accomplish its mission, TCB identifies tax deficiencies of taxpayers who are not filing taxes or are underreporting taxes. The Department of Treasury's authority to audit, assess, and collect tax deficiencies from taxpayers is in Act 122, P.A. 1941 (the Revenue Act).

Audit Objective:

To assess the effectiveness of TCB's efforts to select and conduct audits to address the risk of taxpayer noncompliance.

Audit Conclusion:

We concluded that TCB's efforts were effective in selecting and conducting audits to address the risk of taxpayer noncompliance. However, we noted two reportable conditions (Findings 1 and 2).

Reportable Conditions:

TCB did not review and document all audits in compliance with its audit guidelines (Finding 1).

TCB did not collect and report taxpayer satisfaction information from all audited taxpayers (Finding 2).

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Audit Objective:

To assess the effectiveness of the Discovery and Tax Enforcement Division's efforts to detect and pursue potential individual and business taxes owed to the State of Michigan.

Audit Conclusion:

We concluded that Discovery and Tax Enforcement Division's efforts were effective in detecting and pursuing potential individual and business taxes owed to the State of Michigan. However, we noted one reportable condition (Finding 3).

Reportable Condition:

The Discovery and Tax Enforcement Division did not sufficiently pursue taxpayers with potential tax deficiencies (Finding 3).

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Agency Responses:

Our audit report contains 3 findings and 3 corresponding recommendations. TCB's preliminary response indicates that it agrees with the recommendations.

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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>



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

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

Scott M. Strong, C.P.A., C.I.A.
Deputy Auditor General



STATE OF MICHIGAN
OFFICE OF THE AUDITOR GENERAL
201 N. WASHINGTON SQUARE
LANSING, MICHIGAN 48913
(517) 334-8050
FAX (517) 334-8079

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

March 6, 2013

Mr. Andy Dillon
State Treasurer
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Dillon:

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; 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 response subsequent to our audit fieldwork. The *Michigan Compiled Laws* and administrative procedures require that the audited agency develop a plan to comply with the audit recommendations and submit it within 60 days after the release of the audit report 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,


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

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TAX COMPLIANCE BUREAU DEPARTMENT OF TREASURY

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Description of Agency

The Tax Compliance Bureau's (TCB's) mission* is to increase taxpayer compliance with State tax statutes while concurrently providing improved customer service by effectively managing the Taxpayer Bill of Rights. To accomplish its mission, TCB identifies and collects tax deficiencies from taxpayers who are not filing taxes or who are underreporting taxes by completing audits and tax compliance projects. TCB consists of two field audit divisions, the Discovery and Tax Enforcement Division, the Planning and Strategic Programs support unit, and the Technical Issues and Resolution support unit. Act 122, P.A. 1941 (the Revenue Act) provides the Department of Treasury with authority to audit taxpayers to identify tax deficiencies for assessment and collection.

The field audit divisions are responsible for conducting field audits of taxpayers and have 9 field offices located within the State and 5 field offices located outside of the State. For fiscal years 2009-10 and 2010-11, the field audit divisions completed 3,616 and 3,081 audits, identified \$237 million and \$44 million of net tax deficiencies, and collected payments of \$52 million and \$33 million of those deficiencies, respectively. The field audit divisions forward uncollected tax deficiencies to the Department of Treasury's Office of Collections to issue assessments and pursue further collection. The field audit divisions had 239 employees as of May 31, 2012.

The Discovery and Tax Enforcement Division is responsible for conducting special projects to identify individuals and businesses with potential tax liabilities due to the State and performing special reviews to detect suspected fraud related to tax returns. For fiscal years 2009-10 and 2010-11, the Discovery and Tax Enforcement Division issued letters of inquiry to 202,338 and 157,702 taxpayers, identified potential tax deficiencies of \$176.8 million and \$173.6 million, and collected payments of \$91.0 million and \$97.1 million of those deficiencies, respectively. The Discovery and Tax Enforcement Division forwards uncollected tax deficiencies to the Department of Treasury's Office of Collections to issue assessments and pursue further collection. The Discovery and Tax Enforcement Division had 48 employees as of May 31, 2012.

* See glossary at end of report for definition.

The Planning and Strategic Programs support unit provides taxpayer audit selection, computer software, and management reporting assistance. The Technical Issues and Resolution support unit provides research, training, and audit processing assistance. The Planning and Strategic Programs support unit, the Technical Issues and Resolution support unit, and executive management had 25 employees as of May 31, 2012.

TCB expended \$33.6 million and \$30.9 million for fiscal years 2009-10 and 2010-11, respectively.

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

Audit Objectives

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

1. To assess the effectiveness* of TCB's efforts to select and conduct audits to address the risk of taxpayer noncompliance.
2. To assess the effectiveness of the Discovery and Tax Enforcement Division's efforts to detect and pursue potential individual and business taxes owed to the State of Michigan.

Audit Scope

Our audit scope was to examine the program and other records of the Tax Compliance Bureau. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Our audit procedures, conducted from April through August 2012, generally covered the period October 1, 2009 through May 31, 2012.

Audit Methodology

We conducted a preliminary review of TCB's operations to formulate a basis for defining the audit objectives and scope. Our preliminary review included interviewing TCB personnel and reviewing their performance goals* and objectives*. Also, we reviewed applicable laws, administrative rules, agency procedures, outputs, cost data, and internal control*.

To accomplish our first objective, we interviewed staff from both field audit divisions and reviewed documentation to gain an understanding of their audit process. Also, we reviewed documentation related to program goals and objectives, cost of operation, and audits completed.

* See glossary at end of report for definition.

In addition, we selected a statistical sample of 54 of the 8,791 audits completed during our audit period and reviewed program records from both field audit divisions to determine if taxpayer audits were conducted in a fair, impartial, consistent, and timely manner; were adequately documented; were sufficiently reviewed; and were conducted in compliance with applicable laws, rules, and procedures. Sample results were not projected to the remaining population.

To accomplish our second objective, we interviewed Discovery and Tax Enforcement Division staff and reviewed various program reports and documentation to gain an understanding of their process to identify and pursue individuals and businesses with potential tax liabilities due to the State. Also, we reviewed performance documentation to determine if goals and objectives were established and evaluated, as well as documentation related to cost of operations and projects completed.

We reviewed the Division's records to determine if discovery projects were adequately documented, monitored, and evaluated and to determine if taxpayer contact and follow-up were conducted in a fair, impartial, consistent, and timely manner; were adequately documented; were sufficiently reviewed; and were conducted in compliance with applicable laws, rules, and procedures. We judgmentally selected 2 and randomly selected 4 of the 20 discovery projects conducted during our audit period. In addition, we selected a statistical sample of 40 of the 35,092 taxpayers within the 6 projects. In Finding 3, we projected the percentage of error identified from the 6 projects tested to the remaining affected projects. Our sample was taken from the projects within our audit period to ensure that the projects tested provided a true representation of the entire population.

When selecting activities or programs for audit, we use an approach based on assessment of risk and opportunity for improvement. Accordingly, we focus our audit efforts on activities or programs having the greatest probability for needing improvement as identified through a preliminary review. Our limited audit resources are used, by design, to identify where and how improvements can be made. Consequently, we prepare our performance audit reports on an exception basis.

Agency Responses and Prior Audit Follow-Up

Our audit report contains 3 findings and 3 corresponding recommendations. TCB's preliminary response indicates that it agrees with the recommendations.

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 the State of Michigan Financial Management Guide (Part VII, Chapter 4, Section 100) require the Department of Treasury to develop a plan to comply with the audit recommendations and submit it within 60 days after release of the audit report 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 released our prior performance audit of the Tax Compliance Bureau, Department of Treasury (27-140-03), in June 2004. Within the scope of this audit, we followed up 5 of the 6 prior audit recommendations. TCB complied with 4 of the prior audit recommendations, and 1 recommendation was no longer applicable.

COMMENTS, FINDINGS, RECOMMENDATIONS,
AND AGENCY PRELIMINARY RESPONSES

EFFECTIVENESS OF EFFORTS TO SELECT AND CONDUCT AUDITS

COMMENT

Audit Objective: To assess the effectiveness of the Tax Compliance Bureau's (TCB's) efforts to select and conduct audits to address the risk of taxpayer noncompliance.

Audit Conclusion: **We concluded that TCB's efforts were effective in selecting and conducting audits to address the risk of taxpayer noncompliance.** However, our review disclosed two reportable conditions* related to audit guidelines (Finding 1) and taxpayer satisfaction surveys (Finding 2).

FINDING

1. **Audit Guidelines**

TCB did not review and document all audits in compliance with its audit guidelines. As a result, TCB did not have assurance that audit results were accurate, supported by appropriate documentation, and consistent in the application of tax laws before the results were provided to the taxpayer.

TCB's audit guidelines require certain documentation and reviews of audit working papers subsequent to the completion of the audit fieldwork.

Our review of the audit working papers for a sample of 54 taxpayer audits conducted by TCB during our audit period disclosed:

- a. TCB audit supervisors did not review the working papers of 16 (30%) of the audits before the Notice of Preliminary Audit Determinations (NOPADs)* were provided to the taxpayers. Also, for 8 (15%) other audits, TCB could not provide documentation that the supervisory review was completed before the NOPADs were sent to the taxpayer. The NOPAD is the notification to the taxpayer of the preliminary determination of the tax deficiency, penalty, and interest amounts owed to the State. TCB's audit guidelines require the audit supervisor to review the audit working papers before the NOPAD is provided

* See glossary at end of report for definition.

to the taxpayer to ensure consistency in the application of tax laws, correctness of the calculations, use of approved sampling methodologies, and overall concurrence with the auditor's conclusions.

- b. TCB did not include documentation of the audit confirmation letters and the signed NOPADs in 7 (13%) and 8 (15%) of the audit working papers, respectively. TCB's audit guidelines require scanned copies of the audit confirmation letter and the signed NOPAD to be documented in the audit working papers. The audit confirmation letter establishes the audit commencement date, which suspends the statute of limitations during the audit.

RECOMMENDATION

We recommend that TCB review and document all audits in compliance with its audit guidelines.

AGENCY PRELIMINARY RESPONSE

TCB agrees with the recommendation. TCB indicated that, effective March 1, 2013, it will incorporate testing of completed audits for compliance with the audit guidelines in its quality assurance review process. TCB also indicated that supervisors and managers have been instructed to strictly adhere to the audit guidelines that require the review of the working papers before the NOPAD is provided to the taxpayer.

FINDING

2. Taxpayer Satisfaction Surveys

TCB did not collect and report taxpayer satisfaction information from all audited taxpayers. As a result, all audited taxpayers did not have an opportunity to respond to the survey and, therefore, the taxpayer satisfaction survey results reported on TCB's MiScorecard* Performance Summary may not have been an accurate reflection of all audited taxpayers.

* See glossary at end of report for definition.

TCB had established a 95% taxpayer satisfaction performance goal as part of the Department of Treasury's MiScorecard Performance Summary, a tool used to help management make program decisions. TCB reported a 98% and a 95% taxpayer satisfaction rating for the first and second quarters of fiscal year 2011-12, respectively.

TCB indicated that it did not reconcile the taxpayer satisfaction surveys to the number of taxpayers audited to ensure that all taxpayers were sent an evaluation. Our review disclosed that TCB did not send satisfaction surveys to 29 (54%) of the 54 taxpayers selected for review from audits completed during our audit period.

RECOMMENDATION

We recommend that TCB collect and report taxpayer satisfaction information from all audited taxpayers.

AGENCY PRELIMINARY RESPONSE

TCB agrees with the recommendation. TCB indicated that it plans to automate the current manual process to electronically generate the taxpayer satisfaction survey directly from the audit file when the audit is completed. TCB informed us that the automated process is tentatively planned to be implemented by May 2013.

EFFECTIVENESS OF EFFORTS TO DETECT AND PURSUE TAXES OWED TO THE STATE

COMMENT

Audit Objective: To assess the effectiveness of the Discovery and Tax Enforcement Division's efforts to detect and pursue potential individual and business taxes owed to the State of Michigan.

Audit Conclusion: We concluded that the Discovery and Tax Enforcement Division's efforts were effective in detecting and pursuing potential individual and business taxes owed to the State of Michigan. However, our review disclosed one reportable condition related to taxpayer follow-up (Finding 3).

FINDING

3. **Taxpayer Follow-Up**

The Discovery and Tax Enforcement Division did not sufficiently pursue taxpayers with potential tax deficiencies. As a result, the Department of Treasury did not assess estimated potential tax deficiencies of up to \$6.5 million.

Section 205.23 of the *Michigan Compiled Laws* authorizes the Department of Treasury to determine and notify the taxpayer of a tax liability based upon the examination of a tax return, a payment, or an audit.

According to Section 205.28 of the *Michigan Compiled Laws*, certain aspects of tax auditing and collection, particularly audit selection or processing criteria, are protected, nonpublic data. As a result, this finding does not report our audit results in detail. We have separately reported weaknesses in processes and systems to the Department of Treasury management in accordance with generally accepted government auditing standards.

RECOMMENDATION

We recommend that the Discovery and Tax Enforcement Division sufficiently pursue taxpayers with potential tax deficiencies.

AGENCY PRELIMINARY RESPONSE

TCB agrees with the recommendation. TCB informed us that it complied as of January 1, 2013.

GLOSSARY

Glossary of Acronyms and Terms

effectiveness	Success in achieving mission and goals.
goal	An intended outcome of a program or an entity to accomplish its mission.
internal control	The plan, policies, methods, and procedures adopted by management to meet its mission, goals, and objectives. Internal control includes the processes for planning, organizing, directing, and controlling program operations. It includes the systems for measuring, reporting, and monitoring program performance. Internal control serves as a defense in safeguarding assets and in preventing and detecting errors; fraud; violations of laws, regulations, and provisions of contracts and grant agreements; or abuse.
MiScorecard	Part of the State of Michigan's goal to increase accountability and transparency. The monthly MiScorecard reports current performance levels for certain areas within the various departments and serves as an internal management tool for decision-makers.
mission	The main purpose of a program or an entity or the reason that the program or the entity was established.
Notice of Preliminary Audit Determination (NOPAD)	The notification to the taxpayer of the preliminary determination of the tax deficiency, penalty, and interest amounts owed to the State.

objectives	Specific outcome(s) that a program or an entity seeks to achieve its goals.
performance audit	An audit that provides findings or conclusions based on an evaluation of sufficient, appropriate evidence against criteria. Performance audits provide objective analysis to assist management and those charged with governance and oversight in using the information to improve program performance and operations, reduce costs, facilitate decision making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability.
reportable condition	A matter that, in the auditor's judgment, is less severe than a material condition and falls within any of the following categories: an opportunity for improvement within the context of the audit objectives; a deficiency in internal control that is significant within the context of the audit objectives; all instances of fraud; illegal acts unless they are inconsequential within the context of the audit objectives; significant violations of provisions of contracts or grant agreements; and significant abuse that has occurred or is likely to have occurred.
TCB	Tax Compliance Bureau.

