



MICHIGAN

OFFICE OF THE AUDITOR GENERAL

AUDIT REPORT

PERFORMANCE AUDIT
OF THE

PRINCIPAL RESIDENCE EXEMPTION

DEPARTMENT OF TREASURY

December 2014



Doug A. Ringler, C.P.A., C.I.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

Audit report information can be accessed at:

<http://audgen.michigan.gov>



OAG

Office of the Auditor General

Report Summary

Performance Audit

Principal Residence Exemption

Department of Treasury

Report Number:
271-0245-14

Released:
December 2014

The principal residence exemption (PRE) allows owners who occupy their property as their principal residence to claim an exemption from the 18-mill school operating tax. The Department of Treasury administers PRE under Section 211.7cc of the *Michigan Compiled Laws* and conducts PRE audits within the counties that elect not to perform their own audits.

Audit Objective			Audit Conclusion
Objective 1: To assess the effectiveness of the Department's efforts to ensure compliance with selected PRE requirements.			Effective
Finding Related to This Audit Objective	Material Condition	Reportable Condition	Agency Preliminary Response
The Department did not ensure that its vendor complied with all of the provisions of the PRE audit services contract related to data security. Therefore, the Department could not ensure that the vendor appropriately secured the Department's confidential data (Finding 1).		X	Agrees

Audit Objective			Audit Conclusion
Objective 2: To assess the effectiveness of the Department's efforts to collect the State's share of interest related to denied PREs.			Moderately effective
Finding Related to This Audit Objective	Material Condition	Reportable Condition	Agency Preliminary Response
The Department had not established procedures to ensure that local governmental units remitted the proper amount of PRE interest to the Department. We estimated that the local governmental units owed the State \$1.9 million of PRE interest (Finding 2).		X	Agrees

Audit Objective			Audit Conclusion
Objective 3: To assess the effectiveness of the Department's efforts to monitor the local tax assessment rolls for accuracy in comparison with the PRE determinations.			Effective
Findings Related to This Audit Objective	Material Condition	Reportable Condition	Agency Preliminary Response
Our audit report does not include any findings related to this audit objective.	Not applicable	Not applicable	Not applicable

Audit Objective			Audit Conclusion
Objective 4: To assess the effectiveness of the Department's efforts to properly record PRE expenditures.			Not effective
Finding Related to This Audit Objective	Material Condition	Reportable Condition	Agency Preliminary Response
The Department did not properly charge expenditures to the Principal Residence Property Tax Exemption Audit Fund. Therefore, the Department understated PRE Fund expenditures by \$1.4 million, overstated General Fund/general purpose expenditures by \$0.4 million, and overstated State restricted fund expenditures by \$1.0 million for the period October 1, 2011 through June 30, 2014 (<u>Finding 3</u>).	X		Agrees

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>

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

Doug A. Ringler, C.P.A., C.I.A.
Auditor General

Laura J. Hirst, C.P.A.
Deputy Auditor General



OAG

Office of the Auditor General

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

Doug A. Ringler, C.P.A., C.I.A.
Auditor General

December 3, 2014

Mr. R. Kevin Clinton
State Treasurer
Richard H. Austin Building
Lansing, Michigan

Dear Mr. Clinton:

This is our report on the performance audit of the Principal Residence Exemption, Department of Treasury.

This report contains our report summary; a description; our audit objectives, scope, and methodology and agency responses and prior audit follow-up; comments, findings, recommendations, and agency preliminary responses; various exhibits, presented as supplemental information; and a glossary of abbreviations and terms.

Our comments, findings, and recommendations are organized by audit objective. The agency preliminary responses were taken from the agency's response at the end of 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 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,

Doug Ringler
Auditor General

TABLE OF CONTENTS

**PRINCIPAL RESIDENCE EXEMPTION
DEPARTMENT OF TREASURY**

	<u>Page</u>
INTRODUCTION	
Report Summary	1
Report Letter	3
Description	7
Audit Objectives, Scope, and Methodology and Agency Responses and Prior Audit Follow-Up	10
COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES	
Effectiveness of Efforts to Ensure Compliance With Selected PRE Requirements	16
1. Contractual Compliance Over Data Security	17
Effectiveness of Efforts to Collect the State's Share of Interest Related to Denied PREs	19
2. Oversight and Collection of PRE Interest	19
Effectiveness of Efforts to Monitor the Local Tax Assessment Rolls for Accuracy in Comparison With the PRE Determinations	22
Effectiveness of Efforts to Properly Record PRE Expenditures	23
3. Use of Restricted Funds	23

SUPPLEMENTAL INFORMATION

Exhibit 1 - Estimated State PRE Interest Not Remitted for State-Conducted PRE Audits for Fiscal Years 2007-08 Through 2012-13	27
Exhibit 2 - Flow Chart of the Process to Request a PRE on Property	28
Exhibit 3 - Flow Chart of the Process to Rescind a PRE on Property	29
Exhibit 4 - Flow Chart of the PRE Audit Process for County-Conducted Audit	30
Exhibit 5 - Flow Chart of the PRE Audit Process for State-Conducted Audit	31
Exhibit 6 - Map of the Counties Audited by the State in Calendar Year 2012	32
Exhibit 7 - Map of the Counties Audited by the State in Calendar Year 2013	33
Exhibit 8 - Map of the Counties Audited by the State in Calendar Year 2014	34

GLOSSARY

Glossary of Abbreviations and Terms	36
-------------------------------------	----

Description

Statutory History

The principal residence exemption (PRE), provided for in Section 211.7cc of the *Michigan Compiled Laws*, allows owners* who occupy their property as their principal residence* to claim an exemption from the 18-mill school operating tax provided for under the State School Aid Act of 1979.

The General Property Tax Act provides that a county treasurer or county equalization director may elect to audit the validity of PREs in all local tax collecting units (cities, townships, or villages) located in the county (opt-in counties*) or requires the Department of Treasury to conduct PRE audits within the counties that elect not to perform their own audits (opt-out counties*). To defray the cost of conducting the PRE audits, the law permits the assessment of interest on the additional taxes due on invalid PREs for up to three prior years and provides that the Department and local governmental units (counties and local tax collecting units) impacted by the PRE audit results share the interest collected.

Local Governmental Unit PRE Activities

As of December 2013, 1,856 local governmental units existed in Michigan. To be exempt from the 18-mill school operating tax levied on a principal residence, an owner must file a PRE affidavit* with the local assessor where the property is located. If the request is valid, the local assessor adjusts the tax assessment roll* to reflect the PRE and sends the affidavit to the Department of Treasury. If the request is not valid, the local assessor notifies the owner of the denial* and sends a copy of the denial to the Department. When the property is no longer used as the owner's principal residence, the owner is required to notify the local assessor by submitting a request for rescission*. The local assessor then removes the PRE from the tax assessment roll and sends a copy of the rescission to the Department. Exhibits 2 and 3, presented as supplemental information, depict these activities.

When a county-conducted PRE audit identifies an invalid PRE, the county issues a denial to the owner and sends a copy of the denial to the Department; the local governmental unit removes the PRE from the tax assessment roll and prepares a

* See glossary at end of report for definition.

corrected tax bill for any additional taxes and interest due; and the county reports any changes in the property taxable value to the Michigan Department of Education. A school district's foundation allowance* is funded by the State's School Aid Fund and local property taxes. Accordingly, any changes to the PRE status of property located within the school district will impact the required share of funding from these sources. Exhibit 4, presented as supplemental information, depicts this PRE audit process.

Department of Treasury PRE Activities

The Department's PRE Unit administers PRE activities, including conducting audits of opt-out counties and providing lead lists*, training, and other assistance to local governmental units.

As of October 2009, 34 opt-out counties elected to have the Department perform their PRE audits for the five-year period from 2010 through 2014. Also, the Department selected 16, 14, and 23 opt-in counties in which to conduct PRE audits during calendar years 2012, 2013, and 2014, respectively. Exhibits 6, 7, and 8, presented as supplemental information, depict the 34 opt-out counties and the Department-selected opt-in counties for calendar years 2012, 2013, and 2014.

When a State-conducted audit identifies an invalid PRE, the Department notifies the owner, the county treasurer, and the local governmental tax assessing unit of the denial; the county treasurer or the local governmental tax assessing unit removes the PRE from the tax assessment roll and prepares a corrected tax bill for any additional taxes and interest due; and the county reports any changes in the property taxable value to the Michigan Department of Education. Exhibit 5, presented as supplemental information, depicts this PRE audit process.

As of June 30, 2014, the PRE Unit had eight employees. PRE expenditures and the interest received from local governmental units are presented in the following table:

Fiscal Year	PRE	
	Expenditures	Interest Received
2011-12	\$1,576,163	\$1,799,781
2012-13	\$1,922,244	\$2,743,392

* See glossary at end of report for definition.

The Department estimated that the State's School Aid Fund may realize increased revenue from State-conducted audits during calendar years 2012 and 2013 of \$22.0 million and \$14.8 million, respectively. The realization of any savings depends on the local governmental units' removal of the invalid PRE designation, thus making the property subject to the 18-mill school operating tax assessment and the collection of any retroactive taxes allowed by statute.

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

Audit Objectives

Our performance audit* of the Principal Residence Exemption (PRE), Department of Treasury, had the following objectives:

1. To assess the effectiveness* of the Department's efforts to ensure compliance with selected PRE requirements.
2. To assess the effectiveness of the Department's efforts to collect the State's share of interest related to denied PREs.
3. To assess the effectiveness of the Department's efforts to monitor the local tax assessment rolls for accuracy in comparison with the PRE determinations.
4. To assess the effectiveness of the Department's efforts to properly record PRE expenditures.

Audit Scope

Our audit scope was to examine the processes and records related to the principal residence exemption. The selected principal residence exemption requirements reviewed under our first audit objective included the opt-in county selection process, the State-conducted audit process, the Department of Treasury's responsibilities of the principal residence exemption appeal process for State issued denials, and the assistance provided to the local governmental units. 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, which included a preliminary survey, audit fieldwork, report preparation, analysis of agency responses, and quality assurance, generally covered the period October 1, 2011 through June 30, 2014.

* See glossary at end of report for definition.

As part of our audit report, we prepared supplemental information that relates to our audit objectives (Exhibits 1 through 8). Our audit was not directed toward expressing a conclusion on Exhibits 1, 6, 7, and 8 in this supplemental information.

Audit Methodology

We conducted a preliminary survey of PRE in order to establish our audit objectives and scope. During our preliminary survey, we:

- Interviewed Department staff.
- Reviewed applicable laws, policies, procedures, and guidelines.
- Reviewed the Department's PRE audit services contract.
- Reviewed selected opt-in counties' records and the PRE Unit's records and data.
- Reviewed appeal information, various PRE reports, and PRE-related expenditures.

To accomplish our first audit objective, we:

- Reviewed documentation to determine if the Department used accurate data when it selected opt-in counties for a State-conducted audit.
- Interviewed Department and vendor staff to gain an understanding of their respective processes.
- Reviewed the vendor's monthly PRE audit progress reports to determine if the vendor ran the queries and sent out the PRE questionnaires in a timely manner.
- Reconciled the vendor's list of potentially invalid PRE claims to determine the accuracy of the lead lists that the Department provided to the opt-in counties.
- Reviewed valid PRE claims to determine if the vendor utilized accurate tax assessment roll information when it performed the PRE audits.

- Reviewed contract expenditure transactions to determine if the Department paid the vendor in accordance with the contract.
- Reviewed the reasonableness of the vendor's estimated interest methodology.
- Reviewed the Department's appeal tracking spreadsheet to determine the Department's timeliness in processing an appeal and notifying all applicable parties of an appeal hearing.
- Reviewed the PRE Unit's efforts to analyze the reasons for the appeals overturned by the Department or the Michigan Tax Tribunal.
- Reviewed the Department's PRE training handouts and attendance sheets to determine if the Department provided assistance to the local governmental units.

To accomplish our second audit objective, we:

- Reviewed documentation to determine if the State received the proper amount of interest related to denied PREs of opt-in counties.
- Compared the vendor's estimated interest amounts to the State's share of interest received.

To accomplish our third audit objective, we:

- Interviewed PRE Unit staff to gain an understanding of the process for monitoring the local tax assessment rolls for changes related to denied PREs.
- Reviewed the PRE documentation submitted to the Department for selected counties to identify PREs denied by the local governmental unit.
- Reviewed denied PREs to determine if they were removed from the tax assessment rolls.

To accomplish our fourth audit objective, we:

- Interviewed Department staff to gain an understanding of the Department's process to record PRE expenditures.
- Researched the purpose of the Principal Residence Property Tax Exemption Audit Fund.
- Reviewed PRE expenditure transactions to determine if the Department recorded them appropriately.

We based our audit conclusions on our audit efforts described in the preceding paragraphs and the resulting material condition* and reportable conditions* noted in the comments, findings, recommendations, and agency preliminary responses section. In our professional judgment, the material condition is more severe than a reportable condition and could impair management's ability to operate effectively or could adversely affect the judgment of an interested person concerning the effectiveness of the PRE. The reportable conditions are less severe than a material condition but represent deficiencies in internal control*.

When selecting activities or programs for audit, we direct our efforts based on risk and opportunities to improve the operations of State government. 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. The Department's preliminary response indicates that it agrees with all of the recommendations.

The agency preliminary response that follows each recommendation in our report was taken from the agency's written comments and oral discussion at the end of 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

* See glossary at end of report for definition.

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 Principal Residence Exemption Program, Department of Treasury (271-0245-08), in March 2009. The Department complied with all 4 prior audit recommendations.

COMMENTS, FINDINGS, RECOMMENDATIONS,
AND AGENCY PRELIMINARY RESPONSES

EFFECTIVENESS OF EFFORTS TO ENSURE COMPLIANCE WITH SELECTED PRE REQUIREMENTS

COMMENT

Audit Objective: To assess the effectiveness of the Department of Treasury's efforts to ensure compliance with selected principal residence exemption (PRE) requirements.

Audit Conclusion: Effective.

Factors leading to this conclusion included:

- Our review disclosed a reportable condition related to the contractual compliance over data security.
- Contract expenditures from October 1, 2011 through June 30, 2014 represented 49% of the total PRE expenditures.
- The PRE Unit adequately monitored and ensured contractual compliance with financial and non-data security requirements.
- The Department significantly improved the timeliness of scheduling the informal PRE appeal conferences during our audit period.
- The PRE Unit's process to select the opt-in counties for State-conducted audits was reasonable and based on accurate information.
- The Department's vendor identified and followed up questionable PREs and forwarded potentially invalid PREs to the Department for denial.
- The PRE Unit properly reviewed the overturned appeals and implemented necessary changes to the PRE denial process.
- The PRE Unit provided adequate assistance to the local governmental units.

FINDING

1. Contractual Compliance Over Data Security

The Department did not ensure that its vendor complied with all of the provisions of the PRE audit services contract related to data security. As a result, the Department could not ensure that the vendor appropriately secured the Department's confidential data, increasing the risk of identity theft and illegal or inappropriate use of confidential data.

Department of Technology, Management, and Budget Administrative Guide procedure 0510.37 requires the contract compliance inspector to monitor both State and vendor compliance with contract provisions.

In September 2011, the Department entered into a three-year contract, valued at \$3.8 million, to design an audit methodology and to audit the validity of PREs in the 34 opt-out counties and the Department-selected opt-in counties during calendar years 2012, 2013, and 2014. The contract designated a Department official as the contract compliance inspector.

Our review of the Department's administration of the contract disclosed that although the Department provided confidential data to its vendor, it did not sufficiently monitor the contract to ensure that the vendor conducted security risk assessments and provided the results of the security audits and its annual certifications to the Department. The contract provisions require that the vendor:

- Conduct security risk assessments to identify the damage that could result from unauthorized access, use, disclosure, disruption, modification, or destruction of information.
- Provide information associated with security audits performed in the last three years.
- Provide an annual certification to the Department attesting that all security control requirements were working as intended.

After we brought these matters to the Department's attention, it immediately contacted the vendor to determine what processes the vendor had in place to secure confidential data and request security documentation. The Department also visited the vendor to gain an understanding of the vendor's processes over selected security requirements and obtained various security assessment reports, including a service organization control (SOC 2) report* of the entity that hosted the vendor's data center services. Although the auditor's opinion in the SOC 2 report stated that the controls were suitably designed to provide reasonable assurance regarding the data center services, the Department should continue to work with the vendor to strengthen agreements and implement data security and privacy controls over confidential data.

The Department informed us that the contract compliance inspector was not aware of all of the contract's data and security requirement provisions. Also, the Department's Office of Privacy and Security informed us that it was not aware that the Department provided confidential data to the vendor.

RECOMMENDATION

We recommend that the Department ensure that its vendor complies with all of the provisions of the PRE audit services contract related to data security.

AGENCY PRELIMINARY RESPONSE

The Department provided us with the following response:

The Department agrees with the recommendation and has taken steps to comply. Although the vendor provided brief summaries of data security on an annual basis, the Department, including the Office of Privacy and Security, has since conducted a thorough review of the vendor's data controls. This review included the results of an independent, third-party review of security controls at the location of the vendor's data center provider. The Department is confident that the vendor has adequate controls in place to ensure the confidentiality, integrity, and availability of data. However, the Department agrees that further steps can be taken to gather more documentation to better ensure that the vendor conducts security risk assessments, security audits, and an annual certification that all security control requirements are working as intended. The contract compliance inspector will work closely with the Office of Privacy and Security to ensure all aspects of the contract terms related to data security are met.

* See glossary at end of report for definition.

EFFECTIVENESS OF EFFORTS TO COLLECT THE STATE'S SHARE OF INTEREST RELATED TO DENIED PREs

COMMENT

Audit Objective: To assess the effectiveness of the Department's efforts to collect the State's share of interest related to denied PREs.

Audit Conclusion: Moderately effective.

Factors leading to this conclusion included:

- Our review disclosed a reportable condition related to the oversight and collection of PRE interest.
- The State denied approximately 7,100 PREs per year and estimated potential PRE interest of \$4.4 million per year for the State-conducted audits for calendar years 2011 through 2013. However, during fiscal years 2011-12 and 2012-13, the State collected only \$2.3 million per fiscal year for county-conducted and State-conducted audits.

FINDING

2. Oversight and Collection of PRE Interest

The Department had not established procedures to ensure that local governmental units remitted the proper amount of PRE interest to the Department. We estimated that the local governmental units had not remitted \$1.9 million of PRE interest owed to the State.

Sections 211.7cc(6), 211.7cc(11), and 211.7cc(25) of the *Michigan Compiled Laws* require the local governmental units to notify the Department of the denied PREs and remit to the Department the State's share of any PRE interest collected.

We reviewed the Department's documentation of PREs denied for calendar years 2012 and 2013 and the related interest remitted. We noted that the Department

did not verify the reasonableness of PRE interest remitted by the local governmental units for denied PREs:

- a. For calendar year 2012, the State conducted the PRE audits for 50 counties, denied an average of 168 PREs per county, and received \$1.5 million of PRE interest. However, based on the potential State PRE interest determined by the vendor and the percent of denied PREs not overturned upon appeal for calendar year 2012, we estimated that the local governmental units should have remitted up to \$3.4 million of PRE interest for the PREs denied based on the State-conducted audits for calendar year 2012. See Exhibit 1 for the estimated State PRE interest not remitted for State-conducted PRE audits for fiscal years 2007-08 through 2012-13.
- b. For county- and local-conducted audits, the Department did not receive any PRE interest from any of the local governmental units within 2 and 6 counties for fiscal years 2011-12 and 2012-13, respectively. We analyzed the number of denied PREs and noted:

County	Number of Denied PREs			
	Calendar Year 2012		Calendar Year 2013	
	County Audits	Local Audits	County Audits	Local Audits
1	38	4	48	2
2	0	60	0	58
3			1	3
4			3	11
5			2	1
6			1	49

Based on the respective counties' average interest remitted for fiscal years 2005-06 through 2010-11, we estimated that these local governmental units should have remitted approximately \$31,000 of PRE interest for fiscal years 2011-12 and 2012-13 combined.

- c. The Department did not receive any PRE documentation from any local governmental units within one county for calendar years 2012 and 2013. Therefore, the Department could not determine if any denied PREs associated with these local governmental units existed and if the State should have received any PRE interest.

The Department did not track county and local denied PREs or PRE interest payments by owner and, therefore, did not have a mechanism to ensure that it collected its share of PRE interest.

RECOMMENDATION

We recommend that the Department establish procedures to ensure that local governmental units remit the proper amount of PRE interest to the Department.

AGENCY PRELIMINARY RESPONSE

The Department provided us with the following response:

The Department agrees with the recommendation and is taking steps to comply. Although the Department acknowledges that oversight and collection of PRE interest could be improved through formal procedures and tracking of phone calls, the Department has made reasonable efforts to ensure that local governmental units have remitted the proper amount of PRE interest including seeking legislative changes.

- a. *The annual Principal Residence Exemption Audit Report provided to the Legislature acknowledges that the estimate of PRE interest is based on assessment data gathered by the vendor during the audit process and that several variables impact the amount and timing of PRE interest payments. The Department will work with the vendor to determine if there is a better methodology in estimating the potential interest by taking these variables into consideration.*
- b. *Currently, the local governmental units notify the Department of a PRE denial by submitting a copy of the denial notice to the Department. A denial does not guarantee that interest will be charged or collected. Out of the six counties documented in the finding, the Department received a total of \$40,918 from three of the counties in fiscal year 2014 (County #1 = \$8,877; County #2 = \$15,694; County #5 = \$16,347). PREs were audited by the State in counties #3 and #4 and counties #3, #4, and #6 will be audited in 2015 because they all fell within the Department's audit parameters relating to the collection of interest.*

The Department will explore further sampling of the denials by local governmental units to determine if interest from local denials is being properly submitted to the State. Because of the need for better reporting, the Department provided language in the Substitute for House Bill No. 4406 which would require more comprehensive reporting by local governmental units.

- c. *The one county referenced for which the Department had not received any PRE documentation was found upon further review to have forwarded PRE interest totaling \$390 in fiscal year 2013 and \$468 in fiscal year 2014. County and local officials were contacted and revealed a lack of knowledge about the PRE program requirements. The officials committed to send PRE documentation to the Department and the Department has since received 107 PRE documents from this county. (The county in question is a remote northern county with approximately 2,792 parcels with a PRE. All 83 Michigan counties average nearly 35,000 PRE parcels).*

EFFECTIVENESS OF EFFORTS TO MONITOR THE LOCAL TAX ASSESSMENT ROLLS FOR ACCURACY IN COMPARISON WITH THE PRE DETERMINATIONS

COMMENT

Audit Objective: To assess the effectiveness of the Department's efforts to monitor the local tax assessment rolls for accuracy in comparison with the PRE determinations.

Audit Conclusion: Effective.

Factors leading to this conclusion included:

- The PRE Unit adequately monitored the accuracy of the local tax assessment rolls for changes related to denied PREs.
- Local governmental units properly removed 98% of the denied PRE claims from the tax assessment rolls for calendar years 2012 and 2013.

EFFECTIVENESS OF EFFORTS TO PROPERLY RECORD PRE EXPENDITURES

COMMENT

Audit Objective: To assess the effectiveness of the Department's efforts to properly record PRE expenditures.

Audit Conclusion: Not effective.

Factors leading to this conclusion included:

- Our review disclosed a material condition related to the understatement of PRE Fund expenditures by 31% for the period October 1, 2011 through June 30, 2014. Actual expenditures for the Principal Residence Property Tax Exemption Audit Fund (PRE Fund) were \$4.6 million; however, total expenditures charged to the PRE Fund were only \$3.2 million for the period October 1, 2011 through June 30, 2014.
- The fund balance of the PRE Fund was \$5.7 million and \$6.7 million as of September 30, 2012 and September 30, 2013, respectively, indicating that it had adequate funds to cover all of the expenditures.

FINDING

3. Use of Restricted Funds

The Department did not properly charge expenditures to the PRE Fund. As a result, the Department understated PRE Fund expenditures by \$1.4 million (31%) for the period October 1, 2011 through June 30, 2014. Also, the Department overstated General Fund/general purpose expenditures by \$0.4 million and overstated State restricted fund expenditures by \$1.0 million for the period October 1, 2011 through June 30, 2014.

Section 18.1395(1) of the *Michigan Compiled Laws* requires that General Fund appropriations should only be used after any available restricted funds have been expended. Also, the Department's appropriations acts for fiscal years 2011-12, 2012-13, and 2013-14 authorize the Department to expend PRE Fund revenue for

administration of principal residence audits. In addition, Section 211.7cc(26)(b) of the *Michigan Compiled Laws* requires that money from the PRE Fund shall be expended only for the purpose of auditing PRE affidavits.

The Department recorded expenditures in the PRE Fund of \$3.2 million for the period October 1, 2011 through June 30, 2014. Our review of PRE expenditures from October 1, 2011 through June 30, 2014 disclosed:

- a. The Department recorded \$0.7 million of PRE expenditures as General Fund/general purpose and \$1.0 million of PRE expenditures against State restricted revenues even though the PRE Fund had sufficient funds to cover all of these expenditures.
- b. The Department recorded \$0.3 million of expenditures in the PRE Fund for payroll costs unrelated to PRE.

The Department indicated that it was unaware of the reason why PRE expenditures were charged to multiple funds.

RECOMMENDATION

We recommend that the Department properly charge expenditures to the PRE Fund.

AGENCY PRELIMINARY RESPONSE

The Department provided us with the following response:

The Department agrees with the recommendation and has complied. All expenditures for the Principal Residence Exemption audit program for fiscal year 2014 are now properly charged to the Principal Residence Property Tax Exemption Audit Fund. Future expenses will first be charged to the fund.

SUPPLEMENTAL INFORMATION

INTENTIONALLY BLANK PAGE

PRINCIPAL RESIDENCE EXEMPTION (PRE)
Department of Treasury

Estimated State PRE Interest Not Remitted for State-Conducted PRE Audits
For Fiscal Years 2007-08 Through 2012-13
(In Millions)

	Calendar Year					
	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
Potential State PRE interest (1)	\$ 3.2	\$ 3.0	\$ 2.9	\$ 3.4	\$ 3.5	\$ 2.3
Percent of denied PREs not overturned upon appeal (2)	92%	94%	95%	94%	97%	98%
Estimated State PRE interest	\$ 2.9	\$ 2.8	\$ 2.8	\$ 3.2	\$ 3.4	\$ 2.3

	Fiscal Year					
	<u>2007-08</u>	<u>2008-09</u>	<u>2009-10</u>	<u>2010-11</u>	<u>2011-12</u>	<u>2012-13</u>
Actual State PRE interest remitted	\$ 0.2	\$ 1.0	\$ 0.8	\$ 2.3	\$ 1.5	\$ 2.5
Net estimated State PRE interest (not) remitted	\$ (2.7)	\$ (1.8)	\$ (2.0)	\$ (0.9)	\$ (1.9)	\$ 0.2

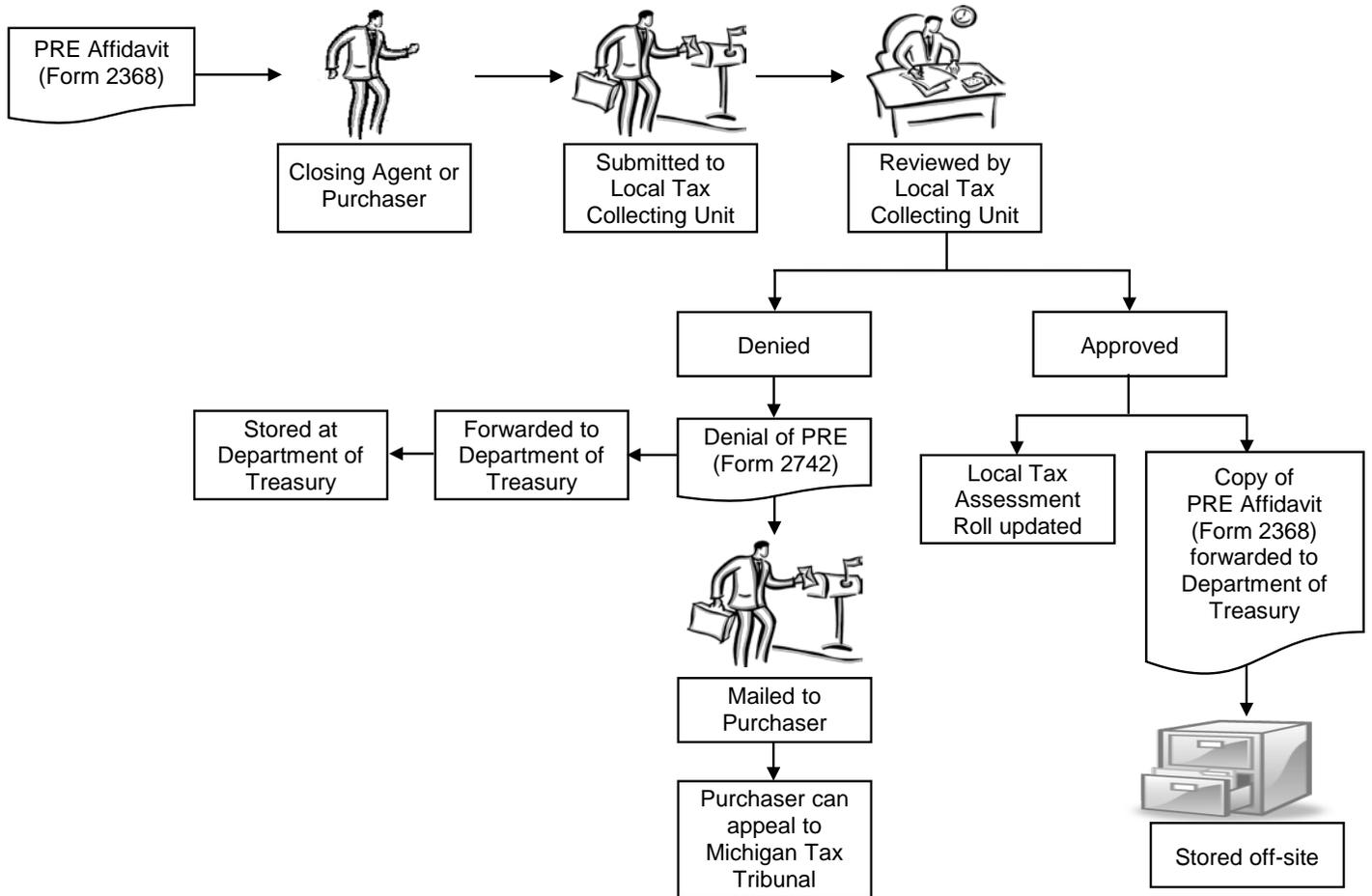
(1) Determined by the Department of Treasury's PRE audit services contract vendor.

(2) Determined by the Office of the Auditor General based on PRE appeals data obtained from the Department of Treasury.

Source: The Office of the Auditor General prepared this exhibit based on unaudited data obtained from the Department of Treasury.

PRINCIPAL RESIDENCE EXEMPTION (PRE)
Department of Treasury

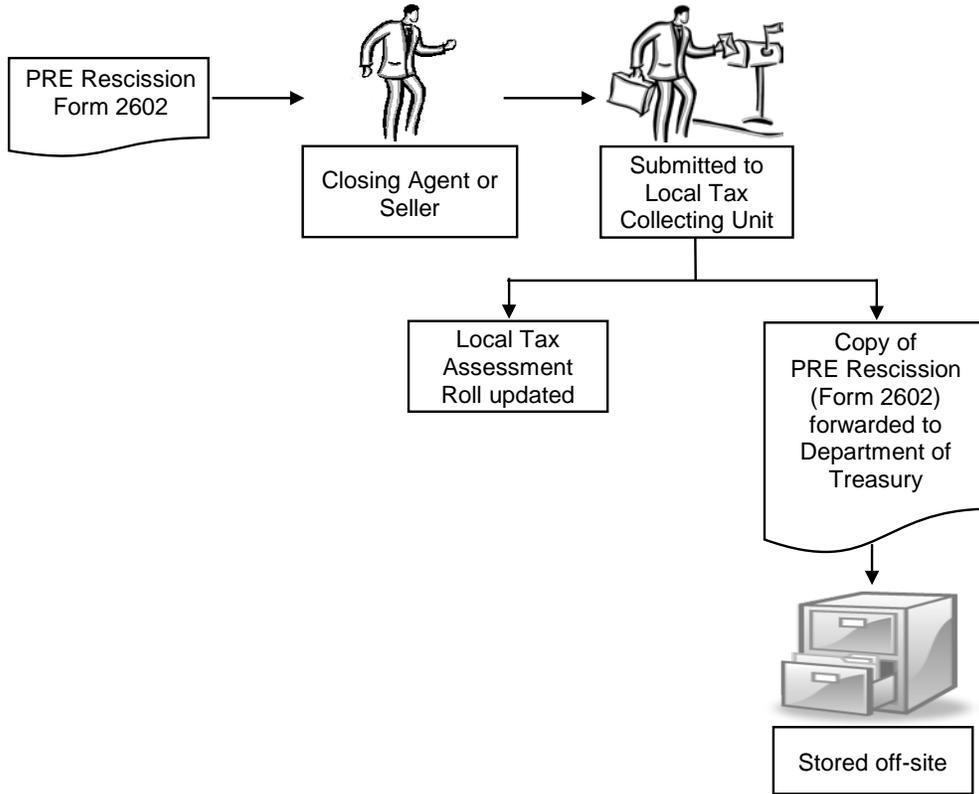
Flow Chart of the Process to Request a PRE on Property
As of June 2014



Source: The Office of the Auditor General prepared this flow chart based on information obtained from the Department of Treasury and from Section 211.7cc of the *Michigan Compiled Laws*.

PRINCIPAL RESIDENCE EXEMPTION (PRE)
Department of Treasury

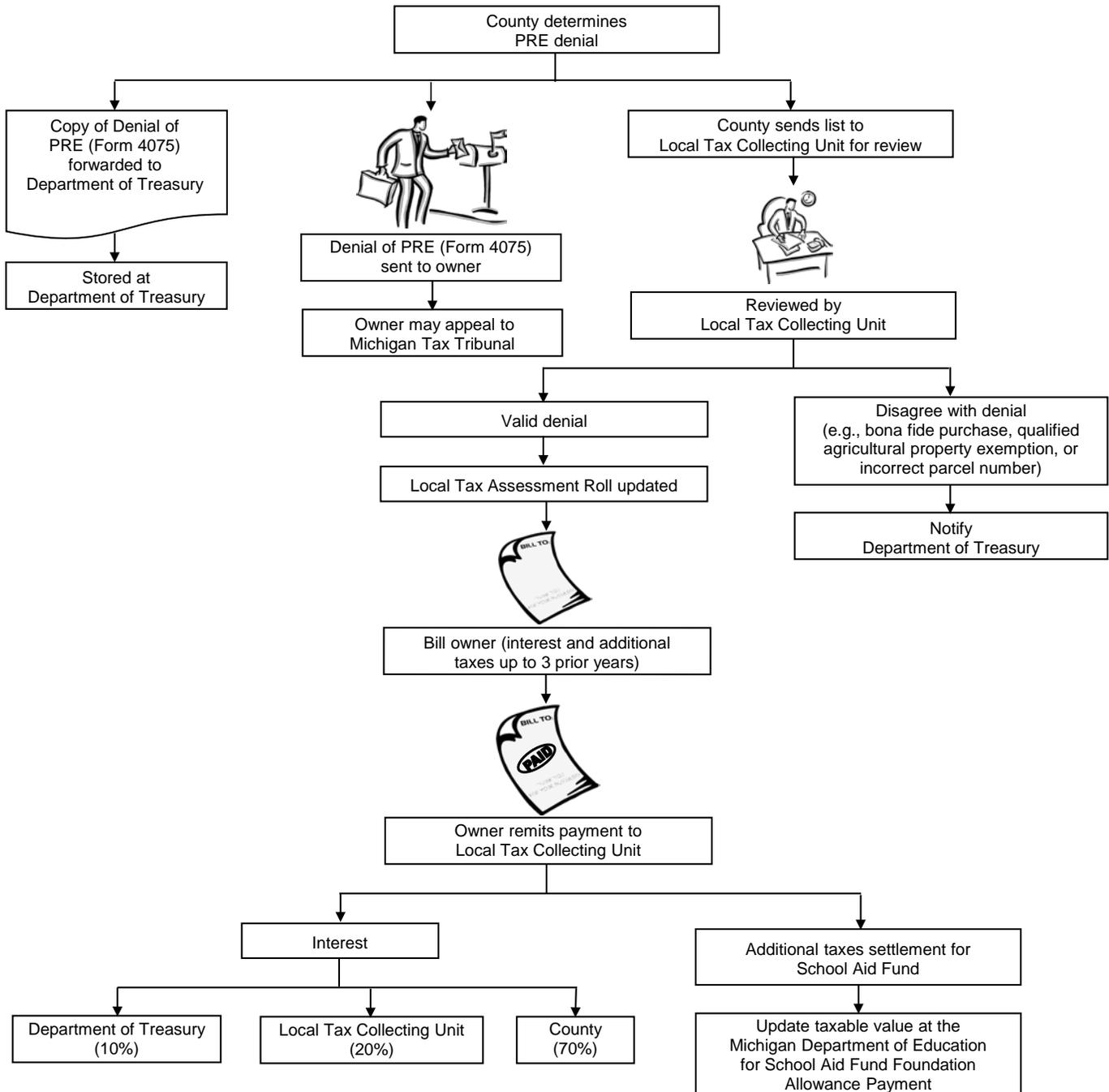
Flow Chart of the Process to Rescind a PRE on Property
As of June 2014



Source: The Office of the Auditor General prepared this flow chart based on information obtained from the Department of Treasury and from Section 211.7cc of the *Michigan Compiled Laws*.

PRINCIPAL RESIDENCE EXEMPTION (PRE)
Department of Treasury

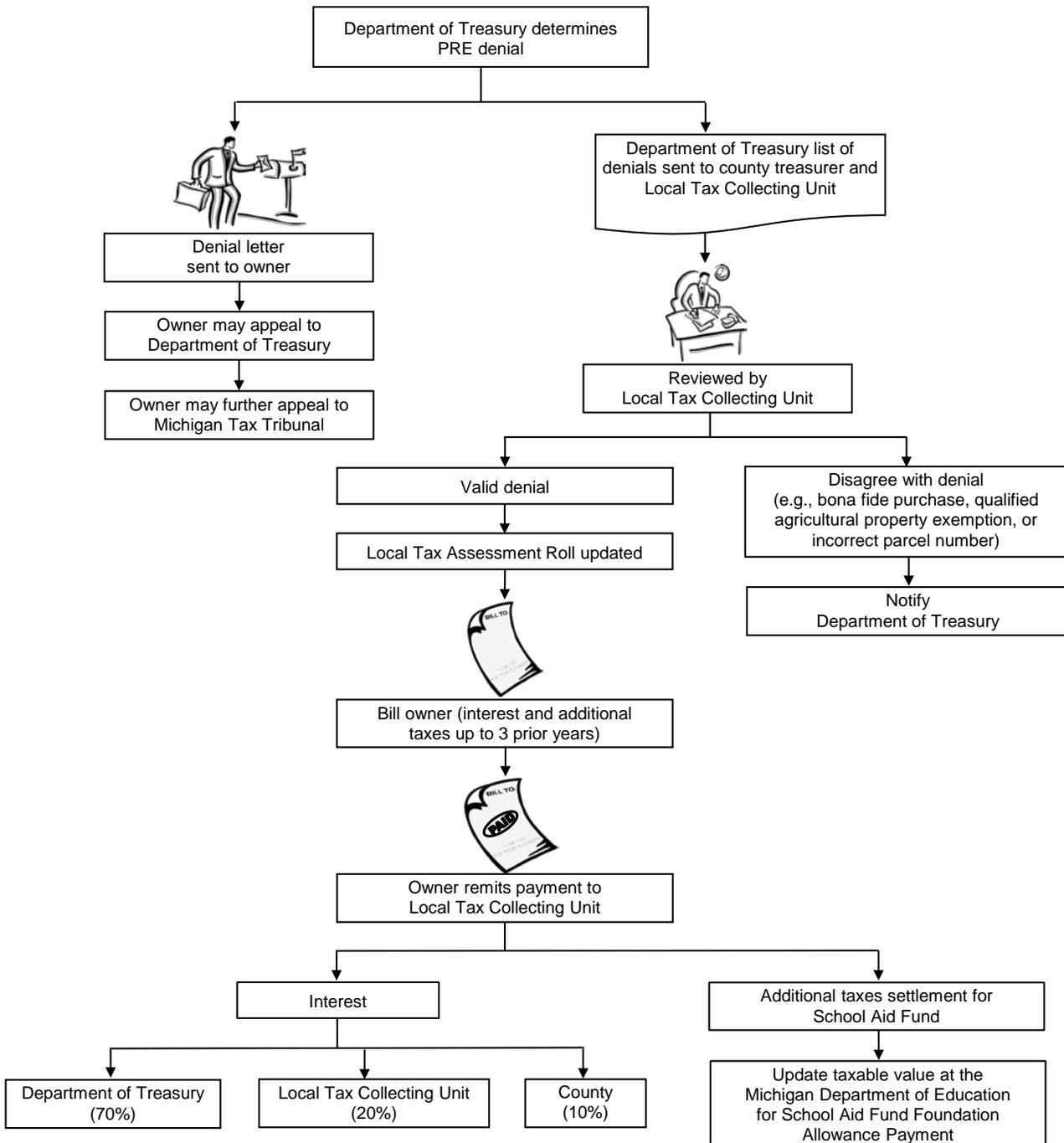
Flow Chart of the PRE Audit Process for County-Conducted Audit
As of June 2014



Source: The Office of the Auditor General prepared this flow chart based on information obtained from the Department of Treasury and from Section 211.7cc of the *Michigan Compiled Laws*.

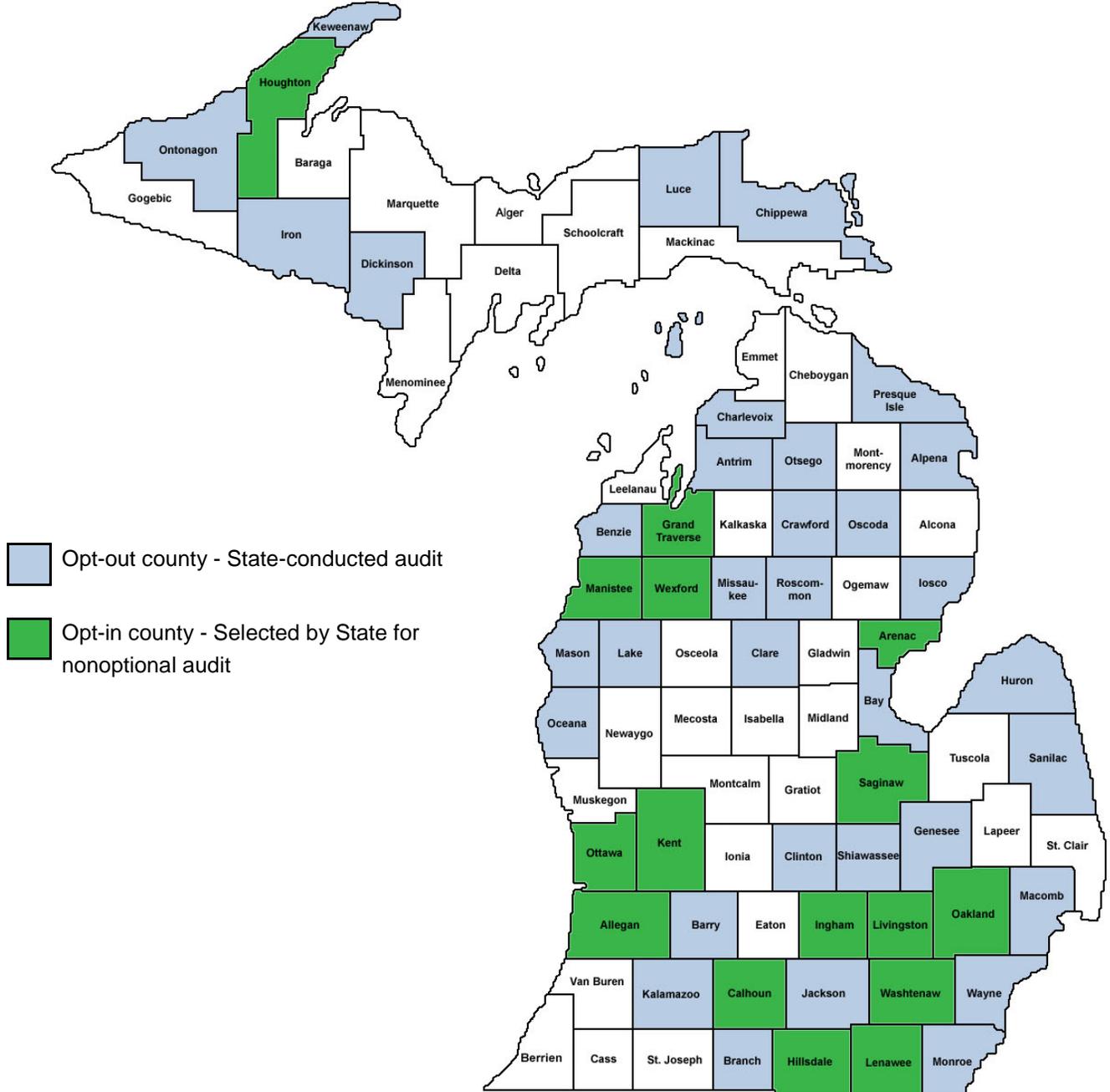
PRINCIPAL RESIDENCE EXEMPTION (PRE)
Department of Treasury

Flow Chart of the PRE Audit Process for State-Conducted Audit
As of June 2014



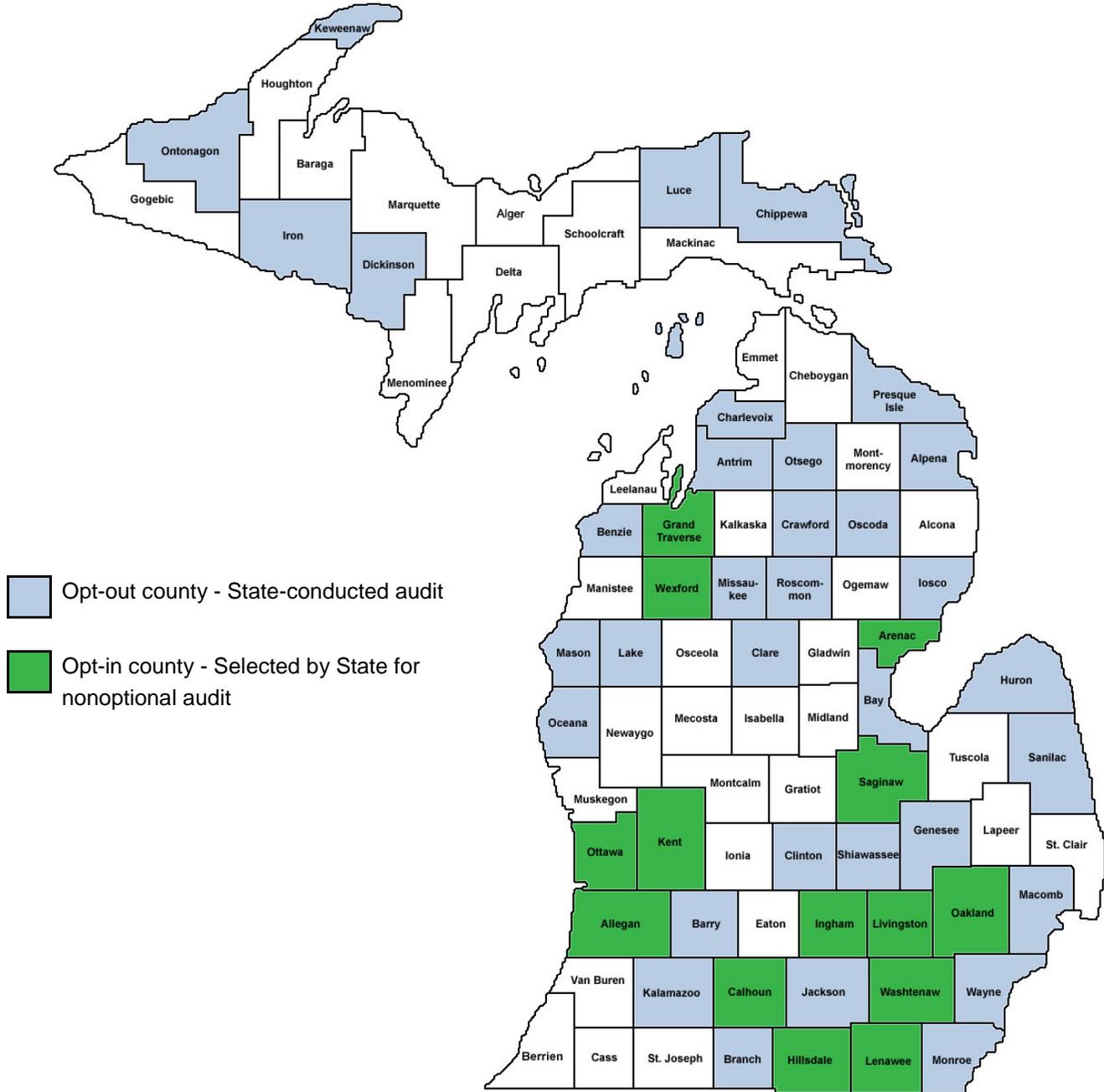
Source: The Office of the Auditor General prepared this flow chart based on information obtained from the Department of Treasury and from Section 211.7cc of the *Michigan Compiled Laws*.

PRINCIPAL RESIDENCE EXEMPTION
Department of Treasury
Map of the Counties Audited by the State in Calendar Year 2012



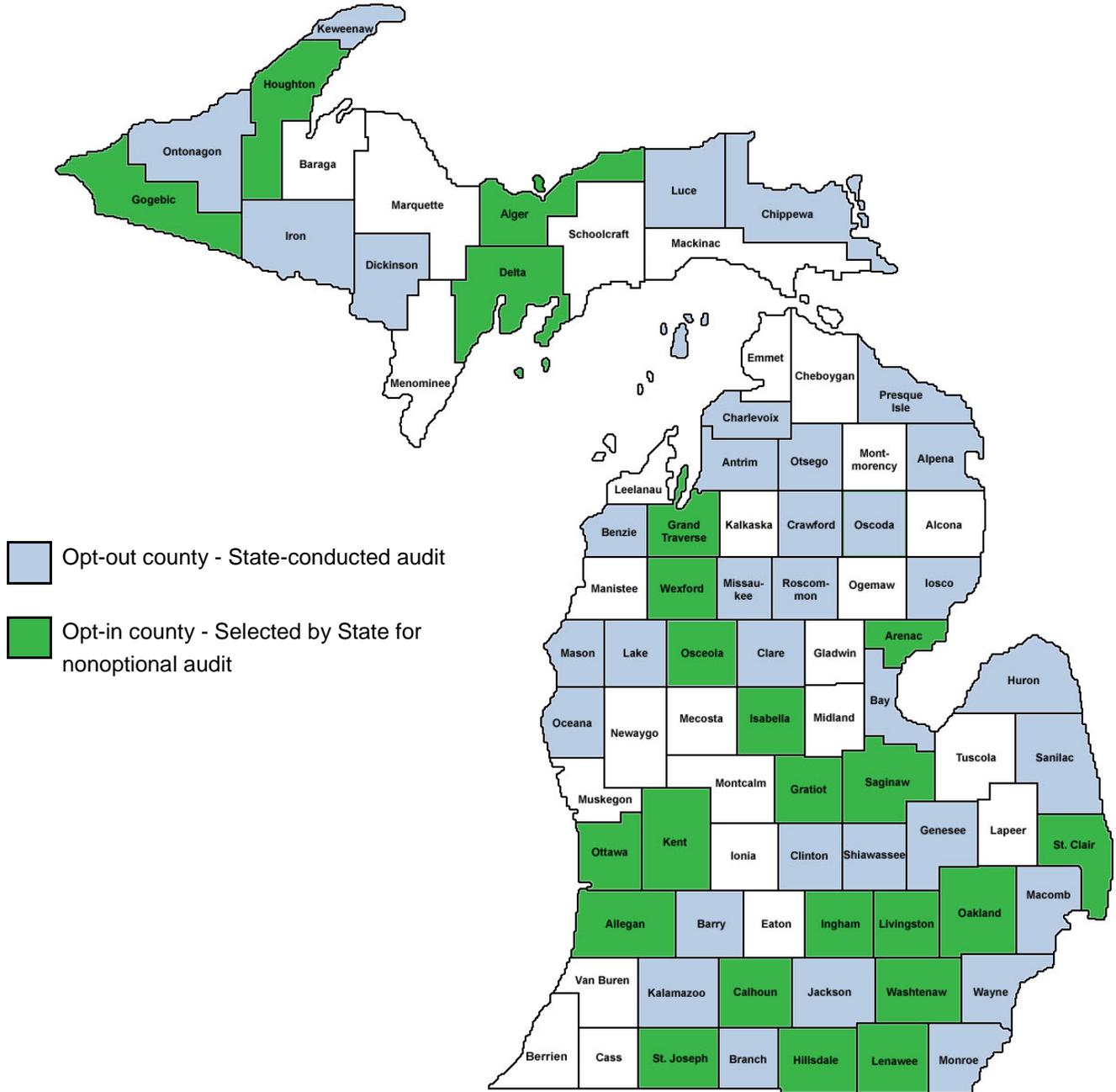
Source: The Office of the Auditor General prepared this exhibit based on data from the Department of Treasury.

PRINCIPAL RESIDENCE EXEMPTION
Department of Treasury
Map of the Counties Audited by the State in Calendar Year 2013



Source: The Office of the Auditor General prepared this exhibit based on data from the Department of Treasury.

PRINCIPAL RESIDENCE EXEMPTION
Department of Treasury
Map of the Counties Audited by the State in Calendar Year 2014



Source: The Office of the Auditor General prepared this exhibit based on data from the Department of Treasury.

GLOSSARY

Glossary of Abbreviations and Terms

affidavit	A form completed by an owner and filed with the local assessor where the property is located to claim a PRE.
denial	A notification sent to an owner and filed with the local assessor that, under certain circumstances, enables a person who has established a new principal residence to retain a PRE on property previously exempt as the owner's principal residence.
effectiveness	Success in achieving mission and goals.
foundation allowance	An annual funding level established by the Legislature for school districts. It is composed of varying levels of funding from the School Aid Fund and local property taxes and represents a district's per-pupil revenue for general operating purposes.
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 also 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.
lead list	A list of potentially questionable PREs by parcel number provided annually to the opt-in counties by the Department.
material condition	A matter that, in the auditor's judgment, is more severe than a reportable condition and could impair the ability of

management to operate a program in an effective and efficient manner and/or could adversely affect the judgment of an interested person concerning the effectiveness and efficiency of the program.

opt-in county A county that elects to audit the PREs claimed in all local tax collecting units located in that county.

opt-out county A county that elects not to audit the PREs claimed in all local tax collecting units located in that county. The Department of Treasury shall audit the PREs for each local tax collecting unit in this county.

owner Any of the following:

- A person who owns property or who is purchasing property under a land contract.
- A person who is a partial owner of property.
- A person who owns property as a result of being a beneficiary of a will or trust or as a result of intestate succession.
- A person who owns or is purchasing a dwelling on leased land.
- A person holding a life lease in property previously sold or transferred to another.
- A grantor who has placed the property in a revocable trust or a qualified personal residence trust.
- The sole present beneficiary of a trust if the trust purchased or acquired the property as a principal

residence for the sole present beneficiary of the trust, and the sole present beneficiary of the trust is totally and permanently disabled.

- A cooperative housing corporation.
- A facility registered under the living care disclosure act (Act 440, P.A. 1976, Sections 554.801 - 554.844 of the *Michigan Compiled Laws*).

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.

PRE

principal residence exemption.

PRE Fund

Principal Residence Property Tax Exemption Audit Fund.

principal residence

The one place where an owner has his or her true, fixed, and permanent home to which, whenever absent, he or she intends to return. This shall continue to be the principal residence until another residence is established.

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.

rescission

A form completed by an owner and filed with the local assessor to remove a PRE from property that was previously exempt.

service organization
control (SOC 2)
report

A report on controls at a service organization relevant to security, availability, processing integrity, confidentiality, or privacy.

tax assessment roll

A listing prepared by a local unit assessor and submitted to a county equalization department that provides the assessed value of each property within a local governmental unit. The tax assessment roll is prepared from the local governmental unit's property assessment records and is to include certain specific data elements, such as the name and address of the property owner and the legal description or the approved parcel identification number for the property.

