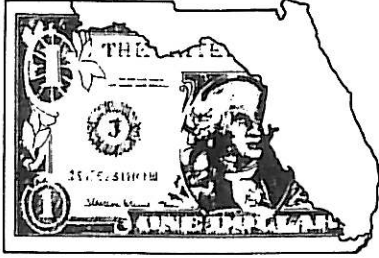


CITIZENS COUNCIL ANALYSIS



**CITIZENS COUNCIL FOR
BUDGET RESEARCH, INC.**
201 S. Monroe St., Suite 400
Tallahassee, Florida 32301
Telephone (904) 222-5052

**Improving Florida's Internal Audit Function
Should Save Taxpayers \$12,000,000**

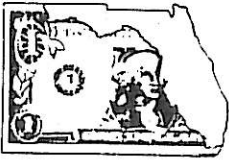
June 1983

The CITIZENS COUNCIL is the only statewide association devoted entirely to Florida taxing and spending issues. Since its inception in 1979, the Citizens Council has worked diligently and effectively to safeguard the interests of the taxpayer, helping to reduce inefficiencies and prompting responsible cost effective improvements in the management and operation of citizens' tax dollars.

The CITIZENS COUNCIL is supported by all types of taxpayers—homeowners, small businesses, large corporations, professional firms, members of the news media, associations and individuals—representing a wide spectrum of Florida's citizens. The Council is a non-partisan, non-profit research and public information organization supported entirely by voluntary tax deductible membership contributions. Membership is open to any organization or individual interested in supporting sound research which promotes effective and efficient government.

The CITIZENS COUNCIL publishes several types of research products which range from detailed research findings and recommendations as to where and how productivity improvements in government can be achieved, to explaining how timely economic, financial and tax related developments may impact on Florida's citizens.

THE COUNCIL DOES NOT OPPOSE ALL TAXES . . . but is ever present to watch that taxes are fair, equitable, not excessive, that their public benefits and costs are weighed, and that government agencies are responsible and efficient in their use of public funds.



CITIZENS COUNCIL FOR BUDGET RESEARCH, INC.

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June 1983

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Dear Taxpayer:

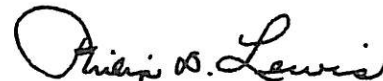
We are sending you our latest Analysis aimed at improving efficiency and economy in government, "Improving Florida's Internal Audit Function Should Save Taxpayers \$12,000,000." We believe that an improved system of internal auditing in Florida will provide a more effective means for early detection of fraud and inefficiency. Every taxpayer dollar saved by controlling questionable expenditures can be used to purchase the needed public services without unnecessarily increasing your taxes.

We hope this Analysis is thought-provoking and trust that the recommendations contained herein will provide sufficient, and not excessive, checks and balances to ensure a more prudent and effective use of your tax dollars. A growing emphasis on maximizing the appropriate use of internal auditors in each agency will result in the reduction of the number and magnitude of problems encountered from inadequate fiscal controls. This should also serve to enhance citizens' support of necessary and well managed public services.

The Citizens Council for Budget Research is now entering its fifth year of responsible service to the taxpayers of Florida. Unlike emotionally charged organizations throughout the country, the Citizens Council has worked diligently to establish a high degree of credibility and public acclaim for objective research aimed at improving the efficiency of government. We submit this Analysis as part of our continuing commitment to improve the management of Florida government.

Respectfully,


Kenneth A. Plante
Chairman


Philip D. Lewis
President

Internal Auditors: Government's Experts in Fiscal Control

Introduction

Funds saved by controlling waste, abuse and inefficient expenditures in State government can be used to purchase needed public services without unnecessarily increasing taxes.

A substantial reduction in improper spending should be realized in Florida through improved systems of internal audit control recommended by the Citizens Council for Budget Research.

The development of a sound system of controls within government agencies will provide timely and valid information on the status of the State's assets and properties, accurate and complete accounting data on all financial transactions and include an effective system of early detection of fraud and improper expenditures.

Management control systems are incomplete without the internal audit unit. The internal auditor evaluates how well the control systems work. In comprehensive reviews of agency operations, the internal auditor can monitor the adequacy of measures to detect and prevent the probability of, and incentives for, improper spending by identifying control weaknesses.

Internal auditors monitor control systems

An environment which is tolerant of mismanagement and loose fiscal controls does not encourage efficient government and effective programs. The costs of errors, anomalies, and abuse are difficult to quantify. Similarly, there are problems in calculating the benefits, both in direct savings and deterrent behavior, of a good internal auditing program. Failure to provide such controls, however, for the expenditure of the State's \$10.4 billion annual budget could result in serious misuse and waste of public funds.

Loose fiscal controls do not encourage efficiency

The Citizens Council suggests that a conservative fiscal savings accruing from the improvements or implementation of internal audit units in all state agencies as recommended in this analysis could result in the diversion of substantial resources to more productive uses. As little as \$12 million in available revenue currently "lost" through waste, fraud, abuse and improper spending may be saved through improvement of the internal audit function in Florida.* The cost of staffing each agency with an adequate number of internal auditors and support staff should be minimized through the reclassification of other areas of existing administrative positions such as press/information and public relations personnel in those agencies lacking certified internal auditors. There is no better public relations tool than effective operations and sound fiscal management controls.

Substantial resources could be saved or diverted to more productive uses through improved internal auditing

Summary of Findings

- **Finding:** There are eight state agencies that have no internal auditors, while appropriated \$580 million this year.
- **Finding:** There are 170 positions classified as professional level auditors in the remaining 18 agencies, 11% less than the number of positions one year ago.
- **Finding:** Internal auditors are authorized and defined by statute in only one agency, the Florida Department of Transportation.
- **Finding:** The salary level for senior professional auditors ranges from approximately \$21,000 to \$35,000 annually.
- **Finding:** There are only four senior level internal auditors (not including Inspectors General) who are Certified Public Accountants.
- **Finding:** In 12 agencies, the senior level internal auditor does not report directly to the agency head.
- **Finding:** The responsibilities of internal auditors often include such tangential duties as budget preparation, handling constituent complaints, fiscal accounting, and acting as legislative liaisons.
- **Conclusion:** The internal audit function needs substantial improvement to be a viable tool of management to provide policies and procedures necessary to ensure fiscal control and accountability and compliance with applicable laws and regulations.

Florida's system of internal auditing can be substantially improved

This conclusion results from a Citizens Council review of agency internal auditing procedures within State government and is illustrated by several incidents involving an apparent lack of proper financial control and improper accountability of funds and property:

- **Department of Transportation:** An engineering consulting firm has been charged by the State Attorney in the 2nd Judicial Circuit for grand theft of as much as \$100,000 in State funds. This may have been accomplished by falsifying financial records and inflating costs.

Internal audits of this engineering firm by DOT internal auditors dated July 1980, October 1980, and February 1981 had advised DOT managers that the firm's accounting system was inadequate to maintain segregation and accumulation of job costs required for a cost reimbursement contract. After

the Department failed to act on three successive internal audits spanning several months, the Chairman of the House of Representatives Committee on Transportation asked the State Attorney to investigate the costs reported by the firm involved.

- Department of Highway Safety and Motor Vehicles: Four top ranking officials of the DHSMV resigned or were fired following allegations of misuse of state funds and property.

Internal auditors had previously identified deficiencies within the vehicle accounting system and the Department's failure to address these weaknesses and resulting lack of proper financial control recently became public. A second area of taxpayer concern relates to insufficient aircraft utilization reports maintained by the Department. Aircraft utilization reports had previously been questioned by internal auditors, however, the lack of proper documentation precluded any finding of irregularity.

- Department of Agriculture and Consumer Services: The State Attorney for the 2nd Judicial Circuit is currently investigating allegations made by the Comptroller of Florida that public funds should have been deposited in the State treasury and not in privately controlled bank accounts held in the Agriculture Commissioner's name. The use of private bank accounts had been questioned three years ago by the Auditor General in his annual financial and compliance audit of the Department. In a second investigation, the Agriculture Commissioner has repaid the State treasury a sum of \$3,996 for the improper use of State owned aircraft by friends and relatives.

The Department of Agriculture does not utilize any position classified as internal auditor.

- State University System: A recent internal audit performed two years following evidence in a previous Auditor General report of Florida State University revealed that the University had overspent its budget by \$2.8 million dollars in Fiscal Year 1981-82.

This audit followed a previous audit released in 1980 by the Auditor General which showed deficit spending in FY 1977-78 and 78-79 totaling \$700,000.

These examples reveal sufficient evidence that internal audits are often not acted upon by agency heads. Some government agencies, in fact, have no systematic and continual internal audit procedures for the design and implementation of fiscal controls necessary to resolve problem areas identified by external auditors.

Internal auditors are often ignored

Some agencies have no system of internal auditing

TABLE I

<u>AGENCY</u>	<u>1982-83 EST. EXPEND. (millions)</u>	<u>1982-83 EMPLOYEE POSITIONS</u>	<u>INTERNAL AUDITOR</u>	<u>INSPECTOR GENERAL</u>
Administration	\$ 344.6	513	No	No
Agriculture	94.3	3,763	No	No
Banking	20.3	586	Yes	No
Business Reg.	59.1	616	No	No
Citrus	47.6	225	Yes	No
Commerce	38.1	333	No	Yes
Community Affairs	50.4	244	Yes	No
Corrections	271.4	10,500	Yes	Yes
Education	4,090.3	26,507	Yes	No
Environmental Reg	25.5	744	Yes	No
Game and Fish	24.6	763	Yes	No
General Services	61.7	1,075	Yes	No
Governor - EOG	15.1	299	No	Yes
HRS	2,246.1	29,697	Yes	Yes
DHSMV	124.4	4,207	Yes	No ¹
Insurance	54.4	878	Yes	No
Labor & Employment	365.2	3,686	Yes	Yes
Law Enforcement	39.9	917	Yes	No
Legal Affairs	9.7	282	No	No
Military Affairs	4.7	158	Yes	No
Natural Resources	102.8	1,669	Yes	Yes
Parole & Probation	4.1	180	No	No
Professional Reg.	20.2	510	No ²	No
Revenue	631.3	1,264	Yes	Yes
State	32.9	667	No	No
Transportation	997.7	9,025	Yes	Yes

Source: Governor's 1983-85 Biennial Budget Recommendations

¹ DHSMV is requesting legislative authorization of an inspector general position and additional staff in their 1983-84 budget request.

² The Department of Professional Regulation has been authorized an Internal Auditor II position but has not filled the position.

Why Do We Need Agency Internal Auditors?

Internal auditors primarily must satisfy two basic interest groups: management, either elected or appointed and, indirectly, the taxpayer. The measure of the success of governmental auditing and fiscal accountability is most often seen at the polls. The concerns and informational needs of these two groups are similar.

Good management requires internal auditors

An agency head has full management responsibility for the proper expenditure of funds by that agency in meeting its constitutional and statutory requirements. The nature, effectiveness and efficiency of an agency's programs are maximized through appropriate fiscal controls and good records management. Essentially, internal auditors serve to prevent the improper expenditure of funds and ensure that financial controls and records, and good management guidelines are followed consistently.

Internal auditors help ensure adequate fiscal controls and records

Without internal auditors, instances of unlawful practices as well as operational inefficiencies would not be detected until the post audit; at which time it becomes extremely difficult to recover taxpayer funds. Moreover, the public's confidence in the integrity and competence of the agency's administration diminishes with successive examples of waste and abuse which go unnoticed until after the fact. Taxpayers have a right to see their public funds spent properly and agency managers and their internal auditors have the legal and ethical responsibility to carry out this public trust.

Taxpayers deserve proper expenditure of public funds

Auditor General, Inspector General, Internal Auditor: Is There a Duplication of Audit Responsibility?

The Auditor General is required to perform an annual post audit of the accounts and records of every agency of State government. The post-audit report is an independent examination of the combined annual financial statements for the previous fiscal year and examination of compliance with applicable federal and state laws and regulations.

Auditor General performs annual post audit

An agency internal auditor, on the other hand, is concerned primarily with a pre-audit function of providing the fiscal control mechanisms which identify any exceptions to the annual combined financial statements, irregularities and illegal acts. In addition, the internal auditor assists an agency head in developing indicators to monitor the effectiveness of steps taken to resolve weaknesses in fiscal controls once identified.

Internal auditor - continuously monitors expenditures and records

In recent years, the internal audit/review process has been greatly expanded to encompass both internal financial audits performed by internal auditors and program review and performance evaluations, primarily performed by program evaluation specialists. Inspector general positions have been created in eight agencies to coordinate the review of these two rapidly growing areas of audit operations. The creation of the inspector general positions has sometimes provided management with additional staff assistance in coordinating as well as implementing corrective actions and improved management practices distinct from the responsibilities of the internal auditor.

Inspectors general improve management practices and effectiveness

An internal auditor's function is to make independent and objective analyses and to report to an agency head the conditions found in a consulting or advisory capacity. An inspector general may have the responsibility of following through on the internal auditor's findings and implementing necessary policy and procedural changes in operations. Several internal auditors have been reclassified as inspectors general, thus possibly diluting the actual audit priority. In addition, not every inspector general has sufficient training and experience to function in the professional capacity of internal auditor.

Inspectors general are not necessarily trained as auditors

Can an Agency Internal Auditor Maintain Objectivity and Independence from Management?

The Citizens Council surveyed agency internal auditors and found areas of concern on these four major issues:

- Senior Management Service (SMS): Five internal auditors occupy positions designated within agencies as policy making positions and participate in the SMS Pay Plan. In accepting an appointment to a position within the SMS Pay Plan, internal auditors withdrew from the Career Service System and the benefits and retention rights therein. Compensation for the loss of employment security was adequately provided under the new plan, with annual salary increases for internal auditors totaling as much as \$4,000.

Does SMS detract from auditors' objectivity?

Most internal auditors indicate that being on the management "team" increases independence. There are some exceptions, however, and although the salary schedule continues to be more attractive than that of career service auditors, there is a concern that salary increases might become increasingly contingent on "clean" audits or reviews. This could have some impact on the quality and objectivity of the audit, or more subtly, on the strength or tone of the deficiencies reported.

One internal auditor in fact, indicated a strong conviction that the position should not have been reclassified to SMS because of the conflict of interest involved since the general appearance of a conflict of interest should be avoided whenever possible.

- Agency assignment and review procedures: There is a high degree of variation in the audit review procedures followed by most agencies. These procedures range from those internal auditors who seldom prepare written reports containing irregularities, relying instead on verbal communication and those who always prepare a written report on audits assigned. Most internal auditors indicate assignments are undertaken on their own initiative as well as by management requests. Others indicate reviews are made at the request of program managers from all levels with priorities being set by the agency head. This variation does not avail itself to a systematic and consistent procedure for applying acceptable audit standards to agency operations.

No systemwide procedure for applying acceptable audit standards exists

- Accessibility: A broken line of direct access to an agency head clearly has a negative impact on an internal auditor's independence and objectivity. The organizational status of the internal audit function is a major indicator of its value. Independence will maximize the timely communication to an agency head on problems for which remedial action can be taken before the usefulness and effectiveness of operations. Additionally, an inspector general may coordinate the reviews of all the auditing staff. However, the inspector general should not edit or withhold a completed internal audit report from an agency head, nor deny or impede direct communication between the internal auditor and the agency head.

Direct communication between internal auditor and agency head maximizes audit value

In 12 agencies, the internal auditor does not report directly to the agency head.

- Auditing and Accounting: Another adverse factor impacting on the independence and objectivity of the internal audit function is the improper segregation of duties. In performing the functions of the internal auditor, the individual or organizational unit should have no direct responsibility for, or authority over, any of the activities which he reviews. If an internal auditor performs any routine accounting functions, assists in agency budget preparation, warrant processing, reconciliation or other accounting operations, this could adversely compromise his independence in monitoring these procedures. The Citizens Council found that this commingling of duties is frequent in the smaller State agencies. The objective of the internal audit, which is to detect weaknesses in the accounting controls of an organization, cannot be assured when there is a questionable degree of independence between the auditor and the activities he audits.

Auditors should audit, not perform variety of ancillary functions

While it is common practice for an agency head to request the internal auditor to prepare the response to findings of the independent post audit of the Auditor General, this practice has several adverse aspects:

1. It shields the agency head from acknowledging the full impact of adverse findings.
2. It places the internal auditor in the conflicting position of defending the management practices of his employer.
3. It usurps valuable staff time of the internal audit unit which could be used more productively.

What Happens When Internal Audit Reports Are Ignored?

In the examples cited earlier, several internal audit reports had failed to prompt adequate and timely agency response. This resulted in serious waste and misuse of public funds and property, as well as the erosion of the confidence of agency employees. The taxpayers' perception of the efficient use of funds was also jeopardized.

Public confidence is at stake and may diminish

A similar consideration must be made of the problems resulting from extensive and substantive editing of audit reports which might alter the proper interpretation of facts. Isolated incidents of auditing staff reductions following submission of adverse audit findings were reported. While no internal auditor admitted to altering or eliminating specific audit findings, several internal auditors indicated they had been encouraged to minimize certain findings. While the proper editing of audit reports to improve accuracy, objectivity and constructive tone is normal procedure, further substantive editing should not be required once a report has been submitted to an agency head. Additionally, long delays between the performance of the audit and communicating the results to the public should be avoided.

Some evidence of "white washed" audits found

Recommendations

The following recommendations should improve the credibility and effectiveness of the internal audit process.

- The function of the internal auditor should be provided by law to require the identification of management controls necessary to ensure fiscal accountability and compliance with applicable laws and regulations, and the performance of operational audits to continually monitor the effectiveness of these controls.
- The eligibility requirements to be an internal auditor should be carefully scrutinized with priority consideration given to candidates having the proper training and experience in the audit of state government entities and to those possessing the training and experience requisite for a Certified Public Accountant or Certified Internal Auditor. The

Internal audit function should be provided by law

Qualifications of internal auditors should be carefully considered

degree to which an internal audit can aid management is proportional to the capabilities and integrity of the staff and the freedom within which staff operates.

- The salary level of all senior level internal auditors should be commensurate with professional responsibility and authority. Internal auditors should be properly compensated
- The senior level internal auditor should report his tentative and preliminary findings and recommendations directly to the agency head. This will allow maximum independence to the auditor while providing timely information to the highest level of agency management. This should be followed by a report from the internal auditor containing a written response from the affected agency program or operational unit. The internal auditor should be able to comment on the response of the program or operational unit in the formal report. Audit findings should be reported immediately
- **It is the recommendation of the Citizens Council that in addition to reporting directly to an agency head, the internal auditor should report to an audit committee established within each agency.** This audit committee should be established by each agency head and include representatives outside of management within the agency. This committee would meet periodically with management, the internal auditors, and staff of the Comptroller in connection with the committee's review of matters relating to the annual financial statement, the internal audit program, the system of internal accounting controls and the findings of external auditors. The internal auditor should have full and free access to meet with the committee - with or without management present - to discuss the results of their examinations, the adequacy of internal accounting controls and the quality of financial reporting. Such is a common practice in private industry today. Audit committees within each agency will provide maximum assurance of proper controls and improved compliance
- Public accountability demands a more general distribution of internal audit reports. This should include the Auditor General and Joint Legislative Auditing Committee, legislative staff of the standing committees involved, the Bureau of Auditing of the Department of Banking and Finance (Comptroller's office) and the Governor's Office of Planning and Budgeting (OPB). An agency head should be required by law to submit a written statement of ameliorative actions to the OPB with the agency's first request for legislative appropriations made more than 60 days after the date of the internal audit. This is a similar procedure required of federal agencies which must respond to U. S. General Accounting Office reports (31 USC Sec. 720). When such necessary action is not taken in a timely manner, OPB should make commensurate reductions in its recommended level of spending (appropriations/funding) of the agency's respective operations for successive years. Wider distribution of internal audits can lead to immediate results and proper follow-up

Summary

The taxpayers' confidence in the integrity and competence of state government suffers with each new uncovered "scandal." To minimize this, there must be a growing emphasis on maximizing the appropriate use of internal auditors in the management team of each state agency. This will reduce the number and magnitude of problems from becoming a crisis and ensure that the agency managers and public interest are better served.

In a recent article published in the Price Waterhouse Review, the distinguished author Professor Frederick L. Neumann states:

The cost of potential errors and irregularities will grow, simply because of increased volume and the size of individual transactions. Preventive controls will gain more attention, and detective controls will be moved closer to the initiation of significant activity in order to reduce losses. The ultimate control - the internal auditors - will benefit from this if they are prepared to meet the rising expectations for their services.

Those department and agency heads of Florida government must demand more from their internal auditors and must be concomitantly prepared to recognize the integrity, objectivity and independence of the internal auditor.

Greater fiscal control and better accountability will result in enhancing the efficiency and economy in government spending of public funds.

Notes

1. Journal of Accountancy. "Financial Reporting: Should Government Emulate Business?" Robert K. Mautz, director of the Paton Accounting Center, University of Michigan. August 1981.
2. Prepared notes for speeches, John P. Thomas, of May, Zima & Co., Tallahassee, Florida. May 15 and May 19, 1981. Subjects: "Recent Activities of the Auditing Standards Board and Audits of Federally Assisted Programs"
3. Preventing Fraud, Waste, Abuse and Error: Internal Control Reform in New York State Government. New York State Legislative Commission on Economy and Efficiency in Government. June 1982.
4. Prevention and Detection of Fraud, Waste, and Abuse of Public Funds. U. S. Department of Justice. November 1979.
5. Price Waterhouse Review. Vol. 26, No. 2. "Educating the Next Generation of Auditors." Frederick L. Neumann, Price Waterhouse Professor of Auditing, University of Illinois, 1982.
6. Report of the Committee on Uniform Internal Management Audit Concepts. Tallahassee Chapter, Institute of Internal Auditors. July 19, 1972. This report was prepared and submitted to Mr. Joe Cresse, Department of Administration.

Note: A net savings of as little as \$12 million in available revenue could be diverted to new and existing programs from the improvement of internal auditing in Florida. This estimate is the result of the Citizens Council analysis of internal auditing in 26 agencies in the Executive Branch: \$9.2 million (one tenth of one percent of the 1982-83 operating budget) in the 17 agencies which currently have an internal audit unit in place, but which could improve its operational structure, policies and procedures. In addition, a minimum of \$2.9 million (one half of one percent) could be diverted or saved in the eight agencies with no segregated internal audit function.

This is a very conservative estimate. In 1978, the Inspector General of the U.S. Department of Health, Education and Welfare stated that at the federal level, the incidence of waste, fraud and abuse in that agency amounted to between 4.7% and 5.4% of the Department's budget. Furthermore, Florida Attorney General Jim Smith estimates that fraudulent and abusive bid-rigging practices at the Department of Transportation inflated contract expenses by 10% or as much as \$45 million annually between 1973 and 1980.

What you can do about your taxes...

Budget crunches. Revenue shortfalls. Tax increases. Shifting of costly programs from the federal level to state and local governments. Population growth and increased costs for providing public services. Since many compounding factors are prompting officials of Florida's state and local governments to raise taxes for increased revenue, taxes are a direct concern to you and your business.

The next few years will be most important for Florida. Sound, prudent fiscal and budgetary policies which will foster a sustained and diversified economic base need to be developed and vigilantly pursued.

Florida is at a crossroads.

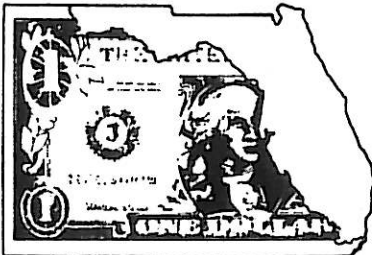
You can sit on the sidelines—a spectator watching others decide the future of how your tax dollars are spent and what your Florida becomes. Or you can join the Citizens Council for Budget Research and have an informed basis to get involved in determining the outcome.

The Citizens Council for Budget Research is dedicated to:

- prompting cost saving improvements in Florida government
- providing timely information and meaningful citizen input in the complex budgetary process
- maintaining and enhancing credibility with responsible public officials, the news media and Florida citizens through careful, objective and well documented research publications.

You can share in the Council's constructive work and in the resultant savings and improved government through your investment in a tax deductible membership. Remember, collecting and spending tax dollars is your business.

For membership and other information contact:



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