STATE OF ILLINOIS
OFFICE OF THE
AUDITOR GENERAL
William G. Holland, Auditor General

SUMMARY REPORT DIGEST

DEPARTMENT OF REVENUE

Financial Audit
For the Year Ended: June 30, 2011

Release Date: June 19, 2012

Summary of Government Auditing Standards Findings:	
Total this report	**12**
Total last report	**12**
Repeated from last report:	**6**

INTRODUCTION

This digest covers our financial audit of the Department of Revenue (Department) for the year ended June 30, 2011. A two year compliance attestation examination and a one year financial statement audit will be performed for the period(s) ending June 30, 2012. The auditors identified 12 findings involving the internal control over financial reporting. The findings are presented in the report beginning at page 60. Following is a summary of five findings included in this report digest.

SYNOPSIS

- During testing, auditors noted the Department has experienced a significant increase in the inventory of Business Income Tax and Withholding Income Tax taxpayer information to be processed and finalized.
- The Department has a $1.64 billion deficit in the General Fund's fund balance as of June 30, 2011. This deficit is primarily due to the State failing to allocate sufficient income tax receipts to the Income Tax Refund Fund, which is a subaccount of the General Fund reported by the Department.
- The Department has not completely implemented controls and safeguards over processing taxpayer information.
- The Department did not comply with provisions of the State Revenue Sharing Act and the Illinois Income Tax Act, as both of these Acts were impacted by the passage of Public Act 096-1496, the *Taxpayer Accountability and Budget Stabilization Act*.
- The Department has weaknesses in their internal control structure over the deposit, allocation, and distribution of receipts from sales and use taxes.

{Financial data is summarized on the reverse page.}

ILLINOIS DEPARTMENT OF REVENUE
FINANCIAL AUDIT
For The Year Ended June 30, 2011

FINANCIAL INFORMATION - Governmental funds (in thousands)	FY 2011	FY 2010
REVENUES		
Program revenue: charges for service	$ 47,412	$ 47,933
Program revenue: operating grants	526	152
General revenue: taxes	27,617,828	22,583,288
General revenue: interest and other	41,110	24,373
Total revenue (1)	$ 27,706,876	$ 22,655,746
EXPENDITURES		
General government	$ 244,022	$ 222,019
Health and social services	120	159
Employment and economic development	5,625	3,750
Environment and business regulation	6,015	5,734
Intergovernmental	4,528,346	4,098,953
Capital outlays	6,098	5,188
Total expenditures (2)	$ 4,790,226	$ 4,335,803
OTHER SOURCES (USES)		
Appropriations from State resources	$ 249,507	$ 255,448
Transfers in	821,086	1,867,162
Transfers out	(435,249)	(1,716,280)
Receipts collected & transmitted to the State treasury	(22,287,709)	(18,515,839)
Lapsed appropriation	(51,216)	(46,993)
Other	(814,472)	(1,604,323)
Total other sources (uses) (3)	$ (22,518,053)	$ (19,760,825)
FUND BALANCE (DEFICITS)		
Increase (decrease) in fund balance (1) - (2) + (3)	$ 398,597	$ (1,440,882)
Fund balance (deficits) July 1	(1,838,497)	(397,663)
Increase (decrese) for changes in inventories	98	48
Fund balance (deficits) June 30	$ (1,439,802)	$ (1,838,497)

SELECTED ACCOUNT BALANCES - Governmental funds (in thousands)	June 30, 2011	June 30, 2010
ASSETS		
Cash and cash equivalents & investments	$ 1,355,059	$ 999,004
Taxes receivable, net	1,309,641	1,080,467
Intergovernmental and other receivables, net	18,159	11,028
Due from other Department and State funds	1,201,922	1,075,132
Inventories	379	477
Unexpended appropriations	29,703	17,303
Total assets	$ 3,914,863	$ 3,183,411
LIABILITIES		
Accounts payable and other liabilities	$ 431,600	$ 371,773
Income tax refunds payable	1,669,732	1,458,465
Intergovernmental payables	1,141,650	1,239,087
Unearned revenue	588,794	535,866
Due to other funds - State & Department	1,357,963	1,251,581
Unavailable revenue	164,926	165,136
Total liabilities	$ 5,354,665	$ 5,021,908
FUND BALANCE (DEFICITS)		
Fund balance (deficits)	$ (1,439,802)	$ (1,838,497)
Total liabilities and fund balance (deficits)	$ 3,914,863	$ 3,183,411

DEPARTMENT DIRECTOR
During Audit Period: Brian A. Hamer
Currently: Brian A. Hamer

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

INCREASED LEVELS OF UNPROCESSED TAXPAYER INFORMATION

Amount of tax information to be processed and finalized has increased

One segment of the Department's taxpayer information inventory consists of original tax returns to be processed and finalized. When taxpayer information is entered into the Department's tax processing system (GenTax), certain returns are automatically flagged by GenTax that require additional manual processing to finalize, which creates this category of inventory. These flags are attached for various reasons including mathematical errors, missing tax forms, etc. This segment has increased significantly over the past few years and is predominantly business income tax returns.

It is the Department's policy to exclude the indicated balances due on these returns from the financial statements, because the true balances are unknown until the returns are manually worked by the Department's tax specialists.

68,862 returns to be processed and finalized

At June 30, 2011, the Department identified $4.7 billion of items related to taxpayer information to be processed and finalized (representing 68,862 returns). Although it is generally agreed the vast majority of the $4.7 billion is invalid and will be reduced upon the tax information being finalized, there is no reasonable methodology or process for estimating the valid receivable amount of these partially processed returns.

Due to increased demands and less staff for processing information the backlog has the potential to increase over time

Due to the increasing backlog of taxpayer information to be processed and finalized, the Department is not able to accurately measure and report associated receivables, deferred revenue, and tax revenue in the financial statements within the proper fiscal year. Additionally, due to increased demands and less staff in general for processing taxpayer information, the backlog has the potential to continue to increase over time. (Finding Code No. 11-1, pages 60-62)

We recommended the Department seek sufficient resources to process taxpayer information in a timely manner to ensure taxpayer records and financial statement information reflect appropriate information and expedite the ability of the Department to collect all taxes due to the State.

Department agrees with auditors

Department officials agreed with the recommendation and indicated they will seek additional resources to resolve this issue. The Business Income Tax Unit operated 20 to 30 percent below approved headcount during FY11. The State's constrained fiscal environment has made it a challenge for the Department to maintain sufficient resources to operate effectively, Department officials noted they have re-assigned and consolidated operations of staff to key units to mitigate the risks to the State.

FUND BALANCE DEFICIT EXCEEDING $1.6 BILLION

$1.64 billion deficit in the General Fund's fund balance

The Department has a $1.64 billion deficit in the General Fund's fund balance as of June 30, 2011. This deficit is primarily due to the State failing to allocate sufficient income tax receipts to the Income Tax Refund Fund (Fund 278), which is a subaccount of the General Fund reported by the Department.

Under the present system, a percentage of income tax receipts (predominantly business and individual income taxes) are deposited into Fund 278 for the purpose of paying refunds to those taxpayers who overpaid their tax liability each year. The percentage of income tax dollars to be deposited into this fund each year is established by statute. By statute, the Department Director is to determine the annual deposit percentage using a predetermined statutory formula, and is to certify this percentage to the State Comptroller. The formula based percentage (referred to as the "Rate as Certified" in the table below) is used only when a different rate is not defined in the statute (referred to as the "Rate per Statute" in the table below).

A comparison of the "Rate per Statute" and the "Rate as Certified" since FY02 is noted in the following table:

Fund balance deficit in Fund 278 has been steadily increasing since 2005

	Individual		Corporate		Fund 278
State Fiscal Year	Rate per Statute	Rate as Certified	Rate per Statute	Rate as Certified	Fund Balance Deficit (in thousands)
2002	7.60%	7.60%	23.00%	23.00%	$ (1,091,619)
2003	8.00%	8.00%	27.00%	27.00%	(1,308,642)
2004	11.70%	11.70%	32.00%	32.00%	(745,086)
2005	10.00%	11.20%	24.00%	36.80%	(530,317)
2006	9.75%	*	20.00%	*	(622,628)
2007	9.75%	*	17.50%	*	(731,784)
2008	7.75%	*	15.50%	*	(854,829)
2009	9.75%	9.62%	17.50%	8.75%	(949,386)
2010	9.75%	11.99%	17.50%	17.14%	(1,380,161)
2011	8.75%	14.60%	17.50%	26.00%	(1,503,610)
2012	8.75%	10.63%	17.50%	24.59%	Not Available

*Note: In the table above, the "Rate per Statute" was executed into law prior to June 30th for FY06, FY07, and FY08. As such, the Department did not prepare the "Rate as Certified."

Department management noted the fund deficit in the General Fund will be eliminated through the collection and allocation of future State revenues to the Department

As a result of the significant deficit within Fund 278, which has grown rapidly since FY09, the auditors inquired with Department management regarding their plans for reducing or eliminating the deficit. For FY10, and FY11, the Department's plans to reduce the deficit were stated in the financial statements as follows: "The fund deficit in the General Fund will be eliminated through the collection and allocation of future State revenues to the Department."

Department was unable to increase the allocation of receipts to be deposited into the Income Tax Refund Fund during FY11

Despite the Department's plan to reduce the deficit through future revenues, the percentage of receipts to be deposited into Fund 278 from individual income tax receipts decreased by 10.26% from 9.75% in FY10 to 8.75% in FY11 and corporate income tax receipts remained stable at 17.5%. Further, the percentage rates for cash receipts to be deposited into Fund 278 during FY12 will remain at the FY11 rates.

As of June 30, 2011, the Department had $1.67 billion in income tax refunds payable reported on their financial statements

As of June 30, 2011, the Department's financial statements reported the Department owes the taxpayers of the State of Illinois approximately $1.67 billion in income tax refunds payable. For any refunds paid late, the Department is incurring additional interest costs. Without a significant increase in deposits into Fund 278, the liability to taxpayers – and the fund deficit – will continue to increase. (Finding Code No. 11-2, pages 63-65)

We recommended the Department work with the Governor and the General Assembly to increase the percentage of income tax receipts deposited into Fund 278.

Department officials agree with auditors

Department officials agreed with the recommendation. However, Department officials noted raising the Income Tax Refund Fund percentages requires legislative action that has not occurred. Department officials further noted that at June 30, 2011, outstanding refunds approved for payment, but in fact not paid due to the lack of funds equaled $645.5 million and the equivalent figure at June 30, 2012 will be substantially less.

WEAKNESSES IN PROCESSING AND TAXPAYER INFORMATION

Weaknesses noted in safeguarding and processing taxpayer information

The Department has not completely implemented controls and safeguards over processing taxpayer information. During FY11, the Department processed approximately 8.2 million tax receipt documents throughout its facilities.

The Department receives and uses federal tax information (FTI) to verify information contained on various State tax returns; therefore, under the Internal Revenue Service's definition of comingling, the information on the Department's tax processing system (GenTax) related to Business Income Tax and Individual Income Tax is considered FTI and should be handled as such. During testing, the auditors noted the Department had made improvements related to internal controls and physical safeguards to protect taxpayer receipts and taxpayer information. However, the auditors still noted areas where there were weaknesses. Weaknesses were specifically noted in the following areas:

Department has not implemented sufficient physical safeguards during non-business hours

Taxpayer files are stored on open shelving units throughout the Department

- Temporary employees hired throughout the year and full time employees are allowed to possess cell phones and other personal devices while processing taxpayer information.
- The Department has not implemented sufficient physical safeguards during non-business hours to control access to the tax processing areas throughout the Department from contractors, vendors and other State employees utilized by the Department.
- Auditors noted taxpayer files were stored on open shelving units throughout the Department. This information is not secure from potential unauthorized access.

The Department is responsible for ensuring the confidentiality of tax information within its possession. State statute and IRS Publication 1075 require the Department ensure it safeguard federal tax information from unauthorized disclosure. (Finding Code No. 11-6, pages 71-72)

We recommended the Department ensure taxpayer information is adequately protected during both business and non-business hours from potential unauthorized access as mandated by State statute and IRS Publication 1075.

Department officials agree with auditors

Department officials agreed with the recommendation noting they consider the safeguarding of confidential taxpayer information to be a core function of the Department, and have taken strides to assure this information remains secure. Department officials also indicated implementing recommendations will continue to be done as funding is available and it should be noted, that no State meets all the requirements of Publication 1075.

NONCOMPLIANCE WITH PROVISIONS OF THE ILLINOIS INCOME TAX ACT AND STATE REVENUE SHARING ACT

During FY11, the General Assembly passed and the Governor signed Public Act 096-1496, which increased the State income tax rates on individuals, trusts, estates, and corporations and contained amendatory provisions to update existing State law. During testing, the auditors noted the following:

The Illinois Income Tax Act was not amended to authorize a portion of deposits into Income Tax Refund Fund

- The Illinois Income Tax Act was not amended by Public Act 096-1496 to authorize deposits of a portion of income tax receipts by the Department into the Income Tax Refund Fund.

Conflict in rates of transfer percentages of receipts between the Illinois Income Tax Act and the State Revenue Sharing Act

- Prior to Public Act 096-1496, the Illinois Income Tax Act and the State Revenue Sharing Act were harmonious statutes directing the Department to transfer 10% of the prior month's income tax receipts deposited into both the General Revenue Fund and Education Assistance Fund from the General Revenue Fund to the Local Government Distributive Fund. Public Act 096-1496 amended the Illinois Income Tax Act to change the transfer percentage to 6.86% for receipts from corporate tax collections and 6% for receipts from individual, estate, and trust collections; however, the State Revenue Sharing Act was not amended. From a review of the statutes, it does not appear a supremacy clause or other language directs which statute controls in this situation or a method exists to reconcile or harmonize the conflicting language.

Department management indicated Public Act 096-1496 created a conflict between statutes and it was their opinion the most recent act of the General Assembly overrules older Acts with which it conflicts; therefore, they made deposits following the new law.

Further, the auditors noted the Department's receipt deposit codes and receipt processing system do not provide sufficient information for the Department to allocate receipts among the various State funds or calculate statutory transfers pursuant to State law. During testing, the auditors identified the following:

Transfers from the General Revenue Fund to the Local Government Distributive Fund may be overstated by as much as $195,713

- It was determined the deposits for estates, trusts, and certain individual income taxes are coded as corporate income tax receipts and transferred at 6.86%; however, the Illinois Income Tax Act transfer calculation includes estates, trusts, and individual income taxes under the 6% transfer calculation for individual income tax receipts.

After this was brought to the Department's attention by the auditors, the Department determined the transfers from the General Revenue Fund to the Local Government Distributive Fund may be overstated by as much as $195,713.

Deposits into the Income Tax Refund Fund, General Revenue Fund and Education Assistance Fund were either overstated or understated

- The Illinois Income Tax Act specifies deposits into the Income Tax Refund Fund between corporate receipts and individual income tax receipts, including receipts from estates and trusts. After notification from the auditors, the Department determined the deposits into the Income Tax Refund Fund during FY11 may be overstated by as much as $12.6 million, the General Revenue Fund may be understated by as much as $11.7 million, and the Education Assistance Fund may be understated by as much as $917,000.

Failure to identify and seek appropriate remedies for inconsistent or outdated State laws results in the Department performing functions not specifically directed by the General Assembly and could subject the State to legal risks. Further, failure to have a receipt processing system and sufficient receipt deposit codes resulted in inaccurate fund deposits, incorrect statutory transfers, and reduces the reliability of Statewide financial reporting. (Finding Code No. 11-9, pages 77-79)

We recommended the Department:

- improve their process of reviewing State tax laws, rules, and regulations to identify statutory inconsistencies and seek appropriate legislative remedy;
- implement systems and controls to capture sufficient information to properly allocate tax receipts among State funds and calculate statutory transfers; and,
- work with the State Comptroller to review and update the Department's receipt codes to ensure the receipt code information reported by the State Comptroller is accurate and fairly presented regarding the type of receipt collected by the Department.

Department officials indicated they are seeking legislative changes to address the conflicts in legislation as well as developing strategies to distinguish between different tax collections in order to more accurately calculate transfers and deposit tax receipts

Department officials indicated they are seeking legislative changes to the Illinois Income Tax Act to authorize deposits of a portion of income tax receipts into the Income Tax Refund Fund and to the State Revenue Sharing Act to reflect the new percentages established by Public Act 096-1496. In addition, Department officials also noted they are developing strategies to distinguish corporate from non-corporate tax collections associated with trust and estate returns in order to more accurately calculate transfers and deposits of these particular tax receipts.

Further, Department officials agreed that, due to the inability to identify the exact breakdown between corporate and non-corporate tax receipts during the second half of FY11, there may have been overstatement/understatement to various state funds no greater than the amounts described in the finding.

WEAKNESSES IN CONTROLS OVER THE DEPOSIT OF SALES AND USE TAX RECEIPTS

The Department has weaknesses in their internal control structure over the deposit, allocation, and distribution of receipts from sales and use taxes (ROT). The auditors identified errors within the Department's "true-up" calculations, noncompliance with State laws in managing certain local government funds, and noncompliance with State laws regarding the allocation of State ROT receipts.

Department's ROT receipt allocation process is a manual paper process involving data amassed from several sources with complex calculations on multiple spreadsheets

One of the weaknesses the auditors noted relates to the Department's receipt allocation process being a manual paper process involving data amassed from several sources with complex calculations on multiple spreadsheets. Monthly the Department performs a "true-up" process that compares cash information associated with perfected returns to deposited ROT receipts to determine any shortages or overages in the local government funds. During testing of the ROT "true-up" calculation process, the auditors noted situations where the Department did not properly account for fund transfers, interest deposits from the State Treasurer, lapse period payments, missing expenditure data, and uncorrected prior year errors noted in previous examinations. The net effect of all the "true-up" errors identified by the auditors resulted in approximately $1.6 million of receipts that should not have been deposited into the local government funds. The errors noted by the auditors affected 14 different funds.

Errors were noted in the Department's ROT "true-up" process where approximately $1.6 million of receipts should not have been deposited into the local government funds

Examples of instances in which the auditors noted noncompliance with State laws in the Department's administration of local government ROT funds, are as follows:

Auditors determined ROT distributions from a couple funds were not made in accordance with statue

- Auditors determined distributions from the County Option Motor Fuel Tax Fund, were not made in accordance with The Counties Code.
- During testing of distributions from the Home Rule Municipal Retailers' Occupation Tax Fund, the auditors noted distributions to municipal governments were not made in accordance with The Illinois Municipal Code.

During testing of ROT receipt deposits, the auditors noted errors in the allocation of State ROT receipts into various State funds, some of the errors noted are as follows:

Auditors noted errors in the allocation of State ROT receipts into various State funds

- The Department treated receipts paid into the McCormick Place Expansion Project Fund as a reduction in receipts from the General Revenue Fund, rather than splitting the reduction between the General Revenue Fund and Special Account for the Common School Fund. As a result, the Department should have deposited an additional $7.3 million into the General Revenue Fund, with a corresponding reduction in receipts for the Special Account for the Common School Fund.
- The Department does not have a system in place to split remaining receipts from the Use Tax Act and Retailers' Occupation Tax Act and receipts from the Service Use Tax Act and Service Occupation Tax Act. As a result, the Department is unable to properly allocate receipts between the General Revenue Fund and Special Account for the Common School Fund.

Failure to exercise adequate control over the deposit and allocation of receipts from sales and use taxes is noncompliance with State law, resulted in deposit errors in the State Treasury, and reduces the reliability of Statewide financial information. (Finding Code No. 11-10, pages 80-83)

We recommended the Department implement controls to ensure the deposit, allocation, and distribution of receipts from sales and use taxes are performed accurately in accordance with State law. In addition, we also recommended the Department implement a process to review the individual fund cash balances to determine the fund cash balances are reasonable.

Department officials responded they have developed a heavily manual deposit estimation and true up process that accounts for the necessary fund allocations and deposits after the returns are processed and perfected, until the State can invest in a general ledger and receipt processing system

Department officials responded they have developed a heavily manual deposit estimation and true up process that accounts for the necessary fund allocations and deposits after the returns are processed and perfected, until the State can invest in a general ledger and receipt processing system. Department officials went to note their longstanding methodology has resulted in accurate payments to locals and no material adjustments to funds.

The Department officials noted they will research the feasibility and cost/benefit of further enhancements to GenTax, a rewrite of the current Consolidated Accounting System, and development of a general ledger system for reconciling detail return information with deposit information.

OTHER FINDINGS

The remaining findings are reportedly being given attention by the Department. We will review the Department's progress towards the implementation of our recommendations in our next engagement.

AUDITORS' OPINION

The auditors stated the Department of Revenue financial statements as of June 30, 2011 and for the year then ended were presented fairly in all material respects.

WILLIAM G. HOLLAND
Auditor General

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SPECIAL ASSISTANT AUDITORS

McGladrey LLP were our Special Assistant Auditors for this engagement.