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

SUMMARY REPORT DIGEST

ILLINOIS STUDENT ASSISTANCE COMMISSION - ILLINOIS PREPAID TUITION PROGRAM

FINANCIAL AUDIT
For the Year Ended: June 30, 2011

Release Date: April 24, 2012

INTRODUCTION

This report covers our financial audit of the Illinois Student Assistance Commission (Commission) – Illinois Prepaid Tuition Program (Program) as of June 30, 2011 and for the year then ended.

As of June 30, 2011, the Illinois Prepaid Tuition Program has a financial statement deficit of $262,131,379. The Actuary's Report on the soundness of the Program as of June 30, 2011 indicates that the Program's cash flow is expected to remain positive through the fiscal year that ends in 2021 even without reflecting expected proceeds from contracts sold after June 30, 2011.

The Actuary's Report estimated the deficit for the Prepaid Tuition Program, as of June 30, 2011. Based upon the actuarial value of assets the deficit was estimated to be $478,688,661 at June 30, 2011 as compared to $340,875,271 deficit in prior year. The deficit using market value of assets basis method was estimated to be $536,337,122 at June 30, 2011 as compared to $531,271,895 deficit in prior year. Current financial reporting standards do not require the actuarial deficit amount be reported on the face of the financial statements; however, the information is disclosed in Note 10 of the financial statements.

SYNOPSIS

- The Program did not comply with the competitive procurement requirements of the Illinois Procurement Code.
- The Program did not fully comply with the guidelines established in its investment policy.
- The Program does not have sufficient control over its financial statement preparation.
- The Program has not established policies and procedures to monitor and value its alternative investments for financial reporting purposes. Additionally, review of fees paid to investment managers was not adequately documented.

{Expenditures and Activity Measures are summarized on the reverse page.}

ILLINOIS STUDENT ASSISTANCE COMMISSION
ILLINOIS PREPAID TUITION PROGRAM - FINANCIAL AUDIT
For The Year Ended June 30, 2011 (in thousands)

STATEMENT OF NET ASSETS	2011	2010
Assets		
Cash and cash equivalents	$ 7,833	$ 14,809
Accrued interest on investments	-	1
Investments	1,124,443	971,481
Total	$1,132,276	$986,291
Liabilities		
Accounts payable and accrued expenses	$ 1,872	$ 947
Tuition payable	906,651	914,437
Accreted tuition payable	485,678	408,593
Compensated absences	91	104
Other	115	98
Total	$ 1,394,407	$ 1,324,179
Net Assets, Unrestricted (Deficit)	$ (262,131)	$ (337,888)

REVENUES, EXPENSE AND CHANGES IN NET ASSETS	2011	2010
Operating revenues		
Income (loss) from investment securities	$ 168,273	$ 88,599
Fees	1,356	1,470
Interest revenue	621	179
Total	$ 170,250	$ 90,248
Operating expenses		
Accreted tuition expense	$ 83,916	$ 76,597
Salaries and employee benefits	3,276	3,347
Management and professional fees	3,607	2,965
Investment advisory fees	1,922	1,926
Investment management fees	1,684	1,610
Total	$ 94,405	$ 86,445
Operating income		
Transfers out	$ (88)	$ (31)
Change in net assets	$ 75,757	$ 3,772

Actuarial Reports on Soundness - Unaudited	2011	2010
- Actuarial Value of Assets	$ (478,689)	$ (340,875)
- Market Value of Assets	$ (536,337)	$ (531,272)

AGENCY EXECUTIVE DIRECTOR

During Examination Period: Mr. Andrew Davis
Currently: Mr. Eric Zarnikow

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

NEED TO COMPLY WITH PROCUREMENT LAW

Noncompliance with Procurement Code

The Illinois Prepaid Tuition Program of the Illinois Student Assistance Commission (Commission) did not comply with the competitive procurement requirements of the Illinois Procurement Code.

During our audit, we noted the following pertaining to the procurement process:

Contract awarded for services not included in the RFP

1. The Commission awarded a contract for investment due diligence services (due diligence services) for College Illinois. The RFP issued to procure the due diligence services was not specific to due diligence services, but rather was for real estate investment manager services.

Pricing for services was not included in the vendor's proposal

2. Pricing for the due diligence services noted above was not included in the vendor's proposal and was negotiated at a later date, outside the competitive procurement process. The fee arrangement with the consultant awarded the due diligence services noted above did not ensure objectivity in the performance of the work which was the subject of the contract.

Investment managers awarded contracts without following the competitive procurement process

3. The required competitive procurement process for awarding investment manager contracts was not followed. During fiscal year 2011, two new investment managers were awarded investment manager contracts based on due diligence services performed by an investment consultant of the Commission (see 1 above), and not through a competitive bidding process in violation of the procurement law.

Vendor awarded a contingent fee of $787,500

The terms of the agreement with the vendor performing the due diligence stated the vendor will receive as payment for services, an acquisition fee amounting to 0.75% of the aggregate capital investment for each of the new investments to be made. By paying the vendor on this basis, the Commission may have created an incentive for the vendor to recommend the investment. The vendor was awarded a contract for an amount not to exceed $390,000 for advisory services, $85,000 for due diligence services for each prospective investment, plus up to $2,500 in expenses in addition to the contingent fee. The contingent fee totals $787,500 based on 0.75% of the $105 million aggregate capital commitment made to the two investment managers. Fees paid to the vendor as of the date of this report were $271,875.

Insufficient oversight of procurement process

The Commission did not provide sufficient oversight over the procurement process which resulted in the above noted departures from the procurement law.

Contract was not awarded in a fair and competitive manner

Based on the RFP issued, there was no clear basis for awarding a contract for investment due diligence services in a fair and competitive manner that allowed all interested parties the opportunity to participate in the procurement opportunity. Additionally, by paying the vendor of due diligence services in the manner in which they did, the Commission may have created an incentive for the vendor to recommend the investments it was investigating. (Finding 1, pages 34-36)

We recommended the following:

1. The Commission should comply with the requirements set forth in the Illinois Procurement Code and Administrative Rules in procuring professional and artistic services.

2. The Commission should establish policies whereby RFPs are thoroughly reviewed before issuance to ensure that all aspects of the needed services are thoroughly described.

3. The Commission should revisit its fee based compensation methods when contracting for opinions on investment purchase decisions that may influence the objectivity or the perception of the objectivity of the opinion rendered.

Commission agrees with auditors

Commission officials accepted our recommendation and indicated it would have more precise descriptions of services to be solicited with clearer pricing requirements. Further, the Commission indicated it would not use contingency-fee based compensation methods based on transaction completion and that a new procurement process has been instituted that includes review, approval, and monitoring by both the Agency Procurement Officer and the externally appointed State Procurement Officer.

NEED TO COMPLY WITH INVESTMENT POLICY

Failure to comply with investment policy

The Illinois Prepaid Tuition Program of the Illinois Student Assistance Commission (Commission) did not fully comply with the guidelines established in its investment policy.

During our audit we tested the Commission's adherence to its investment policy. Through our review of documentation provided and discussions with Commission management, we identified the following instances of noncompliance with the investment policy.

Investment policy not reviewed annually

- The investment policy requires that the investment policy be reviewed on an annual basis. Commission personnel began the process of reviewing and proposing revisions to the Policy during fiscal year 2011, however this process was never finalized. There is no evidence of review by the Investment Advisory Panel or the Commission Board, as required by the investment policy. The Commission last approved an investment policy on January 22, 2010.

Investment Committee never established

- In accordance with the investment policy, the Commission was required to establish an Investment Committee. The Investment Committee is required to consist of two members of the Commission's board appointed by the Chair. This Committee was never established.

Investment Advisory Panel held only one meeting

Vacancies on Investment Advisory Panel

- In accordance with the investment policy, the Investment Advisory Panel is required to hold two meetings per year. The auditors were provided with evidence to support only one meeting held during fiscal year 2011. In addition, we noted that there were three vacancies on the Investment Advisory Panel as of June 30, 2011 with vacancies ranging from September 2003 to March 2011.

Portfolio Committee did not meet monthly

- In accordance with the investment policy, the Portfolio Committee is required to meet monthly. Evidence to support the occurrence of meetings was only available for September 2010 and October 2010.

Investments total $1.1 billion

Investments represent the most significant asset for the Commission (approximately $1.1 billion at June 30, 2011). Lack of compliance with the established investment policy results in inadequate monitoring of the Commission's assets. (Finding 2, pages 37-38)

We recommended the Commission comply with its investment policy and:

- Conduct a formal review and approve the investment policy annually.
- Establish the Investment Committee consisting of two members of the Commission to provide guidance to the Chief Investment Officer on issues related to investments.
- Take the actions necessary to fill the vacancies on the Investment Advisory Panel and ensure the Investment Advisory Panel meets twice yearly.
- Establish the Portfolio Committee and ensure that it meets monthly to review and rebalance the investment portfolio according to the investment policy guidelines.
- Maintain minutes of all meetings for any committees or panels that have been established as required by the

investment policy. Meeting minutes should document all pertinent discussions held by the respective committee or panel. Clear and concise documentation for all significant decisions and recommendations should exist to support decisions made by these groups.

Commission officials accepted our recommendation and indicated there have been significant changes made to the management and administration of the program including:

Commission agrees with auditor

- Appointment of new members to the Commission and a new Chairperson.
- Appointment of new members to the Investment Advisory Panel.
- Appointment of a new Interim Executive Director in July 2011.
- Appointment of a new Executive Director in February 2012.
- Appointment of a new General Counsel with a reporting line to the Commission.
- The Commission hired a new Chief Investment Officer with a reporting line to the Commission.
- Establishment of an Investment Committee.

Commission officials indicated they are in the process of reviewing and approving new changes to the Agency's investment policy.

FINANCIAL STATEMENT PREPARATION

The Illinois Prepaid Tuition Program of the Illinois Student Assistance Commission (Commission) does not have sufficient control over its financial statement preparation.

Debt securities total $199 million

Inaccurate credit ratings reported

Debt security investments subject to credit risk totaled $199 million at fiscal year end June 30, 2011. In performing our testing, we identified various inaccuracies in the debt service investment credit ratings reported for corporate bonds, municipal bonds, corporate asset backed securities, and U.S. agency obligations. Additionally, approximately $30.5 million of government agency mortgage backed securities, were not reported as "Not Rated" as required. These securities were omitted from the credit risk disclosure altogether. Upon investigating the errors and omissions it was determined that the ratings reported in the custodian's report were not ratings as of June 30, 2011. The Commission did not discover this issue prior to preparing the draft financials for submission to the auditors.

According to Commission management, the Commission hired a new Custodian beginning fiscal year 2011 who did not have standardized reports for one of the rating agencies and as a result provided inaccurate rating information. (Finding 3, pages 39-40)

We recommended the Commission improve controls over financial reporting to ensure accurate presentation of the Illinois Prepaid Tuition Program's credit risk disclosures.

Commission agrees with auditor

Commission officials accepted our recommendation and indicated that a new Custodian will run the proper reports at June 30th of each year to ensure accurate credit ratings are obtained for disclosure in the financial statements.

ALTERNATIVE INVESTMENT OVERSIGHT AND MANAGER FEES

The Illinois Prepaid Tuition Program of the Illinois Student Assistance Commission (the Commission) has not established policies and procedures to monitor and value its alternative investments for financial reporting purposes. Additionally, review of fees paid to investment managers was not adequately documented.

Alternative investments total $482 million at June 30, 2011

Alternative investments consist of real estate, infrastructure, hedge fund and private equity investments. As of June 30, 2011, alternative investments represent $482 million or 42.6% of the Commission's portfolio. Alternative investments pose significant valuation concerns as these investments do not have readily available market data for valuation purposes.

Proper valuations protocols not in place

No documentation to support monitoring controls described by management

During our testing of investments, we determined that the Commission does not have proper valuation protocols in place for alternative investments. Management asserts that investment staff participated in investor calls, site visits, corresponding with the general partner, attended annual meetings and reviewed interim financial information pertaining to these investments. In addition, management asserted that investment staff participated as members of advisory committees for the alternative investment fund and held quarterly meetings with investment managers. We were unable to obtain evidence that supports these monitoring controls were in place during fiscal year 2011, and there was no written policy or procedure that required these or other monitoring and valuation procedures.

Analysis comparing balances to audited financial statements not performed

Management used investment statement values that were not independently verified

We noted that the Commission does not prepare an analysis comparing audited financial statements of the alternative investment entity (Fund) to the investment balance as reported by the Commission, as of the Funds' year end. Additionally, the Commission does not perform a roll forward analysis of significant activity from the Fund year-end to the Commission's year-end. Management values alternative investments using the investment statements received from the investment manager, custodian statements and investment consultant reports. However, the custodian and investment consultant only report the balances provided to them by the investment manager and do not perform independent valuation services.

During our testing of fees paid to investment managers, we noted there was no evidence of review of the fees being charged to the investment agreements to ascertain whether the fees charged are appropriate and in accordance with the agreed-upon terms of the arrangement. (Finding 4, pages 41-43)

No evidence fees paid to alternative investment managers were reviewed

We recommended that management of the Commission maintain documentation for each alternative investment to support the existence of monitoring controls over the investment. Further, the Commission should have internal investment personnel charged with determining the value of alternative investments. We also recommended the Commission monitor and maintain evidence of review of all fees charged by the investment manager for reasonableness.

Commission agrees with auditors

Commission officials accepted our recommendations and indicated they have a new Chief Investment Officer who will ensure that appropriate investment valuations are obtained and that adequate backup documentation is maintained.

FUND DEFICITS

Program has a Financial Statement deficit of $262 million

As of June 30, 2011, the Illinois Prepaid Tuition Program financial statement deficit is reported as $262,131,379.

Actuary Report on Soundness of Program

The Actuary's Report on Soundness of the Program as of June 30, 2011 indicates that the Program's cash flow is expected to remain positive through the fiscal year that ends in 2021 even without reflecting expected proceeds from contracts sold after June 30, 2011.

The Actuary's Report estimated the deficit for the prepaid tuition as of June 30, 2011. Based upon the actuarial value of assets the deficit was estimated to be $478,688,661at June 30, 2011 as compared to $340,875,271deficit in the prior year. The actuarial deficit using the market value of assets basis was estimated to be $536,337,122 at June 30, 2011 as compared to $531,271,895 in the prior year. (pages 29-30)

AUDITORS' OPINION

Our auditors stated the financial statements of the Illinois Prepaid Tuition Program are fairly presented in all material respects.

WILLIAM G. HOLLAND
Auditor General

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SPECIAL ASSISTANT AUDITORS

Our special assistant auditors for this audit were McGladrey & Pullen LLP.