



STATE OF ILLINOIS
**OFFICE OF THE
AUDITOR GENERAL**

William G. Holland, Auditor General

SUMMARY REPORT DIGEST

DEPARTMENT OF REVENUE

**FINANCIAL AUDIT AND
COMPLIANCE EXAMINATION
For the Year Ended: June 30, 2010
Release Date: June 28, 2011**

Summary of Findings:

Total this audit:	37
Total last audit:	21
Repeated from last audit:	10

INTRODUCTION

This report digest covers both the Financial Audit and State Compliance Examination of the Department of Revenue (Department) for the year ended June 30, 2010. The Financial Audit and State Compliance Examination present a total of 37 findings, with some of the more significant issues summarized in this report digest.

SYNOPSIS

- The Department had a \$2.13 billion deficit in the General Fund's fund balance as of June 30, 2010 because the State did not allocate sufficient income tax revenues to the Income Tax Refund Fund. At year end, the Department owed taxpayers approximately \$1.5 billion in income tax overpayments that should be refunded.
- The Department included invalid taxes receivable accounts in the accounts receivable calculation.
- The Department had not implemented adequate controls and safeguards over tax receipt processing and taxpayer information. For instance, both temporary and full-time employees were allowed to have mobile devices (cell phones with cameras) and other personal belongings while processing taxpayer receipts and information, general public access to tax processing areas was not adequately controlled, taxpayer files were stored on desks and open shelving units, and taxpayer payments were stored in an open bin in a readily accessible hallway.
- The Department did not have adequate security controls over the GenTax (enterprise wide tax system) system and data. Background checks on employees of the Department of Central Management Services having access rights to GenTax were not performed.
- The Department did not adequately ensure the security and control of confidential and personal information, including taxpayer information. Taxpayer information, including name, social security number and specific tax data, was contained in the GenTax training manual on the Department's Intranet and vendor laptops containing confidential taxpayer information were not encrypted.
- The Department's failure to pay Personal Property Replacement Tax refunds created a statutory excess. Specifically, the Department did not pay all Personal Property Replacement Tax Refunds prior to determining year-end "excess" deposits within the Income Tax Refund Fund.
- The Department procured a private manager to manage the day-to-day operations of the Illinois Lottery. Our review of this procurement involving a \$2 billion State asset found several problems, including:
 - The Department allowed the Transaction Advisor hired to assist in the procurement of a Private Manager for the Lottery to work without an executed contract, to not meet contractual milestone dates and to subcontract with an entity which may have had a perceived objectivity issue. The Department also paid for services in violation of the contractual arrangement with the advisor.
 - The Department failed to adequately monitor and review the payments made to the Transaction Advisor for services provided by the Advisor and its subcontractors. Invoices lacked detailed support for the \$4.94 million in payments.
 - Evaluation team members for the procurement of a Private Manager for the Illinois Lottery failed to attend all evaluation meetings and meetings and/or presentations by the vendors proposing on the procurement and there was no documentation to explain how information disseminated at the meetings was provided to absent evaluation team members.
 - Evaluation Team members for the procurement of a Private Manager for the Illinois Lottery failed to certify scores in all cases and some scores were submitted after decisions had been made and publicly reported.
 - The Department had failed, as of April 1, 2011, to file, with the Comptroller, a completed copy of the Private Management Agreement between the Department and Northstar.

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

**DEPARTMENT OF REVENUE
FINANCIAL AUDIT AND COMPLIANCE EXAMINATION
For the Year Ended June 30, 2010**

EXPENDITURE STATISTICS	2010	2009
Total Expenditures.....	\$ 9,268,554,415	\$ 10,000,148,259
OPERATIONS TOTAL.....	\$ 247,434,130	\$ 284,313,784
% of Total Expenditures.....	3%	3%
Personal Services.....	\$ 119,256,053	\$ 114,222,023
Other Payroll Costs (FICA, Retirement, Group Insurance).....	\$ 28,137,172	\$ 41,566,124
Contractual Services.....	\$ 31,535,181	\$ 37,007,315
All Other Operating Expenditures.....	\$ 68,505,724	\$ 91,518,322
AWARDS AND GRANTS TOTAL.....	\$ 2,854,403,571	\$ 3,206,744,302
% of Total Expenditures.....	31%	32%
REFUNDS TOTAL.....	\$ 1,357,371,548	\$ 1,597,802,455
% of Total Expenditures.....	14%	16%
NON-APPROPRIATED FUNDS.....	\$ 4,809,345,166	\$ 4,911,287,718
% of Total Expenditures.....	52%	49%
Total Cash Collections.....	\$ 29,038,344,781	\$ 31,644,068,502
Income Taxes.....	\$ 12,145,654,682	\$ 13,568,046,406
% of Total Revenues.....	42%	43%
Sales Taxes.....	\$ 11,371,000,169	\$ 11,924,707,140
% of Total Revenues.....	39%	38%
Motor Fuel Taxes.....	\$ 1,259,807,572	\$ 1,301,973,767
% of Total Revenues.....	4%	4%
Public Utility Taxes.....	\$ 1,757,284,685	\$ 1,885,368,966
% of Total Revenues.....	6%	6%
Other Collections.....	\$ 2,504,597,673	\$ 2,963,972,223
% of Total Revenues.....	9%	9%
Average Number of Employees.....	1,955	2,099

SELECTED ACTIVITY MEASURES	2010	2009
PROPERTY AND EQUIPMENT at June 30,.....	\$ 16,733,437	\$ 19,498,429
SELECTED ACCOUNT BALANCES at June 30,		
Taxes Receivable.....	\$ 1,995,302,000	\$ 1,901,250,000
Allowance for Uncollectible Taxes.....	(764,414,000)	(695,956,000)
Net Taxes Receivable.....	\$ 1,230,888,000	\$ 1,205,294,000

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

**FINDINGS, CONCLUSIONS, AND
RECOMMENDATIONS**

FUND BALANCE DEFICIT EXCEEDING \$2 BILLION

\$2.13 Billion deficit in the General Fund’s fund balance

The Department had a \$2.13 billion deficit in the General Fund’s fund balance as of June 30, 2010 principally because the State did not allocate sufficient income tax revenues to the Income Tax Refund Fund (Fund 278), 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 the 278 Fund 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 FY 2002 is as follows:

State Fiscal Year	Individual Income Tax (IIT)		Business Income Tax (BIT)		278 Fund - Fund Balance (Deficit), in thousands
	Rate per Statute	Rate as Certified	Rate per Statute	Rate as Certified	
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%	not available

Fund deficit increased significantly since 2009

Department stated in 2009, “The fund deficit in the General Fund (Refund Fund) will be eliminated through the collection and allocation of future State revenues to the Department”

Department was unable to increase the amount deposited into the Refund Fund for FY10

As a result of the significant deficit in the 278 Fund, which increased significantly since 2009, the auditors inquired with management of the Department as to their plans for reducing or eliminating the deficit. In 2009, the plans to reduce the then \$949 million deficit were stated in the financial statements as follows: “The fund deficit in the General Fund (Refund Fund) will be eliminated through the collection and allocation of future State revenues to the Department.”

Despite this plan as reported in the 2009 financial statements, the Department was unable to increase the amount deposited in the 278 Fund for FY10, which remained at 9.75% of income tax collections for IIT and 17.5% for BIT. As can be seen in the table above, the amount to be deposited in the 278 Fund for FY11 has not increased, but was instead decreased to 8.75% (a 10.3% decrease in the rate) for the 2011 fiscal year. Department management had not provided the auditors a detailed

plan for eliminating the deficit as of the date of the auditor’s report. Although the Department is hopeful that the recent increase in the state income tax rate will provide the additional funds needed for the payment of income tax refunds, there has been no evidence presented to support the assertion that it will be sufficient.

As of June 30, 2010, the Department owed taxpayers approximately \$1.5 billion

As of June 30, 2010, the Department owed the taxpayers of Illinois approximately \$1.5 billion representing income tax overpayments that should be refunded. Of this amount, approximately 6% was owed to individuals (IIT) and approximately 94% was owed to businesses (BIT). Additionally, without a significant increase in deposits into the 278 Fund, the liability to taxpayers, and the fund deficit, will continue to increase. (Finding No. 10-1, pages 14-17)

We recommended the Department work with the Governor and the General Assembly to increase the percentage of deposits into the 278 fund.

Department agrees with auditors

The Department agreed with the recommendation. However, the Department stated that fully funding the Refund Fund can only be accomplished through legislative action. The Governor’s office has proposed to include eliminating the backlog of business refunds in the borrowing plan it has submitted to the General Assembly, a plan that has yet to win approval.

CERTAIN YEAR-END RECEIVABLES NOT VALID

Department included invalid taxes receivable accounts in the accounts receivable calculation at June 30, 2010

The Department of Revenue (Department) included invalid taxes receivable accounts in the Department’s accounts receivable calculation at June 30, 2010.

During our testing of Sales Tax (ROT), Withholding Income Tax (WIT), Business Income Tax (BIT), and Individual Income Tax (IIT) accounts included in the Department’s accounts receivable calculation at June 30, 2010, we noted the following:

Information received but not worked at June 30, 2010	# invalid	# tested	\$ invalid	\$ tested
Sales Taxes	1	33	\$ 38,989	\$ 27,072,092
Income Taxes	16	98	\$ 802,460	\$ 31,701,733
Payment received but not applied correctly or processed by June 30, 2010	# invalid	# tested	\$ invalid	\$ tested
Sales Taxes	1	33	\$ 1,659	\$ 27,072,092
Income Taxes	5	98	\$ 10,253	\$ 31,701,733
Data Entry Error or Error on Account	# invalid	# tested	\$ invalid	\$ tested
Income Taxes	4	98	\$ 647,207	\$ 31,701,733

Grand Total	# invalid	# tested	\$ invalid	\$ tested
Sales Taxes	2	33	\$ 40,648	\$ 27,072,092
Income Taxes	25	98	\$1,459,920	\$ 31,701,733

The errors noted in the chart were projected to the entire billed sales and income tax receivable populations, and the projected estimated overstatement for the populations as a whole are noted in the following

Results of testing were projected on entire billed sales and income tax receivable populations and differences between projections and the Department's adjustments were deemed immaterial

chart. In addition, the Department projected an error rate based on their own review and made the adjustments noted in the chart below. The difference between the auditor's projection and the Department's adjustments were deemed immaterial by the Department and were not recorded in the financial statements.

	Net A/R Expressed in millions			
	SALES	BIT	IIT	WIT
Projected error	\$ 4.8	\$ 10.9	\$ 26.3	\$ 2.2
IDOR adjustment	\$ -	\$ 8.8	\$ 9.9	\$ 1.0
Difference	\$ 4.8	\$ 2.1	\$ 16.4	\$ 1.2

The Department's system does not have required functionality to ensure taxpayer balances are valid receivables

The Department's GenTax system does not have the required functionality to ensure that individual taxpayer balances per the system are valid receivables in accordance with the accrual basis of accounting. Additionally, the Department does not maintain a general ledger. As such, balances reported in GenTax (subsidiary ledger) cannot be reconciled to a general ledger to detect these types of occurrences.

Projected error for the population of sales and income tax receivables was approximately \$44.2 million

As a result of these types of errors, sales and income tax receivables are overstated at June 30, 2010. The projected error for the population of sales and income tax receivables was approximately \$44.2 million, net of the estimated allowance. Additionally, under the present system, the risk of material errors is high for any period in which significant cash receipts are received in the last few days of the fiscal year, but processed after year-end. (Finding No. 10-5, pages 25-27) **This finding was first reported in 2008.**

We recommended the Department continue to evaluate the controls over taxes receivable and implement the necessary edits and controls to better identify valid accounts receivables to report in the financial statements. In addition, we recommend the Department take action to ensure taxpayer information is timely considered or processed to ensure taxpayer's records and financial statement information reflects accurate information. In the long-term, the Department needs to enhance the capabilities of the GenTax system to permit the posting of transactions and adjustments to a previous period for financial reporting purposes.

Department disagrees with auditors

The Department disagreed with our recommendation, stating their tax records are accurate, timely processed, and proper controls are in place over taxes receivable. The Department also stated their estimate of year-end receivables was materially correct and the \$24.5 million adjustment determined by the auditor means that the estimate of year end receivables was 97.8 % accurate.

The Department has submitted a system change request to further identify unworked accounts at year end in order to track historical collection trends and will also submit a system change request for tracking year end payments received prior to June 30th not yet posted to GenTax until early July. However, the Department stated that as GenTax is a tax processing system not an accounting system, it is not economically feasible to change the core tax processing system to backdate processing transactions for financial reporting purposes. (For previous Department response, see Digest Footnote #1)

Auditor's Comment

In an Auditor's Comment, we noted if as the Department stated, "our tax records are accurate, timely processed, and proper controls are in place over taxes receivable," we would not have reported a finding. The Department is responsible for financial reporting in accordance with Generally Accepted Accounting Principles (GAAP). Presently, the Department utilizes tax information from the GenTax system to estimate and record a portion of year-end taxes receivable. Until such a time as an alternative system is available to accumulate receivables for financial reporting, the Department must ensure the information extracted from GenTax is accurate for financial reporting purposes. Based on the sample of 131 items selected, the error occurrence was high. This year, 21% of the accounts selected contained an error in the receivable calculation. Although the total projected error remaining for these accounts stated in dollars (\$24.5 million) is not material to the financial statements, it is not insignificant. Additionally, under the present system, the potential for a material misstatement remains.

INADEQUATE CONTROLS OVER RECEIPT PROCESSING AND TAXPAYER INFORMATION

Department needs to improve controls over tax receipt processing and taxpayer information

The Department had not implemented adequate controls and safeguards over tax receipt processing and taxpayer information. During FY10, the Department received and processed 3.4 million tax receipt documents, totaling over \$4.4 billion, at their Springfield and Chicago locations.

We noted several internal controls and physical safeguards were not in place to protect taxpayer receipts and taxpayer information. We specifically noted deficiencies in the following areas:

Receipt Processing

- All receipt documents were not received and processed with adequate monitoring and security controls, including the Document Control and Deposit section (DC&D). Additionally, the Department hires various temporary employees throughout the year and both temporary and full-time employees are allowed to have mobile devices (cell phones with cameras) and other personal belongings while processing taxpayer receipts and information.
- Appropriate segregation of duties over taxpayer receipts received outside of DC&D did not exist. Individuals in the processing areas could receive payments and adjust accounts in GenTax. Additionally, all accounts did not require supervisory review and verification of adjustments.

Receipts were received and processed in various areas within the Department without adequate monitoring and security controls

Segregation of duties over taxpayer receipts and account adjustments did not exist in all tax processing areas

Monitoring

- Management does not have a true tracking of receipts received in processing areas, specifically lacking the ability to identify the locations, dollar amount, or number of receipts processed at various locations throughout the Department. Without this information, the Department lacks the ability to monitor the receipt processing in the various areas for unusual trends, errors, or discrepancies.

Management does not have a true tracking of receipts received in processing areas

No physical safeguards to control access to tax processing and receipt areas from unauthorized persons

Taxpayer files were stored on desks and open shelving units and are not locked and secured from unauthorized access

Checks and return information in unprotected areas, which are accessible to all Department employees

Lack of a fully functional security system to protect taxpayer information and receipts

Unlike State tax information, the Department does enforce strict security controls over federal tax information

Physical Safeguards

- Physical safeguards to control general public access to tax processing areas, including those accessing daycare and restaurant services, were not implemented. We noted the Department is unable to prevent undetected entry by unauthorized persons during duty and non-duty hours in the Tax Processing and Document Control and Deposit areas.
- Physical safeguards over tax returns and taxpayer information were lacking. We noted taxpayer files are stored on desks and open shelving units and are not locked or secured from other Department employees or other individuals who enter the building past the security checkpoints. Department personnel and the other individuals who enter the building past the security checkpoints should not have access to these areas if they are not authorized to access tax information.
- The Department's Document Control and Deposit area leaves checks and tax return information received out on tables or laying on vertical shelving units in unprotected areas. This information and documents are accessible (specifically, lacking access controlled barriers) to all Department employees, including Lottery employees and Liquor Control Commission employees, as well as Secretary of State and Department of Central Management Services employees.
- Taxpayer payments were stored in an open bin in a readily accessible hallway within a tax processing area.
- The Department lacked a fully functional security system to protect tax receipts and taxpayer information.

In contrast to the weak controls over State tax information, federal tax information was subject to strict physical security controls. These controls included:

- Physically maintaining tax returns in a secure area with limited access. Tax returns are maintained within secure cabinets and bins; the information was not left in the open.
- Employees are not allowed to have cameras or personal belongings within the secure area.

We recommended the Department implement controls to ensure:

- Receipt processing is received and processed in a centralized location with adequate monitoring and security controls. Management should also monitor the receipt process for errors or irregularities and any necessary improvements.
- Segregation of duties exists over the receipt and recording of taxpayer payments and information.
- Tax processing and payment areas are adequately secured and limited to authorized individuals by eliminating unnecessary traffic through critical areas and thereby reducing the opportunity for unauthorized disclosure or theft.
- Taxpayer information is adequately stored and protected during both duty and non-duty hours from unauthorized access.
- Individuals authorized to access taxpayer information are restricted from bringing personal items and mobile devices into the tax processing areas. (Finding No. 10-9, pages 39-42)

Department disagreed with finding, but agreed safeguarding of receipts and taxpayer information can always be improved

Department Officials disagreed that it did not have adequate controls and protection in place, but it agreed that safeguarding of receipts and taxpayer information is critical and can always be improved. The Department disagreed that all receipts can be processed in a centralized area without drastically slowing the process of resolving taxpayer issues, and noted that the auditor's issue involved roughly .1% of payments received through correspondence with taxpayers.

Department officials agreed to see whether further segregation of duties is needed for employees who adjust accounts and occasionally receive a check. The Department plans to work to further enhance the security of the tax environment and agreed to review and discuss with the bargaining unit restricting from the workplace personal items that could erode security.

Auditors' Comment

In an auditors' comment, we noted our concerns addressed all **\$4.4 billion** received at the Chicago and Springfield locations, and not just payments received from correspondence. The Department needs to review their transaction process flows, including the Document Control and Deposit Area, for necessary improvements in security and controls. The Department needs a centralized location for the receipt, processing, and protection of all receipts received to ensure they are deposited into the State Treasury. During the exit conference, we discussed past incidents where employees left the Department and taxpayer checks were found in their desk drawers at later dates.

Although the Department agreed to see whether further segregation of duties is needed for employees who can adjust accounts and receive checks, the auditors' noted that good internal controls would not allow one individual to have the authority to both receive taxpayer payments and adjust the taxpayer's account. Departmental documents reported that three processing areas received 5,086 payments, totaling \$9.4 million. The auditors deem these transactions as more than "occasionally receiv[ing] a check."

INADEQUATE SECURITY OVER GENTAX

Department lacked adequate security over GenTax

The Department of Revenue (Department) did not have adequate security controls over the GenTax (enterprise wide tax system) system and data. During our review, we noted:

- The Department did not have a documented process for the administration of access rights to GenTax.
- The Department did not have a process in place for the periodic review of access rights to GenTax.
- 16 of 31 (52%) Department of Central Management employees with administrative access right did not have required background checks. (Finding No. 10-23, pages 95-96)

CMS employees did not have required background checks

We recommended the Department establish a documented process over the administration of GenTax users. Additionally, the Department should periodically review all user access to GenTax, ensure all accounts are assigned to individuals for accountability, and work with the

Department of Central Management Services to ensure all background checks are appropriately completed.

Department agreed with auditors

The Department indicated in its response that it has created a process for the administration of access rights to GenTax. However, this policy standard has not been reduced to a formal written document at this time. With regard to 16 of 31 CMS employees with administrative access rights that did not have required background checks as found by the OAG, the Department noted that all 16 CMS employees had been given administrative access **by CMS without clearing through Revenue or Revenue being aware of the access granted.** Since then, the CMS employees have submitted appropriate paper work for approving their access.

INADEQUATE CONTROLS OVER CONFIDENTIAL INFORMATION

Confidential and personal information not adequately secured

The Department did not adequately ensure the security and control of confidential and personal information, including taxpayer information. During testing, we noted the following:

- The Department had not performed a risk assessment of its computing resources to identify confidential or personal information to ensure such information is protected from unauthorized disclosure.
- During our review of the Department's Intranet, we noted taxpayer information was contained in the enterprise wide tax system (GenTax) training manual and change requests. The information included the taxpayers name, social security number and specific tax data.
- We noted vendor laptops that contained confidential taxpayer information were not adequately secured (encrypted).
- The Department was unable to provide sufficient documentation to verify the security (encryption) over Department laptops that contained confidential information. (Finding No. 10-25, pages 99-101)

Vendor laptops containing confidential taxpayer information not encrypted

The auditors recommended the Department complete a risk assessment of its computing environment in order to ensure adequate security controls are applied, ensure all taxpayer information is properly secured (encrypted) as required by Federal and State law and ensure they comply with the notification requirements outlined in the Personal Information Protection Act. Further, Department management should consistently communicate the importance of protecting and maintaining accountability for taxpayer information to both Department employees and vendors.

Department agrees with auditors

The Department responded that it acknowledges and understands the need to control access to federal tax information, as well as state tax information and personal information. The Department enumerated specific actions being taken in this area, including creation of a verification process to match each laptop (by property tag) to a corresponding encryption key (encryption key server).

FAILURE TO PAY PERSONAL PROPERTY REPLACEMENT TAX REFUNDS CREATED A STATUTORY EXCESS

Department is holding approved refunds due to cash shortages in the Income Tax Refund Fund

The Department transferred \$184 million from the Income Tax Refund Fund (Fund 278) to the Personal Property Tax Replacement (PPRT) Fund (Fund 802). The Department calculated the transfer on June 30, 2010 pursuant to the Illinois Income Tax Act. At the same time, the Department had estimated there were approximately \$271 million in PPRT refunds that were not paid and were held for payment due to cash shortages in Fund 278. Some of these refunds have been accruing interest since January 2008.

Some of the held refunds are accruing interest back to January 2008

Holding refunds for payment should not create a statutory excess

The Department believes the PPRT portion of refunds approved and held for payment at June 30, 2010 should not be included in the statutory calculation of excess as they were not paid during the fiscal year as referenced in the statute. The auditors believe that simply not paying the PPRT refunds that are due should not create an “excess” amount in accordance with the statutory parameters. Instead, the refunds due should be paid first and any funds remaining would be considered excess and available for transfer.

Department eventually transferred cash out instead of paying refunds

The \$184 million was eventually transferred in September and November, 2010 from the Income Tax Refund Fund to the Personal Property Tax Replacement Fund by the Department as cash was made available. It was not used to liquidate amounts owed to taxpayers for PPRT refunds due at year-end and not paid due to the lack of available cash. As these refunds were not paid, interest accumulates from the date the taxpayer filed the return and overpaid their tax liability. In the future, when PPRT refunds exceed PPRT deposits into the Income Tax Refund Fund, a transfer will have to be made from PPRT Fund into the Income Tax Refund Fund.

Department should pay refunds due to taxpayers

We recommended the Department pay PPRT refunds due to taxpayers from the Income Tax Refund Fund. Amounts remaining only after PPRT refunds are paid should be determined as excess and transferred to the Personal Property Tax Replacement Fund as required by statute, or seek legislative remedy. (Finding No. 10-27, page 105-108) **This finding was first reported in 2009.**

Department disagrees with auditors, stating incorrect legal interpretation

The Department disagreed with the finding and the recommendation. The Department agreed that all refunds should be paid, but stated that it is not possible when there is no money in the Refund Fund. The Department further stated that the OAG’s legal interpretation of the term “excess” in this statute is incorrect. The department’s tax counsel has concluded: “The proposed finding that transfers from the fund should be reduced by refunds due, but not paid, is inconsistent with the plain language of the statute.” The Department will continue to follow the law as determined by its tax counsel. (For previous Department response, see Digest Footnote #2)

Auditor’s Comment

In an Auditor’s Comment, we noted a management decision to simply hold certain refunds and preventing them from being considered “paid” on a statutory and cash basis should not create an excess as defined in

statute. The statute, as written, clearly contemplates the prompt (“as soon as practicable”) examination of returns and credit or refund of any overpayments. The statute as written was not intended to address a management decision to not pay taxpayers from the money deposited into the Income Tax Refund Fund for that specific purpose. As noted in the finding, at June 30, 2010, the Department owed \$271 million in refunds, some dating back to January 2008.

LOTTERY PRIVATE MANAGER PROCUREMENT-USE OF TRANSACTION ADVISOR

Department allowed the transaction advisor hired to assist in the procurement of a Private Manager for the Lottery to work without an executed contract, to not meet milestone dates, to subcontract with an entity with a potential objectivity issue; and, paid for services in violation of the contractual agreement

Department should not allow vendors to work without an executed contract

Department should ensure all subcontractors disclose any potential conflicts of interest

The Department allowed the Transaction Advisor hired to assist in the procurement of a Private Manager for the Lottery: to work without an executed contract; to not meet contractual milestone dates; to subcontract with an entity which may have had a perceived objectivity issue; and, paid for services in violation of the contractual arrangement with the Advisor.

We noted the following:

- The Department **executed** the contract with the Advisor on May 29, 2010.
- The Department allowed the Advisor and its subcontractors to work without an executed contract:
 - The Advisor assisted in the development of the Request for Expressions of Interest which was published on May 12, 2010, **17 days prior** to the execution of the contract.
 - Responses were due to a subcontractor of the Advisor on May 27, 2010, **2 days prior** to the execution of the contract.
- Contractual deadlines not met by Advisor. Per its contract:
 - An Initial Review was to be completed by May 17, 2010, which was **12 days prior** to executing the contract; however, there was no indication, through a contract amendment, that this activity was completed by the due date.
 - The Request for Proposal was to be completed by June 7, 2010; however, it was issued July 2, 2010.
 - The contract was **not amended** to allow for changes to the milestone deadlines.
- A subcontractor **hired by the Advisor** appears to have had a relationship with one of the two entities that combined to form Northstar, Scientific Games. Two Scientific Games board members at the time of proposing as part of Northstar had **previously** been on the board of the subcontractor. The subcontractor had been retained as counsel to Scientific Games’ predecessor. The procurement files contained no indication that the Department was aware of these relationships or documentation to show that the Department deemed them to not be an impairment.
- The Department paid the Advisor for activities conducted prior to the execution of its contract, and as of April 8, 2011, the Department could only produce summary level billing invoices from the Advisor, not the detailed support **to show when the work billed was actually conducted.**

Failure to develop the RFP by the contractual deadline **provided less time** for the evaluation team to review, analyze and score the Step 1 RFP responses. The Department should seek to maintain transparency and avoid the appearance of potential conflicts of interest in procuring the services of a Private Manager for the Illinois Lottery. Allowing a vendor to work without an executed contract does not protect State interests and increases the likelihood that State goals are not accomplished. (Finding No. 10-13, pages 55-59)

We recommended the Department: protect State interests and not allow vendors to work without an executed contract in place; enforce contract milestones or amend the contract to reflect updated priorities and time frames; ensure that all subcontractors disclose any relationships that may, even if only in appearance, impair the integrity of the procurement process; and, comply with its own contractual document and not pay for services performed prior to the execution of a final contract.

Department personnel agreed that beginning services prior to the contract being executed is not ‘best practice’; however, they state there were no potential contractual risks undertaken to the detriment of the State

The Department disagreed with the finding that it did not protect the State’s interest by allowing vendors, at their own risk, to begin work before an executed contract was in place. However, they agreed that it is “best practice” to have a signed contract in place before beginning work. The Department felt it was in the best interest of the State to start work as soon as possible.

Furthermore, the Department stated that the Transaction Advisor was hired to lend expertise and experience in structuring a process for selecting a private manager, and that the State paid only for the deliverables as stated in the contract, with the expectation that dates would shift as the project got underway and as the business strategy was developed. The Department believes that a contract amendment was not warranted, since the scope of the deliverables did not change.

The Department also stated that extensive disclosures were reviewed by counsel and no objectionable relationships were found.

Auditor’s Comment

Our auditor’s comment noted that while the Department indicates that timelines could be modified by “mutual agreement of the parties”, no such modification was maintained in the procurement file or memorialized in the contract on file with the Comptroller. Failure to meet deliverable deadlines may have contributed to State evaluators **having less than one week to evaluate the RFP responses** in Step 1 of the process, a process that eventually would turn over a \$2 billion State asset for private management.

We further commented that while the Department indicates no objectionable relationships were found, that was **not documented** in the procurement file.

LOTTERY PRIVATE MANAGER PROCUREMENT- DOCUMENTATION TO SUPPORT PAYMENT TO TRANSACTION ADVISOR

Department failed to adequately monitor and review payments made for services and did not timely complete an amendment for an increase to a contract

The Department failed to adequately monitor and review the payments made to the transaction advisor for services provided by the advisor and its subcontractors. Additionally, an increase to the legal fees cap was not timely memorialized in the contract with the Transaction Advisor.

We noted the following:

The Department paid \$4.94 million for services from the beginning of the contract through the end of March 2011

\$1.61 million worth of services billed and paid for were on two invoices that the Department did not originally provide to the auditors

The two invoices above were provided after the Office of the Auditor General submitted draft findings (31 days after the Department stated they provided all documentation); however they were only summary billings with no detail

\$4.21 million worth of payments made to the Transaction Advisor included billing invoices with a dollar amount and a brief description of services provided, with no additional support

The Department approved invoices in excess of \$727,000 to one subcontractor that only provided detailed information regarding services performed, totaling \$9,700

- **Lack of Billing Detail:** The Department paid the transaction advisor **\$4.94 million** for the services it and its subcontractors performed since the beginning of the contract through the end of March 2011.

- 33 percent of the payments (\$1,613,951.87 of \$4,941,084.24) made to the Transaction Advisor were on two invoices that the Department **did not produce** for the auditors. An April 11, 2011 memo from internal audit, in response to our questioning the detailed support for transaction advisor payments, indicated that the “budget office, generated a document that cross-referenced the RFP and contract to the modules, so management can follow which modules were being completed.” The two invoices noted above were not included on the document created by the budget office. However, there were payments both before and after the payments we question in this bullet point, which would appear to make it very difficult for management to follow which modules were being completed.

After our draft findings were submitted to the Department, we received the 2 invoices detailed above on May 9, 2011, **31 days after the Department stated they had provided all documentation** to support the Transaction Advisor payments. The new information was summary billings with no detail to support what legal services were provided, or when the professional services were rendered for the State funds.

- 85 percent of the payments (\$4,213,951.87 of \$4,941,084.24) made to the transaction advisor were for non-legal services. These billing invoices listed a dollar amount and a brief description of what services were provided. No other support was provided.
- **Legal Services:** In total, \$727,132.37 in payments to the Transaction Advisor were **for legal services** performed by a subcontractor. This was 15 percent of the total payments made through March 2011. We noted:
 - Legal services invoices were submitted by the subcontractor to the Transaction Advisor, who signed off and submitted them to the Department. The Department also approved the invoices for payment. The subcontractor did provide detail as to who performed certain activities and when those activities were performed **for only** \$9,700 of the over \$727,000 in legal services billed (1 percent). Without support, we were **unable to**

Subcontractor billed between \$251 and \$649 per hour for legal work; however, there were 10 different billing rates on the invoice with some of the different rates within the same title. Therefore, the auditors were unable to verify if the rates were correct billing rates

Contract had a maximum cap of \$550,000, which was exceeded

Department personnel later requested and were granted an extension of that cap up to \$1 million; however, the amendment indicated that the supplies or services to be provided were to “stay the same”

Lack of detailed billing support makes it impossible to know whether the Department paid for items that were a waste of State taxpayer funds

Department should take steps to ensure Transaction Advisor submits the necessary supporting documentation

Department disagrees with auditors

- **determine** what activities were completed or who provided the billed services to determine whether they were appropriate.
- There was little support as to what activities the individuals which were billed were involved in. The State was billed **between \$251.25 per hour and \$648.75 per hour** for legal work by the subcontractor. There were 10 different billing rates on the summary invoices; some within the same title. We were **unable to verify** if those were correct billing rates.
- The Transaction Advisor contract had a cap for legal services at \$550,000. Given the rates charged by the subcontractor, that **cap was met and exceeded**. In October 2010, the Lottery General Counsel requested, and was granted by the Governor’s Office, an extension of that cap amount to \$1,000,000. While the Governor’s Office approved this increase on October 29, 2010, the Director did not sign the amendment for **over two months**, on January 7, 2011. The amendment indicated that the supplies or services to be provided will “stay the same.” Given the lack of detailed legal billings provided and the amendment indicating no additional services were to be provided, we questioned why the increase was necessary.

Absent detailed billing support, it is **impossible** to know whether the Department paid for items that were a waste of State taxpayer funds. Failure to file an amendment to the contract with the Advisor decreases the transparency in how the procurement is viewed. Failure by the Department to have the Advisor complete contract activities by certain dates stated in the contract decreases the ability of the Department’s evaluators for the RFP to have sufficient time to review and score the proposals. In fact, **one evaluator told auditors** that he did not have enough time to properly score the Step 1 proposals given the tight time frame. The evaluator informed the Advisor and Acting Superintendent of the Lottery and he was told “duly noted.” The amount paid out to the Transaction Advisor, over \$4.94 million, is a significant sum of taxpayer dollars. (Finding No. 10-14, pages 60-65)

We recommended the Department take steps to ensure that its Transaction Advisor submits the necessary supporting documentation to allow the Department to review and monitor the contract with the Advisor. Additionally, we recommended the Department enforce provisions of the contract with respect to payments after services have been completed. Finally, if the need for increasing the legal services is justified, the Department should file a timely amendment to the contract so that State interests are publicly known and protected.

The Department disagreed with the finding that it did not monitor and review payments made to the Transaction Advisor, and provided that support to the auditor. The Department stated that there was complete transparency around the activities covered by the contract and compensation. The activities and deliverables in the contract enabled the Governor to make a Private Manager selection by September 15, 2010, as directed by Statute.

As to the legal subcontractor, the Department stated that the invoices were typical of legal services billing. The invoices were verified and

authorized by someone at the Department knowledgeable about the work and the individuals involved. Once the project got underway, it was clear that the complexity of the deal structure and the necessary legal documents were greater than anticipated. The Department sought to amend the contract at the same time that new procurement rules, processes and personnel were being put in place. It took an inordinate amount of time for the amendment to receive approval through this new process, but every required step was completed.

Auditor's Comment

Auditors commented that the hourly legal rates are **not detailed** in the State contract with Wyman. Lack of detail for these legal activities does not appear to reflect any heightened level of transparency. To the contrary, it raises the skepticism level for the activities and the procurement in general.

Auditors also questioned the Department's portrayal that the lack of detail in the legal invoices was "typical" for this type of work. Recently, the **Auditor General reviewed over 60 legal contracts the Governor's Office maintained** and these contract invoices **did have detailed billing activities**. Without this detail, the Department would not have been able to ascertain if the billed activities were in line with the State activities for which services were apparently being completed. Finally, the need for additional legal expenses may not have been from any new activities but the fact that the State was paying as much as almost \$650 per hour for some legal services.

LOTTERY PRIVATE MANAGER PROCUREMENT-EVALUATION TEAM DILIGENCE

Evaluation team members for the procurement of a Private Manager for the Illinois Lottery failed to attend all evaluation meetings and meetings and/or presentations by the vendors proposing on the procurement.

We noted the following:

Procurement evaluation team members did not attend all evaluation procedure meetings

Procurement evaluation team members did not attend all proposer meetings/presentations

The Department did not allow sufficient time to review and score proposals

- Evaluation Team Meetings: Not all team members attended all of the meetings where evaluation procedures were discussed. There was **no documentation** in the procurement file to explain how the team members that missed the meetings were provided the information disseminated at the meeting.
- Proposer Meeting/Presentations: Not all team members attended all the instances where there was interaction with the proposers. Again there was no documentation in the procurement file to explain how the team members that missed the meetings were provided the information disseminated at the meeting/presentations.
- Turnaround Time for Review and Scoring of Proposals:
 - On August 3, 2010, one evaluator received the three Step 1 proposals, proposals that were submitted 5 days earlier (on July 30, 2010) and contained over 2,600 pages that needed to be scored in 3 days (by August 6, 2010).
 - One evaluator picked up the Step 2 proposals on September 8, 2010, the day of the Public Hearing. The evaluator then signed

and dated the Step 2 scoring evaluations **the next day**, on September 9, 2010. Each of the two proposals was in excess of 800 pages and contained the Final Business Plans on how the proposer would manage the \$2 billion State Lottery.

The Evaluation Team was put together in a non-formalized manner, most members designated by the Department and another by the Governor's Office. One member actually **joined the evaluation process in the middle** of the Step 1 evaluation process.

Given the complexity and volume of materials submitted, attendance at clarification meetings with proposers and team meetings helps to ensure that all evaluators have the same information on which to base their scoring. Failure of evaluators to attend these meetings increases the possibility that the procurement was not conducted in a fair and transparent manner. Given that the Lottery Private Manager procurement was unique and unlike any other arrangement in the country, evaluators should have been required to conduct due diligence when deciding on to whom to turn over a \$2 billion State asset. (Finding No. 10-15, pages 66-70)

Department should ensure all evaluation team members attend all team meetings

We recommended the Department ensure all evaluation team members attend all team meetings and vendor presentations or document how those who could not attend were provided the information disseminated at the meetings.

Department agrees that best practice would have everyone at meetings, but recognizes exceptions

The Department agreed that best practice would be to have everyone at all meetings, but recognizes that there will be exceptions particularly in a process as intense and time- compressed as this selection. However, the Department disagreed with any suggestion that the evaluation team was not attentive to their duties and that the process did not assure due diligence in determining which bidder offered the best benefit to State taxpayers. While certain meetings were not attended by all members of the evaluation team, members had access to the information presented through the Transaction Advisors; had the training, tools and resources necessary to make an informed decision on the merits of each business plan; and they undertook their assignment seriously and diligently.

Auditor's Comment

The auditors commented that the Department appears to misrepresent the timeline in its response when it states the Transaction Advisors were selected after the evaluation team was assembled. The Department failed to point out that the evaluation team **was not finalized** until August 3, 2010, four days after the RFP responses were submitted and three days prior to the completion of the Step 1 evaluation process. If the evaluation team was making the decision on awarding the Lottery to a private manager, the team members should have ensured their schedules could accommodate all evaluation commitments. Furthermore, the Department did not provide documentation to show that any information was adequately disseminated to the team members who did not attend meetings.

LOTTERY PRIVATE MANAGER PROCUREMENT-SCORING EVALUATION IRREGULARITIES

The Illinois Lottery failed to certify scores in all cases, including some scores that were submitted after decisions were made and publicly reported

Evaluation Team members for the procurement of a Private Manager for the Illinois Lottery failed to certify scores in all cases and some scores were submitted after decisions had been made and publicly reported.

We noted the following:

- Scoring Tool Irregularities. Auditors questioned the certification (signing/dating) of evaluations by evaluation team members.
 - One evaluator failed to date his evaluation certification of Intralot in Step 1. It is also noted that the correspondence from the Transaction Advisor detailing the due date and time for Step 1 evaluations **was not sent** to this evaluator.
 - One evaluator dated her evaluation certifications for Step 1 on August 9, 2010, **3 days after they were due** and the same day the letters were sent to the proposers notifying them if they qualified for further consideration in Step 2.
 - One evaluator dated her evaluation certifications for Step 1 for two vendors (Intralot and Northstar) **after the proposers had been notified** that “The Department has now completed its review and evaluation of Step 1 proposals consistent with the scoring criteria set forth in the RFP.”
 - One evaluator dated his Step 1 evaluation certifications on August 5, 2010, which was the **day before the clarification meeting** with Intralot. This evaluator did not attend the Intralot meeting on August 6, 2010, a meeting described by other evaluation team members as **important to clarify questions** the team had of the vendor.
 - One evaluator dated her Step 2 evaluations on September 9, 2010, the **day after the Public Hearing** conducted on this procurement. The evaluator attended the Public Hearing. The submission of scores after the Hearing was counter to direction given by the Transaction Advisor. In an email correspondence to the evaluation team, the Advisor explained that if the team member wanted to attend the Hearing their scores needed to be submitted prior to the Hearing and stated, “Comments made at the Public Hearing cannot influence your evaluation of the business plans as the veracity or relevance of comments cannot be confirmed in time.”
 - One evaluator completed and dated his Step 2 evaluations on September 15, 2010, the **same day the Governor announced the award** in favor of Northstar. The evaluator told us that the day he signed the forms was the day he completed the forms. It appears that from the documentation and testimonial evidence presented, this evaluator completed his Step 2 evaluations 5 days after the Department Director and Acting Superintendent of the Lottery sent their recommendation to the Governor that Northstar be given the Private Manager award.

Errors in the submission of evaluations included: not dating the evaluation; dating the evaluation after the due date; submitting evaluations after proposers had been notified that scoring was complete; submitting evaluations prior to clarification meetings; dating the evaluation after the Public Hearing which was contrary to the Transaction Advisor's instructions; and completing and dating the evaluation the same day that the Governor announced the award to the bidder

Failure to follow any statutory or administrative processes for a procurement that involves a \$2 billion State asset, the Illinois Lottery, increases the possibility that the procurement was not conducted in a fair

and transparent manner. Evaluations not being certified by the members of the evaluation team increase the likelihood that the results of the scoring could be considered arbitrary and potentially open the State to legal action by non-winning proposers. When scoring is certified after decisions to eliminate proposers or not until the day an award announcement is made, it sheds a poor light on the overall procurement process and creates skepticism as to the adequacy of the procurement process. (Finding No. 10-17, pages 75-77)

We recommended the Department ensure that all scoring tools are appropriately and timely completed.

Department stated all scoring instruments were timely filed

The Department agreed with our recommendation that scoring instruments be timely filed, and responded that it has documented that this standard was met as it relates to the Lottery Private Manager Transaction. Otherwise, the Department disagreed with the finding. The Department also stated that all scoring instruments were timely filed via e-mail to the Department SPO and/or the Transaction Advisor. The Department also stated that the finding is relying on the dates the hardcopy forms were signed.

Auditor's Comment

Auditors commented that the Department's response appears to want it both ways. They say auditors relied on the hardcopy evaluations which we note **were not timely**. This is factual. Then the Department wants us to utilize emails, which we also considered. However, as we note in the finding, these too showed the electronic submissions **were not timely**. The only constant was that all the discrepancies noted in the finding are from Department documentation, whether hardcopy or electronic.

LOTTERY PRIVATE MANAGER PROCUREMENT-PRIVATE MANAGER AGREEMENT

Department failed to file completed copy of the Private Management Agreement with Comptroller

The Department had failed, as of April 1, 2011, to file, with the Comptroller, a completed copy of the Private Management Agreement (Agreement) between the Department and Northstar.

We noted the following:

- The Department reported that the Agreement was executed with Northstar on January 18, 2011. According to the Step 2 RFP, the Department was not supposed to enter into an Agreement with the Final Offeror until a full investigation of the Finalist had been completed. We were unable to determine if the Department complied with this RFP criteria **because the probity report conducted by Kroll on Northstar is undated**. The Department provided no documentation to show when this investigation was completed.
- A Comptroller official reported to us on March 28, 2011, **69 days after** the Agreement was executed, that the Agreement had been sent back to the Department for more information. The official indicated it may be a week or two before it is returned.
- The Illinois Lottery Law dictates that 21 elements be incorporated

into the Agreement. Given that a final copy of the Agreement has not been filed with the Comptroller, we were unable to determine if these requirements were contained in the Agreement. For example, 20 ILCS 1606/9.1(d)(5) requires the Agreement to contain a “provision providing for compensation of the private manager.”

- The Department, on the Lottery website, has placed an Execution Copy of the Agreement. However, the schedules, including schedule 10.1 on the payment schedule, and exhibits to the Agreement are not contained in this web posting.
- Likewise, Northstar has posted a copy of the Agreement on its website. The schedules are marked “intentionally omitted” by Northstar.
- In its November 12, 2010 response to the Intralot protest, the Department’s General Counsel indicated that “Throughout the procurement process that resulted in the selection of the Private Manager, the Department was fundamentally concerned with ensuring that the process was not only fair and competitive in nature, but also open and transparent.” Failing to file a contract does not appear to be “open and transparent.”

Department personnel stated they did attempt to file the PMA with the Comptroller’s Office and will do so as soon as all certifications are signed, as required by the Comptroller. In addition, the process of negotiating redacted parts of the PMA and certification was further delayed when the Lottery’s General Counsel resigned in December 2010.

Given that the Department is turning over a \$2 billion State asset to a vendor, the filing of the agreement with the Comptroller would create a sense of transparency in the process. Additionally, failure to file the Agreement with the Comptroller is a violation of the Illinois Procurement Code. (Finding No. 10-20, pages 86-88)

Department should file complete PMA with Comptroller

We recommended the Department file a completed and full copy of the Private Management Agreement with the Comptroller.

Department stated that PMA was submitted to Comptroller in March

The Department reported that the Private Management Agreement (PMA) between the State and Northstar Lottery Group was executed on January 18, 2011 and submitted to the Comptroller on March 18, 2011. The Comptroller has since contacted the Department with additional questions regarding the PMA filing and Counsels are working to satisfy the Comptroller’s additional certification and requested explanation/information.

Auditor’s Comment

The auditors commented that the Department disagreed that the contract has been filed with the Comptroller yet in its response the Department **offers no guarantee** that it was filed as of when the response were submitted on May 27, 2011. Additionally, it has taken Department Counsel two months to determine what was proprietary on a page by page basis for the 800 page Northstar contract when one of the members of the evaluation team reviewed those 800 pages in the Northstar Step 2 proposal along with another 800 pages of Camelot Step 2 proposal in just one day. The confidential nature of information should have been reviewed when Northstar submitted its final proposal in September 2010.

Four months have passed since the contract was signed. This does not create an atmosphere of transparency.

OTHER FINDINGS

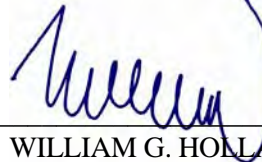
The Department has disagreements with other findings not presented in this digest. The remaining findings are reportedly being given attention by the Department. We will review the Department's progress towards the implementation of all our recommendations in our next engagement.

AUDITORS' OPINION

Our auditors stated the financial statements of the Department of Revenue as of June 30, 2010, and for the year then ended are fairly presented in all material respects.

STATE COMPLIANCE EXAMINATION – ACCOUNTANT'S REPORT

The auditors qualified their report on State Compliance for findings 10-1 through 10-5, 10-7 through 10-11, 10-13, 10-14, 10-17, 10-21, 10-25, 10-27, and 10-31. Except for the noncompliance described in these findings, the auditors stated the Department complied, in all material respects, with the requirements described in the report.



WILLIAM G. HOLLAND
Auditor General

WGH:CL

AUDITORS ASSIGNED

The compliance examination was performed by the Auditor General's staff. McGladrey & Pullen, LLP were our special assistant auditors for the financial audit.

DIGEST FOOTNOTES

#1 - CERTAIN YEAR-END RECEIVABLES NOT VALID

2009: The Department agreed with the recommendation and stated the Department will continue to review its controls over tax processing both procedurally and systematically to implement edits and controls as necessary to create accurate taxpayer accounts for collection and compliance purposes.

**#2 - FAILURE TO PAY PERSONAL PROPERTY
REPLACEMENT TAX REFUNDS CREATED A STATUTORY
EXCESS**

2009: Department officials accepted the recommendation and stated deposits into the Income Tax Refund Fund were insufficient to pay all refunds, and the Department gave priority to Individual Income Tax refunds and delayed some Business Income Tax refunds (including PPRT refunds). The Department stated they believe that when there is too little money to pay all refunds, its policy of paying the higher volume smaller refunds to individuals and delaying the typically larger business refunds makes sense. Further, Department officials agreed to make members of the legislative and executive branches aware of the issue of “statutory excess” identified by the auditors, but recognized that changing the current statutory scheme would raise serious policy and fiscal issues that would need to be carefully weighed.