



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, 2013**

**Release Date: March 20, 2014**

**Summary of Government  
Auditing Standards**

**Findings:**

**Total this audit: 6**

**Total last audit: 9**

**Repeated from last audit: 6**

**INTRODUCTION**

This digest covers our financial audit of the Department of Revenue (Department) for the year ended June 30, 2013. A two year compliance attestation examination and a one year financial statement audit will be performed for the period(s) ending June 30, 2014. The auditors identified 6 findings involving the internal control over financial reporting. The findings are presented in the report beginning at page 58. Following is a summary of four findings included in this report digest.

**SYNOPSIS**

- The Department's year-end financial reporting in accordance with generally accepted accounting principles (GAAP) to the Illinois Office of the Comptroller contained inaccuracies.
- During testing, auditors noted the Department has sustained a level of inventory of Business Income Tax and Withholding Income Tax taxpayer information to be finalized.
- The Department has not completely implemented controls and safeguards over processing taxpayer information.
- Auditors identified conflicts with provisions of the State Revenue Sharing Act and the Illinois Income Tax Act.

{Financial data is summarized on the next page.}

**ILLINOIS DEPARTMENT OF REVENUE**  
**FINANCIAL AUDIT**  
**For the Year Ended June 30, 2013**

<b>FINANCIAL INFORMATION - Governmental funds (in thousands)</b>	<b>FY 2013</b>	<b>FY 2012</b>
<b>REVENUES</b>		
Program revenue: charges for service.....	\$ 46,885	\$ 44,394
Program revenue: operating grants.....	896	370
General revenue: taxes.....	34,689,979	32,811,447
General revenue: interest and other.....	21,678	17,400
Total revenue.....	<u>34,759,438</u>	<u>32,873,611</u>
<b>EXPENDITURES</b>		
General government.....	204,029	174,779
Health and social services.....	12,673	60
Employment and economic development.....	5,000	(75)
Environment and business regulation.....	7,789	6,914
Intergovernmental.....	4,745,056	4,657,469
Capital outlays .....	14,499	85
Total expenditures.....	<u>4,989,046</u>	<u>4,839,232</u>
<b>OTHER SOURCES (USES)</b>		
Appropriations from State resources.....	183,390	212,482
Transfers in.....	1,093,400	1,189,237
Transfers out.....	(795,824)	(783,290)
Receipts collected & transmitted to the State treasury.....	(29,190,535)	(27,463,790)
Lapsed appropriations.....	(9,909)	(18,693)
Amount of SAMS Transfer In/Out.....	(460,915)	(1,054,859)
Total other sources (uses).....	<u>(29,180,393)</u>	<u>(27,918,913)</u>
Net change in fund balance.....	589,999	115,466
Fund balance (deficits) July 1.....	<u>(1,254,435)</u>	<u>(1,369,901)</u>
Fund balance (deficits) June 30.....	<u>\$ (664,436)</u>	<u>\$ (1,254,435)</u>
<b>SELECTED ACCOUNT BALANCES - Governmental funds (in thousands)</b>		
	<b>June 30, 2013</b>	<b>June 30, 2012</b>
<b>ASSETS</b>		
Cash and cash equivalents & investments.....	\$ 1,721,547	\$ 1,225,213
Taxes receivable, net.....	1,540,358	1,329,973
Intergovernmental and other receivables, net.....	16,482	14,618
Due from other Department and State funds.....	1,028,761	1,021,557
Loans and notes receivables, long term.....	41,403	39,840
Inventories.....	114	379
Unexpended appropriations.....	17,811	24,189
Total assets.....	<u>\$ 4,366,476</u>	<u>\$ 3,655,769</u>
<b>LIABILITIES</b>		
Accounts payable and other liabilities.....	\$ 544,825	\$ 443,974
Income tax refunds payable.....	1,327,510	1,274,549
Intergovernmental payables.....	949,813	1,249,400
Unearned revenue.....	680,888	602,523
Due to other funds - State & Department.....	1,339,516	1,188,500
Unavailable revenue.....	188,360	151,258
Total liabilities.....	<u>5,030,912</u>	<u>4,910,204</u>
<b>FUND BALANCE (DEFICITS)</b>		
Fund balance (deficits).....	<u>(664,436)</u>	<u>(1,254,435)</u>
Total liabilities and fund balance (deficits).....	<u>\$ 4,366,476</u>	<u>\$ 3,655,769</u>
<b>DEPARTMENT DIRECTOR</b>		
During Audit Period: Brian A. Hamer		
Currently: Brian A. Hamer		

**FINDINGS, CONCLUSIONS, AND  
RECOMMENDATIONS**

**INACCURACIES IN THE DEPARTMENT’S FINANCIAL  
REPORTING PROCESS**

The Department’s initial year-end financial reporting in accordance with generally accepted accounting principles (GAAP) to the Illinois Office of the Comptroller contained inaccuracies. The issues associated with the inaccuracies, if not detected and corrected, could misstate the Department’s financial statements and impact the Statewide financial statements prepared by the Illinois Office of the Comptroller. Some of the exceptions identified were:

**Use of incorrect information resulted in \$18.7 million in adjustments, \$7.5 million of which were made by the Department**

- Auditors noted errors in the Department’s calculation of sales taxes due to local governments at year end. During the process of estimating the sales tax to be paid to local governments the Department used incorrect information. As a result, taxes receivables and amounts due to the local governments were overstated by a net amount of \$18.7 million. The Department adjusted the calculation and notified the Illinois Office of the Comptroller and requested journal entries to be made to four of the Department’s closed GAAP Reporting packages for a net amount of \$7.5 million. The remaining misstatement of \$11.2 million across twelve funds was not considered material at the fund level by the Department and was not corrected as of June 30, 2013.

**\$10.2 million in errors noted in reporting business income tax and \$20.8 million in errors noted in reporting sales tax**

- Auditors identified errors in the Department’s calculation of lapse period collections for business income taxes and sales taxes. As a result, the lapse period collections for business income taxes, and therefore, the taxes receivables were understated by \$10.2 million. For sales tax, the lapse period collections, and therefore, the taxes receivables reported were overstated by \$20.8 million. The misstatements were not considered material at the fund level by the Department and the eighteen funds impacted were not corrected as of June 30, 2013.

**Auditors noted exceptions in testing certain income and sales tax accounts**

- During audit testing of accounts receivable, exceptions were noted with certain income and sales tax accounts. From the exceptions noted the accounts receivable was potentially overstated by \$3.3 million.

As a result of the exceptions noted in the finding, the initial GAAP Reporting packages submitted to the Illinois Office of the Comptroller were misstated. In addition, the exceptions have the potential to misstate the Department’s financial statements. Accurate preparation of the Department’s financial information for GAAP and financial reporting purposes is important due to the impact adjustments have on the Statewide financial statements. (Finding 1, pages 58-61)

We recommended the Department take steps to improve the review process of the underlying data that helps compile the financial statements.

**Department agrees with auditors**

Department officials agree they should always be taking steps to improve the financial reporting process and the underlying data used to compile the financial statements. The Department noted: 1) human errors occurred during the process of preparing the financial statements, 2) there are a number of complex calculations and adjustments that require manual intervention or changes to properly process data, and 3) enhancements continue to be made to reduce manual processes and improve upon the review process.

**TAXPAYER INFORMATION PENDING FINALIZATION**

During testing, auditors noted the Department has sustained a level of inventory of Business Income Tax and Withholding Income Tax taxpayer information to be finalized. Taxpayer information to be finalized consists of tax returns that are data entered but need further manual review and taxpayer correspondence that has been received but yet to be processed.

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. While this segment has improved from the prior year, the inventory is higher than the previous 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.

**101,172 returns to be finalized**

At June 30, 2013, the value carried in GenTax related to original taxpayer returns to be finalized was \$2.2 billion (representing 101,172 returns). Although it is generally agreed the vast majority of the \$2.2 billion is invalid and will be reduced upon the tax information being finalized, the Department has represented there is no reasonable methodology or process for estimating the valid receivable amount of these partially processed returns.

**Settled taxpayer information that had not been entered into GenTax was not considered for financial statement reporting**

In addition to the inventory noted above, during testing auditors identified inventories of settled taxpayer information that had not been processed by the Department and/or taken into consideration for financial statement reporting purposes. Auditors considered "settled taxpayer information" to be defined as taxpayer information where there is a legally executed agreement, signed and dated between the taxpayer and the Department that sets forth the terms, including the amounts or other changes both parties have agreed to, as well as court restitution orders.

The effect of testing performed on settled accounts found on a net basis accounts receivable was overstated by approximately \$1.4 million. In addition, \$20 million should have been taken into consideration in the Department's computation of refunds payable. Factoring the \$20 million in the refunds payable estimation, refunds payable was understated by approximately \$1.4 million. Department management reviewed the court restitution orders and determined approximately \$2.8 million, gross of an allowance for uncollectable accounts, was omitted from the Department's computation of accounts receivable. On a net basis, the effects of the issues noted were not considered material by the Department and were not adjusted at June 30, 2013.

**Inventories of taxpayer information to be finalized can lead to the Department's financial statements not being fairly stated**

Failure to process and finalize the taxpayer information and determine the final disposition delays the recognition of receivables, deferred revenue, and tax revenue in the financial statements. In addition, failure to take settled taxpayer information not entered into GenTax into consideration for financial reporting purposes can lead to the Department's financial statements, accounts receivable and refunds payable, not being fairly presented. (Finding 2, pages 62-66)

We recommended the Department continue to seek sufficient resources to process taxpayer information such that the inventory of taxpayer information is reduced from its current levels. We also recommended the Department take into consideration the inventory of settled taxpayer information not entered into GenTax when gathering information for year-end financial reporting.

**Department agrees with auditors**

Department officials agreed with the recommendation noting they continue to seek sufficient resources to process taxpayer information in a timely manner. In addition, Department officials noted the establishment of edit checks, which creates inventories, is a critical part of the operations of the Department and is critical to combating fraud and identity theft. The inventories represent the accounts on which they are performing additional due diligence in order to ensure the taxpayer is in compliance with tax laws and to validate refunds due or amounts owed. The June 30 inventory levels will always be the highest of the year, due to the tax filing deadline of April 15.

Department officials indicated all existing restitution orders and payments have been entered in GenTax to allow tracking and activity will be integrated into GenTax at a future date. Department officials also indicated they will develop procedures to record and monitor the various stages of settlements and include communication to accounting staff as needed to allow for financial statement analysis

**CONTROLS AND SAFEGUARDS OVER THE PROCESSING OF TAXPAYER INFORMATION**

The Department has not completely implemented controls and safeguards over processing taxpayer information. During fiscal year 2013, the Department processed 19.6 million tax receipt documents throughout its facilities, totaling \$40.2 billion.

**Weaknesses noted in safeguarding taxpayer information**

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 related to Business Income Tax and Individual Income Tax is considered FTI and should be handled as such. During testing auditors noted instances in which the Department's internal controls to protect taxpayer information contained weaknesses. Weaknesses were noted in the following areas:

**Weaknesses were noted in certain physical safeguards and storage of taxpayer information**

- Auditors noted weaknesses in certain physical safeguards to control access to areas within the Department as well as the storage of taxpayer information.
- The Department identified an instance where controls over processing of taxpayer information were not sufficient regarding assignment of taxpayer information to be processed by an employee. The Department brought to the auditors' attention an issue where an employee failed to timely process 6,735 taxpayer documents affecting 5,270 taxpayers. Some of the taxpayer documents dated back to 2008.

**Department identified an instance where an employee failed to timely process 6,735 taxpayer**

The Department is responsible for ensuring the confidentiality of tax information within its possession. The Department maintains data that is covered by both State and Federal requirements. (Finding 4, pages 69-71) **This finding was first reported in 2010.**

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. We also recommended the Department improve controls regarding the assignment and monitoring of taxpayer information assigned for processing.

**Department agrees with auditors**

Department officials agree and indicated they continue to implement compensating controls that limit/restrict access to taxpayer information in the building. Department officials also noted non-Department employees have been relocated to public areas and as funding is available will continue to implement other physical controls. Department officials noted they have implemented improved controls to help prevent recurrence of the incident noted in the second bullet point above. (For the previous Department response, see Digest Footnote #1.)

**CONFLICT IN PROVISIONS OF THE ILLINOIS INCOME TAX ACT AND STATE REVENUE SHARING ACT**

Conflicts exist within provisions of the State Revenue Sharing Act (30 ILCS 115) and the Illinois Income Tax Act (35 ILCS 5/901), as both of these Acts were impacted by the passage of Public Act 096-1496, the Taxpayer Accountability and Budget Stabilization Act.

During fiscal year 2011, the General Assembly passed and the Governor signed Public Act 096-1496, which increased the State income rates on individuals, trusts, estates, and corporations and contained amendatory provisions to update existing State law. During testing, auditors noted the following:

**The Illinois Income Tax Act was not amended to authorize a portion of deposits into the 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.
- 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 the 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.

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

Department personnel stated they believed they followed the intent of the General Assembly and that an oversight in Public Act 096-1496 created a conflict between statutes. It is the Department's legal opinion that the most recent Act of the General Assembly supersedes the older Act with which it conflicts; therefore, deposits into the Income Tax Refund Fund and transfers into the Local Government Distributive Fund were properly made.

Functioning with inconsistent State laws results in the Department performing functions not specifically directed by the General Assembly and could subject the Department to legal risks. (Finding 5, pages 72-73)

We recommended the Department continue to seek a legislative remedy to the conflicting provisions of the State Revenue Sharing Act and the Illinois Income Tax Act.

**Department indicated they are seeking a legislative change to address the conflicts in legislation**

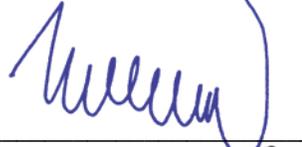
Department officials indicated they are continuing to seek changes to the above. The corrective language has been written and the Department is working to get the legislation enacted.

**OTHER FINDINGS**

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

## **AUDITORS' OPINIONS**

Auditors stated the financial statements of the Department of Revenue as of June 30, 2013, and for the year then ended are presented fairly in all material respects.



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WILLIAM G. HOLLAND  
Auditor General

WGH:RPU

## **SPECIAL ASSISTANT AUDITORS**

Sikich LLP was our special assistant auditors for this engagement.

## **DIGEST FOOTNOTES**

### **#1 CONTROLS AND SAFEGUARDS OVER THE PROCESSING OF TAXPAYER INFORMATION - Previous Department Response**

2012: Recommendation accepted: The Department agrees with this recommendation and considers the safeguarding of confidential taxpayer information to be a critical function of the Department, and continually acts to assure this information remains secure. The IRS certified our most recent Safeguard Procedures Report on November 29, 2012 stating "We are accepting this report as certification that the confidentiality of Federal tax information (FTI) is adequately protected." The Department is one of the few states that have received verification of improvement in safeguarding procedures from the IRS.

As new threats to security emerge, the efforts to make improvements evolve to meet them. We receive recommendations from our own internal reviews, third-party security consultants and the IRS, and we implement these recommendations as quickly as practicable. It should be noted no State meets all of the requirements of Publication 1075. The IRS expects to see continuous improvements and the Department has ongoing discussions with the IRS to ensure that we are meeting its expectations regarding safeguarding data.

The Department was allocated \$1 million in FY2013 by the Capital Development Board for security initiatives and has requested an additional \$5 million in FY2014.