

LEGISLATIVE AUDIT COMMISSION



Review of
Department of Revenue
Year Ended June 30, 2010
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Springfield, Illinois 62706
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REVIEW: 4363
ILLINOIS DEPARTMENT OF REVENUE
YEAR ENDED JUNE 30, 2010

FINDINGS/RECOMMENDATIONS - 37

ACCEPTED - 9
IMPLEMENTED - 12
NOT ACCEPTED - 11
UNDER STUDY - 5

REPEATED RECOMMENDATIONS - 10
PRIOR AUDIT FINDINGS/RECOMMENDATIONS - 21

This review summarizes the auditors' reports on the Illinois Department of Revenue for the year ended June 30, 2010, filed with the Legislative Audit Commission June 28, 2011. The auditors conducted a compliance examination and financial audit in accordance with Government Auditing Standards and State law. Auditors stated the financial statements were fairly presented.

The Department of Revenue is organized to provide for administering, collecting, enforcing and determining distribution of the taxes imposed by the State's major tax acts. During the audit period, the Department also administered and oversaw the operations of the Illinois Lottery and the Liquor Control Commission. Effective July 1, 2009, the Department transferred all functions performed for the Illinois Racing Board and the Illinois Gaming Board, and all associated powers, duties, rights and responsibilities, to those respective agencies in accordance with Executive Order 09-05. As of July 1, 2011, the Lottery operations transitioned to a private manager, Northstar Lottery Group.

The Department collects approximately 64% of the receipts deposited into the General Revenue Fund. A significant portion of the Department's total effort relates to the collection of the Retailers' Occupation Tax (ROT) and related taxes, income taxes, and personal property replacement taxes. The revenue collected from these sources approximates 81% of taxes collected by the Department. The remaining 19% of the Department's revenue is derived from the collection of 25 other taxes. In addition to collecting State taxes, the Department collects some taxes on behalf of local governments, and administers the "Senior Citizens' and Disabled Persons' Property Tax Relief Act" and the "Additional Tax Relief Act."

The Director since February 2003 is Mr. Brian Hamer. Director Hamer had no previous association with the Department. The average number of employees at June 30 was:

	FY10	FY09
Tax Operations	1,694	1,682
Illinois Gaming Board	0	77
Liquor Control Commission	42	42
Illinois Racing Board	0	53
Illinois State Lottery	176	176
Shared Services	43	69
TOTAL	1,955	2,099

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The reduction in headcount reflects the separation of the Illinois Gaming Board and the Illinois Racing Board from the Department on July 1, 2009.

Service Efforts and Accomplishments

Appendix A contains service efforts and accomplishments of the Department of Revenue as well as the Liquor Control Commission and the Lottery.

Expenditures From Appropriations

The General Assembly appropriated \$1,567,136,600 to the Department in FY10. The Department had expenditures of \$917,166,131 in FY10 compared to \$1,105,330,237 in FY09, a decrease of about \$188 million, or 17%. Significant changes in fund expenditures were as follows:

- \$107.1 million decrease in State Gaming due to the separation of the Illinois Gaming Board from the Department of Revenue;
- \$35.5 million increase in the State Lottery due to increase in prizes and shares;
- \$25.5 million decrease in Federal HOME Investment Trust due to slowdown in housing and construction market and funds being paid directly to IHDA;
- \$25.3 million decrease in GRF;
- \$16.7 million decrease in Rental Housing Support Program due to higher than usual expenses in FY09;
- \$15.1 million decrease in Motor Fuel Tax Fund due to payments owed to International Fuel Tax Agreement jurisdictions and several large refunds paid to a company denaturing gas and turning it into ethanol;
- \$13.9 million decrease in Illinois Affordable Housing Trust due to reduction in the volume and value of real estate transactions;
- \$13.9 million decrease in Local Government Distributive Fund; and
- \$6.4 million decrease in Horse Racing Fund due to the separation of the Illinois Racing Board from the Department of Revenue.

Appendix B summarizes the appropriations and expenditures for the period under review. Lapse period expenditures in FY10 were about \$103.4 million, or 11.2% of total expenditures.

Cash Receipts

Appendix C summarizes cash receipts of the Department for the year under review. Cash receipts were \$31.6 billion in FY09 compared to \$29 billion in FY10, a decrease of \$2.6 billion or almost 8.2%. More than half of the reduced amount was lost through lower receipts of income tax and fees (\$1.423 billion). Sales tax receipts were down \$553 million. Significant portions of the receipts relate to the collection of the income tax (41.8% of all revenues) and the Retailers' Occupation Tax and related taxes (39.1% of all revenues). The remaining 19.1% of the Department's revenue is derived from numerous

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other taxes, fees, assessments, penalties and interest which the Department is empowered to collect.

Taxes Receivable Balances

Appendix D is a summary of taxes receivable balances. Net taxes receivable increased from \$1,205,294,000 at June 30, 2009 to \$1,230,888,000 at June 30, 2010. These taxes are due from individuals, corporations, and businesses. In FY10, approximately \$763 million of \$1.99 billion in total taxes receivable was considered uncollectible.

Property Report

Appendix E is a summary of changes in State property for FY10 and FY09. Total property decreased from \$19,498,429 at July 1, 2009 to \$16,733,437 at June 30, 2010. Equipment comprised almost \$16.3 million of total property.

Accountants' Findings and Recommendations

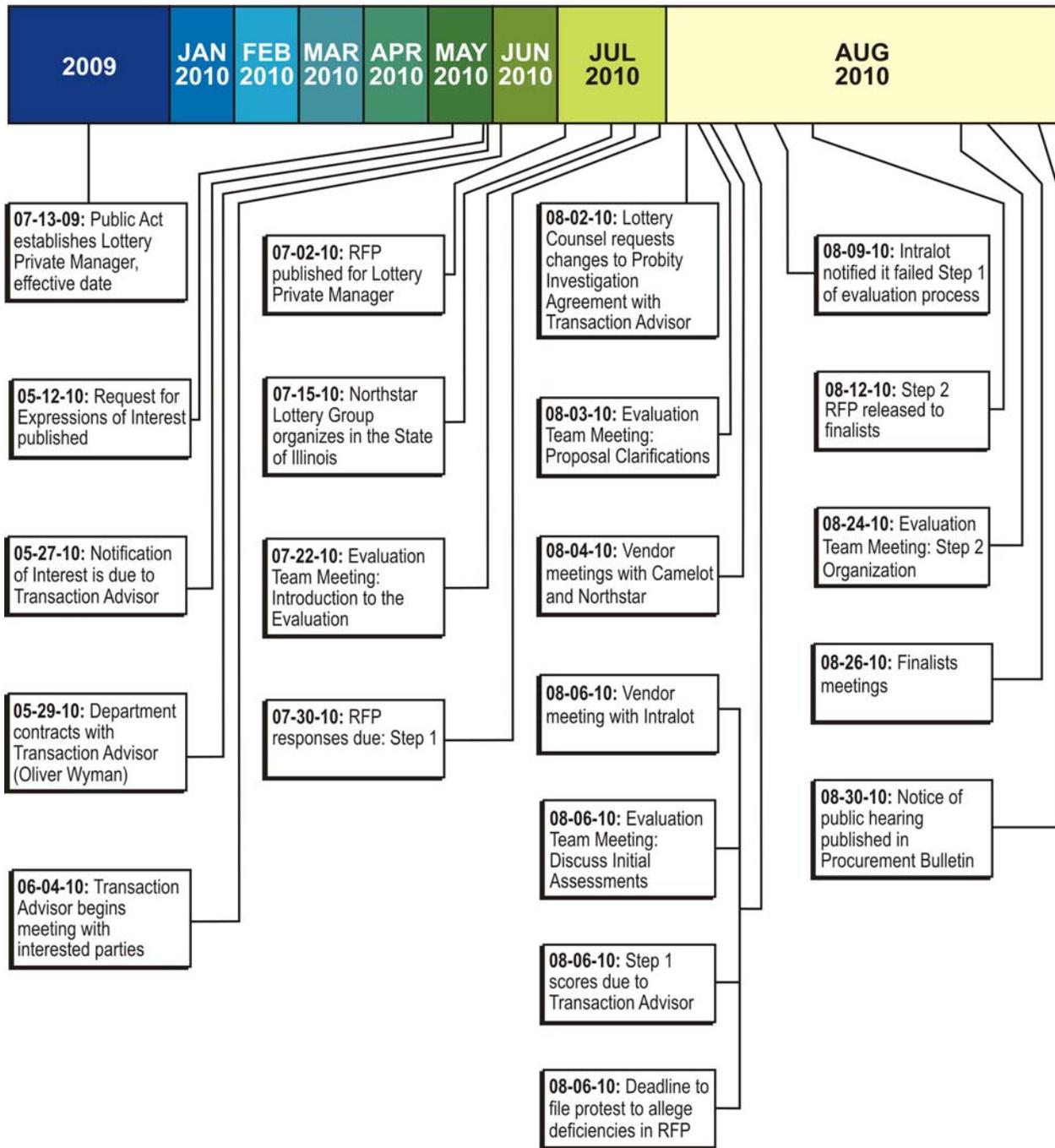
Condensed below are the 37 findings and recommendations presented in the reports. There were 10 repeated recommendations. Responses to the recommendations are classified based on updated information provided by Douglas Hathhorn, Chief Internal Auditor, and DOR management in memos received via electronic mail on November 14 and 15, 2011.

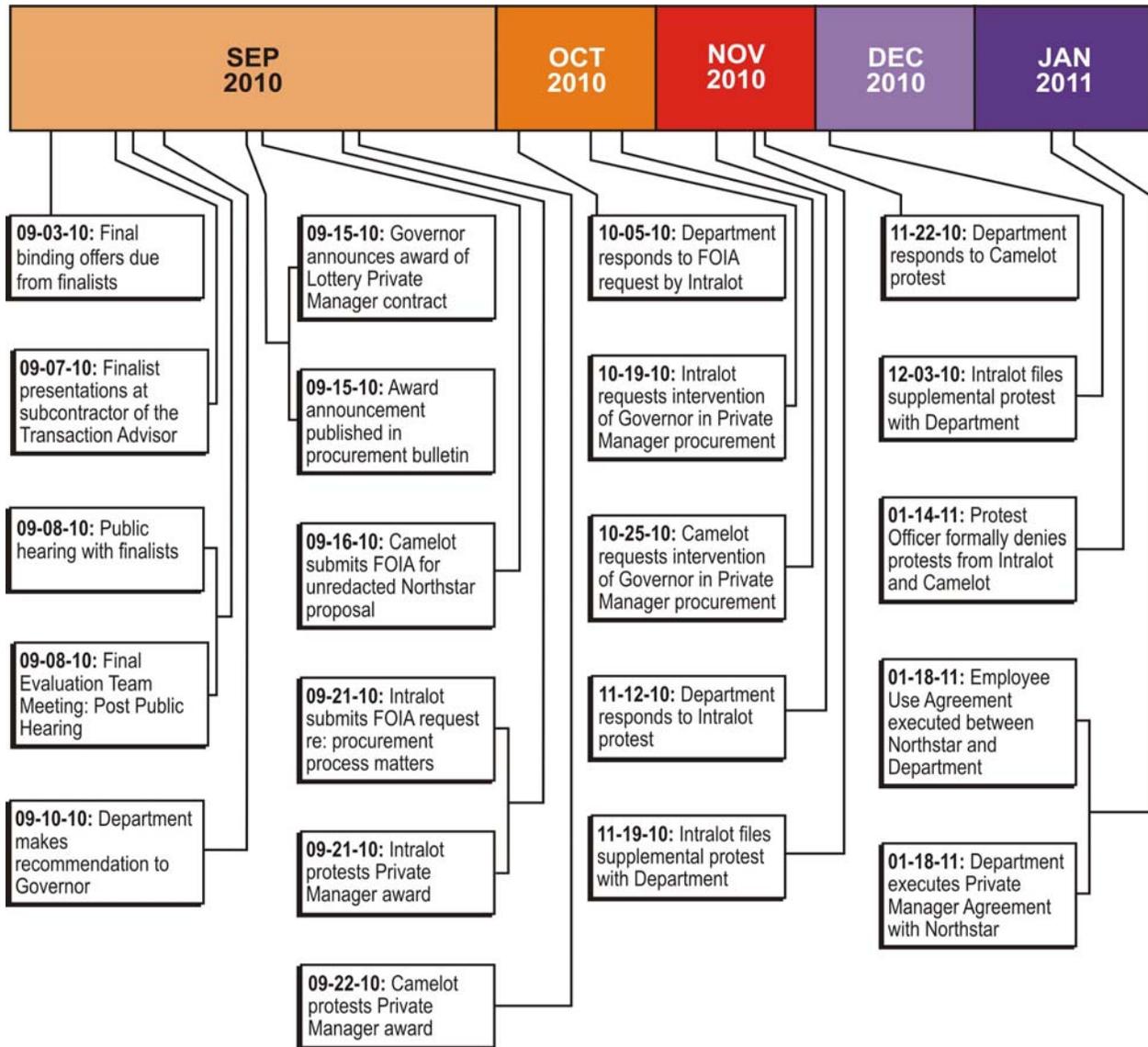
Not Accepted

- 13. Protect State interests and do not allow vendors to work without an executed contract in place. Additionally, enforce contract milestones or amend the contract to reflect updated priorities and time frames. Further, ensure that all subcontractors disclose any relationships that may, even if only in appearance, impair the integrity of the procurement process. Finally, comply with the contractual document and do not pay for services performed prior to the execution of a final contract.**

Finding: In July 2009, the Illinois General Assembly amended the Illinois Lottery Law (20 ILCS 1605/9.1) to direct the Department to procure a private manager to manage the day-to-day operations of the Illinois Lottery. As part of the compliance examination of the Department, the Auditor General reviewed the procurement. A timeline of activities for the procurement, and the findings developed from this audit work follows in Findings 10-13 through 10-20.

Not Accepted - continued





The Illinois Department of Revenue (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.

During the review of the procurement process utilized by the Department in selecting a vendor to provide private management of the Illinois Lottery, auditors examined the procurement files and other documentation maintained by the Department. Additionally, auditors reviewed the contract executed with Oliver Wyman to provide advisory services for this procurement. The following items were noted:

Not Accepted – continued

- **Subcontractors:**
 - The Wyman contract identified four subcontractors to be utilized in the performance of the contract: Scott Balice Strategies, Christiansen Capital Advisors, Kroll Associates, and DLA Piper. The contract estimated payment to these subcontractors at \$2.15 million.
- **Contract Execution Date:**
 - The final party to sign the contract was a representative for the Department's General Counsel. That signature was dated May 29, 2010 and thus became the execution date for the contract. The Comptroller's date stamp showed the contract was filed with the obligations section on June 15, 2010.
- **Work Prior to Executing Contract:**
 - The Department allowed the advisor and its subcontractors to work without an executed contract. On May 12, 2010, 17 days prior to executing a contract with Wyman, a Request for Expressions of Interest (RFEI) was issued to identify parties interested in serving as the Lottery private manager.
 - Responses were due May 27, 2010, 2 days prior to executing a contract with Wyman, to a managing director of one of the subcontractors, Scott Balice Strategies.
 - The RFEI noted that all "questions or requests for information regarding this RFEI should only be directed to the representative of the Transaction Advisor" – Scott Balice Strategies.
 - It would appear that Wyman and/or its subcontractors also assisted in the development of the RFEI, which would have been classified as work prior to the issue on May 12, 2010.
- **Failure to Meet Contractual Timelines:** Section 2.2 of the Wyman contract with the Department lists the services required to be performed by Wyman under the contract.
 - The Initial Review of the Lottery Industry and Economic and Non-Economic Factors Impacting the Transaction was to be completed by May 17, 2010 unless otherwise agreed to by the parties. This date was 12 days prior to executing the Wyman contract. There was no indication, through a contract amendment, that this activity was completed by the due date. Wyman was to be paid \$400,000 for these activities.
 - The Development of the RFP was to be completed by June 7, 2010 unless otherwise agreed to by the parties. The Advisor was still meeting with prospective, interested bidders during this time period to ascertain how the RFP and Private Management Agreement should be structured. It would appear that Wyman would not have met this milestone date nor was there indication, through a contract amendment, that the Department allowed this date to be extended. Wyman was to be paid \$800,000 for these activities. The RFP for Step 1 was issued July 2, 2010.
- **Appearance of Objectivity Issue of Subcontractor:**
 - A Wyman subcontractor, Kroll Associates, appears to have had a relationship with one of the two entities that combined to form NorthStar, Scientific Games.
 - According to Kroll, they were "*retained to oversee the integrity of the process and to provide investigative and consulting services.*" Further, a Kroll employee was "*responsible for ensuring the RFP process was fair and open.*"

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- Two Scientific Games board members at the time of proposing as part of NorthStar had previously been on the board at Kroll (from 2002 through 2006). Kroll had been retained as counsel to Scientific Games' predecessor in 2002.
- 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.
- **Payments Made in Violation of Contract:** The Department paid Wyman for activities conducted prior to the execution of its contract with the vendor. As of April 8, 2011, the Department could produce only summary level billing invoices from Wyman, not the detailed support to show when the work billed was actually conducted.

Response: The Department disagrees 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. The Department agrees that it is "best practice" to have a signed contract in place before beginning work. However, with the task of developing a completely new business model for the lottery under strict time constraints, it was also in the best interest of the State to start work as soon as possible. The contractor did so with the understanding that they were assuming risk, but continued out of dedication to a productive and positive outcome for the State.

AUDITOR'S COMMENT: *The Department refers to the "strict time constraints" that was part of the rationale for allowing Wyman to work without a signed contract. The changes to the Lottery Law passed the General Assembly and were signed into law **almost one year before** the RFP was issued for the Private Manager procurement. We would also disagree that allowing Wyman to work and represent the State without an executed agreement best protects the State's interest.*

The Transaction Advisor was hired to lend expertise and experience in structuring a process for selecting a private manager for the state lottery, as well as crafting the business terms of the agreement. The project was bid fixed-price, based on milestone deliverables, which are clearly outlined in the Transaction Advisor RFP, the Wyman response and the resulting contract. The State paid only for the deliverables as stated in the contract. The milestone dates in the contract were in place to illustrate that the work could be accomplished in the time allowed by the legislation. It was fully expected that dates would shift as the project got underway and the business strategy was developed. The contract allows for modifications for the timeline by "mutual agreement of the parties." The Department believes that a contract amendment was not warranted, since the scope of the deliverables did not change.

AUDITOR'S COMMENT: *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*

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of the process, a process that eventually would turn over a \$2 billion State asset for private management.

Not Accepted – continued

The Transaction Advisor Request for Proposal and contract had extensive disclosure and conflict of interest requirements. Section 5 of the RFP required a bidder to disclose with its offer any and all financial interests, potential conflicts of interest and contract information as a condition of receiving an award or contract in accordance with 30 ILCS 500/50-13 and 50-35. Section 4 of the Conflict of Interest Disclosures required a vendor to identify any material financial or business relationship it has had during the last three years.

Oliver Wyman, on its own and on behalf of its subcontractors, filed extensive disclosures with the State. These disclosures were reviewed by counsel and no objectionable relationships were found.

AUDITOR'S COMMENT: *While the Department indicates no objectionable relationships were found, that was **not documented** in the procurement file. Further, the Department did not provide auditors **any** documentation to show the relationship detailed in the finding was reported by Wyman in its submission.*

With respect to the alleged objectivity issue of Kroll Associates, the Department believes this allegation is without merit. Wyman retained certain subcontractors in order to provide the services set out by the contract. It retained Kroll Associates to assist in the probity investigation of prospective bidders. The qualifications and experience of Wyman and Kroll are not at issue. Both parties were very qualified to do the work required. The allegation involves two board members (Mr. Cohen and Mr. Wright) who served on the boards of both Kroll Inc. and Scientific Games. Mr. Cohen left the board of Kroll in 2006 but continues on the board of Scientific Games. Mr. Wright served on the board and was the CEO of Scientific Games until December 31, 2009 and is no longer connected to Scientific Games. Mr. Wright also served on the Kroll board until 2004 when Kroll was sold to Marsh and McLennan. Because these relationships, service on the boards of Kroll and Scientific Games, were over three years prior to the services rendered by Kroll, no disclosures of these relationships were required to be made under Section 4 of the Financial Advisor RFP. It is important to note that the investigation performed by Kroll was conducted by Jeffrey Cramer, a former Assistant U.S. Attorney for the Northern District of Illinois. He had more than 10 years of experience in investigating and prosecuting cases in New York and Illinois. The OAG cited no examples of questionable findings or conclusions in any of Kroll's or Wyman's reports.

- 14. Take steps to ensure that the Transaction Advisor submits the necessary supporting documentation to allow the Department to review and monitor the contract with the Advisor. Additionally, 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, file a timely amendment to the contract so that State interests are publicly known and protected.**

Finding: 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.

The Department responded on April 8, 2011 that they had provided all documentation to support the Wyman payments. From the Department's perspective, the invoices were approved by either the Lottery General Counsel and/or the Acting Superintendent of the Lottery. The following items are noted:

- **Lack of Billing Detail:** According to Comptroller records, the Department has paid Wyman \$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 Wyman were on two invoices (#BR27607 and BR27976) that the Department did not produce for the auditors. The Department did provide a summary document that gave an invoice date, services, amount and comments for the payments. An April 11, 2011 memo from internal audit, in response to questioning the detailed support for Wyman 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."* Unfortunately, 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 questioned in this bullet point. This would appear to make it very difficult for management to follow which modules were being completed.

After draft findings were submitted to the Department, auditors received the 2 invoices detailed above on May 9, 2011. This was 31 days after the Department told us, on April 8, 2011, that they had provided all documentation to support the Wyman 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 Wyman 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. For instance, Invoice #BR27118 states the work performed was the *"First invoice for professional services upon completion of Modules 3.3.1 & 3.3.2A."* The invoice was for \$1.15 million and was dated July 29, 2010. The problem with the lack of detail is based on the following:
 - **Contract Differences:** The budget office document noted in the bullet above references this to Section 2.2.1 of the contract with Wyman. The contract lists a compensation structure that showed that Wyman would be paid *"\$400,000 upon completion of tasks and services outlined in Section 2.2.1."* There was no support provided by the Department to show why this difference in payment amount was necessitated. This is but one instance of many discrepancies between the budget

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office document that was to be used by “management” and the contractual compensation schedule.

- **Timing:** An additional concern is that the contract with Wyman lists milestone dates that Wyman needed to complete the different tasks by. For example, Section 2.2.1 referenced in the above bullet was to “be completed by May 17, 2010, unless otherwise agreed to by the parties.” There was no indication that this milestone date had changed; the invoice did not state when the activities were performed; only a billing date of July 29, 2010 appears to apply to these activities.
- **Legal Services:** The review of what support the Department did have for the \$4.94 million in payments to Wyman included the legal services subcontracting work performed by DLA Piper. In total, there was \$727,132.37 in payments to Wyman for legal services performed by the subcontractor. This was 15% of the total payments made through March 2011. Auditors note:
 - **Lack of Detail:** The legal services invoices were submitted by the subcontractor to Wyman, who signed off and submitted them to the Department, who also approved the invoices for payment. The subcontractor did provide detail as to who performed certain activities and when those activities were performed. Unfortunately, this was only for \$9,700 of the over \$727,000 in legal services billed (1%). Without support, auditors were unable to determine what activities were completed or who provided the billed services to determine whether they were appropriate.
 - **Billing Rates:** The summary billing statement on the invoices did list a number of individuals that were charging time to the project being paid by the Department, the number of hours billed and total dollar value of the billing by person. As explained above there was little support as to what activities these individuals 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. Auditors were unable to verify if those were correct billing rates.
 - **Legal Cap:** The Wyman contract filed with the Comptroller on June 15, 2010 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, auditors question why the increase was necessary. Additionally, the Lottery General Counsel indicated that “\$300,000 of the \$450,000 increase will be paid from fees due from the selected final offeror, Northstar Lottery Group, for reimbursement of lottery costs related to probity and the private manager procurement.” It was an understanding that the \$300,000 would be an offset to the total charges the State was to pay to another subcontractor, Kroll, for probity work under the contract.

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Response: The Department disagrees 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 has adequate support and monitoring for the payment of this contract. As our attached chart shows (see below) the Transaction Advisor RFP, Oliver Wyman's response and the resulting contract, detailed set deliverables for a fixed price, broken up into milestone payments were the basis for reviewing and authorizing payment to the vendor. There is complete transparency around the activities covered by the contract and compensation. In most instances the deliverables were part of a public process and their completion evident to all. The activities and deliverables detailed in the contract enabled the Governor to make a Private Manager selection by September 15, 2010, as directed by Statute.

AUDITOR'S COMMENT: *The Department states there was "complete transparency" in the activities covered by the contract and compensation. 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.*

As to the legal subcontractor, the invoices are typical of legal services billing. They detail the number of hours each team member worked on the project. The various billing rates are a substantial discount from the firm's standard rates and reflect the various experience levels of the professionals involved. Again, as is typical, law partners are billed at a higher rate than paralegals. These 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 was 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: *The Department indicated 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.*

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AUDITOR'S COMMENT: *The Department's chart, which was submitted with its responses to the audit, is undated so it is impossible for auditors to know when the document was created. We can note that the invoice for probity (contract section 2.2.4) work indicates a payment of \$1.35 million that was approved December 10, 2010. The **amount is inconsistent** with what the Wyman contract indicated the subcontractor (Kroll) would be paid under the agreement (\$675,000) for probity. The approval of the invoice is also 38 days **prior to** when Wyman submitted the final probity report on Northstar, according to Department counsel.*

15. 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.

Finding: 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. The following items are noted:

- **Evaluation Team Meetings:** Not all team members attended all of the meetings where evaluation procedures were discussed.
 - July 22, 2010 Evaluation Team Meeting: Purpose was for the Transaction Advisor to present *An Introduction to the Evaluation*. There was no documentation to show that **33%** (3 of 9) of the evaluation team members attended this meeting. Two evaluation team members had not been assigned when the meeting occurred. The third evaluator was not included on the meeting log, although the member thought she "was there by phone." Auditors did note that another member that attended the meeting by phone was recorded as present on the log. While there was no formal documentation assigning the evaluation team to this procurement, Conflict of Interest Disclosures for two of the team members that missed this meeting were dated 8 and 12 days after the meeting. There was no documentation in the procurement file to explain how those team members that missed the meeting were provided the information disseminated at the meeting.
 - August 3, 2010 Evaluation Team Meeting: Purpose was to offer clarification on any proposal. Documentation indicated that **22%** (2 of 9) of the evaluation team members did not attend this meeting. There was no documentation in the procurement file to explain how those team members that missed the meeting were provided the information disseminated at the meeting. On May 9, 2011, the Department provided documents from the two evaluators stating that they were "pretty sure" they were at the meeting and "Nothing definitive on this one, but I really do think I was there (again by phone)." One of the members was listed in the staffing plan for the Northstar proposal. When questioned by auditors, this evaluator stated he had not seen the document referenced. The document where his name appears is the Step 2 Northstar proposal, a document he surely should have seen since he should have evaluated the proposals.

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- August 6, 2010 Evaluation Team Meeting: Purpose was to discuss with one another and the Transaction Advisor the initial assessments to ensure consistency and accuracy of scoring. An additional purpose was to verify any significant scoring discrepancies. These meeting minutes, unlike the handwritten notes from the Department's SPO at all other evaluation team meetings, were in typed form. The minutes indicated that all team members were present. This meeting took place immediately after the Intralot meeting, a meeting where meeting documentation shows that two team members did not attend, although one of the two team members states he was there. Additionally, one of those two team members submitted his scores for Step 1 the day before this team meeting.
- August 24, 2010 Evaluation Team Meeting: Purpose was to document any questions the team wanted to ask the two finalists. **Eleven percent** (1 of 9) of the team did not attend this meeting. There was no documentation in the procurement file to explain how the team member that missed the meeting was provided the information disseminated at the meeting.
- September 8, 2010 Evaluation Team Meeting: Post Public Hearing/Post Vendors Presentation meeting. Attended by all members.
- **Proposer Meeting/Presentations:** Not all team members attended all the instances where there was interaction with the proposers.
 - August 4, 2010 Vendor Meeting with Camelot: The purpose of this meeting was to clarify any issues the team had with the vendors Step 1 proposal. **Twenty-two percent** (2 of 9) of the team did not attend this meeting. There was no documentation in the procurement file to explain how these team members that missed the meeting were provided the information disseminated at the meeting. The two team members did attend the Northstar meeting on that same day.
 - August 6, 2010 Vendor Meeting with Intralot: The purpose of this meeting was to clarify any issues the team had with the vendors Step 1 proposal. Documentation showed that **22%** (2 of 9) of the team did not attend this meeting. There was no documentation in the procurement file to explain how these team members that missed the meeting were provided the information disseminated at the meeting. The two team members did attend the evaluation team meeting on that same day, according to the typed minutes.
 - September 7, 2010 Finalist Presentation by Camelot: **11%** (1 of 9) of the team did not attend this meeting. There was no documentation in the procurement file to explain how the team member that missed the meeting was provided the information disseminated at the meeting.
 - September 7, 2010 Finalist Presentation by Northstar: **11%** (1 of 9) of the team did not attend this meeting. There was no documentation in the procurement file to explain how the team member that missed the meeting was provided the information disseminated at the meeting. The Acting Superintendent of the Lottery, a member of the Evaluation Team, told the member that did not attend the finalist presentations, "Your eval will be based on the written material. You probably shouldn't attend the second presentation if you can't make the first. No worries."
- **Turnaround Time for Review and Scoring:** With respect to scoring on proposals:

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- 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 Acting Superintendent of the Lottery told auditors that the evaluation committee knew the timeframe and they were told this was going to have to be their singular focus. However, the exceptions noted above do not indicate such an understanding. For example:

- One evaluator asked the Acting Superintendent if she could attend a luncheon on August 4, 2010, during the Step 1 evaluation process, when two vendor presentations were given and the Acting Superintendent replied, "Your luncheon shouldn't be a problem." Also, the same evaluator told the Acting Superintendent she may have to leave early on August 6th, when scores were due and when Intralot ended up presenting. The Acting Superintendent responded, "I don't think leaving early on Friday will be a problem." Meeting minutes from the team meeting on August 6, 2010 described above indicated that the evaluator was in attendance. This was the same evaluator that missed the vendor presentations in Step 2 and did not pick up the Step 2 proposals until the day of the Public Hearing. It is unclear how the private manager procurement process would have been the singular focus for this evaluator.
- Another evaluator explained that he has mandated times that he has to transfer money, etc. He did his job duties that could not wait, and then went back to the evaluations. This evaluator did miss a meeting with a proposer.

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.

Response: The Department agrees 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 disagrees 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. The Department assembled a diverse, 9-member team for this important assignment. It even took the unusual step of selecting members from outside the Department to ensure a well-rounded set of perspectives. The Department then hired a team of Transaction Advisors to develop the evaluation methodology and tools, and to work with the Evaluation Team, both as a group and individually. The Transaction Advisors made themselves fully available to the Evaluation Team, both in-person and via telephone and e-mail. The Evaluation Team then held numerous meetings as checkpoints that the task was understood and progress was being made. While certain

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Not Accepted – continued

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 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 fails 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. As the finding indicates, the Governor's Office recommended one of the evaluation team members. It was the Acting Lottery Superintendent who indicated to auditors this procurement was to be the **singular focus** for the evaluation team. Given the lack of complete participation in the process we note in the finding, the Lottery official may have not communicated the importance as she stated. 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.*

The process used the Transaction Advisors to deal with those situations and to be sure all members had the information they needed. The Department disagrees with OAG's conclusion that the Department violated 30 ILCS 10/3001. The Department further believes the facts noted above demonstrate the Department met the express language of that statute and the fundamental view that everyone involved in the State's procurement has to proceed in the best interest of the State.

AUDITOR'S COMMENT: *The Department did not provide documentation to show that this information was adequately disseminated to team members who did not attend meetings.*

16. Ensure all information needed to evaluate proposals is collected, documented and provided to members of the evaluation team.

Finding: The Department, in conducting the evaluation process for the procurement of a Private Manager for the Illinois Lottery, failed to document clarifications needed during the evaluation process. The following items are noted:

- **Evaluation Clarification Issues:** Team meetings, reviewed as part of auditors' review of the procurement files, lacked documentation to show that questions of evaluation team members had been addressed and answered by the Transaction Advisor or proposing vendors. Auditors found:
 - On August 6, 2010, an evaluation team meeting was held to discuss with one another and the Transaction Advisor the initial assessments to ensure consistency and

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accuracy of scoring. An additional purpose was to verify any significant scoring discrepancies. These meeting minutes, unlike the handwritten notes from the Department's SPO at all other evaluation team meetings, were in typed form. The minutes indicated that all team members were present. This meeting took place immediately after the Intralot clarification meeting, a meeting where there was no documentation showing that two team members attended. Additionally, one of those two team members submitted his scores for Step 1 the day before this team meeting.

- **Step 1 Evaluation Process:** One area of the evaluation process was "Past Performance." Past performance was worth 20 evaluation points in the process.
 - The Lottery Law (20 ILCS 1605/9.1(e)(4)) instructed the Department, while selecting a private manager, to take into account the offerors poor or inadequate past performance in servicing, equipping, operating or managing a lottery on behalf of Illinois, another State or foreign government and attracting persons who are not currently regular players of a lottery.
 - The RFP published by the Department instructed the proposers to "Report any instance in which it has been alleged that you (a) performed poorly or inadequately in servicing, operating...of a lottery. Please provide an explanation of the circumstances, and the actions you took to address the situation." (emphasis added)
 - The Acting Superintendent of the Lottery, who was on the evaluation team, was concerned about the scoring for "past performance" and in a July 27, 2010 correspondence with the Transaction Advisor noted, *"I think this is a tricky one that could land us in trouble, especially since it is widely believed that its inclusion as an evaluation criteria was directed at a certain bidder."*
 - In a correspondence with the legal subcontractor for the Transaction Advisor on that same day, the Acting Superintendent explained, *"It is a tricky one to score on a scale of 1 to 20. Consider a bidder lists no issues (really?); a bidder describes a dozen issues over the past 10 years, none fatal, all lessons learned; a bidder lists a really big issue from 15 years ago; bidder lists a semi-serious issue from last year that they dealt with expeditiously. Furthermore, we believe this provision was purposely inserted to trip up a likely bidder. I think this is fertile protest territory."*
 - There was no documentation in the Department's procurement files that showed the legal subcontractor answered this query by the Acting Superintendent.
 - Another evaluator, who is an employee of the Lottery, also questioned the "past performance" issue. In an August 3, 2010 correspondence to 7 of the other 8 on the evaluation team and the Transaction Advisor, the following was detailed, *"I don't know whether I can ask this question or not but here it is anyway. Northstar's response to Past Performance indicates a belief that neither Northstar or any of its members have been guilty of any performance issues. Camelot for instance, referred to many similar instances that we have experienced with GTECH. Like Camelot, GTECH identified the problem, formulated a solution, fixed it, and things have been fine ever since. Did Camelot go too far because they didn't understand the requirement or did Northstar not go far enough?"* The Transaction Advisor thanked the evaluator for the question and indicated they would get clarity at the meeting tomorrow. There was no documentation to show whether this was discussed with the Northstar team at the meeting on August 4, 2010.

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- **Step 2 Evaluation Process:** One area of the evaluation process was “Compliance with applicable laws and regulations.”
 - On September 3, 2010, one member of the evaluation team emailed the Transaction Advisor and the rest of the team with the question *“For the first part of the evaluation, compliance with applicable laws and regulations, should we simply consider the laws and regulations that we are each aware of that apply to this project?”*
 - Also on September 3, 2010, the Advisor responded *“Yes please – no need to head to the law library this weekend! Just the laws and regulations that you are each aware of.”*
 - Not all members of the evaluation team were employees of the Illinois Lottery. One evaluator worked for the Department of Commerce and Economic Opportunity and at the time of this procurement evaluation had been with the State for approximately 5 years and had worked on 1 RFP evaluation. This individual told auditors that he was familiar to some extent with the laws, but that he does not have in depth knowledge of lottery laws.
 - Another evaluator, who had also been with the State 5 years at the time of the evaluation process, works for the Department of Public Health but had previously been detailed to the Governor’s Office under a previous administration. This evaluator told auditors that her knowledge of the applicable laws would have been in the RFP and in the orientation meetings and anything that would have come from group discussions. Documentation showed that this evaluator missed evaluation team meetings on July 22, 2010 and August 24, 2010.
 - The third evaluator that was not a Lottery employee worked for the Tourism Bureau and had been with the State for about 8 years when the evaluation process was completed. This evaluator reported having substantial experience with procurements in the past and that she was familiar with the basic, boilerplate laws that have to be followed. The evaluator also told auditors that she was familiar with Illinois Lottery laws because they (Tourism Bureau) have done work with the Lottery before. It should be noted that this evaluator did not even pick up the Step 2 proposals to evaluate the “Applicable Laws” until 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.
 - An evaluator who did work for the Lottery told auditors that he essentially punted on this evaluation criteria. His comment on the evaluation was *“I am not an expert in lottery law, but to the best of my knowledge, this proposal is compliant (sic) with existing laws and regulations.”* The evaluator told auditors, *“It became a criteria that was impossible to score.”*
 - Given the complexity and volume of the proposals submitted for this procurement, the response from the Transaction Advisor may not have clarified the scoring issue for the evaluators.
- **Timing of Vendor Contacts:** The review of documentation showed an email from an evaluator to the Transaction Advisor with questions relative to Northstar. When

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auditors did not see a response they asked the evaluator if one was provided. The evaluator told auditors that he submitted his questions to the Acting Superintendent of the Lottery and they were supposed to be forwarded to the Transaction Advisor and the questions got addressed only to the extent they were included in the questions for the vendors to answer at the vendor presentations. The evaluator reported that sometimes there were no answers back to his questions. The evaluator thought that was an effort to keep the vendor presentations at the same length, but that doesn't mean that the Transaction Advisor shouldn't have gone outside of the presentations to get answers. The Acting Superintendent confirmed the vendor meetings were kept to the same time limit because they wanted to treat all proposers the same.

Response: The Department agrees and ensured that all information needed to evaluate proposals was collected, documented and provided to members of the evaluation team. The Department disagrees with the finding. The very emails and communications that the auditor cites are evidence of the full and robust dialogue that occurred between the Evaluation Team and the Transaction Advisors over the course of the evaluation.

The level of attention paid to fairness, transparency and bidder engagement during the Private Manager transaction process was unprecedented in State procurement. The State hired a team of experts in lottery economics, procurement law, contract law, deal structures, and probity to ensure a process that was robust and rigorous. The process was in fact complimented by the Interested Parties with several noting the professionalism of the deal team as an indication of the seriousness with which the State undertook this endeavor.

AUDITOR'S COMMENT: *The Department's assertion that dialog was "full and robust" would carry merit had the questions raised by the evaluation team had documented answers in all cases, **documentation that we did not see.** This conclusion was confirmed by a member of the evaluation team. We would also note that the losing proposers protested the award of this contract which was the **end result of the procurement process** that was followed.*

17. Ensure that all scoring tools are appropriately and timely completed.

Finding: 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 following items were noted:

- **Scoring Tool Irregularities:** After initial review of the procurement files and auditors questioning the certification (signing/dating) of evaluations, the Department provided additional evaluations. The following exceptions are still noted:
 - 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.

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- 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.

Updated Response: Not Accepted. The OAG report raises questions about when scores were submitted by evaluators. In each case, as documented to the OAG, scores were submitted to the Transaction Advisor and were tallied **before selections were made**.

The Step 1 initial evaluation was based on scoring of the bidders in different categories (ability to grow the customer base, social responsibility, past performance, management record, and business plan, etc.) and an overall average score. The bidders needed to receive a minimum score in 5 categories and an overall average minimum score.

The Evaluation Committee held a meeting on August 6, 2010 with the State Procurement Officer (SPO), the Transaction Advisor and the Legal Advisor. The primary objective of the meeting was to allow the Evaluation Committee to discuss with one another and the Transaction Advisor about their initial assessments and to compare observations to ensure consistency and accuracy of scoring relative to the instructions and to verify that any significant discrepancies in scoring was not due to misunderstanding or oversight of pertinent information.

One bidder was eliminated in the Step 1 evaluation scoring based on two criteria:

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- Their business plan did not meet the minimum scoring requirement. Six of the nine evaluators gave a failing score to Intralot's business plan.
- Their overall average score for all the categories did not meet the minimum scoring average to proceed to the Step 2 evaluation process.

On the evening of August 9, the bidders received letters regarding their qualification to move to Step 2 of the evaluation process. One bidder did not qualify for the Step 2 phase, while the other two bidders met all the requirements of the Step 1 evaluation.

The Step 2 final evaluation was based on a pass/fail evaluation of the finalists' business plan and the NPV (Net Present Value) of the net income target received from the finalists. It should be noted that both finalists received a unanimous **PASSING** score on their Step 2 evaluations. The determining factor for awarding the contract was based on the NPV of the income targets presented by the finalists. The winning bidder **guaranteed net income of \$540 million greater** than the other finalist over a five year period to the Illinois Lottery. (NOTE: The OAG reviewed the NPV calculations of the finalists and made no comments regarding those calculations.)

The Governor awarded the Lottery private manager contract to the Northstar Lottery Group on September 15, 2010.

The Department disagrees with the specific bullet points on page 75 and 76 in the Auditor General's report:

- Page 75 1st bullet - OAG stated the evaluator failed to date his evaluation certification of Intralot Step 1.
 - Department Response: The evaluator emailed the score sheets to the SPO and Transaction Advisor on 8/6/2010 (See Attachment A). The missing date on the form has no relevance to the scoring process.
- Page 75 2nd bullet - OAG stated the evaluator did not date the Step 1 evaluation until 8/9/10.
 - Department Response: The evaluator filed the score sheets with the SPO and Transaction Advisor on 8/9/2010 (See Attachment B). It was at the end of the business day on 8/9/2010 (See Attachment C) that the SPO released the letters to the bidders, thus all the scoring sheets were received and tabulated prior to the release of the letters.
- Page 75 3rd bullet - OAG stated the evaluator dated her evaluation certification for two vendors (Intralot and Northstar) after the SPO released the letters to the bidders.
 - Department Response: The evaluator had confirmed her final scores through email with the Transaction Advisor on the morning of 8/9/2010 (See Attachment D). All the scoring sheets were received and tabulated prior to the release of the letters.

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- Page 75 4th bullet – OAG stated the Step 1 evaluations were certified on August 5, 2010 before a final clarification meeting on 8/6/2010 with Intralot that he did not attend.
 - Department Response: The evaluator was on military leave on August 6, 2010, but the evaluator performed his due diligence and prepared his scoring sheets prior to his military leave. It should be noted that this evaluator gave Intralot their second highest score.
- Page 75 5th bullet – OAG stated the Step 2 evaluation for one evaluator was submitted on 9/9/2010, the day after the public hearing.
 - Department Response: This evaluator presented at the Public Hearing. Her attendance at the public hearing had no effect on her Step 2 scoring; all the evaluators gave both bidders a PASSING score for Step 2.
- Page 75 6th bullet - OAG stated the Step 2 evaluations were not completed until 9/15/2010, the same day the Governor announced the award.
 - Department Response: The evaluator emailed the Step 2 final score sheets to the SPO and Transaction Advisor on 9/8/2010 (See Attachment E). All scoring sheets were received and tabulated prior to the release of bidding results.
- Page 76 1st bullet – OAG stated the evaluator submitted her Step 1 scores to the SPO on 8/16/2010 and the Department did not provide evidence of the Step 2 electronic file being received.
 - Department Response: The evaluator confirmed her final Step 1 scores through email with the Transaction Advisor on the morning of 8/9/2010 (See Attachment D). The evaluator emailed the Step 2 score sheets to the Transaction Advisor on 9/9/2010 (See Attachment F). All scoring sheets were received and tabulated prior to the release of bidding results.
- Page 76 2nd bullet – OAG stated the evaluator submitted her Step 2 scores to the SPO electronically on 9/10/2010 and the Northstar Step 1 scores on 8/11/2010.
 - Department Response: As noted by the OAG on page 75 5th bullet point, the evaluator submitted her completed Step 2 scoring sheets on 9/9/2010. The evaluator filed the Step 1 score sheets with the SPO and Transaction Advisor on 8/9/2010 (See Attachment B). All scoring sheets were received and tabulated prior to the release of bidding results.
- Page 76 3rd bullet - OAG stated the evaluator submitted Step 2 electronic scores on 9/15/2010, the same day the Governor announced the private manager award.
 - Department Response: The evaluator filed the completed Step 2 final score sheets on 9/8/2010 with the SPO and Transaction Advisor (See Attachment F). All scoring sheets were received and tabulated prior to the release of bidding results.

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AUDITOR'S COMMENT: *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.*

- 18. Adequately document when scope changes are needed to State contracts and memorialize those changes in the contract document. Additionally, the Department should enforce contractual provisions and require contractors to produce written reports when taxpayer funds are expended for such purposes. Finally, the Department should utilize probity investigations only for stated evaluative purposes for vendors being considered for an award and not because a losing vendor has protested the procurement process and award.**

Finding: The Department increased the scope of the probity investigations utilized in the procurement of a Private Manager for the Lottery without documentation to support who made the decision or why the decision was made. This decision increased the cost to taxpayers. Additionally, while the probity contractor conducted six investigations, only two were reduced to writing and neither was dated, a condition that violated its contract with the Department. Finally, it appears the Department utilized the probity investigation of one non-finalist, by releasing it to the public, due to the fact the vendor had protested the award of the contract. The following items are noted:

- The Department **expanded** the number of probity investigations conducted by Kroll Associates to include a proposer that **did not achieve** the status of a finalist for the Lottery Private Manager procurement.
- The procurement file **did not contain** any documentation to support who made this decision or why the decision was made.
- In the Department's November 12, 2010 response to a FOIA from Intralot, there is an August 2, 2010 correspondence from the Lottery General Counsel to the General Counsel of Oliver Wyman to clarify the understanding of the probity section of the contract. The Lottery Counsel wrote, *"It now appears that there will be a need for only one comprehensive source investigation, and three preliminary investigations. We have discussed the revised schedule with Kroll, and it is our understanding that Kroll will now be conducting preliminary public records investigations of all three offerors, related companies, and key executives, as well as a comprehensive source investigation of the final offeror."*
- While the Department filed a number of revisions related to the increasing or decreasing of the obligation amount to the Comptroller for the Wyman contract, **none of the issues** detailed in the Lottery Counsel's August 2, 2010 correspondence was amended to the contract.
- Intralot was notified on August 9, 2010 – 7 days after the Lottery Counsel's correspondence – that it **failed to become a finalist** in the procurement.

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- While the correspondence indicated that Kroll would conduct three preliminary investigations, auditors were only provided with the investigation conducted on **one proposer**, Intralot, a non-finalist. This **report was undated** so auditors could not determine when the report was actually prepared. In a FOIA response, the Department's General Counsel indicated that the Kroll report on Intralot was sent to the Department on October 27, 2010. This was:
 - 79 days **after** Intralot had been ruled out as a finalist for the procurement,
 - 36 days **after** Intralot protested the award of the Lottery Private Manager procurement,
 - 8 days **after** Intralot requested intervention by the Governor on the procurement, and
 - 16 days **before** the Department's General Counsel responded to the Intralot protest.
- The Department reported to us "*The Illinois Lottery received **oral presentations** on the preliminary background probity investigations on all three Offerors. The Intralot investigation was reduced to written form in response to Intralot's FOIA and subsequent protest of the Private Manager award.*" (emphasis added) Oral presentations were **reportedly** made to the Lottery General Counsel and Acting Superintendent, Department General Counsel and members of the Governor's staff. However, there was **no documented minutes** or other documentation to support when these oral presentations were made. **No one from the evaluation team**, other than the Acting Lottery Superintendent, was part of the presentations.
- This written report on Intralot was **subsequently released** to the public.
- A December 3, 2010 protest from Intralot alleges that the Department's General Counsel "*told a representative of Intralot that if Intralot continued to pursue its protest, the Department would release damaging allegations about Intralot S.A.*" The protest goes on to explain that on November 12, 2010 the threat was executed when the Department released its response to the Intralot protest. The Department's Procurement Manual states that only the SPO or PIO shall release information on any protest.
- The Department appears to have treated Intralot different than the other proposers. A finalist, Camelot, also protested the award yet the Department did not reduce the oral presentation on Camelot to writing.
- According to the Department, Kroll was paid **\$675,000** for the probity investigations. Given that only one undated report was documented on the 3 proposers for Step 1, it is impossible to determine whether the taxpayer funds were appropriately expended.
- Kroll did issue a written report on the award winner, Northstar. However, this too was **undated** which precludes us from knowing when the report was compiled.
- Auditors inquired, on February 16, 2011, whether Northstar had paid the State the \$300,000 for the probity investigation as required by the RFP. The Department provided a copy of a check, dated 8 days after the request on February 24, 2011, from Northstar for the \$300,000.

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- The recommendation from the Department Director and Acting Superintendent of the Lottery to the Governor on September 10, 2010 was “made in advance of completion of full probity investigations.”

Response: The Department disagrees with the finding and, as it has told the auditor, believes that the thoroughness of the probity review was an important tool in protecting the taxpayers of Illinois’ interest in the Lottery.

The Oliver Wyman team was chosen as Transaction Advisor in part because of the inclusion of Kroll, a respected risk management and investigation firm. In its response to the Transaction Advisor RFP, Kroll outlined a detailed, multi-phased approach to the probity investigation process. In order to price the scope of work in its proposal, not knowing how many bidders would respond, Kroll limited initial probity to three bidders and in-depth investigation to two Finalists.

In the Step 1 response, Bidders were required to submit Multi Jurisdictional Disclosure Forms for “each corporate officer and director of the Offeror.” This form is standard in the gaming industry.

As there were only three respondents in Step 1, the Lottery’s General Counsel clarified that initial probity should be conducted on all three bidders. There was no scope change and no additional fee paid. Initial probity included reviewing that Multi Jurisdictional Disclosure Forms were included for each person required and verifying that the information contained in those Forms were complete and accurate using publically available sources. The State was completely within its rights to verify the fitness of the firms and individuals who submitted themselves as responsible Bidders.

The results of the initial probity review had no bearing on the Step 1 evaluation or the qualification of any Bidder for Step 2 consideration.

The lottery industry is a global, highly-competitive industry, dominated by a few large players. The Department’s initial plan was not to allow its initial probity review to be used as leverage by one firm over another in other jurisdictions’ proceedings, as such, all briefings on the initial probity results were conducted orally, and none of the initial probity reports were reduced to written documents. Only the final probity report on the Awarded Finalist, Northstar, would be (and was) reduced to writing.

However, in responding to the protest of one of the bidders, Intralot, the probity investigative report had to be memorialized in writing in order to properly and timely preserve and not waive the State’s right to subsequently raise the issue of Intralot’s standing to protest or sue in a court of law. In determining if a party has standing to bring a protest action, one needs to assert that “but for the actions complained of in the protest, the party bringing the protest action would have been awarded the contract.” Intralot’s initial probity report contained negative information that would have prevented Intralot from being awarded the contract. Camelot’s initial probity report did not contain any such negative information. Thus, in the Camelot protest, standing was not an issue and Camelot’s initial probity results did not have to be memorialized in writing. Thus, a

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written report of the Intralot probity investigation – and only Intralot’s - had to be prepared and included in the Department’s response to Intralot’s protest in order to preserve and not waive the issue in future proceedings.

AUDITOR’S COMMENT: *Absent a written report, auditors could not determine that State funds were **appropriately expended**. Further, absent dates on the reports **that were reduced to writing**, the auditors could not determine the use or usefulness of the probity information.*

19. Follow documented laws and administrative rules in handling protests to awards of procurement opportunities.

Finding: The Department utilized an unconventional protest process for the procurement of a Private Manager. This process may not have allowed proposers the necessary opportunity to gather all information necessary to submit a substantive protest of the process. Additionally, the process resulted in the final decisions on the protests not being provided until over 100 days after the protests were filed. The following items are noted:

- Section 5.8.1 of the Step 1 RFP details that “Any and all actions, protests, or challenges regarding any alleged improprieties, ambiguities, or defects regarding this RFP, any of the procedures or requirements herein, or any other terms or conditions whatsoever stated herein or contemplated thereby must be asserted, on or before 11:59PM CDT August 6, 2010. Failure to file such actions, protests, or challenges on or before 11:59PM CDT August 6, 2010 shall constitute a full and absolute waiver to take action against, protest, or challenge any and all alleged improprieties, ambiguities, or defects regarding the RFP, any of the procedures or requirements herein, or any other terms or conditions whatsoever stated herein or contemplated thereby.”
- Part of the Step 1 RFP detailed the evaluation process utilized to score the proposals (section 3.3). It would be **impossible** for the proposers to know problems with evaluation issues (i.e., such as evaluation team members not attending presentations/meetings with vendors or not submitting evaluation scores until after the vendors had already been notified of the results to Step 1) by the time designated in the RFP. For instance, information on the evaluation scores and the public information maintained in the procurement files would not have been available for the proposers until after the award was announced **40 days later** when the Governor announced the award on September 15, 2010.
- The protests, according to Step 1, needed to be submitted by August 6, 2010, which was **3 days prior** to the Department informing the proposers who were finalists and who did not qualify for Step 2 of the process on August 9, 2010.
- Two vendors (Intralot on September 21, 2010 and Camelot on September 22, 2010) protested the award decision within the 7 days following the announcement on September 15, 2010. The protests were directed to the protest officer delineated in the RFP documents.

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- The Department implemented an **unconventional method** to respond to the protests that is not outlined in the RFP, Illinois Procurement Code, or Standard Procurement Rules.
- The Department's General Counsel, along with a subcontractor (DLA Piper) to the Transaction Advisor completed responses to the Intralot protest on November 12, 2010 and the Camelot protest on November 22, 2010. The General Counsel and subcontractor were party to the procurement process.
- The **conclusion** to these responses by the Department's General Counsel stated that for *"the reasons set forth above, the Department respectfully requests"* that the protest be denied in its entirety. It would be safe to assume the *"request"* was being made to the protest officer named in the RFP.
- The protest officer is an attorney that reports to the Department's General Counsel who was making the "request."
- The Lottery General Counsel told a representative for Camelot on October 15, 2010 that *"With regard to protest rules, as you recall, I mentioned that because this procurement is statutorily exempted from the Procurement Code, there are no specific protest rules which govern. However, I trust that the Department will conduct the protest process consistent with the spirit of 44 Ill. Adm. Code 1.5550 and 30 ILCS 500/20-70 and 20-75."* The process utilized by the Department did not appear to be in the "spirit" of that criteria.
- While the Lottery counsel states the procurement is "exempt" from the Procurement Code, the Lottery Law (20 ILCS 1605/9.1) does not set forth a specific process for how protests are to be processed for the Private Manager procurement.
- This unconventional process slowed the protest review process. The protest officer denied the Intralot and Camelot protests on January 14, 2011, **over 100 days after** the protests were submitted by the vendors.

Response: The Department disagrees with the findings. The Department implemented a process that ensured that all parties, the protester and the Department, were provided due process. Specifically, an impartial and independent arbiter of facts and law was appointed to hear the protest. This individual was not involved in the RFP, the evaluation of the bids, or the selection process for the Private Manager. This arbiter was free to make his decision without interference or the involvement of any other Department or Lottery personnel. As part of this process, the protest officer would review the protest filing, review the Department's response, conduct any additional investigation that might be necessary and enter the Protest Officer's Decision. This process is similar to the Department's procedure for handling protests in its Administrative Hearings Division.

Auditor's Comment: *The protest process utilized by the Department was not documented. This increases the likelihood that parties would feel they were not afforded due process and that the award process was arbitrary and capricious.*

The finding notes the timing of Camelot's and Intralot's protests, complaining that insufficient time was allowed to potential protesters, to allow them to fully develop their facts and arguments. Both protests were filed within 7 days of the Governor's public
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notification of his selection of a Private Manager as required by Section 1605/9.1(i) of the Lottery Act. The time lines in question were set by statute, not by the Department. Due to delays during the bidding and evaluation process the Department and in fairness to all bidders, the Department extended and did not enforce the August 6, 2010 deadline for filing protests as provided in the RFP.

Auditor's Comment: *The Department's response is inaccurate. Auditors did not question whether the protests from the vendors were not submitted timely. They were submitted within the time frame delineated in the Lottery Law. The auditors did question the process utilized by the Department, including the protest deadline the Department implemented in Step 1, which was not detailed in the Lottery Law, nor in the spirit of any documented protest criteria. Vendors proposing in Step 1 could not have known of the procurement discrepancies detailed in these Lottery Private Manager findings and the procurement process by the August 6, 2010 deadline. Further, the Department states in its response that the August 6 deadline date was not enforced. However, the Department responses to the Intralot and Camelot protests did reference this requirement.*

The finding also noted that it took the Protest Officer over 100 days to enter his decision with respect to the protests. Given the volume of material the Protest Officer was required to review, 100 days is not an excessive amount of time for a thorough review of the Protester's challenges and is consistent with the amount of time required to file a decision in other complicated Department hearings. Furthermore, the protestors submitted a number of supplemental filings during the process. The only parties impacted by this delay were the successful bidder and the Lottery by not being able to proceed to contract until the protests were resolved.

Auditor's Comment: *It is unclear whether the Department's protest officer started the review process immediately upon receiving the protests or after the Department provided its response to the protesting firms. The Department spent 52 days developing its protest response to Intralot and 61 days to respond to Camelot.*

That said, Sections 1605/9.1(o) and 1605/9.1(e) of the Lottery Act and Section 1-10 of the Procurement Code specifically exempted the Department and Lottery from provisions of the Illinois Procurement Code in the selection of a Private Manager for the Illinois Lottery. Thus, the Lottery was not required to follow any set protest procedure other than the provisions of Section 20-35 of the Procurement Code.

- 20. File a completed and full copy of the Private Management Agreement with the Comptroller.**

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Finding: 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. The following items are noted:

- 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. Auditors 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, auditors 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 contract does not appear to be “open and transparent.”

Response: The Department disagrees with the findings. 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 PMA includes certain schedules and attachments that contain proprietary, competitive information. Parties routinely protect competitive information of this nature from public disclosure. From the time the PMA was signed until it was filed, the Department’s General Counsel, in addition to his regular responsibilities, was reviewing the entire PMA in order to make a determination of items that were of a competitive and proprietary nature – the Lottery’s General Counsel left State service on January 3, 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. This agreement is entirely unique and does not conform to regular State contract structure, so the time to review and ensure that everything is in order at the beginning of this 10-year relationship is appropriate.

Not Accepted – continued

AUDITOR'S COMMENT: *The Department disagrees 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.*

21. Develop a monitoring process to ensure contractual requirements are fulfilled and satisfactorily meet expectations.

Finding: The Department did not exercise sufficient monitoring and oversight over the completion of functional requirements as outlined in the contract for the development of a new enterprise-wide tax system (GenTax).

In October 2006, the Department entered into a contract with a vendor for the development of GenTax to replace over 70 legacy tax systems. The contract continues through June 2012. The contract maximum is approximately \$52.1 million, and through FY10, the Department had paid the vendor approximately \$34.7 million.

A Request For Proposal (RFP) was issued in May 2006 and included specific "Processing and Accounting Functional Requirements." In response to the RFP, vendors **were required** to select one of the following three responses for each functional requirement:

- 1) Included in base product at time bid submitted;
- 2) Not included in base product but will be readily available at implementation; or,
- 3) Will not be included.

The vendor responses **were used** to evaluate proposals and select the winning vendor. The winning vendor's response (technical response) to the RFP was attached and incorporated in its entirety to the final contract.

The review of the final contract (which included the vendor's technical response) identified several required functions that **were not** currently components of GenTax. For example, the following items **were not** implemented in GenTax but were listed as "Included in base product at time bid submitted" in the contract:

- Compliant with Generally Accepted Accounting Principles (GAAP).
- Booking all accounting transactions to a journal utilizing the double entry system of accounting.
- Supporting the State's chart of accounts.

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In addition, the following items **were not** implemented in GenTax but were listed as “Not included in base product but will be readily available at implementation” in the contract:

- Interfacing with the Office of the State Comptroller’s Statewide Accounting Management System (SAMS).
- Providing an automated reconciliation process with SAMS.
- Capable of interfacing with the Social Security Administration to receive updates of death records.

As a result of GenTax lacking these **required** capabilities, the Department had to implement manual processes to achieve required objectives.

Response: Accepted. The Department agrees on the necessity of a monitoring process to ensure contractual requirements are fulfilled and satisfactorily meet expectations, and believes it has such a process in place for its tax processing system implementation project.

Although the Technical Proposal was referenced as part of the final contract, the core of the contract relates to the implementation of registration, processing, collections, audit and taxpayer service functionality related to the administration of 40 of the 70 taxes for which the Department has responsibility – literally thousands of complex tasks, letters and reports. The Department has received far more functionality than was detailed in the technical matrix, including the ability to administer the recent tax amnesty program without an additional charge from the vendor.

AUDITOR’S COMMENT: *A comprehensive and effective approach to contract monitoring for a complex and \$50+ million project would include detailed tracking of compliance with contractual provisions. Sufficient documentation was not provided during fieldwork that outlined management’s review and approval of contractual changes. Thus, documentation to support the Department’s contention that items outlined in the contract were no longer required, did not exist. In addition, if the changes associated with the recent tax amnesty program replaced other requirements, documentation to support the changes should have been maintained and provided.*

The OAG has identified six items in the Technical Proposal related to financial reporting that have not been implemented. These functions were not implemented because they simply didn’t make sense in the context of the state’s financial reporting infrastructure. For instance the GenTax system is faulted for not “booking all transactions to a journal” – but the Department doesn’t have a general ledger system to book transactions to. Without a general ledger for revenue accounting, interfacing the tax system directly to the Statewide Accounting Management System (SAMS) is not practical or worthwhile.

GenTax was never intended to be utilized as a general ledger. At the time of the contracting for the new Tax Processing System in FY2006, the State had proposals to obtain a new statewide financial reporting system; hence the Department made the conscious decision to choose the product that was the best tax processing system. It

Not Accepted – continued

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should be noted that the State did not procure a new financial reporting system and still has not obtained such a system.

The Department continues to work with its vendor to develop functionality to compensate for the lack of a modern financial reporting system. The new tax processing system **has the capability** to interface with a new financial reporting system, if such a system existed.

Auditor's Comment: *We are confused about the Department's statement that the new tax processing system has the capability to interface with a new financial reporting system. The statement appears very bold since a new financial reporting system and its capabilities, software, requirements, etc. are completely unknown at this time.*

22. Ensure the development process is adequately controlled and documented. Specifically,

- **Ensure all required documentation and critical deliverables are developed, reviewed, and approved by the Department prior to system implementation.**
- **Ensure all artifacts outlined in the development methodology are developed, reviewed and approved prior to implementation of each phase.**
- **Ensure all system testing is properly documented, reviewed and approved and data reconciliations are properly completed. (Repeated-2008)**

Finding: The Department had not ensured the development process and project management of the enterprise wide tax system (GenTax) was properly controlled and documented.

During previous audits, auditors identified significant problems with the controls over the functions and the development process. During the current audit, auditors continued to identify weaknesses in the development process, specifically noted:

- The lack of sufficient internal controls over the tax system (GenTax) functions affected financial data and financial reporting. Finding 10-29 included issues that resulted from deficiencies in the development of GenTax.
- Internal control deficiencies included inadequate system test documentation and incomplete reconciliation of data.
- The vendor supplied a development methodology which outlined the artifacts to be developed during each phase of the project. However, a review of the artifacts indicated eight of the 27 (30%) artifacts, required to be delivered during this phase had not been developed and nine others appeared to lack compliance with the methodology.
- Several deliverables critical for the Department's ability to maintain the system on its own had not been received. Examples of such deliverables included the Operations Manual, Procedures Manual, and Knowledge Transfer Plan.

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At the end of June 2011, the Department will become responsible for the day-to-day maintenance of GenTax; however, without the appropriate documentation of GenTax, maintenance tasks may be hindered.

Response: Accepted. The Department agrees that the development process should be adequately controlled and documented, and believes that, in the case of its tax system replacement project, this standard has been met. By every measure, this complex, far-reaching technology implementation project has been a success. Each phase has been delivered on-time and on-budget. System functionality meets or exceeds the needs of the agency to register taxpayers, process tax returns, issue bills, collect payments and conduct audits.

There are over 13 million individuals registered in the new system and over 2.5 million business tax accounts. The system is processing millions of transactions, representing billions of dollars in tax payments, credits and refunds – almost without incident. Not to say that there have not been problems and mistakes, as there would be with any complex process and as there was in our legacy systems, but the transparency of the data and the level of reporting and system monitoring, allows the Department to identify and respond to issues quickly.

The vendor has gone above and beyond its contract to accommodate our needs, including implementing the recent tax amnesty program at no additional cost. Department IT staff are now maintaining the system and have implemented the administration of taxes outside the scope of the project on their own. Throughout the project, the Department has worked to improve development, testing and documentation processes.

For Roll Out 3A and 3B, there were almost 800 test cases developed to verify system integrity. Further each phase went through extensive testing, with 12 – 13 weeks of system testing (individual functions); 6 – 8 weeks of regression testing (all the individual functions together) and 5 weeks of end-to-end testing (the new functions running with the existing application).

The OAG has been supplied the Operations Manual. The Department's extensive on-line training materials make up the "Procedures Manual." The plan for knowledge transfer was simply the process of attending training classes and working side-by-side with vendor staff to develop an understanding of the system and subject-area expertise.

As a further proof point that the Department has the knowledge and tools necessary to maintain the system, new staff that have joined the Department over the last 5 years, they have received the necessary training and support – both on-line and class room – to perform their jobs at a high level.

- 26. Implement controls to ensure timely distribution of all funds due to local governments in accordance with the Water Commission Act of 1985 and the Local Mass Transit District Act.**

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Not Accepted - continued

Finding: The Department did not timely distribute the balance of moneys in the County Water Commission Tax Fund or the Metro-East Mass Transit District Tax Fund to local governments as specifically required by State law. The statutes below require the Department to distribute the balance of moneys in the funds each month to the local governments; however, the Department maintains an approximate cash balance of two to three months of sales tax collections in the funds. During testing, auditors noted:

- The Office of the State Comptroller reported month-end fund balances between \$7,735,418 and \$8,721,260 for the County Water Commission Tax Fund during FY10.
- The State Comptroller reported month-end fund balances between \$4,323,681 and \$5,627,091 for the County Water Commission Tax Fund during FY10.

Updated Response: Not Accepted. The Department does not accept the auditors' legal interpretation. While the Department agrees that the language could be changed to further clarify the distribution language for these taxes to be the same as all other sales tax language, the Department believes the current process is reflective of the intent of the statute. Other language within the statute and the implication that the Department should pay the locals monies before we can actually identify the appropriate fund payments would be in error.

The Department is following the intent and tax administration language of the Acts. The sales tax authorized to be imposed by the Metro-East Mass Transit District (MED) under the Local Mass Transit District Act (70 ILCS 3610/5.01) and County Water Commission (CWC) under the Water Commission Act of 1985 (70 ILCS 3620/4) does not contain the "second preceding month" language and instead requires distribution of "the then balance in the fund, less any amount determined by the Department to be necessary for the payment of refunds" However, these two local sales taxes contain the statutory language found in other local sales tax statutes that requires that these taxes be administered using the same modes of procedure as the State imposed sales taxes. A part of administering these taxes using the same modes of procedure as State-imposed sales taxes is that the local taxes distributed are those collected in the second preceding month. The "then balance in the fund" means amount eligible to be certified for distribution: Given that deposits into any local sales tax fund upon receipt by the Department are only the Department's best guess as to the proper deposit amount. And, given that the balance in the fund that the Department can "certify" under the statute as being eligible for distribution is only that amount that the Department has determined, by processing and perfecting the returns for a given liability period as being available. It follows that when the statute requires the Department to "certify . . . the then balance in the fund" for distribution to the MED or the CWC, this refers to the amount eligible for distribution based on the liability period for which returns have been processed and perfected. To do otherwise would be to "certify" a balance which is based only on the Department's best estimate of the true amount available. Such a procedure would make no sense.

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AUDITOR'S COMMENT: *The County Water Commission Tax Fund distributes funds only to the DuPage Water Commission and the Metro-East Mass Transit District Tax Fund distributes funds only to the St. Clair County Transit District and Madison County Transit District. The statute as written would provide funding to these entities as receipts are collected from taxpayers. The current process delays the distributions of moneys due to these entities for two months. In the event of an overpayment, the Department has mechanisms within the Statewide Accounting Management System to adjust the cash balance in the fund when the detailed return information is available and perfected.*

The Department has drafted legislation that would further clarify the distribution language "the second preceding month" for these taxes to be the same as all other sales tax language.

31. Implement controls to ensure all expenditures are paid out of the proper fiscal year appropriation in accordance with fiscal year limitations in the State Finance Act and in the timeframes outlined in the Senior Citizens Real Estate Tax Deferral Act.

Finding: The Department did not exercise adequate internal controls over distributing funds due to local governments in accordance with State statute and fiscal year and appropriation limitations. During testing, auditors noted:

- The Department received an annual appropriation to distribute one-third of the total receipts deposited into the Illinois Gaming Law Enforcement Fund to local governments for law enforcement purposes. The Department's procedures call for calculating the distribution from total receipts deposited during the fiscal year, recording a liability to local governments in the financial statements, and presenting vouchers to the State Comptroller for payment from expiring appropriations during the Lapse Period.

In FY09, the Department calculated the distribution during the Lapse Period and recorded the liability to local governments, but failed to present the vouchers to the State Comptroller by the close of the Lapse Period. In November 2009, the Department determined that the FY09 grants from the Illinois Gaming Law Enforcement Fund should be paid from the FY10 appropriations, well after the August 31, 2009 end of the Lapse Period for 2009. The Department charged the FY09 expenditure of \$1,067,966 to FY10's appropriation in November 2009. No expenditures were presented to the State Comptroller against the FY09 appropriation for these grants.

In FY10, the Department calculated the distribution, recorded the liability to local governments, and presented the vouchers to the State Comptroller during the Lapse Period. However, due to previously exhausting the FY10 appropriation, the Department charged the FY10 expenditure of \$1,032,272 to the Department's FY11 appropriation in August 2010.

Not Accepted - continued

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- The Department received an annual appropriation to distribute the amount of real estate taxes deferred by senior citizens to county collectors in accordance with the Senior Citizens Real Estate Tax Deferral Act. The Act requires the county collector to send to the Department the tax bills, including special assessment bills, on all tax deferred property in that collector's county. The Department shall then pay by June 1 or within 30 days of the receipt of these tax bills, whichever is later, to the county collector, for distribution to the taxing bodies in his county, the total amount of taxes so deferred. The Department shall make these payments from the Senior Citizens Real Estate Deferred Tax Revolving Fund.

In FY09, the Department received an appropriation of \$5.4 million and expended \$3.6 million to cover the costs of the program. At June 30, 2009, the Department held approximately \$2.3 million in approved grant payments the Department did not present to the Office of the State Comptroller due to a low cash balance in the Senior Citizens Real Estate Deferred Tax Revolving Fund and an insufficient appropriation of \$500,000.

Updated Response: **Partially Implemented.** The Department agrees that the law requires it to pay the counties the deferred tax bills by June 1 of the calendar year in which they are due or within 30 days of the receipt of these tax bills, whichever is later. However, there was not sufficient money in the fund or appropriation to make the payments; hence the payments were not made. Faced with this problem, the Department paid the bills (for low-income seniors) as quickly as it could. We believe we took the correct action.

The Department has drafted and proposed legislation changes to address submission of the bills when it crosses fiscal years providing more flexibility in payment timeframes.

Not Accepted. The Department disagrees that additional controls need to be implemented to assure that all expenditures are to be paid out of the proper fiscal year in accordance with fiscal year limitations in the State Finance Act and in the timeframes outlined in the Senior Citizens Real Estate Tax Deferral Act.

The annual Charitable Games Distribution to local units of government was properly paid from the fiscal year 2010 appropriation. The Department changed past practice after review of the statute with the Department legal counsel and determined that it was indeed appropriate to make the distribution of one-third of the receipts from the games during July 2009, through June 2010, from the fiscal year 2010 appropriation that began July 1, 2010.

AUDITOR'S COMMENT: *According to documents provided by the Department, through oversight, it failed to timely submit vouchers to the State Comptroller to distribute the local government share of FY09 receipts out of the FY09 appropriation. At that point, the Department decided to change its longstanding past practice and instead to pay the local government share of FY09 receipts out of the FY10 appropriation. The Department's failure to timely submit vouchers to the State Comptroller for payment circumvented the ability of the State to determine and report the amount of unpaid bills outstanding on a budgetary basis.*

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37. Comply with the Counties Code and the Property Tax Code or seek legislative assistance regarding the compensation and reimbursement of county officials. Further, implement internal controls to ensure assessors are paid in accordance with State law. (Repeated-2009)

Finding: The Department was unable to comply with statutory requirements regarding payments to certain county officials due to insufficient appropriations. The Department was appropriated \$9,530,500 for payments to county officials, but the required statutory payments totaled \$11,813,413.

During testing, auditors noted the Department did not have adequate appropriations to pay the required statutory payments. The Department notified the counties that they would not pay the remainder of the required payments, as noted below:

	Approved Invoices	Actual Payments	Difference	Counties Affected
<i>Stipends</i>				
Sheriff	\$663,000	\$427,992	\$235,008	102
Coroner	\$656,500	\$423,796	\$232,704	101
Treasurer	\$663,000	\$427,992	\$235,008	102
Auditor	\$110,500	\$71,332	\$39,168	17
<i>Compensation Reimbursement</i>				
Public Defender	\$6,154,611	\$5,700,000	\$454,611	102
<i>Compensation</i>				
Compensation	\$2,662,802	\$1,906,596	\$756,206	100
Additional Compensation	\$294,000	\$189,917	\$104,083	86
Performance Compensation	\$609,000	\$382,875	\$226,125	60
Total:	\$11,813,413	\$9,530,500	\$2,282,913	

Further, the Department did not exercise adequate internal control over compensation paid to assessors meeting the specific sales assessment ratio. Auditors noted the following:

- Two assessors receiving a distribution per the Department’s records were ineligible, as their coefficient of dispersion exceeded the statutory maximum; and,
- Two assessors from a downstate county received a distribution of \$3,000, while the remaining assessors received a distribution of \$1,875. The Department stated they were paying prior year distributions to the two noted assessors out of the FY10 appropriation.

Updated Response: **Implemented.** The Department agrees that we should comply with the Counties Code. However, we cannot make payments without an appropriation
Not Accepted – concluded

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and reduced all payments proportionally to stay within the appropriation. The appropriation request for the Department (FY12) was sufficient to meet the obligations for payments to County Officials. The request was amended in the Spring legislative session. Therefore, payments were prorated accordingly by the Department.

The Department agrees that it paid one assessor a performance bonus in error because of a rounding error and has instituted additional reviews of the manual calculation. Based on the advice of our legal counsel, we will no longer round coefficient of dispersions of between 15.01 and 15.49 to 15 and between 30.01 and 30.49 to 30 following the finding by the OAG earlier this year.

Not Accepted. The Department disagrees that it paid two assessors from the FY10 appropriation improperly, as the fiscal year and property tax cycles do not match.

AUDITOR'S COMMENT: *In regards to the disagreement over the payments to the two assessors, the assessor's coefficient of dispersion exceeded the statutory maximum set in the Property Tax Code (Code) (35 ILCS 200/4-20). The Code states, "the coefficient of dispersion must not be greater than 15%" for larger counties and "the coefficient of dispersion must not be greater than ... 30% in 1999 and every year thereafter" for small counties. The statute clearly states the coefficient of dispersion cannot exceed the statutory maximum. In regards to the disagreement over the \$3,000 payments to the assessors, the Department paid the FY09 liability out of FY10 appropriations, violating the State Finance Act and fiscal year limitations.*

Accepted or Implemented

1. **Work with the Governor and the General Assembly to increase the percentage of deposits into the 278 Fund.**

Finding: The Department of Revenue (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, 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 the statute. Additionally, under the statute, the Department's Director is to determine the annual percentage necessary, using a predetermined formula defined in the statute, and is to certify this percentage to the State Comptroller.

The formula is based on refunds approved for payment in the preceding fiscal year (AR), plus approved but unpaid refunds as of the end of the preceding fiscal year (UR), less

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amounts transferred to Fund 278 from the Tobacco Settlement Fund (TS) divided by income tax collections under the Act during the preceding fiscal year (C):

$$\frac{AR + UR - TS}{C}$$

Under the Illinois Income Tax Act (35 ILCS 5/901), 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		Business Income Tax		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

* In the table above, the “Rate per Statute” was enacted prior to June 30th for fiscal years 2006, 2007, and 2008. As such, there was no formula based rate calculation performed (“Rate as Certified”).

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 FY2010, which remained at 9.75% of income tax collections for IIT and 17.5% for BIT. The amount to be deposited in the 278 Fund for FY 2011 has not increased, but was instead decreased to 8.75% (a 10.3% decrease in the rate) for FY11. Department management has not provided the auditors a detailed plan for eliminating the deficit as of the date of the auditor’s report. Although the

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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 has recorded a liability of approximately \$1.5 billion for refunds payable to taxpayers.

Updated Response: Accepted. The Department continues to agree that the Refund Fund should be fully funded and has made all parties aware of the issues related to unpaid Income Tax refunds. However, raising the Refund Fund percentages requires legislative action that has not occurred.

In FY 2011 the Department paid \$263.4 million in Business Income Tax (BIT) refunds and ended the year with a backlog of unpaid BIT Refunds of \$645.5 million. Our current projection is that we will pay \$382.7 million in BIT refunds in FY2012 and end the year with \$594.2 million in unpaid BIT Refunds.

2. **Due to the manual nature of the year-end reporting process and the numerous accounts that must be manually adjusted, prepare a year-end closing checklist that details all the required year-end adjustments, the source documents used to prepare the adjustments, the related accounting policy (if any) and any other helpful information. After the year-end adjustments are completed, direct the reviewer(s) to examine the adjustments against the checklist to make sure there are no missing entries, the correct source information was used, the policies and procedures were followed, and other information noted on the checklist, if any, was considered. Direct the responsible supervisor to initial each item on the checklist to indicate the adjustment has been accurately prepared and recorded.**

Additionally, allocate sufficient personnel to the year-end reporting process to ensure all stated policies and procedures for properly reporting accounts receivable balances at year-end are followed and performed prior to preparation and submission of the GAAP packages to the Comptroller.

Finding: The Department did not follow its established procedures for determining the accuracy of its billed accounts receivable for financial reporting purposes. This led to the overstatement of balances initially reported in the GAAP packages for business income tax, individual income tax, withholding income tax and sales tax (BIT, IIT, WIT and ROT).

During the audit of the billed portion of taxes receivable from GenTax (BIT, IIT, WIT, ROT), auditors noted the Department did not thoroughly review certain accounts according to their established procedures. This oversight resulted in an overstatement of accounts receivable

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in the GAAP Packages initially submitted to the Comptroller. The receivable balance in the originally submitted GAAP packages totaling \$2 billion (\$1.3 billion net of the

allowance) included billed receivables totaling \$1.06 billion (\$296 million net of the allowance), for all tax types (BIT, IIT, WIT, ROT and Excise). After the oversight was detected, the review procedure was performed and the GAAP packages and financial statements were adjusted to reduce the net receivables by \$17.6 million.

Updated Response: Implemented. The Department agrees that because of the manual nature of preparing year-end reports in a tight timeframe it did not follow its established procedures, resulting in the estimate of receivables being overstated by 1.7%. The Department notes that this affected only year-end financial statements and not tax collections or deposits. The Department concurs with the auditors, as noted in 10-5, that the GAAP packages were materially correct and in accordance with GAAP requirements.

The Department updated the procedures for calculating accounts receivable and booking the journal entries and these were followed in FY2011.

- 3. Due to the manual nature of the year-end reporting process and the numerous accounts that must be manually adjusted, prepare a year-end closing checklist that details all the required year-end adjustments, the source documents used to prepare the adjustments, the related accounting policy (if any) and any other helpful information. After the year-end adjustments are completed, direct the reviewer(s) to examine the adjustments against the checklist to make sure there are no missing entries, the correct source information was used, the policies and procedures were followed, and that other information noted on the checklist, if any, was considered. Direct the responsible supervisor to initial each item on the checklist to indicate the adjustment has been accurately prepared and recorded.**

Additionally, revise the policy for estimating deferred revenue pertaining to credit-carry forwards. Require that information through June 30th of each fiscal year is used in the calculation and that any additional information received after year-end that could significantly impact the estimate be examined and utilized in the estimation process.

Finding: The Department does not have sufficient procedures and controls in place to ensure that the amount reported for deferred revenue relating to income tax credit-carry forwards is determined based on all available information on hand.

The Department's original calculation for the estimate of deferred revenue associated with credit carry forwards (\$521 million) is based on a three year average, but was not prepared using all current information available. During the review of the credit calculation, auditors noted the Department performed its analysis using data which did not reflect the activity of the entire fiscal year for the most recent year used in their 3 year average. The Department

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re-analyzed data as of fiscal year-end (June 30, 2010) which led to an adjustment of the credit carry forward accrual (deferred revenue). Auditors proposed a \$14.5 million credit

Accepted or Implemented - continued

adjustment to deferred revenue to reflect the results of the updated calculation (\$536 million as adjusted). This adjustment was recorded by the Department.

Updated Response: Implemented. The Department notes that the original estimate of deferred revenue associated with credit carry forwards, an issue that affects year-end financial statements but not the collection of taxes, was more than 97% accurate. The Department has updated the checklist used for GAAP preparation, the supervisor review process, and the checklist used by the outside consultant review of all large GAAP packages.

The Department has established data marts in GenTax that enables the Financial Control Bureau to run data cubes for financial reporting of credit carry forwards. This data cube can be run continuously after year-end to identify any "material" impact to the estimation. Procedures have been changed accordingly to reflect this change and to require information through June 30.

- 4. Due to the manual nature of the year-end reporting process and the numerous accounts that must be manually adjusted, prepare a year-end closing checklist that details all the required year-end adjustments, the source documents used to prepare the adjustments, the related accounting policy (if any) and any other helpful information. After the year-end adjustments are completed, direct the reviewer(s) to examine the adjustments against the checklist to make sure there are no missing entries, the correct source information was used, the policies and procedures were followed, and that other information noted on the checklist, if any, was considered. Direct the responsible supervisor to initial each item on the checklist to indicate the adjustment has been accurately prepared and recorded.**

Finding: The Department incorrectly allocated accrued taxes receivable for year-end financial reporting. A portion of the receivable pertaining to the Illinois Sports Facility's Fund (225) was recorded in error to the General Revenue Fund.

During review of taxes receivable, auditors noted that hotel/motel taxes receivable within the Illinois Sports Facility's Fund was understated by approximately \$4.3 million. This amount was recorded in error to the General Revenue Fund. This adjustment was deemed immaterial and was not recorded to the financial statements.

By recording the receivable and related revenues within the General Revenue Fund, the Department has overstated taxes available for the State's general use and has understated amounts that must be used for the Illinois Sports Facility Fund.

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Response: Accepted. The Department agrees that because of this oversight the year-end financials were inaccurate by the estimated receivable adjustment of \$4.3 million, which was an immaterial amount. The General Funds and the Sports Facility Fund did receive the proper amounts of money. The Department agrees that a year-end closing checklist that details all the required adjustments should be utilized. The Supervisor will review and initial spreadsheets used to allocate lapse period collections for Hotel Tax to ensure accurate allocation to appropriate funds.

Updated Response: Implemented

6. **Obtain and adequately review copies of the independent reviews (SAS 70 reports) for tax processing services provided by all third-party service providers (Providers) on an annual basis. Implement and monitor the user controls delineated in these reports. For those providers that do not have a SAS 70 performed, perform sufficient procedures to obtain satisfaction that internal controls are adequate for safeguarding assets and accounting information, and that controls are operating effectively. Fully document any procedures performed including exceptions noted, the disposition of exceptions, conclusions reached and corrective action taken by the vendor. Maintain this information for review by the external auditors. (Repeated-2009)**

Finding: The Department did not obtain SAS 70 reports containing independent reviews of externally controlled service organizations used to process tax returns. Without these reviews, the Department did not have adequate assurance that the tax processing controls necessary to prevent errors or irregularities from occurring were established and operating effectively throughout the year.

The Department uses three external service providers that provide data entry services for many sales tax and business, individual and withholding income tax returns. Of the total returns processed by the Department, approximately 75% of the volume is processed by these three third party service providers.

Updated Response: Accepted. The Department has in place a systematic review process for reviewing the work of data entry vendors. That process has detected and prevented problems.

It was determined in July 2011 that there would not be funding to contract for independent review services due to budget constraints. Per discussion with the Director, it was decided that Internal Audit would perform a review of the largest data entry vendor in FY2012 as part of the Two-Year Audit Plan to get appropriate coverage for these services. The Department will continue to pursue independent review services of data entry vendors in future years as funds are available.

10. **Prepare a year-end closing checklist that details all the required year-end adjustments, the source documents used to prepare the adjustments, the related accounting policy (if any) and any other helpful information;**

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implement controls to ensure all statutory tax credits are timely calculated and issued to taxpayers in accordance with State law; and, record liabilities from tax credits in the Department's financial statements.

Accepted or Implemented - continued

Finding: The Department did not calculate and timely issue the invested capital tax on the distribution of electricity credit (tax credit), leading to an unrecorded \$18.7 million liability in the Department's June 30, 2010 financial statements.

During testing, auditors noted the following:

- The Department did not timely compute the tax credit.
- The Department did not record the corresponding liability of \$18.7 million for the tax year 2008 tax credit in the Department's Personal Property Tax Replacement Fund (Fund 802) GAAP package at June 30, 2010.
- The Department did not have adequate procedures governing the computation or issuance of the tax credit to ensure it was done on an annual basis.

The Public Utilities Revenue Act requires the Department to calculate the tax credit for all taxpayers who paid invested capital tax on the distribution of electricity during the preceding tax year by December 1 and adopt reasonable regulations to implement the law and calculate the tax credit pursuant to a statutory formula.

Updated Response: Implemented. The Department agrees that a checklist should be maintained to identify year-end adjustments and record the appropriate liabilities in the financial statements. Implementation of this has been completed by scheduling the task to assigned staff on the managerial critical task calendar tool.

The Investment Capital Tax (ICT) credit calculation became computer systemic when excise taxes were brought into the GenTax system in June 2011. However, since the first year of data conversion is a half-year, this year's calculation of the ICT will still be manual. The unused ICT credit was appropriately recorded as a liability in the Department's financial statements on June 30, 2011.

11. Implement controls to ensure the deposit and distribution activity from the Illinois Sports Facilities Fund and Sports Facilities Tax Trust Fund are performed accurately.

Finding: The Department did not exercise adequate control over the Illinois Sports Facilities Fund or the Sports Facilities Tax Trust Fund.

During testing, auditors noted the Department did not deposit the entire statutory "advance amount" into the Illinois Sports Facilities Fund from the State's share of Hotel Operators' Occupation Tax (HOOT) receipts. During FY10, the Department deposited only \$29,500,000 of the \$34,341,000 statutorily required advance.

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During testing, auditors noted distribution errors of receipt collections from the Hotel Operators' Occupation Tax imposed by the Illinois Sports Facilities authority (ISFA) deposited into the Sports Facilities Tax Trust Fund.

Department personnel stated that staff has worked with ISFA for years to ensure that the Department deposited the advance payment based on the certified amount and then required repayment to GRF throughout the fiscal year until the advance payment was satisfied. The Department received confirmation from the ISFA CFO documenting their agreement with the Department's process and handling of the advance payments. Although the Department received a confirmation from IFSA, the auditors believe the Department was still obligated to comply with statutory requirements regarding deposits.

Updated Response: Accepted and Partially Implemented. Although the Department believes it has implemented the law as it was intended and as all parties (ISFA, GOMB and IDOR) have agreed it should be implemented. The Department is recommending to amend the Illinois State Finance Act and the Hotel Operators' Occupation Tax Act to cap the "Advance Amount" that is deposited from State hotel tax receipts into the Illinois Sports Facilities Fund in any fiscal year so that it does not exceed the amount that can be distributed to the IL Sports Facilities Authority out of that Fund for that fiscal year (thereby avoiding stranding GRF dollars in a special fund until the end of each fiscal year). The parties agree that no one intended to have \$4.8 million sit in a fund for a year.

Auditor's Comment: *Per the finding as noted, the General Assembly specified amounts to be paid into the Illinois Sports Facilities Authority Fund. It is unclear as to whom "all parties" are as referenced by the Department, or the relevancy to this statutory requirement. The primary responsibility of State agencies is to administer functions given to them by the General Assembly in accordance with State law as written. If the Department believes the statutes need to be amended, they should seek a legislative remedy.*

The Department has implemented a monthly review checklist and reconciliation process that will ensure all excess need/distributions to ISFA and administrative fees to GRF are processed timely. Local Tax Allocation Division (LTAD) is distributing according to statute. However, the advance payment is still based on certification by ISFA, not escalation in the statute.

12. Implement controls to ensure compliance with statutory requirements regarding the allocation of tax receipts and fees into various funds. (Repeated-2009)

Finding: The Department did not exercise adequate control over the deposit and allocation of locally-imposed School Facility Occupation Taxes (SFOT), Flood Prevention Occupation Taxes (FPOT), or Metro-East Mass Transit District fees. The net cash deficiency at June 30, 2010 as a result of these errors is as follows:

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Tax Compliance and Administration Fund (Fund 384)		
	SFOT	FPOT
Error Due to Change in Deposit Process	\$85,026	\$38,917
FY10 Deposit Errors (August 2009 and March 2010)	\$13,117	\$22,572
FY09 Deposit Errors (February 2009 and April 2009)	\$8,552	\$14,114
FY10 Department Correction (May 2010)	(\$20,208)	\$0
Cash Deficiency at June 30, 2010	\$86,487	\$75,603

School Facility Occupation Tax Fund (Fund 498)	
Error Due to Change in Deposit Process	\$3,861,444
Cash Deficiency at June 30, 2010	\$3,861,444

Flood Prevention Occupation Tax Fund (Fund 558)	
Error Due to Change in Deposit Process	\$1,500,480
Cash Deficiency at June 30, 2010	\$1,500,480

During testing, auditors noted the Department did not retain any administration fee receipts from the fee imposed on tangible personal property that is titled or registered with a State agency within the Metro-East Mass Transit District. Since the imposition of the fee in FY05, the Department should have deposited \$63,080 on a cash basis into the Tax Compliance and Administration Fund.

Updated Response: Implemented. The Department notes that local governments received the proper amounts of School Facility and Flood Prevention Occupation Tax. The Department has developed a checklist so monthly transactions are reviewed and appropriate transfers/deposits and vouchers are processed based on actual return data as received.

The Tax Administration and Compliance Fund deposit errors have been corrected and the administrative fees for the MED were calculated and deposited in July 2011. Also, a transfer to the Tax Compliance Fund of \$71,902.44 on August 16, 2011 was completed to re-coup the monies for previous years.

23. **Establish a documented process over the administration of GenTax users. Additionally, periodically review all user access to GenTax. In addition, ensure all accounts are assigned to individuals for accountability. Finally, work with the Department of Central Management Services to ensure all background checks are appropriately completed.**

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Finding: The Department did not have adequate security controls over the GenTax (enterprise wide tax system) system and data. During the review, auditors 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.
- Sixteen of 31 (52%) Department of Central Management employees with administrative access right did not have required background checks.

In addition, during a review of IDs with access to GenTax, auditors noted:

- Seven active generic or unassigned accounts, with varying degrees of access rights, including some with the capability to view and modify taxpayer data.
- An excessive number of vendor staff with access to the GenTax system and taxpayer data.

Updated Response: Partially Implemented. The Department has created a process for the administration of access rights to GenTax. This was discussed with senior staff during Steering Committee meetings and through email correspondences. All have agreed to the process. However, this policy standard has not been reduced to a formal written document at this time. The policy standard will be written and documented, but other standards have to be addressed first. At the time this process was agreed to, the Department removed all Fast staff from having access to security over the GenTax system. Currently, only IT Revenue employees have access to the Security Manager in GenTax.

When Revenue IT Security staff took over all security for GenTax, the Department required all owners of different parts of the system to look at all employees who had access to their portion of the system (i.e. a complete periodic review was completed by Revenue IT Security). We removed staff that did not have documented permission to have access, and we tightened down groups and reworked security groups. Since that time, only Revenue IT Security staff can grant any access to any part of the system. Permission must be granted by appropriate owners before access is allowed. An annual periodic review process will be part of our security procedures being written.

In regards to 16 of 31 CMS employees with administrative access rights that did not have required background checks as found by the OAG, it should be 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.

The Department is developing an automated control process that will produce a list of accounts with administrative access to the Revenue servers that have not been cleared through background checks and approved by the Department. This will then be communicated to CMS to begin the process of the background check.

Of the seven listed accounts designated as generic or unassigned accounts, the following facts should be noted:

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- One of seven is assigned to an IT employee who must create and email statements that are created for the transaction taxes. It is not a generic or

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- unassigned account as it belongs to an employee doing their designated duties in GenTax.
- Five of seven are shared IDs used by data entry for the sole purpose of entering IFTA returns into GenTax. Data Entry employees did not need access to GenTax except for keying in IFTA returns. These generic IDs were created so that any data entry staff could be used to key in IFTA returns. Once IT staff complete building the screens for capturing IFTA returns, these IDs will be turned off and made invalid.

24. Ensure the change management process is effectively controlled and documented. In particular, ensure all changes adhere to established standards, processes and procedures. Also, develop a tracking mechanism and policies and procedures relating to help desk tickets. (Repeated-2008)

Finding: The Department had not ensured the change management process for the enterprise-wide tax system (GenTax) was properly controlled and documented. During the review, auditors noted the Department had developed standards, processes and procedures to control the change process; however, they were not consistently followed.

During a detailed review of 32 completed change requests, auditors noted:

- Documentation required by the established standards, processes, and procedures had not been developed or maintained;
- Approvals were not obtained before changes were moved to the production environment.
- Documentation of test results was not completed or maintained for changes moved to the production environment.

Updated Response: Implemented. The Department concurs with the recommendation and has worked to create production change control procedures for GenTax. There was an oversight in that the finalized procedures were not distributed to IT GenTax supervisors and Fast Production Control Staff. The finalized procedures have now been communicated with all appropriate staff.

Management is continually enhancing the established procedures and is currently working to update the change management process. IT managers are in the final stage of approving the newest version of the change management process.

Currently, help desk tickets are not tracked through the IDOR change management process, but through the CMS remedy system. CMS is the Help Desk for the Department since IT infrastructure was transferred as part of the IT Consolidation with BCCS.

25. **Complete a risk assessment of the computing environment in order to ensure adequate security controls are applied. Ensure all taxpayer information is properly secured (encrypted) as required by law and ensure compliance with notification requirements outlined in the Personal Information Protection Act. Further, consistently communicate the importance of protecting and maintaining accountability for taxpayer information to employees and vendors.**

Finding: The Department did not adequately ensure the security and control of confidential and personal information, including taxpayer information. During testing, auditors 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 a review of the Department's Intranet, taxpayer information was contained in the enterprise wide tax system (GenTax) training manual and change requests. The information included the taxpayer's name, social security number and specific tax data.
- 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.

Updated Response: Partially Implemented. The Department acknowledges and understands the need to control access to federal tax information as well as state tax information and personal information. The Department has many processes in place to address the protection of taxpayer information and is continually working to improve our processes. The following specific actions have been addressed or in process by the Department:

- The Department has enhanced its process of reviewing all documents before they are posted on the Intranet for confidential information. Once the posted confidential information was pointed out to appropriate staff, it was immediately removed.
- The encryption of all Department laptops is an important security standard to the Department. The installation of encryption software has been part of the standard load process for all laptops issued since 2007, and now the Department has instituted a required check-off to enhance the documentation of encryption. The Department is progressing in completing a verification process to match each laptop (by property tag) to a corresponding encryption key (encryption key server).
- The Department has created a more expansive annual safeguard training program that is required for all employees and contractors of the Department to complete on an annual basis. This training addresses both federal and state requirements for

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protecting confidentiality of information and is updated by management on an annual basis.

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- The Department contracted with IBM to perform a Risk Assessment on our sites as well as Department interests at the State Data Center which is controlled by Central Management Services. The Risk Assessment Report was issued in June 2010 and this was a high-level review.
- A Security Consultant has been contracted with to perform a security review and risk assessment of IDOR facilities during FY2012. This project has been delayed due to lack of funding.
- The Department is in the process of hiring a Chief Information Security Officer that will oversee the improvement of existing security, perform a more detailed risk assessment on data classification, create new processes, and enhance training with regards to safeguarding taxpayer information.
- Processes required by the Personal Information Protection Act are covered by the Department Security Breach Policies, standards, processes and DCMS policies and procedures.
- Encryption of tax data is an IRS Publication 1075 requirement and with the recent upgrade of SQL Server technology, the capability of encrypting the tax data is now available. GenTax technicians are researching the impact to determine if server upgrades will be required before data encryption can be implemented.
- The new security camera system has been implemented and operational in the Willard Ice Building. Internal Affairs manages the camera system.
- Department has implemented new locking shred bins with a new shred policy to better secure and destroy printed taxpayer documents.

28. Implement controls to ensure the Department complies with statutory administrative expenditure limitations.

Finding: The Department exceeded administrative expenditure limitations for the Personal Property Tax Replacement Fund (Fund 802) and the County Option Motor Fuel Tax Fund (Fund 190).

- The State Revenue Sharing Act limits necessary administrative expenses incurred by the Department to 105% of the actual administrative expenses of the prior fiscal year. During testing, the Department's administrative expenditures from Fund 802 grew by 108% over the prior year's administrative expenditures in FY10. The total amount of excess expenditures incurred by the Department during FY10 was \$657,016, which would have otherwise been distributed to local governments.
- The Counties Code limits administration and enforcement expenses incurred by the Department during FY10 to 2% of the amount deposited into the Fund 190 during the preceding fiscal year. During testing, the Department's Fund 190 administrative expenditures exceeded 2% of FY09 deposits by \$184,674, which would have otherwise been distributed to local governments.

Response: Implemented. The Department agrees and has already implemented controls to ensure that it does not exceed statutory limitations on expenditures from the Personal Property Tax Replacement and County Option Motor Fuel Tax Funds for fiscal year 2011 and going forward.

29. Implement internal controls to ensure:

- the Tire User Fee is imposed on all tires at the statutory rate of \$2.50;
- the GenTax system correctly grants tire retailers a discount of \$0.10 per tire sold to the amount that is timely paid with a timely return;
- duplicate return controls are implemented within GenTax to require taxpayers to file Tire User Fee returns quarterly;
- taxpayers are required to file a final return within one month of ceasing to sell tires;
- the accuracy of taxpayer correspondence generated from the GenTax system;
- the accuracy of all GenTax screens;
- receipts collected are properly allocated among the Used Tire Management Fund and Emergency Public Health Fund; and,
- transfers between the Used Tire Management Fund and the General Revenue Fund are properly calculated.

Finding: The Department failed to comply with the requirements of the Environmental Protection Act (Act) regarding the Tire User Fee, resulting in errors on taxpayer accounts, inaccurate correspondence, inaccurate fund deposits and statutory transfers, and related financial reporting. During testing, some examples of noncompliance noted by the auditors are as follows:

- In five of 12 returns tested, the Department's GenTax system did not impose the correct statutory rate of \$2.50 per tire sold at retail. For retailers reporting an odd number of tire sales, the GenTax system rounds the total tire fees due to the next dollar, effectively overcharging tire retailers by \$0.50.
- The Act requires tire retailers to collect from consumers a fee of \$2.50 per tire sold and remit that amount, less any allowed discount, to the Department.
- In seven of 12 returns tested, the Department's GenTax system did not correctly calculate the discount allowed on tires that were timely paid by a taxpayer that timely filed their return.

The Act requires the following allocation process for tires paid with a timely return:

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<i>For Tires Timely Paid with a Timely Return</i>		
Fund	Cash Allocation	Percentage Allocation
Used Tire Management Fund	\$1.90	79.17%
Emergency Public Health Fund	\$0.50	20.83%

Further, the Act requires the following allocation process for all other tires:

<i>For All Other Tires</i>		
Fund	Cash Allocation	Percentage Allocation
Used Tire Management Fund	\$2.00	80.00%
Emergency Public Health Fund	\$0.50	20.00%

- In addition, the Department's statutory transfers of \$0.10 per tire sold from the Used Tire Management Fund to the General Revenue Fund do not appear logical and resulted in an excess transfer of, at least, \$1,525,360 to the General Revenue Fund during FY10.
- In 2 of 12 (17%) returns tested, the Department's GenTax system had the taxpayer classified as a monthly taxpayer and had assessed penalties and interest to the taxpayer that would not have been assessed on a quarterly basis.
- In two final returns tested, the Department's GenTax system did not require a taxpayer filing a final return to file the return within one month of the cease date of the business. Further, the instructions for the Department's Form ST-8, *Tire User Fee*, does not notify taxpayers of this requirement.
- In five of 12 returns tested, the Department's GenTax system generated and sent conflicting letters to taxpayers on the same date.
- In two of 12 returns tested, the information on the taxpayer's primary screen for the Tire User Fee differed from the information on the taxpayer's main screen for the tax period tested.

Updated Response: Implemented. The Department concurs with the recommendation and has implemented the following changes:

- Ceased rounding Tire User Fee returns to the nearest dollar.
- Made system changes to generate correct notices to taxpayer from GenTax.

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- Made system changes to ensure the \$.10 discount per tire for returns filed timely through GenTax.
- Revised procedures to inform taxpayers that a final return is due 30 days after a business ceases operations and accommodate more frequent filing.
-
- Enhanced receipt allocation process to ensure that tire user fee receipt allocations and transfers are made according to statute.

30. Implement internal controls to ensure issued retailer liquor licenses are properly recorded to permit accurate:

- **accounting and recording of the number of retailer liquor licenses issued during each fiscal year;**
- **allocation of receipts between the Dram Shop Fund and General Revenue Fund; and,**
- **transfer of accrued receipts from the General Revenue Fund to the Youth Alcoholism and Substance Abuse Prevention Fund on August 30 of each year.**

Finding: The Liquor Control Commission did not exercise adequate control over recording retailer liquor licenses issued or calculating and timely reporting the annual liquor license fee transfer, leading to an unrecorded liability in the Department's June 30, 2010 financial statements. During testing, auditors noted the following:

- The Department provided the auditors with three different numbers of retailer liquor licenses issued during FY10, as noted below:

Source Document	Issued Licenses
Department Receipt Transmittals	21,444
Bank Transmittal Reports	21,640
Annual Transfer from the GRF	21,710

- The Department incorrectly calculated the annual transfer of accrued prior year liquor retailer licensee fee receipts from the General Revenue Fund to the Youth Alcoholism and Substance Abuse Prevention Fund.

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	FY10 Receipts Transferred in FY11		
	Department Receipt Transmittals	Bank Transmittal Reports	Annual Transfer from the General Revenue Fund
Retailer Licenses Issued	21,444	21,640	21,710
Less: NSF Returned Checks	8	8	8
Net, Retailer Licenses Issued	21,436	21,632	21,702
Transfer Amount, Per License	\$50	\$50	\$50
Transfer Amount	\$1,071,800	\$1,081,600	\$1,085,100
Department Transfer	\$1,091,478	\$1,091,478	\$1,091,478
Over(Under) Transfer	\$19,678	\$9,878	\$6,378

- The Department did not record the corresponding General Revenue Fund liability for the annual liquor transfer in the Department’s June 30, 2010 financial statements.
- The Department did not timely initiate the transfer of funds from the General Revenue Fund to the Youth Alcoholism and Substance Abuse Prevention Fund for FY09 receipts. The *Fund Transfer Notification* (Form C-55) was filed on November 2, 2009, which was 64 days late.

Updated Response: Implemented. The Department concurs with the recommendation. Before the 2010 audit commenced, the Commission had been working on the clarification of the distributor license categories and we were trying to interpret the distributor license categories per the ILCC Act to make sure the licenses were issued under the correct categories. As a result during this transition, the category utilized in arriving at the Retailer Licenses issued that was provided to the auditors was incorrect.

The Commission has implemented the following actions:

- Updated our license applications to reflect the updated distributor categories and the correct fee amounts.
- Updated our database so the importing distributor’s license (2B) and foreign importer’s license (2C) reflects \$25 not \$295.
- Removed the 2D license category from applications and have put alerts in the database so that any license that is classified as a 2D cannot be renewed. At renewal time for each licensee that holds the 2D; we are re-categorizing their license to the correct license categories.

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As of September 2010, all correct license fee amounts have been updated in our system. If an incorrect fee amount is entered, the user will receive an alert. In addition, on August

2, 2011 the Commission authorized the transfer of accrued receipts from the General Revenue Fund to the Youth Alcoholism and Substance Abuse Prevention Fund. This will

initiate the fund transfer in a timely manner and allow the Department to properly record the liability accrual in the financial statements.

- 32. Work with the Director of the Governor's Office of Management and Budget to seek clarification as to whether the transfer from the Illinois Tourism Tax Fund must be repaid by the General Revenue Fund, and, if necessary, seek a formal, written opinion from the Attorney General. Further, maintain adequate supporting documentation in accordance with the State Records Act and timely submit distributions of tax collections to the Office of the State Comptroller.**

Finding: The Department did not exercise adequate control over distributing Hotel Operators' Occupation Tax collections on behalf of the Illinois Sports Facilities Authority, Metropolitan Pier and Exposition Authority, and a local government.

Underpayments to a Local Government

During testing, auditors noted the Department did not certify all collections on behalf of the local government for distribution to the local government to the Office of the State Comptroller. Two of 12 (17%) distributions were certified for an amount less than the amount required by statute, which were tax collections occurring during the second preceding calendar month. The total FY10 underpayment to the local government was \$187,500.

Untimely and Unsupported Distributions

- 16 of 24 distribution vouchers for taxes collected on behalf of the Illinois Sports Facilities Authority were submitted to the Office of the State Comptroller between one and seven days late.
- Eight of 12 (67%) distribution vouchers for taxes collected on behalf of the local government were submitted to the Office of the State Comptroller between two and ten days late.
- The Department did not prepare a distribution in August 2009 for June 2009 taxes collected on behalf of the Illinois Sports Facilities Authority.
- The Department did not maintain documentation to support the distribution in August 2009 for June 2009 taxes collected on behalf of the local government and the Metropolitan Pier and Exposition Authority.

Updated Response: Partially Implemented. The Office of Management and Budget agrees that there should be a "due to" the Tourism Trust Fund from the General Revenue

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Fund and proposed legislation in the Spring 2011 legislative session that was not introduced by the General Assembly. In addition, to ensure all eight distributions are prepared during

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the fiscal year, the Department added an additional level of voucher review and approval to ensure that all allocations are completed.

- 33. Properly calculate and distribute the State’s direct payment from the TVA in accordance with the provisions of the Tennessee Valley Authority Payment Act, or seek a legislative remedy to allow a payment to the third county.**

Finding: The Department’s distributions to counties appear to be in violation of the Tennessee Valley Authority Payment Act. Each year, TVA calculates direct payments due to states and counties throughout the Central United States in accordance with federal law. After completing the calculation, the TVA sends the Department of Revenue a letter with the total distribution amount for all governments receiving a direct payment from the TVA.

After receiving a direct payment from the TVA, the Act requires the Department to distribute 70% of the State’s share of the TVA distribution to counties that have coal reserved for the TVA and receive a direct payment from the TVA in proportion to the net book value of TVA property in the county to the total net book value of counties eligible to receive a share of the funds. During testing, auditors noted the following:

- The Department issued payments to three downstate counties; however, the TVA only issued direct payments to two downstate counties with coal reserved for the TVA. The Department believes the third county was originally intended to receive payments, but the wording of the statute was incorrect.
- The Department did not maintain supporting documentation for the net book value of TVA property or counties with coal reserved for the TVA within the State. The Department had to request the data from the TVA after inquiry from the auditors.

The net effect of the noncompliance during FY10 is as follows:

	County 1	County 2	County 3
Per Department	\$ 133,311	\$ 116,251	\$ 31,034
Per Auditor	\$ 149,708	\$ 130,888	\$ -
Over(Under) Payment	\$ (16,397)	\$ (14,637)	\$ 31,034

Updated Response: Implemented . The Department disagrees with the auditor’s statutory interpretation and has paid the proper amount of federal funds that flow through the state to these three counties. We have confirmed with the Tennessee Valley Authority (TVA) that the three counties in question should be receiving such payments.

AUDITOR'S COMMENT: *The Tennessee Valley Authority Payment Act states, "payment shall be divided among counties in Illinois in which the Tennessee Valley Authority has coal reserved, and which counties themselves receive direct payments pursuant to Section 13 of the Tennessee Valley Authority Act of 1933." While all three counties have coal reserved for the Tennessee Valley Authority (TVA), only two counties receive a direct payment from the TVA. We would note that the legislation referenced in the Department's response would conform the statute to the Department's historical practice in distributing these funds.*

The Department introduced legislation to clarify the language and HB2500 was effective June 28, 2011 that amended the TVA legislation to reflect the practice of the Department.

34. **Upgrade the contingency plans to address the current environment, including the enterprise wide tax system (GenTax). Also, ensure the contingency plans include details specific to the recovery applications and data. In addition, test the plans on an annual basis and continually update the plans to reflect environmental changes and improvements identified from tests. Finally, work with the Department of Central Management Services to ensure plans, facilities, and other operational provisions are appropriately aligned. (Repeated-2006)**

Finding: The Department had not provided adequate planning for the recovery of its applications and data. Additionally, midrange recovery testing had not been performed during the audit period.

The Department had established 22 individual contingency plans; however, they had not been updated within the last four to eight years and did not depict the current environment. In addition, the plans did not address the restoration of applications/data, and testing procedures for recovery.

Response: Accepted. The Department continues to support the re-engineering of the Business Continuity Plan, in specific, Disaster Recovery Plans for critical applications. Legacy recovery plans remain in place as the Department moves through the last phases of the GenTax conversion.

Public Act 93-025 formally consolidated Information Technology services into the Department of Central Management Services (CMS). As implemented, the consolidation created an intertwined cooperative effort between IDOR and DCMS for many services. IDOR (as the client) owns the recovery process, handles functional application recovery, some file restoration, data synchronization and continuation of production processes. However, CMS as our managed service provider **does not have the required recovery environment** to implement or test a disaster recovery plan.

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IDOR is dedicated to completing the recovery plan detail and providing adequate plan testing on an annual basis for all processing environments. Recent coordinated efforts with CMS have given IDOR the best hope of forward movement on the lack of recovery process.

IDOR has CMS commitment that they will be working with us, and IDOR has seen movement all but slowly towards resolving some of the most serious recovery issues.

35. Ensure all contracts, interagency agreements, and grant agreements are approved prior to the start of the contract period and before services are performed. Further, prepare Contract Obligation Documents in accordance with SAMS. (Repeated-2007)

Finding: The Department did not maintain adequate control over contractual, interagency, and grant agreements. During testing, auditors noted the following:

- The Department did not timely execute contractual, interagency, and grant agreements.
 - One of 38 vouchers tested was related to a contract that was executed after the vendor began providing services.
 - One of 25 contractual agreements tested was executed after the vendor began providing services.
 - Five of 25 contractual agreements tested were not signed and approved by the Department prior to the effective date specified in the contract.
 - Three of nine interagency agreements tested were not signed and approved by the Department prior to the effective date specified in the agreement.
 - Two of five tobacco enforcement agreements tested were not signed and approved by the Department prior to the effective date specified in the grant agreement.
- The Department did not comply with the contract and grant filing provisions of the Illinois Procurement Code.
 - Nine of 25 contractual agreements tested were not filed with the Office of the State Comptroller within 15 days of execution. Agreements were between 3 and 126 days late.
 - Four of the nine contractual agreements untimely filed were required to have late filing affidavits. One of those four (25%) did not have a notarized late filing affidavit.
- The Department did not comply with the contract obligation provisions of SAMS.
 - One of 25 Contract Obligation Documents (COD) tested obligated a different amount than specified in the underlying contractual agreement.
 - Two of 25 CODs tested had multiple rates listed as the method of compensation; however, the contract specified quarterly payments of a fixed

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amount.

Accepted or Implemented - continued

- Six of 25 CODs tested did not match the service dates specified in the underlying contractual agreement.
- Four of 25 CODs tested did not have a proper signature.

Updated Response: Implemented. Department procedures already document this process. Our Chief of Staff issued an email directive to staff emphasizing the importance of prior approval for all contracts etc.

The Department has hired an Agency Procurement Officer (APO) to oversee and monitor contracts and IGAs for the agency. The APO will work very closely with Department staff and the EEC State Purchasing Officer to ensure that all contracts are processed timely. We will work with other governmental units to emphasize the need to execute IGAs prior to the start date.

- 36. Ensure employee performance evaluations are performed in a timely manner; ensure personnel files are maintained and payroll transactions are properly supported; properly calculate and record employee deductions and fringe benefits; require employees maintain timesheets in compliance with the State Officials and Employees Ethics Act; maintain accurate accumulated leave records for all employees; and, ensure all employees obtain all mandated training as required by State law. (Repeated-2007)**

Finding: The Department did not maintain adequate control over personal services. During testing, auditors noted the following:

- The Department did not maintain adequate control over employee evaluations.
 - 10 of 25 employees' annual performance evaluations tested were completed 34 to 334 days late.
 - Four of 25 tested employees did not receive an annual evaluation during the examination period.
 - Three of 25 tested employees did not receive a probationary evaluation during the examination period.
- The Department did not maintain adequate control over payroll deductions. One of seven (14%) employees with personal use of a State vehicle tested did not have the proper value of the fringe benefit included in the employee's taxable income.
- The Department did not maintain adequate control over employee timekeeping.
 - Eight of 25 (32%) employees tested did not have complete support for time spent on "official State business". The Department of Central Management Services' reports from the Central Time and Attendance System (CTAS) were either months late or lacked the required signatures of the employee, timekeeper, and/or division manager.
 - Nine of 25 (36%) employees tested had employee absences that did not trace to

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supporting leave request documentation and/or leave requests were not properly approved or completed timely.

Accepted or Implemented - concluded

- Four of the nine employees had leave request slips that were not signed by the employee or the employee's supervisor as required by the Handbook.
- Three of the nine employees had leave request slips signed by the employee or supervisor a significant time after the leave was taken.
- Four of the nine employees' time off was not correctly accounted for in CTAS.
- The Department did not comply with requirements regarding employee training.
 - 14 of 25 (56%) new employees tested did not have documentation in their employee files to show that sexual harassment training was completed within one year of employment with the Department. These employees had a registration form on file that was signed by the employee. A certificate of completion was not received from the training coordinator separate from the registration form that was signed only by the employee.
- 7 of the 14 noted employees registered for sexual harassment training in January and March of 2011, 48 to 210 days late, after inquiry by the auditors.
 - Two of 25 (8%) new employees tested had a training certificate on file, but did not complete sexual harassment training until February and March 2011, after auditor inquiry. Employees completed training 237 to 247 days late. Sexual harassment training should be completed within one year after the employee starts employment with the Department.
 - One of the 25 (4%) new employees did not complete sexual harassment training during the individual's 494-day tenure as a Department employee.
 - Two of 18 (11%) employees did not complete their annual ethics training timely, 207 and 227 days late. The training was completed after auditor inquiry in January 2011.

Response: The Department agrees that timely completion of evaluations, up-to-date personnel files, and accurate time sheets and leave records are important. The Department has a notification process in place that informs managers and supervisors of evaluations due.

The Department requires all employees to maintain time sheets in compliance with the State Officials and Employees Ethics Act and IDOR to maintain accurate accumulated leave

records for all employees. The Department will remind timekeepers, employees, and managers that all CTAS reports must be signed, as required by timekeeping policy.

The IRS employers Tax Guide top Fringe Benefits requirement to include the value of a vehicle used for commuting purposes is followed by IDOR. The Department has proper controls in place, but this was an isolated occurrence of human oversight in entering the incorrect information into the system.

The Department will ensure that all employees obtain all mandated training. Going forward, the Department has implemented a New Employee Orientation (NEO) program. This program is operated by the A and R Shared Services Center. All new employees are required to attend NEO on their first day working for the Department. NEO is a day-long

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process of completing paperwork, reviewing agency policies and receiving mandatory training.

Under Study

- 5. 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, take action to ensure taxpayer information is timely considered or processed to ensure taxpayer's records and financial statement information reflect accurate information. In the long-term, enhance the capabilities of the GenTax system to permit the posting of transactions and adjustments to a previous period for financial reporting purposes. (Repeated-2008)**

Finding: The Department included invalid taxes receivable accounts in the Department's accounts receivable calculation at June 30, 2010. During 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, auditors noted the following:

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 above 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 chart.

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. For example, if a taxpayer payment or other information is received prior to fiscal year-end, but processed and posted after fiscal year-end, the system does not allow the payment or adjustment to be applied to the previous fiscal year, which is necessary for financial reporting purposes. 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.

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.

Updated Response: Partially Implemented and Under Study. The Department's tax records are accurate, timely processed, and proper controls are in place over taxes receivable. The Department's estimate of year-end receivables was materially correct.

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The \$24.5 million adjustment determined by the auditor means that the estimate of year-end receivables was 97.8% (\$24.5 million out of \$1.1 billion) accurate.

Under Study – continued

Auditor's Comment: *If, as the Department stated, "our tax records are accurate, timely processed, and proper controls are in place over taxes receivable," the auditors 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.*

The Department has established the following enhancements to GenTax:

- Data marts that enable the Financial Control Bureau to run data cubes for financial reporting and historical trending of TRM stop bills and lapse period transactions. Procedures and processes have been changed accordingly.
- A system change request to further identify unworked accounts at year end in order to track historical collection trends.
- A system change request for tracking year-end payments received prior to June 30th but not yet posted to Gen Tax until early July (total of these receipts \$7 million).

GenTax is a tax processing system and not an accounting system, it is not economically feasible to change the core tax processing system to backdate processing transactions for financial reporting purposes as recommended.

7. **Perform a monthly comparison of detailed data from the legacy system (perfected return data) to the previous month's cash detail per the Consolidated Accounting System (CAS). This information should be reviewed to ensure all noted differences in the data is reasonable and reflects an explainable timing difference between the date in which cash is collected for a HOOT return versus the date in which the collected cash has been associated with a perfected return. This information should be reviewed by a supervisor and unusual/unexpected differences should be investigated.**

Finding: The Department did not exercise adequate control over Hotel Operators' Occupation Tax (HOOT) deposit allocations or reconciliations.

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During testing, auditors noted the Department's allocations of HOOT collections on behalf of the Illinois Sports Facilities Authority, Metropolitan Pier and Exposition Authority, and a local government did not appear to be in compliance with statutory formulas. In following up on this exception, auditors determined the Department **does not perform a reconciliation** of deposit allocations to actual return information for all funds receiving HOOT collections. During FY10, the Department processed a total of \$250,774,221 in HOOT collections.

Response: The Department disagrees with the auditors' contention that it does not exercise adequate control over deposit allocations and reconciliations of State HOOT tax. The timely deposit of receipts and accurate distribution of funds is a critical mission for the Department of Revenue and a function that the Department takes seriously. The Department has used the same deposit and reconciliation process for at least 20 years without audit findings. The following is a brief outline of this process:

AUDITOR'S COMMENT: In regards to the Department stating they have "used the same deposit and reconciliation process for at least 20 years without audit findings," the Department did not, in our opinion, account for increases in the capability of technology allowing for the full reconciliation of receipts to deposits into the State Treasury or recognize significant statutory changes to the allocation of HOOT deposits in July 2001. As stated in both the *Independent Auditor's Report* and the *Independent Accountants' Report on State Compliance, on Internal Control over Compliance, and on Supplementary Information for State Compliance Purposes*, our examination is performed on a test basis, and as such, will not discover every instance of noncompliance in every audit period. The auditors select only a sample of statutory mandates in each audit cycle out of the several hundred imposed by State law on the Department.

While it is impractical to reconcile a total daily deposit batch to tax processing system totals after all returns are "perfected", we can trace any individual receipt to a deposit batch if required and vice versa. We also perform a myriad of reconciliations and reasonableness reviews to ensure that deposits are calculated and posted as intended per statutes and balance to daily and monthly deposit batch totals in Gen Tax and CAS to make adjustments for movement between tax types and funds, and perform a reasonable test of all deposits with statutory calculations.

AUDITOR'S COMMENT: The Department's response only indicates reconciliations are completed between cash deposits from one system to cash deposits on another system, which means their cash deposits agree between the Department's various systems. The Department's response excludes any reconciliation of cash deposits to amounts that should have been deposited per fund, in accordance with statutory requirements, from return data to ensure deposits into the State Treasury were complete and accurate.

The Department agrees that some small deposits/transfers and allocations were not performed during this fiscal year due to human error, lack of sufficient funds, and a misinterpretation of statute. We agree to correct the deposit and transfer errors and to recommend statute changes.

Under Study – continued

AUDITOR’S COMMENT: The Department’s process is to estimate the amounts to deposit into the funds; however, they do not reconcile these estimated deposits to actual return data to ensure the accuracy and completeness of HOOT deposits into the State Treasury. If the Department had performed a simple reconciliation of the moneys deposited into the three fiduciary funds that are for HOOT taxes only charged within the City of Chicago, the Department would have discovered deposit allocation errors, as noted in this finding. A full reconciliation would reveal deposit errors requiring an adjustment by the Department.

The Department is in the process of moving the Excise Taxes to the new Gen Tax system and has developed a checklist so that monthly transactions are reviewed and appropriate transfers and vouchers are processed based on actual return data as received which should eliminate the missing transactions and deposits not made as required. Any discrepancies noted will be processed as receipt adjustments. In addition, after GenTax

rollout 4 is complete, the Department will research further enhancements to GenTax and a rewrite of the current Consolidated Accounting System/new general ledger in order to determine the feasibility and cost/benefit of reconciling detail return information with deposit information.

Updated Response: Under Study.

8. **Perform a monthly comparison of detailed data from the GenTax system (perfected return data) to the previous month’s cash detail per the Consolidated Accounting system (CAS). Review information to ensure all noted differences in the data is reasonable and reflects an explainable timing difference between the date in which cash is collected for a sales tax return versus the date in which the collected cash has been associated with a perfected return. Direct a supervisor to review the information and investigate unusual/unexpected differences. Review any material differences and determine if they impact the allocation of the 2% reserve funds for sales tax.**

Finding: The Department did not exercise adequate control over the tax allocation process for State sales tax.

The Department is required by State statute, to allocate sales tax collections to local governments and various State funds based on legislated amounts and/or percentages. As cash is collected, the Department allocates it daily to the various State and local government funds based on estimates. Additionally, the first 2% of all collections are set aside (2% reserve) in order to have sufficient funds to “true-up” the various local government funds once the sales tax returns are perfected and the correct/final local government allocations are known. This is necessary because there is a delay of typically

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one month to process and approve (perfect) the sales tax return, from the date it is received by the Department. Amounts remaining in the 2% reserve after this “true-up” are then allocated to the various State funds. During FY10, the Department processed approximately \$12 billion in sales tax collections.

The Department makes sales tax allocations to local governments monthly, based upon the batches of sales tax returns which were perfected during the previous month. These batches also include new cash receipts from previously perfected returns (collections on receivables), as well as other miscellaneous items. These perfected returns consist predominantly, but not exclusively, of sales tax amounts that were collected one month prior to the month in which the returns were perfected. Sales tax amounts collected for returns not yet perfected are not distributed to the local governments until after the perfection process, regardless of when the cash was collected. As such, there are always differences between the cash collected in the month prior to the measurement period (per CAS) when compared to the perfected returns (GenTax).

During testing, auditors noted the Department does not perform a **monthly** reconciliation or review of sales tax deposit records per their Consolidated Accounting System (CAS) to sales tax cash records in their GenTax system, for the perfected returns used to make sales tax distributions to the local governments. Although cash recorded in each of the systems is compared each day, with differences investigated, there is not a monthly reconciliation between the two systems to ensure all variances between the systems are legitimate, explainable timing differences. Auditors were able to conclude that there were no material misallocations of sales tax receipts to the various funds in FY2010.

Response: The Department disagrees with the auditor’s assertion that we did not exercise adequate control over deposit allocations and reconciliations of state sales tax. We conduct multiple reconciliations to assure that we are recording and depositing the correct amount of tax. The timely deposit of receipts and accurate distribution of funds is a critical mission for the Department of Revenue and a function that the Department takes seriously. The Department has used the same deposit and reconciliation process for at least 20 years adapting to the new Gen Tax system as necessary. The Department processed \$29 billion in total receipts with 19.2 million documents following this process during FY10. The following is a brief outline of this process:

Auditor’s Comment: *As per the Department, they “processed \$29 billion in total receipts with 19.2 million documents following this process during FY10,” making the reconciliation of State sales tax, approximating \$12 billion, a material and significant revenue source that should, in our opinion, be reconciled to tax return data for proper fund allocation and deposit. Additionally, under the present system, the potential for a material misstatement in financial reporting remains. In regards to the Department stating they have “used the same deposit and reconciliation process for at least 20 years adapting to the new Gen Tax system as necessary,” the Department did not, in our opinion, account for increases in the capability of technology allowing for the full reconciliation of receipts to deposits into the State Treasury or recognize significant statutory changes to the allocation of Sales Tax deposits in **October 2009**. As stated in both the Independent Auditor’s Report and the Independent Accountants’ Report on State Compliance, on Internal Control over*

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Compliance, and on Supplementary Information for State Compliance Purposes, our examination is performed on a test basis, and as such, will not discover every instance of noncompliance in every audit period. The auditors select only a sample of statutory mandates in each audit cycle out of the several hundred imposed by State law on the Department.

While it is not practical to reconcile a total daily deposit batch to our tax processing system in total after all returns are “perfected”, we can trace any individual receipt to a deposit batch if required and vice versa. We also perform a myriad of reconciliations and reasonableness reviews to ensure that deposits are calculated and posted as intended per statutes and balance to daily and monthly deposit batch totals in Gen Tax and CAS to make adjustments for movement between tax types and funds, and perform a reasonable test of all deposits with statutory calculations.

Updated Response: Under Study.

9. Implement controls to ensure

- **Receipt processing is received and processed in a centralized location with adequate monitoring and security controls. 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 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: The Department has 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. During testing, auditors noted several internal controls and physical safeguards were not in place to protect taxpayer receipts and taxpayer information.

Receipt Processing

- All receipt documents were not received and processed with adequate monitoring and security controls. The Department receives the majority of the tax receipts

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through the Document Control and Deposit (DC&D) section. However, receipts were initially received and processed by various other areas within the Department. The DC&D section and the other areas receiving receipts did not have adequate controls in place to adequately monitor and safeguard receipt documents. 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 do not require supervisory review and verification of adjustments.

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.

Physical Safeguards

- Physical safeguards to control general public access to tax processing areas, including those accessing daycare and restaurant services, were not implemented. 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. Auditors 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 lying on vertical shelving units in unprotected areas. This information and documents are accessible 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:

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- 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.

Updated Response: Partially Implemented/Under Study

The Department disagrees with the finding that it does not have adequate controls and protections in place, but it agrees that safeguarding of receipts and taxpayer information is critical and can always be improved. The Department is in the process of hiring a Chief Information Security Officer to oversee assuring that taxpayer information is protected. Specifically:

AUDITOR'S COMMENT: *While the Department disagrees with the finding that it does not have adequate controls and protections in place over taxpayer receipts, the bullets in the finding depict significant deficiencies in their internal controls over receipt processing and taxpayer information. Internal Revenue Service Publication 1075 details strict security and processing controls over taxpayer information the Department does not currently have in place.*

- We disagree that **all** receipts can be processed in a centralized area without drastically slowing the process of resolving taxpayer issues. The Department directs taxpayers to send payments to the Document Control & Deposit section (DC&D). However, taxpayers responding to general correspondence occasionally send payments elsewhere in the Department. In essence, the auditor's issue involves roughly 0.1% of payments received through correspondence with taxpayers. Without slowing the resolution of taxpayer accounts (see finding 10-5 that involves needs to resolve accounts very quickly), all mail cannot be directed through DC&D.

AUDITOR'S COMMENT: *The auditor's concerns address 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.*

The Department of Revenue utilizes a minimum of **65 different addresses** to direct payments, correspondence, and general mail. In FY2010, the Department processed 19.2 million tax documents and deposited \$28.5 billion. Of this amount the majority of the receipts are **deposited immediately** through various electronic commerce processes totaling \$21.1 billion (74% of total receipts). The Department agrees it can improve

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reporting and monitoring of receipts for the tiny fraction of payments received outside of DC&D. The following changes have been implemented in the past six months:

- Check handling procedures have been updated to not allow checks received in DC&D to be released to other areas without proper authorization.
 - When a check is not properly identified for posting within a specified timeline, the check in question will be deposited in the Revenue Clearing account pending resolution.
 - All checks received in the check processing areas within DC&D are locked up/secured before leaving for the day.
 - Procedures have been written and implemented in the Clerical Support Division to ensure checks are logged in, monitored, and routed properly.
 - Additional PO Boxes have been utilized to receive receipts directly into DC&D, thus checks received are researched and processed by DC&D staff.
- The Department has adequate controls and segregation of duties over receipts and has implemented additional controls in the last six months (as noted above and below). The OAG noted in an auditor comment that 5,086 payments totaling \$9.6 million was received in the processing areas. However, it must be stated that these payments represent 0.15% of the transactions (3.4 million) and 0.22% of the payments (\$4.4 billion) processed through the Springfield and Chicago locations and there are adequate checks receipt controls in place in these processing areas.

AUDITOR'S COMMENT: *The Department agreed to see whether further segregation of duties is needed for employees who can adjust accounts and receive checks. Good internal controls would not allow one individual to have the authority to both receive taxpayer payments and adjust the taxpayer's account. The auditors noted the Department 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."*

- The Department plans to work to further enhance the security of the tax environment – beyond the currently secure building with security guards, badge requirements, and employee training – as part of its efforts to comply with IRS Publication 1075. The following items were implemented in the past six months:
 - The Document Control and Deposit Division (DC&D) is deemed a secure area and is restricted to only authorized employees. Temporary barriers have been erected around the perimeter of DC&D, until a more permanent solution can be funded. Sign-in and sign-out log sheets are maintained at the entrance to DC&D and reviewed by DC&D managers. Signage has been posted as an alert that they are entering a restricted area.
 - DC&D deposit operations have been moved to one side of the work area to segregate check processing and deposit functions.
 - The deposit preparation work area has been moved to a more secured location.

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- The new security camera system has been implemented and operational in the Willard Ice Building. Internal Affairs manages the camera system.
- The Records Management Division (RMD) has worked to limit the number of employees needing access to the Central File storage area. Temporary barriers have been erected around the perimeter of RMD, until a more permanent solution can be funded.
- A Security Consultant has been contracted with to perform a security review and risk assessment of IDOR facilities. This project has been delayed due to lack of funding.

The Department will continue to implement additional security measures as security/control measures are defined, floor plans are reviewed, and funding is available.

- In an effort to strengthen the safeguard controls the Records Management Division implemented a new work rule to restrict the use of personal recording devices (including but not limited to cell phones, I-Pads, etc.) until a formal policy can be negotiated with AFSCME. Negotiations are underway to implement a new policy to restrict the use of personal devices in restricted areas of the Department.

27. 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 the Department should seek legislative remedy. (Repeated-2009)

Finding: During fieldwork, auditors noted 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 statute. 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.

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.

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

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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.

Updated Response: Under Study. Everyone agrees that all refunds should be paid, but that is not possible when there is no money in the Income Tax Refund Fund. The OAG’s legal interpretation of the term “excess” in this statute is incorrect. However, the Department is in the process of drafting legislative language that would change Section 901 of the Illinois Income Tax to address this issue.

AUDITOR’S COMMENT: *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.*

Emergency Purchases

The Illinois Procurement Code (30 ILCS 500/) states, “It is declared to be the policy of the State that the principles of competitive bidding and economical procurement practices shall be applicable to all purchases and contracts...” The law also recognizes that there will be emergency situations when it will be impossible to conduct bidding. It provides a general exemption when there exists a threat to public health or public safety, or when immediate expenditure is necessary for repairs to State property in order to protect against further loss of or damage to State Property, to prevent or minimize serious disruption in critical State services that affect health, safety, or collection of substantial State revenues, or to ensure the integrity of State records; provided, however that the term of the emergency purchase shall not exceed 90 days. A contract may be extended beyond 90 days if the chief procurement officer determines additional time is necessary and that the contract scope and duration are limited to the emergency. Prior to the execution of the extension, the chief procurement officer must hold a public hearing and provide written justification for all emergency contracts. Members of the public may present testimony.

Notice of all emergency procurement shall be provided to the Procurement Policy Board and published in the online electronic Bulletin no later than 3 business days after the contract is awarded. Notice of intent to extend an emergency contract shall be provided to the Procurement Policy Board and published in the online electronic Bulletin at least 14 days before the public hearing.

A chief procurement officer making such emergency purchases is required to file an affidavit with the Procurement Policy Board and the Auditor General. The affidavit is to set forth the circumstance requiring the emergency purchase. The Legislative Audit Commission receives quarterly reports of all emergency purchases from the Office of the

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Auditor General. The Legislative Audit Commission is directed to review the purchases and to comment on abuses of the exemption.

The Department filed two affidavits for emergency purchases in FY10 totaling \$43,941.74 as follows:

- \$24,823.24 for Lottery IT operations; and
- \$19,118.50 for a website host to help taxpayers look up answers to questions.

Headquarters Designations

The State Finance Act requires all State agencies to make semiannual headquarters reports to the Legislative Audit Commission. Each State agency is required to file reports of all its officers and employees for whom official headquarters have been designated at any location other than that at which official duties require them to spend the largest part of their working time.

In July of 2010, the Department indicated it had 451 employees who spent at least 50% of their time working at locations other than their official headquarters.