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

SUMMARY REPORT DIGEST

ILLINOIS STUDENT ASSISTANCE COMMISSION – ILLINOIS PREPAID TUITION PROGRAM

FINANCIAL AUDIT
For the Year Ended: June 30, 2010

Release Date: April 7, 2011

Summary of Findings:

Total this audit:	**1**
Total last audit:	**0**
Repeated from last audit:	**0**

INTRODUCTION

This report covers our financial audit of the Illinois Student Assistance Commission (Commission) – Illinois Prepaid Tuition Program (Program) as of June 30, 2010 and for the year then ended. The financial statement opinion includes a paragraph **emphasizing** that the Program has a **deficit of $338 million** as of June 30, 2010.

SYNOPSIS

- The Program did not comply with the competitive procurement requirements of the Illinois Procurement Code and did not follow sound business practices in its selection of a vendor to provide due diligence services. Further, the Commission lacked documentation showing the vendor performed the same services specified in the contract.

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

ILLINOIS STUDENT ASSISTANCE COMMISSION
ILLINOIS PREPAID TUITION PROGRAM - FINANCIAL AUDIT
For The Year Ended June 30, 2010 (in thousands)

STATEMENT OF NET ASSETS	2010	2009
Assets		
Cash and cash equivalents	$ 14,809	$ 61,332
Accrued interest on investments	1	7
Securities lending collateral	-	72,331
Investments	971,481	824,995
Total	$986,291	$958,665
Liabilities		
Accounts payable and accrued expenses	$ 947	$ 638
Securities lending obligation	-	77,664
Tuition payable	914,437	884,485
Accreted tuition payable	408,593	337,369
Compensated absences	104	68
Other	98	101
Total	$ 1,324,179	$ 1,300,325
Net Assets, Unrestricted (Deficit)	$ (337,888)	$ (341,660)

REVENUES, EXPENSE AND CHANGES IN NET ASSETS	2010	2009
Operating revenues		
Income (loss) from investment securities	$ 88,599	$ (155,994)
Fees	1,470	1,940
Interest revenue	179	121
Total	$ 90,248	$ (153,933)
Operating expenses		
Accreted tuition expense	$ 76,597	$ 67,775
Salaries and employee benefits	3,347	1,856
Management and professional fees	2,965	3,438
Investment advisory fees	1,926	-
Investment management fees	1,610	1,650
Total	$ 86,445	$ 74,719
Operating income		
Transfers out	$ (31)	$ (31)
Change in net assets	$ 3,772	$ (228,683)

AGENCY EXECUTIVE DIRECTOR
During Examination Period: Mr. Andrew Davis
Currently: Mr. Andrew Davis

FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS

PROCUREMENT LAW AND SOUND BUSINESS PRACTICES NOT FOLLOWED

Noncompliance with Procurement Code

The Illinois Prepaid Tuition Program of the Illinois Student Assistance Commission (Commission) did not comply with the competitive procurement requirements of the Illinois Procurement Code and did not follow sound business practices in its selection of a vendor to provide investment due diligence services. Further, the services performed by the vendor did not match the services specified in the contract.

The Commission awarded a contract for investment due diligence services without following established procurement law, administrative rules or sound business practices. We noted the following:

Request for proposal not specific

Price quotes for investment services not obtained from other respondents

Work began before obtaining a signed contract

No documentation required contract services were provided

Fee arrangement issues

Focus on one investment only

1. The Request for Proposal (RFP) issued to procure the Services was not specific to investment due diligence services, but rather was for financial advisory services pertaining to issuing or restructuring debt;
2. Only one of ten "prequalified vendors" provided pricing for the investment due diligence services and there was no effort to obtain quotes from any of the other successful respondents when it was determined that investment due diligence services were needed;
3. The performance of the work commenced prior to obtaining a signed contract;
4. The Commission could not provide documentation showing the vendor's "due diligence" services were provided as required by the contract;
5. The fee arrangements with the selected vendor did not ensure objectivity in the performance of the work which was the subject of the contract; and
6. Management focused on only one private equity investment alternative.

<u>Competitive Price Procurement Circumvented in the RFP Process (Exceptions #1 and #2)</u>

RFP primarily pertained to issuance/restructuring debt

On January 4, 2008, the Commission (through Central Management Services) issued an RFP. The auditors concluded the RFP was primarily issued to assist the Commission with services pertaining to the issuance/ restructuring of debt.

Vendor awarded investment services contract provided <u>unsolicited</u> fee quote

The auditors reviewed the proposal provided by the vendor awarded investment due diligence services under this RFP. The vendor did not present qualifications in the proposal pertaining to investment advisory services or investment due diligence services. The price proposal, however, did contain the following additional <u>unsolicited</u> fee quote that was not included in the RFP fee proposal form:

"Other Services: Financial Advisor, investment banking and analysis services related to investment of 529 prepaid tuition plan assets in illiquid assets and/or private placement in new asset categories charges: 1.25 to 2% of invested assets."

Award not competitive

Based on the RFP issued, there was no clear basis for awarding a contract for investment due diligence services in a fair and competitive manner that allowed all interested parties the opportunity to participate in the procurement opportunity. There is no evidence that any of the 9 other respondents were asked to provide pricing for due diligence services after the proposals were received and scored.

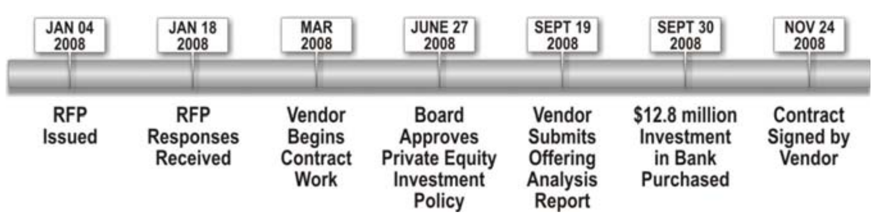
According to Commission management, the Commission believed that the RFP process complied with the Illinois Procurement Code and permitted selection of a vendor from the qualified list of financial advisors to perform the services requested.

Contract Not Reduced to Writing and Performance of Contract Requirements not Adequately Documented (Exceptions #3 and #4)

Services limited to one private equity investment

All contract work was complete prior to the beginning date and signature of the contract

The Vendor's investment due diligence services were limited to one recommended transaction – a private equity investment in a specific bank. According to Commission management, the Vendor began performing its due diligence work on the viability of the recommended private equity investment in the Bank around March 2008. This was prior to the Board approving changes to the investment policy on June 27, 2008 that would allow for direct private equity investments. The Vendor issued its final Offering Analysis report on September 19, 2008. The investment in the Bank was actually made on September 30, 2008. The terms of the contract with the vendor provided for services to be performed between November 24, 2008 and March 31, 2009. The contract was not signed until November 24, 2008. Thus all the work required by the contract was completed and the private equity investment was purchased prior to the date and terms of the contract beginning November 24, 2008.



No documentation to support the vendor performed the same services as specified in the contract

The Commission lacked documentation showing that the vendor performed the same services as specified by the contract. The contract called for the vendor to "Conduct thorough due diligence of the proposed investment". Due diligence generally requires the independent verification of material facts, and in this case, Bank management representations. In the Offering Analysis, provided as the final work product of the Vendor, it states "All information concerning the Bank was provided by (Bank) management. All information received has been accepted by (the Vendor) to be accurate with no further investigation". The auditors requested but were not provided any evidence that the Vendor independently verified management's representations.

Management stated work began before the contract was signed because of unclear communication

According to Commission management, the contract was not executed prior to the commencement of work because of unclear communication and an incorrect assumption that contracts were entered into with all vendors prequalified to provide financial advisory services. Commission management stated the vendor, in conjunction with the Commission's outside attorneys, reviewed financial records and reports, conducted site visits and interviews, reviewed reports of federal regulators and other corporate records and documents prior to preparing their report.

<u>Vendor Fee Arrangement Not Objective and Alternative Investments Not Considered (Exceptions #5 and #6)</u>

Vendor paid 2% of invested amount

The terms of the agreement with the Vendor performing the due diligence services stated the Vendor would receive as payment for services, 1.25% to 2% of the invested amount. The fee paid was 2% of the amount invested, or $255,600. The vendor was asked to provide due diligence services leading to a conclusion as to the viability of one specific private equity investment. Management did not solicit from this vendor or any other vendor information on the viability of other alternate investment choices.

Contingent fee may have created incentive to recommend the investment

By paying the vendor on a commission or a contingent fee basis, the Commission may have created an incentive for the vendor to recommend the private equity investment. Specifically, there was no contractual means for the vendor to be paid under the signed contract if the investment was not made.

Other private equity investments not considered

The Commission did not consider other private equity investment choices for this asset allocation category. We noted that in each category of the Offering analysis report prepared by the vendor there were potential red flags as to the soundness of the investment.

Red flags noted in report

$12.8 million value of investment deemed worthless at June 30, 2010

Despite the red flags noted the vendor recommended the investment in the Bank and the Commission purchased the $12.78 million investment on September 30, 2008. By the end of fiscal year 2010, the Commission determined the entire $12.78 million value of the investment was worthless when the Bank was taken over by the FDIC.

According to Commission management, the Commission believed the fee arrangement was appropriate and consistent with the Vendor's price proposal and contingent fee proposals from other qualified vendors in response to the RFP that were based upon the principal amount of securities offered. Commission management stated the decision to consider only the one Bank investment was a business decision. (Finding 1, pages 35-39)

We recommended the following:

Auditors' recommendations

- The Commission should comply with the Procurement Code and Administrative Rule in procuring professional and artistic services.
- The Commission should establish policies whereby RFP's are thoroughly reviewed before issuance to ensure that all aspects of the needed services are thoroughly described in the document.
- If one RFP is being issued to solicit vendors for multiple and/or varying services, the pricing portion of the RFP should provide a detailed schedule or table specifying the manner in which pricing should be provided for the different types of services requested.
- The Commission should process and approve all contracts in writing before the beginning of the contract period or commencement of any services.
- The Commission should ensure that the provisions of contracts are performed and documented before paying vendors for services.
- The Commission should revisit contingent fee based compensation methods when contracting for opinions on investment purchase decisions that may influence the objectivity or the perception of objectivity of the opinion rendered.
- The Commission should consider taking into account other alternate investments choices when making investment decisions.

Commission accepted auditors' recommendations

The Commission accepted our recommendations and stated that while appropriate procurement procedures were followed, ISAC's future RFP's will have more precise descriptions of services to be solicited with clearer pricing requirements. The Commission stated that it has changed its procedures for RFP's that result in a large number of qualified bidders in order to ensure that services begin only after the contract is signed. Further the Commission indicated it will review contingent-fee compensation and consider taking into account different investment choices when making investment decisions.

AUDITORS' OPINION

Program has $338 million deficit

Our auditors stated the financial statements of the Program are fairly presented in all material respects. Auditors included a paragraph emphasizing that the Program has a deficit of $338 million as of June 30, 2010.

WILLIAM G. HOLLAND
Auditor General

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SPECIAL ASSISTANT AUDITORS

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