SPRINGFIELD OFFICE:
ILES PARK PLAZA
740 EAST ASH • 62703-3154
PHONE: 217/782-6046
FAX: 217/785-8222 • TTY: 888/261-2887

CHICAGO OFFICE:
MICHAEL A. BILANDIC BLDG. • SUITE S-900
160 NORTH LASALLE • 60601-3103
PHONE: 312/814-4000
FAX: 312/814-4006

OFFICE OF THE AUDITOR GENERAL
WILLIAM G. HOLLAND

REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

Honorable Michael J. Madigan, Speaker of the House
Honorable John J. Cullerton, President of the Senate
Members of the General Assembly
Honorable Patrick Quinn, Governor
Honorable Daniel Hynes, Comptroller

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Illinois as of and for the year ended June 30, 2008 as listed in the Table of Contents for Section II of the Illinois Comprehensive Annual Financial Report, which collectively comprise the State of Illinois' basic financial statements and we have issued our report thereon dated July 10, 2009. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. For purposes of this report, our consideration of internal control over financial reporting and our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, and other matters did not include the State's discretely presented component units. Separate reports have been issued for these entities. The findings, if any, included in those reports are not included herein.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the State of Illinois' internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not for the purpose of expressing an opinion on the effectiveness of the State of Illinois' internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the State of Illinois' internal control over financial reporting.

Our consideration of the internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies described as findings 08-1 and 08-2 in the accompanying schedule of findings to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, of the significant deficiencies described above, we consider finding 08-1 and 08-2 to be a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of Illinois' financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings and responses as finding 08-3.

We also noted other matters involving the internal control over financial reporting, which we have reported to management of the Office of the State Comptroller in a separate letter dated July 20, 2009.

The Office of the Governor's and the Office of the State Comptroller's responses to the findings identified in our audit are described in the accompanying schedule of findings. We did not audit these responses and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the Auditor General, the General Assembly, the Legislative Audit Commission, the Governor, the Comptroller, the State's Management and federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

WILLIAM G. HOLLAND
Auditor General
State of Illinois

Bruce L. Bullard

BRUCE L. BULLARD, CPA
Director of Financial and Compliance Audits
Office of the Auditor General

July 20, 2009

08-1. **FINDING** (Financial Reporting Weaknesses)

The State of Illinois did not have adequate controls to assess the risk that information reported by individual agencies of the primary government would not be fairly stated and compliant with generally accepted accounting principles.

Restatements – Correction of Errors

The financial statements have been restated as of July 1, 2007 for the following prior reporting errors:

Governmental Activities

- Understatement of unearned income tax revenues of $343.6 million. This issue was identified by the auditors.
- Understatement of unearned driver's license and fee revenue of $34 million. This issue was identified by management and refined by the auditors.
- Lack of allocation of accrued motor fuel tax revenues to other State funds and understatement of accrued shared revenue liabilities associated with motor fuel tax revenues of $122.6 million. This issue was identified by management.

Business-type Activities

- Overstatement of allowance for unemployment taxes, penalties, and interest of $31.6 million in the Unemployment Compensation Trust Fund, a major fund of the State. This issue was identified by the auditors.

Misstatements Identified by Auditors

In addition to the restatements described above, the following misstatements were noted by the auditors:

Two main adjustments were made to the State's Department of Revenue's financial statements for the reporting period to fairly state multiple accounts. The largest of these adjustments was to increase Deferred Revenue – (Unearned) by $433 million for governmental funds and governmental activities. Another adjustment was made to decrease Taxes Receivable by $87.6 million.

The Illinois Prepaid Tuition Program of the Illinois Student Assistance Commission, a major fund of the State, did not properly account for its securities lending transactions. One adjustment was made to record collateral investments and liabilities of $168 and $171 million respectively, and a $3 million unrealized loss. In addition, the initial financial statements did not have required disclosures related to these transactions.

The Illinois Designated Account Purchase Program (IDAPP) of the Illinois Student Assistance Commission (ISAC), a major fund of the State, did not have sufficient controls over financial reporting. Several errors and omissions were identified during the audit of the IDAPP draft financial statements provided by ISAC.

Audit adjustments were identified for errors in financial information submitted by the State's Department of Corrections. These adjustments primarily related to unrecorded liabilities and misstatements in capital asset amounts.

The State's Department of Healthcare and Family Services did not perform timely reconciliations for its Medicare Part D wrap around benefit program. Audit adjustments to three reporting units were made and ranged from $20.7 million to $55 million.

Adjustments were made to the State's Department of Transportation's (IDOT) financial information for revenue recognition/deferred revenue errors. In addition, IDOT's commodity inventory balance was adjusted $3.493 million based on discrepancies noted during audit testwork. IDOT reports 100% of the inventory balance of the Road Fund, a major fund of the State.

The Illinois Environmental Protection Agency did not identify errors in its financial statements of the Water Revolving Fund, a major fund of the State. Errors noted by the auditors resulted in a reclassification of $2.855 million from restricted net assets for debt service to unrestricted net assets.

The auditors determined that the State Universities Retirement System had not properly accounted for its alternative investments. As a result, the System's beginning Plan Net Assets and Net Increase in Plan Net Assets were understated by approximately $85 million.

Organizational Deficiencies

The State's decentralized reporting system and related decentralized internal control system is not adequate to reduce the likelihood that a material misstatement of the State's financial statements could occur and not be detected during the normal course of business. The following are descriptions of deficiencies, in addition to those described above, that were noted during our audits at various agencies and the Office of the State Comptroller (IOC).

- Significant problems were noted during our audit of the State's Department of Revenue related to accounting for and processing taxes receivable; development, change management and deficiencies in the production modules of a new integrated tax management system; preparing reporting packages for submission to the IOC; calculating penalties and interest; timely processing taxpayer information; making adjustments to tax accounts; and procedures for reconciling records.

- Significant problems were noted during our audit of the State's Department of Central Management Services related to compliance with federal regulations in the operation of its internal service funds; calculating the State's auto liability; payment of Worker's Compensation Claims from other internal service funds; security, control and recordkeeping for computer systems.

- Significant problems were noted during our audit of the State's Department of Human Services related to payments being made without sufficient supporting documentation, measuring and reporting liabilities, and controlling commodity inventories.

- Significant problems were noted during our audit of the State's Department of Healthcare and Family Services related to internal control review of its third parties; using the Health Insurance Reserve Fund to pay Worker's Compensation Claims; insufficient controls over the University of Illinois Hospital Services Fund; lack of controls over contributions to the Community College Health Insurance Security Fund; and incorrect charges for health insurance premiums for the Teacher's Retirement Insurance Program and College Insurance Program as well as an inadequate rate-setting methodology for the Teacher's Program. We also reported the Department provided incomplete and inaccurate census data to the actuary for the calculation of the State's other post employment benefit.

- Significant problems were noted during our audit of the State's Department of Corrections related to proper accounting for capital assets, inventories, liabilities and local fund transactions. In addition, the Department did not provide all requested documentation to the auditors in a timely manner and generally demonstrated a lack of cooperation during the audit. As a result, the auditors' report for the Department's financial statements included multiple qualifications.

- The IOC is dependent on agencies under the jurisdiction of the Office of the Governor to implement and comply with most provisions related to Governmental Accounting Standards Board (GASB) Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* and GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans.* Although the IOC assists with and monitors the reporting responsibilities associated with these two new Standards, the IOC is not directly involved in the selection of the actuary or the data gathering process for actuary purposes and financial reporting. The IOC is dependent on the State's Department of Healthcare and Family Services to provide the final actuarial information timely, which has not occurred in the past two years.

- Audit adjustments were routinely identified for the primary government's State agencies required to prepare financial statements that were not deemed material by agency management and were not posted to the financial statements. In working with the IOC to finalize the State's financial statements, it is necessary to accumulate all of the "passed adjustments" and evaluate these adjustments in total to ensure that they do not misstate the financial statements. Because of the volume of these passed adjustments, there is a continual risk that the State's financial statements may be materially misstated until this accumulation and evaluation process is completed. In addition, these passed adjustments require continued accumulation and evaluation in subsequent years.

In discussing these conditions with the Office of the Governor personnel, they stated that the weakness is due to separation in the responsibility for the State's internal control procedures among agencies and component units. The IOC has the statutory authority to develop and prescribe accounting policy for the State but there is no centralized statewide accounting system to capture all items necessary to provide underlying support to review agency financial transactions. In addition, there is an overall lack of qualified individuals in the State to ensure that all transactions are recorded in accordance with government accounting standards.

In discussing these conditions with the IOC personnel, they stated that misstatements were caused by a separation in the responsibility for the State's internal control. The IOC has the statutory authority to develop and prescribe accounting policy for the State but does not have the statutory authority to monitor adherence to these policies as performed by State agencies at the transactional level. Instead, the IOC monitors transactional activity of State agencies in compliance with budgetary and legal requirements for spending from the State Treasury. The IOC, to some degree, would have the ability to better analyze the financial activities of State agencies from a financial reporting perspective if the State had a centralized automated financial reporting system. The estimate cost of such a system would well exceed $100 million. In accordance with the Fiscal Control and State Internal Auditing Act, each State agency's Chief Executive Officer maintains statutory responsibility for the establishment and continuous monitoring of the internal control function for accounting and other operating policies of the Officer's agency. The IOC, in turn, relies upon State agencies' compliance with these statutory responsibilities. (Finding Code No. 08-1, 07-1, 06-1, 05-1, 04-1, 03-1, 02-1)

RECOMMENDATION

We recommend the State implement additional internal control procedures in order to assess the risk of material misstatements to the financial statements and to identify such misstatements during the financial statement preparation process. The internal control procedures should include a formal evaluation of prior problems and implementation of procedures to reduce the risk of these problems reoccurring.

AGENCY RESPONSES

Office of the Governor:

We agree. The Office of the Governor and the Office of the State Comptroller will work together to convince the Illinois Legislature of the necessity to include capital funding for the purpose of procuring and implementing a statewide accounting system with all necessary components including general ledger, procurement, inventory, grants management, payroll and timekeeping information systems. In addition, we will work together to enhance internal controls over the year-end financial reporting process.

Office of the State Comptroller:

The IOC will continue to provide consultation and technical advice to State agencies in relation to identification and establishment of adequate internal control with respect to financial reporting.

08-2. **FINDING** (Delays in Financial Reporting)

The State of Illinois' current financial reporting process does not allow the State to prepare a complete and accurate Comprehensive Annual Financial Report (CAFR) or the Schedule of Expenditures of Federal Awards (SEFA) in a timely manner. Reporting issues at various individual agencies caused delays in finalizing the financial statements which did not occur until June of the subsequent year for the past two fiscal years.

Accurate and timely financial reporting problems continue to exist even though the auditors have: 1) continuously reported numerous findings on the internal controls (material weaknesses and significant deficiencies), 2) commented on the inadequacy of the financial reporting process of the State, and 3) regularly proposed adjustments to financial statements year after year. These findings have been directed primarily toward the Office of the State Comptroller (IOC) and major State agencies under the organizational structure of the Office of the Governor.

The State has not been able to solve these problems or make substantive changes to the system to effectively remediate these financial reporting weaknesses. The process is overly dependent on the post audit program being a part of the internal control for financial reporting even though the Illinois Office of the Auditor General continues to inform State agency officials that the post audit function **is not and should not** be an internal control mechanism for any operational activity related to financial reporting.

The State of Illinois has a highly decentralized financial reporting process. The system requires State agencies to prepare a series of complicated financial reporting forms (SCO forms) designed by the Office of the State Comptroller to prepare the CAFR. For the most part, these SCO forms are completed for each of the State's 786 active funds. The forms are completed by accounting personnel within each State agency who have varying levels of knowledge, experience, and understanding of generally accepted accounting principles (GAAP) and of the State's accounting policies and procedures. Agency personnel involved with this process are not under the organizational control or jurisdiction of the IOC. Further, these agency personnel may lack the qualifications, time, support, and training necessary to timely and accurately report year end accounting information to assist the IOC in the preparation of the statewide financial statements in accordance with GAAP.

Although these SCO forms are subject to the review by the IOC financial reporting staff during the CAFR preparation process, audit adjustments and significant internal control deficiencies relative to the financial statements have been identified during the last seven audits of the CAFR. Additionally, beginning balances related to the primary government have been restated for 5 of the last 7 years.

Although the deficiencies relative to the CAFR and SEFA financial reporting processes have been reported by the auditors for a number of years, problems continue with the State's ability to provide accurate and timely external financial reporting. Corrective action necessary to remediate these deficiencies continues to be problematic.

Concepts Statement of the Governmental Accounting Standards Board (GASBCS 1, paragraph 66) states, "if financial reports are to be useful, they must be issued soon enough after the reported events to affect decisions."

According to OMB Circular A-133 § .300(d) and (e), a recipient of Federal awards is required to prepare appropriate financial statements, including the Schedule of Expenditures of Federal Awards and to ensure that audits required by this part are properly performed and submitted when due. Additionally, the A-102 Common Rule requires that non-Federal entities receiving Federal awards establish and maintain internal control designed to reasonably ensure compliance with Federal laws, regulations, and program compliance requirements.

In discussing these conditions with the Office of the Governor, they stated due to a lack of an automated accounting system and decentralized agencies with over 100 separate financial systems in the State results in wide and varied controls instead of a uniform set of controls to carry out the accounting policy set by the Office of the State Comptroller. This lack of automated systems and lack of a general ledger system requires labor intensive manual tabulations by accounting personnel who lack the qualifications and systems to report accurate financial information on a timely basis.

In discussing these conditions with IOC personnel, they indicated delays were caused by a separation in the responsibility for the State's internal control procedures among agencies and component units. The IOC has the statutory authority to request submission of financial information but does not currently have the ability to enforce those submissions on a timely basis from other State agencies. For example, in order for the State of Illinois to have financial statements in accordance with generally accepted accounting principles for the year ended June 30, 2008, the State needed to implement GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. The State's Department of Healthcare and Family Services failed to submit needed data in the form of accurate actuarial reports necessary to implement GASB Statement No. 45 until March 19, 2009. In order for timely financial statements to be prepared and audited, the correct information should have been submitted by the Department in October of 2008.

Failure to establish effective internal controls at all State agencies regarding financial reporting for the preparation of the CAFR and the SEFA prevents the State from completing an audit in accordance with timelines set forth in OMB Circular A-133 which may result in the suspension of Federal funding. Delays in financial reporting decrease the usefulness of such information and affect the State's ability to comply with continuing disclosure requirements. (Finding Code No. 08-2, 07-2)

RECOMMENDATION

We recommend the Office of the Governor and the Office of the State Comptroller work together with State agencies to establish a corrective action plan to address the quality and timeliness of accounting information provided to and maintained by the Office of the State Comptroller as it relates to year end preparation of the CAFR and the SEFA.

AGENCY RESPONSES

Office of the Governor:

We agree. The Office of the Governor will continue to work with the Office of the State Comptroller to implement additional procedures to assist in preparing the complex SCO forms currently used in the preparation of the Comprehensive Annual Financial Report and the Schedule of Expenditures of Federal Awards.

Office of the State Comptroller:

The IOC will continue to provide consultation and technical advice to State agencies in relation to financial reporting in order to increase the likelihood that State agencies will report financial information in a timely manner. The IOC will also seek legislation that provides it with enforcement tools to compel State agencies to comply with necessary reporting deadlines.

08-3 **FINDING** (Delays in Required Filings)

The State of Illinois did not fully comply with annual financial reporting requirements set forth by continuing disclosure undertakings.

We noted the following:

- For filings due January 26, 2008 unaudited financial statements were not submitted to repositories as required for all 4 (100%) continuing disclosure undertakings tested. In addition, audited financial statements were filed 133 days late.

- For filings due March 26, 2008 unaudited financial statements were not submitted to repositories as required for the 2 (100%) continuing disclosure undertakings tested. In addition, audited financial statements were filed 133 days late.

- For filings due January 26, 2009 unaudited financial statements were not submitted to repositories as required for all 5 (100%) continuing disclosure undertakings tested. Audited statements were not yet available.

- For filings due March 27, 2009 unaudited financial statements were not submitted to repositories as required for all 3 (100%) continuing disclosure undertakings tested. Audited statements were not yet available.

The above exceptions relate to continuing disclosure undertaking agreements for General Obligation and Special Obligation Bonds issued during Fiscal Years 2006 and 2008. The State did provide timely notice to repositories of the failure to provide the FY08 Comprehensive Annual Financial Report (CAFR) timely but did not provide any notice to repositories of the failure to provide the FY07 CAFR timely.

Continuing disclosure undertakings require the State to submit annual financial information to each repository within specified timelines which ranged from 210 to 270 days after the end of the fiscal year. The State is required to submit audited financial statements to each repository at the same time. However, if audited financial statements are not available at the time the annual financial information is filed, unaudited financial statements are required to be filed, and audited financial statements are to be filed within 30 days of their availability to the Governor's Office of Management and Budget.

The State's financial statements are prepared by the Office of the State Comptroller and filings required by continuing disclosure requirements are made by the Governor's Office of Management and Budget.

The financial statements were not completed timely and therefore were not available to be submitted to the repositories as required.

Continuing disclosure undertakings are entered into when the State issues long-term debt pursuant to the requirements of the Securities and Exchange Commission's rules. Continuing disclosure undertaking agreements are signed by the Director of the Governor's Office of Management and Budget.

A failure by the State to comply with an Undertaking must be reported in accordance with Rule 15c2-12 adopted by the Securities and Exchange Commission and must be considered by any broker, dealer or municipal securities dealer before recommending the purchase or sale of the Bonds on the secondary market. Consequently, such a failure may adversely affect the transferability and liquidity of the Bonds and their market price. (Finding Code 08-3, 07-2)

RECOMMENDATION

We recommend the Office of the State Comptroller and the Office of the Governor implement policies and procedures necessary to ensure timely reporting of financial information in accordance with continuing disclosure undertakings.

AGENCY RESPONSES

Office of the Governor:

We agree. The Office of the Governor and the Office of the State Comptroller will work together to establish and implement policies and procedures necessary to ensure that the required reporting of financial information is provided on a timely basis in accordance with continuing disclosure undertakings.

Office of the State Comptroller:

The IOC will continue to provide consultation and technical advice to State agencies in relation to financial reporting in order to increase the likelihood that State agencies will report financial information timely.