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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, 2009 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 June 30, 2010. Our report was modified to include a reference to other auditors and included an explanatory paragraph which stated that as discussed in note 2, the financial statements have been restated as of July 1, 2008 for prior year reporting errors. Our report also included an explanatory paragraph which stated the deficit for net assets of the governmental activities in fiscal year 2009 continued to increase by $5,397,943,000 from $24,546,623,000 at June 30, 2008 to $29,944,566,000 at June 30, 2009. This deficit, which is presented on an accrual basis, is the excess of total liabilities over total assets and represents a deferral of current and prior year costs to future periods. 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 as a basis for designing our auditing procedures for the purpose of expressing our opinions 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 was not designed to identify all deficiencies in the internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses.

A deficiency in internal control over financial reporting 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 and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described in findings 09-1, 09-2, and 09-4 in the accompanying schedule of findings to be material weaknesses.

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 09-3.

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 June 30, 2010.

The Office of the Governor's, the Office of the State Comptroller's, and the Illinois Student Assistance Commission'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	BRUCE L. BULLARD, CPA
Auditor General	Director of Financial and Compliance Audits
State of Illinois	Office of the Auditor General

June 30, 2010

09-1. **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 of the primary government have been restated as of July 1, 2008 for a $124.8 million understatement of claims by the Department of Central Management Services for the State's workers' compensation program.

Misstatements Identified During the Audit Process

In addition to the restatement described above, the following financial statement deficiencies were noted during our audits:

- The Department of Employment Security understated cash and cash equivalents of the Unemployment Trust Fund by $43 million. The related benefit payments payable was also understated by the same amount.

- Numerous inaccuracies were noted by the auditors related to the financial information prepared by the Department of Human Services (DHS). Additionally, due to discussions and communication between DHS, the State Comptroller, and other State agencies and universities, the financial information reported by DHS did not receive the Comptroller's final approval until February 24, 2010.

- During the Department of Revenue audit, the auditors identified a multitude of financial statement adjustments. Ultimately, adjustments totaling $114 million were posted to four different funds.

- The Department of Healthcare and Family Services' year end reporting contained several errors ranging from $1.7 million to $16.970 million.

- The Illinois State Board of Investment (ISBI) did not have adequate internal controls over financial reporting for its securities lending transactions. Management had recorded the cash collateral invested at historical cost and did not take into consideration market fluctuations. The resulting unrealized loss of $71.4 million was proposed by the auditors and recorded in the June 30, 2009 financial statements. ISBI manages and invests the pension assets of the three separate public employee retirement systems: the General Assembly Retirement System of Illinois, the Judges' Retirement System of Illinois, and the State Employees' Retirement System of Illinois.

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 that were noted during our audits at various agencies and the Office of the State Comptroller (IOC).

- A wide range of financial reporting problems were noted during our audit of the Department of Revenue related to accounting for taxes receivable; lack of controls over refunds; lack of formal business rules; unrecorded interest amounts; deficiencies of a new integrated tax management system; no evidence of testing or management approval to changes to the enterprise wide tax system; inaccurate cigarette tax allocations; inadequate controls over local government tax collections; and not obtaining reports from service organizations.

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

- The Illinois Student Assistance Commission (Illinois Designated Account Purchase Program) did not apply cash collections in a timely manner. The auditor noted during their analysis of the deferred credit fees account and a review of the year-end reconciliation for this account, there was unapplied student loan payments totaling $760 thousand. This relates to cash received that had not been applied to the respective borrower loan accounts or returned to sender as of June 30, 2009.

- Significant problems were noted during our audit of the Department of Human Services related to the measuring of accounts receivable, accounting for capital asset changes, and the control over commodity inventories.

- The auditors identified financial reporting errors made by the Department of Transportation (IDOT) related to capital assets, liabilities/encumbrances, and inventory valuation. IDOT reports 100% of the inventory balance of the Road Fund, a major fund of the State.

- The Secretary of State's Office (Office) did not have adequate review procedures in place to ensure the Office's financial statements were accurately prepared. In addition, the Office did not have adequate controls for reporting accounts receivable including the methods for estimating the uncollectible portion. These control deficiencies attributed to financial reporting errors of $3.186 million.

- The auditors determined that the State Universities Retirement System (System) did not have an adequate internal control over the accuracy and completeness of individual member's earnings and contributions. An error in contributions or earnings may create an error in the actuarial determined liability for the System. The System also did not have adequate controls over securities lending transactions resulting in a financial reporting error of $6.87 million.

- 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 Statements, the IOC is not directly involved in the selection of the actuary, the data gathering process for actuary purposes, or the time tables for reporting actuary results. The IOC is dependent on the Department of Healthcare and Family Services to provide the final actuarial information timely. The June 30, 2009 actuarial valuations were not available to the auditors until January 8, 2010.

- 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 uncorrected adjustments and evaluate these adjustments in total to ensure that they do not materially 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 uncorrected adjustments require continued accumulation and evaluation in subsequent years.

- Those charged with governance are not actively involved in the financial reporting process. Specifically, those charged with governance do not have a formal process for establishing financial reporting target completion dates and routinely monitoring progress towards meeting completion dates or ensuring audit requests are completed timely.

In discussing this condition with the Office of the Governor, 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 the State lacks an enterprise accounting system to capture all items necessary to provide underlying support to review agency financial transactions. In addition, there is a shortage of qualified individuals in the State to ensure that all transactions are recorded in accordance with governmental accounting standards.

In discussing these conditions with IOC management, 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 transaction 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 estimated 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. 09-1, 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 Governor's Office is conducting an evaluation that includes prior year adjustments, staffing, and implementation of new accounting standards to determine the additional internal control procedures necessary to reduce the risk of material misstatements during the financial statement preparation process. In addition, the Governor's Office and the Illinois Office of the Comptroller have agreed to increase communications and work closely throughout the financial statement preparation and GAAP package review 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.

09-2. **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 three 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 solved these problems or made 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 has repeatedly informed 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 769 primary government/fiduciary funds and 26 component units. 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 eight audits of the CAFR. Additionally, beginning balances related to the primary government have been restated for 6 of the last 8 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 this condition with the Office of the Governor, they stated that the lack of an enterprise accounting system – there are over 100 separate decentralized agency financial systems in the State – results in widely varied controls rather than a uniform set of controls to carry out the accounting policy set by the Office of the State Comptroller. The decentralized nature of the State's accounting systems and lack of a general ledger system results in time consuming, 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 management, 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.

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. (Finding Code No. 09-2, 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. As noted in the discussion, the root cause of the finding is the State of Illinois' highly decentralized financial reporting process, reliant on over 100 separate agency financial accounting and reporting systems. While the most effective long-term solution will be to replace these systems with a single entity-wide accounting system, the State's resources do not currently permit an investment of this size. The Office of the Governor will work with the Illinois General Assembly and the Office of the State Comptroller to establish the business case for procuring and implementing a statewide accounting system with all of the necessary components including general ledger, accounts payable, procurement, inventory, grants management, and payroll.

Prior to replacing the State's legacy financial systems, the Governor's Office is undertaking the following short-to-medium-term measures to address this issue.

First, the Governor's Office is conducting an evaluation that includes prior year adjustments, staffing, and implementation of new accounting standards to determine the additional internal control procedures necessary to reduce the risk of material misstatements during the financial statement preparation process. The Governor's Office and the Illinois Office of the Comptroller have agreed to increase communications and work closely throughout the financial statement preparation and GAAP package review process.

Second, the Governor's Office will work with the Illinois Department of Central Management Services to establish additional titles for accounting staff to increase education and experience requirements, to ensure that staff responsible for preparing financial information and financial statements have the necessary skills to effectively perform their duties. In addition, on-going training will be provided to current and future staff to ensure that new accounting standards are implemented in compliance with generally accepted accounting principles and OMB Circular A-133.

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 continue to support legislation, as was introduced in the past two legislative sessions, that provides it with enforcement tools to compel State agencies to comply with necessary reporting deadlines.

09-3. **FINDING** (Noncompliance with Statute and Debt Covenant)

During our audits of individual agencies, we noted the following noncompliance issues that involve amounts material to the State's financial statements.

- The Office of the Comptroller did not make all statutorily mandated transfers between State funds within established timeframes, as required. During Fiscal Year 2009, 223 transfers from the General Fund to various other funds were made greater than 30 days after the statutorily mandated transfer date. These untimely transfers were processed between 31 and 203 days after the mandated transfer date for a total of $1.5 billion. Because not all transfers were made on a timely basis, there were approximately $185 million of statutorily mandated transfers for fiscal year 2009 paid after June 30, 2009. The timing of the payment of the transfers does not impact the amounts reported in the State's financial statements or the State's budgetary schedules.

  In discussing these conditions with IOC management, they stated the late payment of transfers occurred because of cash management decisions and prioritization required due to the lack of available cash in the State Treasury.

  Failure to make inter-fund transfers within applicable timeframes represents noncompliance with State law, and untimely transfers of monies may have delayed the receiving fund's use of appropriated funds.

- The Illinois Student Assistance Commission (Illinois Designated Account Purchase Program) was not in compliance with one of the covenants relating to the agency's revolving credit line agreement. As a result of the violation, the bank has certain remedies available to it under the terms of the loan agreement, principal of which would be rights to call the loan and take possession of the collateral (the underlying student loan portfolio). The bank has been made aware of the event default and, as of the end of fieldwork at the agency on October 30, 2009, had not communicated to the Commission any intent to exercise the remedies available to it under the terms of the loan agreement.

  The debt covenant violation with the bank also triggered a default in one of the covenants in the loan agreement with another bank. This bank granted IDAPP a deferment for exercising its rights in connection with such default until January 30, 2010. The balance in the line of credit with this bank was $2,990,109 at June 30, 2009.

  The noncompliance with these covenants was attributed to an incorrect calculation of the amount for loans in forbearance. Failure to comply with debt covenants could result in the debt becoming due and payable in advance of scheduled retirement dates.

RECOMMENDATION

We recommend the Office of the Comptroller make transfers within timeframes established by applicable statute. We also recommend that the Illinois Student Assistance Commission improve controls over calculation of and monitoring debt covenants.

AGENCY RESPONSES

Office of the State Comptroller:

The IOC agrees with the recommendation but, as stated above, is not able to make the transfers timely due to the lack of available cash in the State Treasury for the General Revenue Fund.

Illinois Student Assistance Commission:

Since the initial response, Citibank has acknowledged the breach and sent a Notice Letter dated May 5, 2010. A meeting was held with Citibank on May 18, 2010 to discuss the revolving line of credit. A one year waiver is being negotiated.

The other bank impacted by the debt covenant violation granted IDAPP a deferment for exercising its rights in connection with such default until July 31, 2010.

We accept the recommendation.

IDAPP has a master checklist that incorporates all reporting requirements of the various indentures. The checklist is monitored and maintained on a monthly basis. All of the reporting requirements are reviewed by management.

09-4. **FINDING** (Weaknesses in Compilation Process)

The Office of the Comptroller's process for compiling the Comprehensive Annual Financial Report (CAFR) lacked adequate internal controls. We noted the following control deficiencies during our audit:

- One person has the responsibility for implementing new accounting standards, preparing the majority of the CAFR, addressing accounting issues with individual agencies, and responding to external audit requests.
- There was no formal process for a documented review of all CAFR components by a person independent of the preparer.
- There was no formal process that all financial journal entries posted by the Comptroller's staff have a documented review by a person independent of the person that initiates them.
- There has been no internal audit work related to the CAFR financial reporting process in the past three years.

The Fiscal Control and Internal Auditing Act (30 ILCS 10/3001) requires State agencies to establish and maintain a system of internal fiscal and administrative controls which provides assurance that revenues, expenditures, and transfers of assets, resources, or funds applicable to operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the State's resources. The Act also requires the chief executive officer to ensure the internal auditing program includes an audit of major systems of internal accounting and administrative control conducted on a periodic basis so that all major systems are reviewed at least once every 2 years (30 ILCS 10/2003).

Good internal controls would require that no one individual should control all key aspects of a transaction or event. Duties and responsibilities should be assigned systematically to a number of individuals to ensure that effective checks and balances are in place and routinely practiced. (SAMS Procedure 2.50.10)

Over reliance on one individual for the financial reporting process subjects the State to potential serious disruption in the event that there are changes to that individual's employment status. Lack of independent reviews leaves the compilation process open to risks of erroneous or fraudulent financial reporting. Internal audits are an essential monitoring process to enable management to determine whether components of internal control over financial reporting continue to function over time.

In discussing these conditions with IOC management, they indicated the lack of resources to hire additional personnel. (Finding Code No. 09-4)

RECOMMENDATION

We recommend the Office of the Comptroller allocate sufficient, competent resources to the financial reporting function in order to reduce reliance on key personnel and provide adequate segregation of duties. We also recommend the Office ensure the internal audit program includes an audit of the CAFR reporting process at least every two years.

OFFICE OF THE COMPTROLLER RESPONSE

The IOC will attempt to obtain additional staffing to allow for segregation of duties with the limited resources allocated by the State.

Prior Findings Not Repeated

A. **FINDING** (Noncompliance with continuing disclosure undertaking)

During the prior audit, we reported that the State did not fully comply with annual financial reporting requirements set forth by continuing disclosure undertakings (CDU). For the instances tested, the State did not submit audited or unaudited financial statements as required. (Finding Code 08-3, 07-2)

During the current audit, our test results noted that the State complied with the CDU requirements by timely filing notices of failure to comply and filing audited financial statements within required timeframes once the statements were made available.