STATE OF ILLINOIS

OFFICE OF THE AUDITOR GENERAL

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

For the Year Ended June 30, 2011

WILLIAM G. HOLLAND

AUDITOR GENERAL

STATE OF ILLINOIS
COMPREHENSIVE ANNUAL FINANCIAL REPORT
FINANCIAL AUDIT
For the Year Ended June 30, 2011

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The annual financial statements of the State of Illinois for the year ended June 30, 2011 were issued under a separate cover.

STATE OF ILLINOIS
COMPREHENSIVE ANNUAL FINANCIAL REPORT
FINANCIAL AUDIT
For the Year Ended June 30, 2011

STATE OFFICIALS

Governor	Patrick Quinn
Comptroller (January 10, 2011 to Present)	Judy Baar Topinka
Comptroller (through January 9, 2011)	Daniel W. Hynes
Speaker of the House	Michael J. Madigan
President of the Senate	John J. Cullerton

SUMMARY

The audit of the State of Illinois' financial statements was performed in accordance with *Government Auditing Standards*. This report is an integral part of that audit.

SUMMARY OF FINDINGS

Number of	Current Report	Prior Report
Findings	5	8
Repeated findings	5	4
Prior recommendations implemented or not repeated	3	0

SCHEDULE OF FINDINGS

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		FINDINGS (*GOVERNMENT AUDITING STANDARDS*)	
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(*GOVERNMENT AUDITING STANDARDS*)

A	22	Noncompliance with General Obligation Financing Provisions
B	22	Weaknesses Identified in the Securities Lending Program
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EXIT CONFERENCE

An exit conference was held with the Office of the State Comptroller's personnel on June 11, 2012. Those attending were:

Office of the State Comptroller

Steve Valasek, Assistant Comptroller
Katie Madonia, Director of Financial Reporting
Tracy Allen, Chief Internal Auditor

Office of the Auditor General

Georgine Stephens, Assistant Director

AGENCY RESPONSES

Responses to the findings and recommendations were provided as follows:

Mr. Jerome Stermer, Acting Director, Governor's Office of Management and Budget on June 15, 2012.

Mr. Tracy Allen, Chief Internal Auditor, Office of the State Comptroller on June 13, 2012

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OFFICE OF THE AUDITOR GENERAL
WILLIAM G. HOLLAND

INDEPENDENT AUDITORS' 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 Judy Baar Topinka, 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, 2011 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 1, 2012. 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, 2010 for a prior year reporting error and due to the implementation of GASB Statement 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, certain fund balances were reclassified as of June 30, 2010. Our report also included an explanatory paragraph which stated "The deficit for net assets of the governmental activities in fiscal year 2011 continued to increase by $6,282,545,000 from $37,535,105,000 at June 30, 2010 to $43,817,650,000 at June 30, 2011. 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.

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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 11-1, 11-2, and 11-5 in the accompanying schedule of findings and responses 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 findings 11-3 and 11-4.

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.

Bruce L. Bullard

WILLIAM G. HOLLAND
Auditor General
State of Illinois

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

Springfield, Illinois
June 1, 2012

11-1. **FINDING** (Inadequate Financial Reporting Process)

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 at least the end of May of the subsequent year for the past five fiscal years. See also finding 11-2 for additional detail. The lack of timely financial reporting limits effective oversight of State finances, adversely affects the State's bond rating, and jeopardizes federal funding.

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 and major State agencies under the organizational structure of the Office of the Governor.

The Office of the State Comptroller has made changes to the system used to compile financial information; however, the State has not solved all the problems 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 821 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 Office of the State Comptroller. 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 Office of the State Comptroller in the preparation of the Statewide financial statements in accordance with Generally Accepted Accounting Principles (GAAP).

Although these SCO forms are subject to review by the Office of the State Comptroller's 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 ten audits of the CAFR. Additionally, beginning balances related to the primary government have been restated for 8 of the last 10 years.

The Illinois Office of the Auditor General released a management audit in February 2011 that further assessed the State's financial reporting system. The survey of 88 of 90 primary units of government revealed that 263 different financial reporting systems are used by primary government agencies. Furthermore, the agencies reported that only 16 percent of these financial reporting systems are compliant with GAAP, which drastically increases the amount of time spent by agencies during the year-end GAAP conversion process. In addition, fifty-three percent of the financial reporting systems are not interrelated which consequently requires manual intervention to convert data increasing the likelihood of errors and causing further reporting delays.

In an effort to improve the financial reporting system, the Office of the State Comptroller started the process to develop and implement a new financial reporting system (System) in March 2011. However, due to the ongoing development of the new System, the availability to allow agencies to enter financial data into the System was staggered based on the type of GAAP Package. The first GAAP Packages the System was available to accept was on August 10, 2011 and the last GAAP Packages the System was available to accept was November 2, 2011. This is several months later as compared to prior years when the prior System was available for agencies to begin submitting GAAP Packages by the third week in July.

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.

The Office of the State Comptroller's management stated that the indicated delays were caused, in part, by inaccurate data being submitted by some agencies. In addition, GAAP packages with inaccurate data cause delays in the audit process which in turn causes delays in releasing the final reports.

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. 11-1, 10-1, 09-2, 08-2, 07-2)

RECOMMENDATION

We recommend the Office of the Governor and the Office of the State Comptroller work together to resolve the State's inability to produce timely and accurate GAAP basis financial information and a Statewide SEFA.

AGENCY RESPONSES

Office of the Governor:

The Governor's Office agrees with this finding. The Governor's Office, the Governor's Office of Management and Budget and the Office of the Comptroller are working to address these challenges. The Governor's Office, the Governor's Office of Management and Budget (GOMB) and the Office of the Comptroller have developed a timeline for short term, mid-term and long range plans. In fiscal year 2012, all agency heads signed a letter recognizing the importance to the Governor of timely and accurate reporting. Due to challenges with the Comptroller's financial reporting system the agencies were often unable to comply with this initiative.

In addition, GOMB continues to work with the Department of Central Management Services to develop job descriptions to allow agencies to hire employees skilled in financial statement preparation. This is a complicated and lengthy process. GOMB also requested budgetary authority for FY2013 to hire accountants knowledgeable about governmental financial reporting, although this was not part of the legislative budget.

GOMB and the Governor's Office have been primarily responsible for developing a plan for a Statewide financial accounting system. This Statewide financial accounting system would also include a grants management module to enable preparation of the Schedule of Expenditures of Federal Awards. A steering committee was convened. It is comprised of the chief information officer, members of the General Assembly as well as representatives of the Governor's Office of Management and Budget, the Comptroller's Office and several operating agencies. The steering committee has met several times and has reviewed the information available from work by prior consultants. Currently a request for proposals (RFP) is being developed to secure a consultant. This consultant will develop the necessary Statewide accounting requirements and develop an RFP for software and implementation services to address the State's need. Unfortunately capital money has not been forthcoming. The project cannot go forward without funding. Once funding and a vendor are secured it will still take several years and internal control issues will persist until this is complete.

The Governor's Office will continue working with the agencies to provide as much complete information as possible given the State's current capacities.

Office of the State Comptroller:

The Office accepts the recommendation. The 2011 CAFR opinion was signed on June 1, 2012. That was the earliest opinion date in the last five years. The accelerated date was due to system efficiencies and the combined efforts of the staff at the Comptroller's Office and the Office of the Auditor General. The IOC will continue to assist the Governor's Office in their efforts to increase the quality of GAAP packages and provide training and technical assistance to State Agencies. In addition, legislation was passed by the General Assembly, and if approved by the Governor, it would create a Financial Accounting Standards Board whose mission would be to improve the timeliness, quality and processing of financial reporting for the State.

11-2. **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. As reported in Finding 11-1 the State has a decentralized financial reporting process. Primarily in response to this decentralized process, we perform audits at 23 agencies of the primary government, including the five pension systems and the State Board of Investments. During these audits, we noted deficiencies that were either material weaknesses or significant deficiencies related to the internal controls over the financial reporting process.

A *material weakness* is a deficiency, or a combination of deficiencies, in internal control 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. A *significant deficiency* is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

The chart below summarizes the number of material weaknesses and significant deficiencies we reported for each agency.

Agency	Material Weaknesses	Significant Deficiencies	Combined Total
General Assembly Retirement System	0	1	1
Judges' Retirement System	0	1	1
Department of Central Management Services	1	1	2
Department of Employment Security	0	2	2
Department of Human Services	2	3	5
Department of Healthcare and Family Services	2	2	4
Department of Revenue	2	10	12
Department of Transportation	3	2	5
Capital Development Board	0	1	1
Illinois Gaming Board	0	1	1
Illinois State Board of Education	1	0	1
State Employees' Retirement System	0	1	1
Illinois Student Assistance Commission	5	3	8
Total	16	28	44

Details of each material weakness and significant deficiency are reported in each of the agency's financial audit for the year ended June 30, 2011 (reports are available on the Auditor General's web-site). Material weaknesses and significant deficiencies further extend financial reporting timelines since additional measurements and reporting is required. Completion or substantial completion of these audits is necessary in order for the Auditor General to issue an opinion on the State's basic financial statements.

In addition to the deficiencies noted above, we identified two material errors during our audit of the Office of the State Comptroller's compilation process. Summary information regarding these errors is provided below.

Restatements – Correction of Errors

The Governmental Activities' and General Fund financial statements have been restated as of July 1, 2010 totaling $325.778 million due to the Department of Healthcare and Family Services understating the Department's drug rebate receivables.

Misstatements Identified During the Audit Process

In addition to the restatement described above, the following chart indicates adjustments identified during our audits.

Opinion Unit	**Amount (in thousands)***	**Responsible Agency**
Governmental Activities	$68,634	Department of Central Management Services
Governmental Activities	$117,213	Department of Healthcare and Family Services
Governmental Activities	$41,243	Department of Revenue
Governmental Activities	$5,792	Illinois State Board of Education
Business-type Activities	$39,520	Department of Employment Security
Business-type Activities	$1,613	Department of Healthcare and Family Services
Business-type Activities	$33,500	Illinois Student Assistance Commission
General Fund	$157,018	Department of Healthcare and Family Services
General Fund	$349,061	Department of Revenue
Road Fund	$9,971	Department of Healthcare and Family Services
Prepaid Tuition Fund	$12,254	Illinois Student Assistance Commission
Aggregate Remaining Fund Information	$39,520	Department of Employment Security
Aggregate Remaining Fund Information	$68,634	Department of Central Management Services
Aggregate Remaining Fund Information	$1,613	Department of Healthcare and Family Services
Aggregate Remaining Fund Information	$5,393	Department of Revenue
Aggregate Remaining Fund Information	$11,584	Illinois State Board of Education
Aggregate Remaining Fund Information	$33,500	Illinois Student Assistance Commission

* *Amounts resulted in one adjustment or a series of adjustments for the opinion unit. The dollar amount reported is the largest account type adjusted.*

During our audit, we also noted other errors in the preparation of the Comprehensive Annual Financial Report (CAFR) including amounts not agreeing between statements and/or footnotes and typographical/formatting errors.

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. 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 Office of the State Comptroller 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 State's 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 the subsequent year.

The Office of the State Comptroller's management stated that the misstatements were caused by a lack of sufficient internal control processes in State agencies for the accumulation and reporting of financial information used to prepare the financial statements. The Office of the State Comptroller has the statutory authority to develop and prescribe accounting policies for the State but does not have the statutory authority to monitor adherence to these policies as performed by State agencies.

In accordance with the Fiscal Control and Internal Auditing Act (30 ILCS 10/1002), 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. (Finding Code No.11-2, 10-2, 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:

The Governor's Office agrees with this finding. The response to finding 11-1 is also applicable here. With agencies all using many financial systems it is difficult to set Statewide internal controls. Rather than spend time monitoring a multitude of financial systems and the internal controls needed, the Governor's Office has focused on solving this problem with a centralized financial accounting system discussed in the above finding. If the State had an entity-wide financial accounting system, internal controls would be built into the system to lessen the risk that statements are not fairly presented. These internal controls would detect any deficiencies that could result in a material weakness or a significant deficiency.

Office of the State Comptroller:

The Office accepts the recommendation. The IOC will continue to assist the Governor's Office in their efforts to increase the quality of GAAP packages and provide training and technical assistance to State Agencies. In addition, legislation was passed by the General Assembly, and if approved by the Governor, it would create a Financial Accounting Standards Board whose mission would be to improve the timeliness, quality and processing of financial reporting for the State.

11-3. **FINDING** (Late Payment of Statutorily Mandated Transfers)

The Office of the State Comptroller (Comptroller) did not make all statutorily mandated transfers from the General Revenue Fund within established timeframes, as required.

The Comptroller had a system in place to identify and record inter-fund transfers it was required to make. During the fiscal year ended June 30, 2011, the Comptroller timely recorded within the Statewide Accounting Management System (SAMS) the receivables and related payables for transfers of money in the State Treasury to be made between State of Illinois' funds. However, not all transfers were made timely. During fiscal year 2011, we noted 386 transfers from the General Revenue Fund to various other funds that were made greater than 30 days after the statutorily mandated transfer date. Transfers that were made between one and 30 days after the statutorily mandated transfer date were excluded from the information provided in this finding. The following summary concerning late payment of statutorily mandated transfers from the General Revenue Fund highlights the increase in delays of making such transfers in fiscal year 2011 compared to fiscal years 2010 and 2009:

	Fiscal Year 2011	Fiscal Year 2010	Fiscal Year 2009
• Number of late transfers	386 transfers	289 transfers	223 transfers
• Range of days transfers were late	31 to 454 days	31 to 525 days	31 to 203 days
• Total volume of late transfers, in dollars	$2.48 billion	$2.0 billion	$1.5 billion
• Late transfers outstanding at June 30, paid during lapse period*	$1.08 billion	$941.8 million	$184.6 million

* (Lapse period for fiscal years 2011 and 2010 was from July 1 through December 31. For fiscal year 2009, lapse period was from July 1 through August 31.)

Comptroller management stated that the late payment of transfers occurred because of cash management decisions and prioritization that was required due to the lack of available cash in the State Treasury. Further, some statutory provisions relating to transfers contain language such as "as soon as practicable." The Office of the State Comptroller states that approximately 55 of the fiscal year 2011 transfers totaling $160 million contain this type of statutory provision.

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. (Finding Code No. 11-3, 10-3, 09-3)

RECOMMENDATION

We recommend the Office of the State Comptroller make transfers within timeframes established by applicable statute. While we realize that lack of available funds in the State Treasury requires prioritization and cash management decisions, we recommend the Office of the State Comptroller continue in its efforts to make transfers in as timely manner as possible.

AGENCY RESPONSE

Office of the State Comptroller:

The Office accepts the recommendation. Taking into account the financial condition of State funds the Office will continue in its efforts to make transfers in the timeliest manner possible.

11-4. **FINDING** (Debt Covenant Violation)

The Illinois Student Assistance Commission (Illinois Designated Account Purchase Program) was not in compliance with two of the covenants relating to the agency's revolving line of credit agreement.

During the audit of the agency's June 30, 2009 financial statements, the Illinois Designated Account Purchase Program (IDAPP) management brought to our attention that they had violated one of the covenants relating to the agency's revolving credit line (loan) agreement with a bank. The noncompliance pertained to the "Coverage condition ratio" covenant. According to the line of credit agreement with the bank, the "Forbearance Excess Amount," defined as the aggregate value of all eligible student loans that are subject to forbearance, is to be used in the calculation of the Coverage condition ratio covenant. When IDAPP completed the report, created by the bank, and as instructed by the bank, the report produced an inaccurate calculation of the amount for the loans in forbearance. Once the error was discovered and the Coverage condition ratio was recalculated, it resulted in noncompliance with the Coverage condition ratio by IDAPP. The minimum Coverage condition ratio required by the line of credit agreement is 104% and the current ratio as of June 30, 2011 was 102%.

During the audits of the agency's June 30, 2010 and 2011 financial statements, we noted that IDAPP was in violation of the same covenant noted above. In addition, the agency was in violation of another covenant, the "Default ratio." According to the line of credit agreement with the bank, the Default ratio is defined as "the annualized percentage of the aggregate principal balance of all student loans which have become defaulted pledged student loans during such settlement period." IDAPP is required to maintain a maximum Default ratio of 6.25%. As of June 30, 2011, IDAPP's Default ratio was 13.39%, resulting in noncompliance with the Default ratio by IDAPP.

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 of default and has not communicated to IDAPP any intent to exercise the remedies available to it under the terms of the loan agreement. Management believes the bank would have little incentive to call the line of credit and begin servicing the student loans itself, particularly because IDAPP has made all of its required payments in a timely fashion. The balance of the line of credit with the bank was $314,456,827 at June 30, 2011.

According to IDAPP management, the noncompliance with the Coverage condition ratio and the Default ratio is due to the increased level of delinquent accounts in the portfolio. The level has increased due to the poor global economic conditions.

Failure to comply with debt covenants could result in the debt becoming due and payable in advance of scheduled retirement dates. As a result of the violation, the bank may have certain remedies under the terms of the loan agreements, principal of which would be the right to call the loan and take possession of the collateral (the underlying student loan portfolio of IDAPP). (Finding Code No. 11-4, 10-6, 09-3)

RECOMMENDATION

We recommend that IDAPP continue to monitor these loan covenant violations and continue seeking remedies from the lenders involved.

AGENCY RESPONSE

Office of the Governor:

The Governor's Office recognizes that the Illinois Student Assistance Commission (ISAC) violated a loan covenant with its bank. Because ISAC continues to make the necessary monthly payments to Citibank, Citibank has not exercised any of its option for the violation. The line of credit expired in Fiscal Year 2011. ISAC is considering issuing an RFP to see if there is any desire to invest in student loans and to take over this portfolio. Resolution on this issue will happen when bids are received. ISAC also actively tries to collect on the student loans. The Governor's Office will continue to monitor the situation.

11-5. **FINDING** (Finances Increase Risks)

The State of Illinois did not have sufficient controls over its finances to ensure obligations are paid timely. This condition increases the risk that liabilities will not be properly recorded. We noted the following during our financial audit of the State's financial statements and our financial audits at various Departments.

As disclosed in Footnote 18 B, the State had transactions, totaling $4.740 billion, on hand at June 30, 2011 that had been approved for payment by the State, but remained unpaid at year end due to the State's cash flow difficulties. Of this amount, approximately $3 billion was owed to external parties, the remaining balance was related to intra-governmental transactions and statutorily mandated transfers. The external parties include State vendors, State Universities, local schools and local governments. The majority of these "held-payments" were payable from the General Revenue Fund.

The State's inadequate financial reporting process as described in Finding 11-1 was designed in 1981 under the assumption that cash payments would be made at the time the expenditures were processed by the Comptroller. Since this was not the case at year-end, extra effort was required by the accountants and the auditors to ensure the "held-payments" were appropriately accounted for.

During our audit of the Illinois Department of Revenue (IDOR), the auditors reported that there was a deficit balance in the Income Tax Refund Fund (Fund 278), a sub account of the General Revenue Fund, because the State did not allocate sufficient income tax revenues into Fund 278. Under the Illinois Income Tax Act (35 ILCS 5/901), the portion of the income tax receipts deposited into Fund 278 is a formula based percentage (referred to as the "Rate as Certified" in the table below) only when a different rate is not defined in 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 fiscal year 2002 is as follows:

	Individual Income Tax		Business Income Tax		Fund 278
State Fiscal Year	**Rate per Statute**	**Rate as Certified**	**Rate per Statute**	**Rate as Certified**	**Fund Balance (Deficit), in thousands**
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%	(1,503,610)
2012	8.75%	10.63%	17.50%	24.59%	Not Available

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

As can be seen from the table, the amounts deposited in Fund 278 for 2002 through 2004 were based on the "Rate as Certified", and the Fund 278 deficit was reduced over those years. Since then, the General Assembly has annually passed legislation which the Governor signed into law specifying the "Rate per Statute" for deposits of income tax receipts into Fund 278. Since this change, the deficit with Fund 278 has been gradually increasing. The underfunding of Fund 278, as indicated by the corresponding increasing deficit, is a major contributing factor to the significant deficit that has accumulated within the General Fund through June 30, 2011.

Large deficits in the Income Tax Refund Fund indicate that the State is essentially borrowing from taxpayers (individuals and businesses) since overpayments of taxes are not revenue to the State when accounted for in accordance with generally accepted accounting principles (GAAP). Delays in paying tax refunds generates additional adjustments to convert cash basis amounts to GAAP basis. These necessary adjustments, due to lack of cash payment, increases the risk that liabilities will not be recognized in the proper period.

Economic conditions as well as years of unbalanced budgets appear to be the cause of above conditions.

Sound business practices require sufficient controls to ensure liabilities are paid timely and funds are used for the purpose for which they were originally obtained. (Finding Code No. 11-5, 10-7)

RECOMMENDATION

We recommend the Governor work with the General Assembly to improve the State's control over State finances in a manner that eliminates significant payment delays including refunds due to taxpayers.

AGENCY RESPONSE

Office of the Governor:

The Governor's Office recognizes that significant balances are owed at year-end; however disagrees that this is the result of insufficient controls over its current finances. These unpaid bills are the result of decades of fiscal mismanagement as well as the economic downturn and diminished revenues. The Governor's Office successfully undertook Medicaid reform in the 2012 legislative session. This reform will have a 2013 impact of reducing the part of the unpaid accounts payable that belongs to Medicaid payments. In addition the Fiscal Year 2013 budget that passed the legislature has funds set aside to begin paying down the liability. These unpaid bills create a risk that liabilities are unrecorded is the result of finding 11-1. If the State had a consolidated accounting system with a general ledger, these liabilities could be properly recorded.

The Governor's Office and GOMB agree that the refund rate set by the General Assembly is insufficient to pay tax refunds. The 2013 refund rate that is set for FY 2013 is closer to what is estimated to be needed to pay refunds in fiscal 2013.

AUDITORS' COMMENT

The amount of held payments of $4.740 billion at the end of Fiscal Year 2011 created an additional risk that material liabilities would not be recorded in the proper period. Auditing standards require the auditor to report such risks as material weaknesses to those charged with governance. The held payments had legal authorization for payment and were unpaid due to a lack of resources. Attributing the cause of this additional weakness to a lack of control over State finances is reasonable since the State essentially follows a cash basis budget process. As noted in the finding, we do agree that economic conditions are relevant to the cause of the condition.

PRIOR FINDINGS NOT REPEATED
(*GOVERNMENT AUDITING STANDARDS*)
For the Year Ended June 30, 2011

A. **FINDING** (Noncompliance with General Obligation Financing Provisions)

Pursuant to Public Act 96-44, the Office of the State Comptroller transferred general obligation bond proceeds from the Coal Development Fund for general operating expenses of the State of Illinois. The transfer of the bond proceeds for operating expenses of the State of Illinois represents noncompliance with the terms of the bond sale order related to the issuance of State of Illinois general obligation bonds.

We recommended the Office of the State Comptroller coordinate with the Director of the Governor's Office of Management and Budget regarding possible resolutions to the transfers made to the General Revenue Fund, and if necessary, seek a formal opinion from the Attorney General.

The Office of the State Comptroller coordinated with the Governor's Office of Management and Budget as well as the Illinois Department of Commerce and Economic Opportunity to attempt to obtain legislation to allow for the return of the bond proceeds. However, those efforts were not successful and the Office of the State Comptroller has requested a legal opinion from the Illinois Attorney General. (Finding Code No. 10-4)

B. **FINDING** (Weaknesses identified in the Securities Lending Program)

During the prior year audit, auditors identified a number of weaknesses in the Illinois Office of the Treasurer's securities lending program by not complying with provisions of the Deposit of State Moneys Act and the Federal Financial Institution Examination Council guidelines.

During the current year audit, auditors noted that controls over the Illinois Office of the Treasurer's securities lending program improved. (Finding Code No. 10-5)

C. **FINDING** (Weaknesses in Compilation Process)

During the prior year audit, auditors noted that the Office of the State Comptroller's process for compiling the Comprehensive Annual Financial Report (CAFR) lacked adequate internal controls. Specifically, we noted that only one person had the primary responsibility for implementing new accounting standards, addressing accounting issues with individual agencies, and managing the compilation of the CAFR. In addition, there was no formal documentation that there were reviews of all CAFR components and financial journal entries by an independent person.

In the current examination period, auditors noted that the Office of the State Comptroller implemented new procedures for compiling and reviewing the Comprehensive Annual

Financial Report (CAFR). Specifically, more than one person is now responsible for implementing new accounting standards, addressing accounting issues with individual agencies, and managing the compilation of the CAFR. In addition, there is a formal process for a documented review of all CAFR components as well as a formal process for all financial journal entries posted by the Comptroller's staff in which all are documented and reviewed by a person independent of that person that initiates them. (Finding Code No. 10-8)