ADELFIA LLC
CERTIFIED PUBLIC ACCOUNTANTS
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CHICAGO, ILLINOIS 60601
TEL (312) 240-9500 FAX (312) 240-0295
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STATE OF ILLINOIS
ILLINOIS WORKERS' COMPENSATION COMMISSION

FINANCIAL AUDIT
SELF-INSURERS SECURITY FUND
For the Year Ended June 30, 2016

Performed as Special Assistant Auditors
For the Auditor General, State of Illinois

STATE OF ILLINOIS
ILLINOIS WORKERS' COMPENSATION COMMISSION
FINANCIAL AUDIT
SELF-INSURERS SECURITY FUND
For the Year Ended June 30, 2016

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STATE OF ILLINOIS
ILLINOIS WORKERS' COMPENSATION COMMISSION
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AGENCY OFFICIALS

Chair	Joann Fratianni
Fiscal Officer	
(10/01/17 to Current)	Paul Fichtner
(08/04/17 to 09/30/17)	Brendan O'Rourke (Acting)
(12/01/15 to 08/03/17)	Darlene Senger
(11/04/15 to 11/30/15)	Bob Devereaux (Acting)
(07/01/15 to 11/03/15)	Mary Wells
General Counsel	Ronald Rascia
Chief Internal Auditor*	
(07/01/15 to 04/30/16)	Mark Kimmet
*-position eliminated after 04/30/16	

The Commission's offices are located at:

James R. Thompson Center
100 W. Randolph Street, Suite 8-200
Chicago, Illinois 60601

4500 S. 6th Street, Frontage Road
Springfield, Illinois 62703

200 S. Wyman
Rockford, Illinois 61101

1803 Ramada Blvd., Suite B201
Collinsville, Illinois 62234

401 Main Street, Suite 640
Peoria, Illinois 61602

STATE OF ILLINOIS
ILLINOIS WORKERS' COMPENSATION COMMISSION
FINANCIAL AUDIT
SELF-INSURERS SECURITY FUND
For the Year Ended June 30, 2016

FINANCIAL STATEMENT REPORT

SUMMARY

The audit of the accompanying financial statements of the Self-Insurers Security Fund of the State of Illinois, Illinois Workers' Compensation Commission (Commission) was performed by Adelfia LLC.

Based on their audit, the auditors expressed an adverse opinion on the Self-Insurers Security Fund's basic financial statements.

SUMMARY OF FINDINGS

The auditors identified matters involving the Commission's internal control over financial reporting that they considered to be material weaknesses. The material weaknesses are described in the accompanying Schedule of Findings on pages 23-44 of this report as Finding 2016-001, *Inadequate Financial Accounting and Reporting*, Finding 2016-002, *Inadequate Process to Determine Claims Liabilities*, and Finding 2016-003, *Uncertainty Regarding Statutory Interpretation*.

EXIT CONFERENCE

The findings and recommendations appearing in this report were discussed with Commission personnel at an exit conference on December 28, 2017.

Attending were:

Illinois Workers' Compensation Commission
Paul Fichtner, Chief Fiscal Officer
Ronald Rascia, General Counsel
Mark Kimmet, Fiscal Operations
Maria Parrino, Fiscal Staff

Office of the Auditor General
Daniel J. Nugent, CPA, Senior Audit Manager
Jose Roa, CPA, Senior Audit Manager

EXIT CONFERENCE (continued)

Adelfia LLC
Stella Marie Santos, CPA, Partner
Jennifer Roan, CPA, Partner

The responses to the recommendations were provided by Mark Kimmet, Fiscal Operations, in a letter dated January 4, 2018.

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INDEPENDENT AUDITOR'S REPORT

Honorable Frank J. Mautino
Auditor General
State of Illinois

Report on the Financial Statements

As Special Assistant Auditors for the Auditor General, we have audited the accompanying financial statements of the Self-Insurers Security Fund of the State of Illinois, Illinois Workers' Compensation Commission, as of and for the year ended June 30, 2016, and the related notes to the financial statements, as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse audit opinion.

Basis for Adverse Opinion

As described in Finding 2016-001 and Finding 2016-002, the State of Illinois, Illinois Workers' Compensation Commission had an inadequate process to determine the claims liabilities of the Self-Insurers Security Fund. Under the accounting principles generally accepted in the United States, the Self-Insurers Security Fund must have an accounting methodology to properly account for incurred but not reported (IBNR) claims liabilities and the associated administrative costs necessary to continue processing the amounts due to the employees over time as of the date when it is both (1) probable a liability has been incurred and (2) the amount can be reasonably estimated or disclose the situation in the Self-Insurers Security Fund's notes if one or both conditions are not met. We noted the State of Illinois, Illinois Workers' Compensation Commission's current methodology for its claims liability generally reflects cash basis or modified accrual basis accounting for the Self-Insurers Security Fund's unpaid medical claims and unpaid administrative and legal expenses. These liabilities must be reported on the full accrual basis of accounting. The effects on the financial statements from this error have not been determined.

In addition, as described in Finding 2016-001 and Finding 2016-003, the proper accounting treatment for an insolvent self-insurer's security collected by the State of Illinois, Illinois Workers' Compensation Commission is not determinable due to two different irreconcilable interpretations of the Workers' Compensation Act (820 ILCS 305). As such, we were unable to obtain sufficient, appropriate audit evidence to conclude the State of Illinois, Illinois Workers' Compensation Commission's presentation of the Self-Insurers Security Fund's financial statements complied with the Workers' Compensation Act. According to officials of the State of Illinois, Illinois Workers' Compensation Commission, changing the Self-Insurers Security Fund's current treatment would result in the Self-Insurers Security Fund reducing its recognition of revenue in current and prior periods of approximately $16.9 million, which would result in the Self-Insurers Security Fund showing a negative net position of approximately $5.4 million.

Adverse Opinion

In our opinion, because of the significance of the matters described in the Basis for Adverse Opinion paragraphs, the financial statements referred to above do not present fairly the financial position of the Self-Insurers Security Fund of the State of Illinois, Illinois Workers' Compensation Commission, as of June 30, 2016, or the changes in financial position and cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matters

As discussed in Note 2, the financial statements present only the Self-Insurers Security Fund and do not purport to, and do not, present fairly the financial position of the State of Illinois or the State of Illinois, Illinois Workers' Compensation Commission, as of June 30, 2016, the changes in its financial position, or its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Further, the State of Illinois' self-insurance program administered by the State of Illinois, Illinois Workers' Compensation Commission consists of two funds: the Self-Insurers Administration Fund and the Self-Insurers Security Fund. Pursuant to the Workers' Compensation Act (820 ILCS 305/4a-4 and 820 ILCS 305/4a-6.1), the Self-Insurers Administration Fund collects a $500 application fee from each private self-insurer applying for or seeking renewal of the self-insurance privilege, which is available only for paying the salaries and benefits of the employees and the operating costs of the Self-Insurers Advisory Board within the State of Illinois, Illinois Workers' Compensation Commission. During our audit, we noted the Self-Insurers Administration Fund's expenses have exceeded revenues recognized for a significant period of time. According to the State of Illinois, Illinois Workers' Compensation Commission's most recent unaudited accrual basis financial reports filed with the Office of the State Comptroller, the Self-Insurers Administration Fund's net loss was $157 thousand, $132 thousand, and $86 thousand during Fiscal Year 2015, Fiscal Year 2016, and Fiscal Year 2017, respectively. Without operational changes and/or a legislative remedy, the continuing negative trend will eventually consume the Self-Insurers Administration Fund's remaining net position, which the State of Illinois, Illinois Workers' Compensation Commission's unaudited accrual basis financial reports filed with the Office of the State Comptroller reported was $304 thousand at June 30, 2017. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information
Management has omitted management's discussion and analysis and budgetary comparison information for the Self-Insurers Security Fund that accounting principles generally accepted in the United States of America require to be presented to supplement the financial statements. Such missing information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. Our opinion on the financial statements is not affected by this missing information.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated January 4, 2018, on our consideration of the State of Illinois, Illinois Workers' Compensation Commission's internal control over financial reporting of the Self-Insurers Security Fund and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the State of Illinois, Illinois Workers' Compensation Commission's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the State of Illinois, Illinois Workers' Compensation Commission's internal control over financial reporting of the Self-Insurers Security Fund and its compliance.

Restricted Use of this Auditor's Report

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 Self-Insurers Advisory Board within the State of Illinois, Illinois Workers' Compensation Commission, and State of Illinois, Illinois Workers' Compensation Commission's management and is not intended to be and should not be used by anyone other than these specified parties.

SIGNED ORIGINAL ON FILE

Chicago, Illinois
January 4, 2018

STATE OF ILLINOIS
ILLINOIS WORKERS' COMPENSATION COMMISSION
SELF-INSURERS SECURITY FUND
STATEMENT OF NET POSITION
JUNE 30, 2016

ASSETS		
Current Assets		
Cash Equity in the State Treasury	$	20,161,353
Cash and Cash Equivalents		1,280
Accrued Interest Receivable		9,615
Excess Insurance Receivable		317,514
Securities Lending Collateral Equity with the State Treasurer		5,352,000
Total Current Assets		25,841,762
Total Assets	$	25,841,762
LIABILITIES		
Current Liabilities		
Accounts Payable	$	26,045
Due to Other Funds		2,858
Obligations Under Securities Lending of the State Treasurer		5,352,000
Unearned Security Deposit		1,289,441
Liabilities for Unpaid Claims		738,818
Total Current Liabilities		7,409,162
Noncurrent Liabilities		
Compensated Absences		17,925
Liabilities for Unpaid Claims		6,917,328
Total Noncurrent Liabilities		6,935,253
Total Liabilities		14,344,415
NET POSITION		
Restricted Net Position		11,497,347
Total Liabilities and Net Position	$	25,841,762

See accompanying notes to the basic financial statements.

STATE OF ILLINOIS
ILLINOIS WORKERS' COMPENSATION COMMISSION
SELF-INSURERS SECURITY FUND
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION
FOR THE YEAR ENDED JUNE 30, 2016

OPERATING REVENUES		
Assessments	$	1,397,695
Excess Insurance Recoveries		424,589
Total Operating Revenues		1,822,284
OPERATING EXPENSES		
Personal Services		117,269
Employee Retirement		47,124
Social Security Contribution		7,307
Group Insurance		32,421
Contractual Services		11,470
Benefit Payments		248,986
Total Operating Expenses		464,577
OPERATING INCOME		1,357,707
NONOPERATING REVENUES		
Interest Income		90,719
Total Nonoperating Revenues		90,719
CHANGE IN NET POSITION		1,448,426
NET POSITION, BEGINNING OF YEAR, AS PREVIOUSLY REPORTED		11,716,217
PRIOR PERIOD ADJUSTMENTS		(1,667,296)
NET POSITION, BEGINNING OF YEAR, AS RESTATED		10,048,921
NET POSITION, END OF YEAR	$	11,497,347

See accompanying notes to the basic financial statements.

STATE OF ILLINOIS
ILLINOIS WORKERS' COMPENSATION COMMISSION
SELF-INSURERS SECURITY FUND
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2016

CASH FLOWS FROM OPERATING ACTIVITIES		
Cash Received from Assessments, Excess Insurance Recoveries and Security Deposits	$	1,743,337
Payments to Suppliers - Net		(80,622)
Payments to Employees and Other Personal Services		(194,096)
Deposit Refunds Paid		(508,000)
Benefit Payments		(1,022,103)
Net Cash Used in Operating Activities		(61,484)
CASH FLOWS FROM INVESTING ACTIVITY		
Interest and Dividends on Investments		96,051
Net Cash Provided by Investing Activity		96,051
NET INCREASE IN CASH EQUITY IN THE STATE TREASURY AND CASH AND CASH EQUIVALENTS		34,567
CASH EQUITY IN THE STATE TREASURY AND CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR		20,128,066
CASH EQUITY IN THE STATE TREASURY AND CASH AND CASH EQUIVALENTS, END OF YEAR	$	20,162,633

Reconciliation of Operating Income to Net Cash Used in Operating Activities:		
Operating Income	$	1,357,707
Adjustments to Reconcile Operating Income to Cash Flows from Operating Activities		
Changes in Assets and Liabilities:		
Excess Insurance Receivable		(78,947)
Accounts Payable		(72,545)
Due to Other Funds		(557)
Unearned Security Deposit		(508,000)
Compensated Absences		13,975
Liabilities for Unpaid Claims		(773,117)
Net Cash Used in Operating Activities	$	(61,484)

See accompanying notes to the basic financial statements.

(1) Description of Funds

The Illinois Workers' Compensation Commission Self-Insurers Advisory Board (Board) established within the Illinois Workers' Compensation Commission (Commission) administers the Self-Insurers Security non-shared proprietary fund described below. A non-shared fund is a fund in which a single State agency is responsible for administering substantially all financial transactions of the fund.

The Self-Insurers Security Fund (Fund) was established by the Workers' Compensation Act (820 ILCS 305/4a-5). The Fund provides compensation to employees of insolvent self-insured employers for any type of injury or occupational disease and all claims for related administrative fees, operating costs of the Board, attorney fees and other costs reasonably incurred by the Board. The Commission may upon the direction of the Board from time to time assess each of the private self-insurers a pro rata share of the funding reasonably necessary to carry out its activities.

(2) Summary of Significant Accounting Policies

The financial statements of the individual non-shared proprietary funds administered by the Board established within the Commission have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP), as prescribed by the Governmental Accounting Standards Board (GASB). To facilitate understanding data included in the financial statements, significant accounting policies are summarized below.

A. Reporting Entity

As defined by GAAP, the financial reporting entity consists of primary government, as well as its component units, which are legally separate organizations for which the elected officials of the primary government are financially accountable. Financial accountability is defined as:

i) Appointment of a voting majority of the component unit's board and either (a) the primary government's ability to impose its will, or (b) the possibility that the component unit will provide a financial benefit to or impose a financial burden on the primary government; or

ii) Fiscal dependency on the primary government.

Based on the required criteria, the Fund does not have any component unit, nor is it a component unit of another entity. The Fund is not legally separate from the State; therefore, the financial information of the Fund is included in the financial statements of the State. The State's Comprehensive Annual Financial Report (CAFR) may be obtained by writing to the State Comptroller's Office, Division of Financial Reporting, 325 West Adams Street, Springfield, Illinois 60274-1871, or by accessing its website at www.illinoiscomptroller.gov.

The financial statements present only the Fund administered by the Board established within the Commission and do not purport to, and do not, present fairly the financial position of the Commission or the State as of June 30, 2016, nor changes in the Commission or State's financial position and cash flows, for the year ended in conformity with GAAP.

B. Basis of Presentation

In government, the basic accounting and reporting entity is a fund. A fund is defined as an independent fiscal and accounting entity with a self-balancing set of accounts recording cash and/or other resources together with all related liabilities, obligations, reserves, and equities which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations. The Commission has presented: (i) a statement of net position; (ii) a statement of revenues, expenses and changes in net position; and (iii) a statement of cash flows for the Fund.

Operating revenues, such as security deposits converted to cash when a self-insurer becomes insolvent or unwilling to meet its obligations, assessments, and excess insurance reimbursements, result from exchange transactions associated with the principal activity of the Fund. Exchange transactions are those in which each party receives and gives up essentially equal values. Non-operating revenues, such as investment earnings, result from non-exchange transactions or ancillary activities.

C. Basis of Accounting

The Fund is reported using the economic resources measurement focus and the accrual basis of accounting. As an enterprise fund of the State, the Fund follows GASB standards, particularly GASB 34 which concerns recording revenue and expenses for exchange and exchange-like transactions. Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flow takes place. Non-exchange transactions (GASB 33), in which the Board gives (or receives) value without directly receiving (or giving) equal value in exchange are not applicable.

On an accrual basis, revenues from assessments, reimbursements from excess insurance, and converted security deposits are recognized in the fiscal year in which the underlying exchange transaction occurs. In the case of collected security, the exchange transaction occurs when the Self-Insurers Security Fund becomes responsible for paying claims of the self-insurer. The gross method of accounting is used so revenues are reported for the full amount of the security collected and expenses are reported for the full amount of estimated future claims when they are assumed by the Fund. As claims are paid, the liabilities for unpaid claims are reduced.

Securities collected before an exchange has occurred are reported as unearned revenues.

D. Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

E. Cash Equity in the State Treasury

The State Treasurer is the custodian of the State's deposit and investment maintained in the State Treasury. As of June 30, 2016, deposits in the custody of the State Treasurer (or in transit) totaled $20,161,353. This consists of security deposits (letters of credit, surety bonds, and escrow accounts) held by the Commission as security for the payment of private self-insurers obligations incurred under the Workers' Compensation Act. Deposits in the custody of the State Treasurer are pooled and invested with other State funds in accordance with the Deposit of State Moneys Act of the Illinois Compiled Statutes (15 ILCS 520/11). Funds held by the State Treasurer have not been categorized as to credit risk because the Fund does not own individual securities. Details on the nature of these deposits and investments are available within the State's Comprehensive Annual Financial Report (CAFR).

F. Cash and Cash Equivalents

Cash and cash equivalents include a petty cash fund of $100 and cash in transit from the State Treasurer of $1,180.

G. Excess Insurance Receivable

Excess insurance receivable consists of receivables from insurance companies as reimbursements of claims paid by the Commission in excess of the retention limit.

H. Compensated Absences

The liability for compensated absences reported for the Fund consists of unpaid, accumulated vacation and sick leave balances for Fund employees. The liability is calculated using the vesting method for eligible employees. The liability estimate is based on the employee's current salary level and includes salary related costs (e.g., Social Security and Medicare tax).

Legislation that became effective January 1, 1998, capped the paid sick leave for all State Employees' Retirement System members at December 31, 1997. Employees continue to accrue twelve sick days per year, but will not receive monetary compensation for any additional time earned after December 31, 1997. Sick days earned between January 1, 1984, and December 31, 1997, (with a 50% cash value) would only be used after all days with no cash value are depleted. Any sick days earned and unused after December 31, 1997, will be converted to service time for purposes of calculating employee pension benefits.

For the year ending June 30, 2016, compensated absences totaled $17,925.

I. Due to Other Funds

This represents amounts owed to the Department of Central Management Services for group insurance and the State Employee Retirement System (SERS) for retirement contributions.

J. Securities Lending Collateral

The State Treasurer lends securities to broker-dealers and other entities for collateral that will be returned for the same securities in the future. The State Treasurer has, through a Securities Lending Agreement, authorized Deutsche Bank AG to lend the State Treasurer's securities to broker-dealers in banks pursuant to a form of loan agreement.

In accordance with GASB Statement No. 28, paragraph 9, the Office of the State Treasurer may allocate assets and obligations arising from securities lending agreements to the various funds of the State. The securities lending collateral invested in repurchase agreements allocated to the Fund was $5,352,000 on June 30, 2016.

K. Unearned Security Deposit

Unearned Security Deposit consists of proceeds drawn upon letters of credit by the Commission, including related interest determined by the State Treasurer, as a security for the payment of the private self-insurer's obligations incurred under the Workers' Compensation Act. These proceeds are considered Unearned Security Deposit if the Commission has not yet assumed responsibility for paying the injured worker claims of the company whose security was drawn.

L. Liability for Unpaid Claims

The liability for unpaid claims is established based on estimated ultimate cost of claims that have been reported but not settled in cases where the Self-Insurers Security Fund has collected the self-insured company's security and taken responsibility for paying their claims. The liability excludes any portion of the estimated claims that are expected to be paid by excess insurance carriers; total claims were $15,223,773 of which $7,567,627 was expected to be paid by excess insurance carriers. All excess insurance companies had an AM Best rating of "A" or better.

The estimates were based upon claim history, medical reports, awarded benefits, legal pleadings, life expectancy, and other factors. Approximately 75% of the claims liability concerned indemnity payments which remain constant throughout the life of the claimant and are based upon life expectancy tables.

The following represents changes in aggregate liabilities during the year ended June 30, 2016.

Liability for unpaid claims, beginning of year (includes $1,767,296 increase for prior period adjustments)	$8,429,263
Total provision for events of the current fiscal year and any change in the provision for events of prior fiscal years	(773,117)
Liability for unpaid claims, end of year:	$7,656,146

M. Net Position

Net Position is displayed in one component as follows:

Restricted - This consists of net position that is legally restricted by outside parties or by law through constitutional provisions or enabling legislation. When both restricted and unrestricted resources are available for use, generally it is the Commission's policy to use restricted resources first, then unrestricted resources when needed.

N. Operating Revenues

Revenues include assessments, excess insurance recoveries, and collected security. Assessment revenue is recognized at date of assessment while excess insurance recoveries are recognized when the Self-Insurers Security Fund becomes eligible for recovery. Revenue for collected security is recognized when the Self-Insurers Security Fund assumes responsibility to pay workers' compensation obligations against an insolvent self-insurer.

O. Employee Retirement

Substantially all of the Fund's full-time employees participate in the State Employees' Retirement System (SERS), which is a pension trust fund in the State of Illinois' reporting entity. The SERS is a single-employer defined benefit public employee retirement system, in which State employees participate, except for those covered by the State Universities, Teachers', General Assembly, and Judges' Retirement Systems. The financial position and results of operations of the SERS for Fiscal Year 2016 are included in the State of Illinois' CAFR for the year ended June 30, 2016. The SERS issues a separate CAFR that may be obtained by writing to SERS, 2101 South Veterans Parkway, Springfield, Illinois, 62794-9255.

A summary of SERS benefit provisions, changes in benefit provisions, employee eligibility requirements including eligibility for vesting, and the authority under which benefit provisions are established are included as an integral part of the SERS' CAFR. Also included is a discussion of employer and employee obligations to contribute and the authority under which those obligations are established.

The Commission pays employer retirement contributions from the Fund based upon an actuarially determined percentage of payroll. For Fiscal Year 2016, the employer contribution rate was 45.598%. The Commission's contribution to SERS was $47,124 for the year ended June 30, 2016.

P. Post-Employment Benefits

The State provides health, dental, vision, and life insurance benefits for retirees and their dependents in a program administered by the Department of Central Management Services. Substantially all State employees become eligible for post-employment benefits if they eventually become annuitants of one of the State-sponsored pension plans. Health, dental, and vision benefits include basic benefits for annuitants and dependents under the State's self-insurance plan and insurance contracts currently in force. Annuitants may be required to contribute towards health, dental, and vision benefits with the amount based on factors such as date of retirement, years of credited service with the State, whether the annuitant is covered by Medicare, and whether the annuitant has chosen a managed health care plan. Annuitants who retired prior to January 1, 1998, and who are vested in the SERS, do not contribute towards health, dental, and vision benefits. For annuitants who retired on or after January 1, 1998, the annuitant's contribution amount is reduced five percent for each year of credited service with the State allowing those annuitants with twenty or more years of credited service to not have to contribute towards health, dental, and vision benefits. Annuitants also receive life insurance coverage equal to the annual salary of the last day of employment until age 60, at which time the benefit becomes $5,000.

The total cost of the State's portion of health, dental, vision, and life insurance benefits of all members, including post-employment health, dental, vision, and life insurance benefits, is recognized as expenditure in the State's CAFR. The State finances these benefit costs on a pay-as-you go basis. The total cost incurred for health, dental, vision, and life insurance benefits are not separated by department or component unit for annuitants and their dependents nor active employees and their dependents.

A summary of post-employment benefit provisions, changes in benefit provisions, employee eligibility requirements including eligibility for vesting, and the authority under which benefit provisions are established are included as an integral part of the financial statements of the Department of Central Management Services. A copy of the financial statements of the Department Central Management Services may be obtained by writing to the Department of Central Management Services, 715 Stratton Building, 401 South Spring Street, Springfield, Illinois, 62606-4100.

Q. Prior Period Adjustments

The Commission restated its net position balance at July 1, 2015 due to the following:

A. To correct recording of a refund previously recorded as an operating expense during the prior year as opposed to a reduction to the unearned security deposit liability account. This adjustment increased net position (decrease in Unearned Security Deposit) by $100,000.

B. To correct recording of a loss exposure in the prior year that has not been incurred as of June 30, 2015. This adjustment increased net position (decrease in Liabilities for Unpaid Claims) by $235,416.

C. To record the prior period effect of the Commission's change of the Fund's methodology for calculating claims accruals discussed in the next section. This adjustment decreased net position (increase in Liabilities for Unpaid Claims) by $2,002,712.

A reconciliation of net position reported in the prior period financial statements and as restated follows:

Net position, beginning of year, as previously reported	$11,716,217
Cumulative effect of correction of errors	(1,667,296)
Net position, beginning of year, as restated	$10,048,921

R. Change in Accounting Methods

The Commission made two changes in accounting methods for Fiscal Year 2016 financial reporting related to Liabilities for Unpaid Claims.

In prior years, when a self-insurer's collected security exceeded its estimated unpaid claims, the related unpaid claims were not reported as a liability. Starting in Fiscal Year 2016, these claims were reported as liabilities consistent with other estimated unpaid claims. In this way, revenues and expenses related to collected security are reported in the same period. The effect of this change was a $3,006,160 increase in Liabilities for Unpaid Claims ($207,060 current and $2,799,100 prior period).

Also, in prior years the Commission added a 20% reserve to estimated unpaid claims when reporting Liabilities for Unpaid Claims. This practice was not consistent with GAAP and therefore the reserve was eliminated. The effect of this change was a $929,998 decrease in Liabilities for Unpaid Claims ($133,610 current and $796,388 prior period).

The net effect of these changes was a $2,076,162 increase in liabilities for unpaid claims ($73,450 current and $2,002,712 prior period).

S. Subsequent Events

Liabilities for Unpaid Claims exceeded eventual actual payments for two claimants in the amount of $262,422 ($9,458 current and $252,964 noncurrent). One claimant died on September 9, 2016, earlier than estimated based on life expectancy tables ($121,140). Another claimant became ineligible for payments on August 29, 2017, when reaching age 18, while the liability was based on the claimant remaining eligible until age 25 by remaining in school full-time until that age ($141,282).

T. Future Adoption of GASB Statements

Effective for the year ending June 30, 2017, the Commission will adopt GASB Statement No. 73, *Accounting and Financial Reporting for Pensions and Related Assets That Are Not within the Scope of GASB Statement 68, and Amendments to Certain Provisions of GASB Statements 67 and 68,* which is to improve the usefulness of information about pensions included in the general purpose external financial reports of state and local governments for making decisions and assessing accountability. The Commission does not expect a material impact on the Funds' financial statements as a result of adopting this statement.

Effective for the year ending June 30, 2018, the Commission will adopt GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans***,** which is to improve accounting and financial reporting by state and local governments for postemployment benefits other than pensions (other postemployment benefits (OPEB)). It also improves information provided by state and local governmental employers about financial support for OPEB that is provided by other entities. The Commission does not expect a material impact on the Funds' financial statements as a result of adopting the statement.

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INDEPENDENT AUDITOR'S 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 Frank J. Mautino
Auditor General
State of Illinois

As Special Assistant Auditors for the Auditor General, we have audited, in accordance with the 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, the financial statements of the Self-Insurers Security Fund of the State of Illinois, Illinois Workers' Compensation Commission, as of and for the year ended June 30, 2016, and the related notes to the financial statements, and have issued our report thereon dated January 4, 2018.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the State of Illinois, Illinois Workers' Compensation Commission's internal control over financial reporting (internal control) of the Self-Insurers Security Fund to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State of Illinois, Illinois Workers' Compensation Commission's internal control. Accordingly, we do not express an opinion on the effectiveness of the State of Illinois, Illinois Workers' Compensation Commission's internal control.

A *deficiency in internal control* 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 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 a 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.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. We did identify certain deficiencies in internal control, described in the accompanying schedule of findings as items 2016-001, 2016-002, and 2016-003 that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of Illinois, Illinois Workers' Compensation Commission's Self-Insurers Security Fund's financial statements are free from 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 no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

State of Illinois, Illinois Workers' Compensation Commission's Response to Findings

The State of Illinois, Illinois Workers' Compensation Commission's responses to the findings identified in our audit are described in the accompanying schedule of findings. The State of Illinois, Illinois Workers' Compensation Commission's responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on the responses.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the State of Illinois, Illinois Workers' Compensation Commission's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the State of Illinois, Illinois Workers' Compensation Commission's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

SIGNED ORIGINAL ON FILE

Chicago, Illinois
January 4, 2018

2016-001. **FINDING** (Inadequate Financial Accounting and Reporting)

The Illinois Workers' Compensation Commission (Commission) did not exercise adequate internal control over its financial reporting for the Self-Insurers Security Fund (Fund).

Material and Pervasive Misstatement

During testing, the auditors noted the Commission had an inadequate process to determine the claims liabilities of the Fund. This matter is described in greater detail in Finding 2016-002.

The Codification of Statements on Auditing Standards (AU-C § 705.07(a)) requires auditors to modify the opinion in the *Independent Auditor's Report* when the "auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are materially misstated."

Commission officials stated this condition was the result of reevaluating the Commission's claims liabilities using the Governmental Accounting Standards Board's definition of a liability.

Material and Pervasive Inability to Obtain Sufficient and Appropriate Evidence

During testing, the auditors noted the proper accounting treatment for an insolvent self-insurer's security collected by the Commission is not determinable due to two different irreconcilable interpretations of the Workers' Compensation Act (Act). This matter is described in greater detail in Finding 2016-003.

The Codification of Statements on Auditing Standards (AU-C § 705.07(b)) requires auditors to modify the opinion in the *Independent Auditor's Report* when the "auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement."

Commission officials stated the audit brought to light two different interpretations of the Act.

Basis for an Adverse Opinion

As a result of (1) the Commission not adopting a more robust process to determine the estimated claims liabilities of the Fund and (2) our inability to obtain sufficient and appropriate audit evidence regarding the proper accounting treatment for an insolvent self-insurer's security under the Act, the auditors expressed an adverse

2016-001. **FINDING** (Inadequate Financial Accounting and Reporting) (continued)

opinion on the Fund's financial statements as of and for the year ended June 30, 2016.

The Codification of Statements on Auditing Standards (AU-C § 705.09) states auditors "should express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements."

Other Noted Errors Corrected by the Commission

In addition to the foregoing conditions that resulted in an adverse opinion on the Fund's financial statements as of and for the year ended June 30, 2016, we noted other financial reporting problems that were corrected in the Fund's final financial statements by the Commission. These include the following matters:

- The Commission changed the Fund's methodology for calculating claims accruals (which is discussed in more detail within Finding 2016-002) by eliminating a 20% markup and additional reserve for claims. The auditors determined the Commission did not have (1) a reasonable basis for the markup or (2) documentation to support why the 20% markup was included within its claims accrual methodology. This change resulted in the Fund recording a prior period adjustment of $796,388 and a current period adjustment of $133,610.

  Governmental Accounting Standards Board Statement No. 62 (Paragraph 102), *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, requires estimated losses be accrued if both (1) information available prior to the issuance of the financial statements indicates it is probable a liability has been incurred as of the date of the financial statement and (2) the amount of the loss can be reasonably estimated. Further, the Codification of Statements on Auditing Standards (AU-C § 540.18) requires auditors to evaluate, based on audit evidence obtained, whether an accounting estimate in the financial statements is reasonable or misstated.

  Commission officials stated the 20% markup in the claims accrual was based on the *Keystone v. Industrial Commission* stipulation signed by the parties on October 30, 1996. This agreement stipulated that the required minimum balance in the Fund should include not only exposure for known bankruptcies but also an additional amount equal to 20% of the total Fund exposure associated with known bankruptcies. While the Commission had

2016-001. **FINDING** (Inadequate Financial Accounting and Reporting) (continued)

included this 20% markup in its reported unpaid claims liabilities for the past 20 years, this additional 20% was not consistent with generally accepted accounting principles.

- The Commission recorded a prior period adjustment of $235,416 for a loss exposure recorded in the prior year that did not meet the requirement that a liability must have been incurred as of the date of the financial statements under Governmental Accounting Standards Board Statement No. 62 (Paragraph 102) (noted above).

  Governmental Accounting Standards Board Statement No. 62 (Paragraph 107), *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, requires if an accrual for a loss contingency is not recorded because one or both of the required conditions within Governmental Accounting Standards Board Statement No. 62 (Paragraph 102) have not been met, then the exposure should be merely disclosed in the notes to the financial statements.

  Commission officials stated the Commission misinterpreted the nature of two subsequent events, which resulted in recording the transactions too early.

- The Commission changed its longstanding accounting policy for claims liabilities to include claims liabilities for insolvent self-insurers whose unpaid claims were less than the security collected by the Commission from those self-insurers. This policy change resulted in the Fund recording a prior period adjustment of $2,799,100 and a current period adjustment of $207,060.

- The Commission recorded a prior period adjustment of $100,000 to increase the Fund's beginning net position and reduce its unearned security deposits liability account. This adjustment was needed to reflect a refund previously incorrectly recorded as an operating expense during a prior year as opposed to a reduction to the unearned security deposits liability account.

- The Commission recorded a current period adjustment of $508,000 to reduce the Fund's current operating expenses and unearned security deposits liability account. This adjustment was needed to reflect refunds incorrectly recorded as an operating expense as opposed to a reduction to the unearned security deposits liability account.

2016-001. **FINDING** (Inadequate Financial Accounting and Reporting) (continued)

National Council on Governmental Accounting Statement No. 1 (Paragraph 59), *Governmental Accounting and Financial Reporting Principles*, states that under the accrual basis of accounting, transactions are generally recorded when the transaction occurs, regardless of when cash is received or disbursed. Additionally, Concepts Statement No. 4 of the Governmental Accounting Standards Board (Paragraph 17), *Elements of Financial Statements*, notes, "*Liabilities* are present obligations to sacrifice resources that the government has little or no discretion to avoid." As such, assets received in advance of the date when a transaction occurs that are subject to refund should be held as liabilities, with the payment of the refund reducing assets and liabilities and not being reflected on the Statement of Revenue, Expenses, and Changes in Net Position.

- The Commission recorded a current period reclassification of $3,950 for contractual auditing and management consulting services wrongly booked as personal services expenses.

  The State Finance Act (30 ILCS 105/14) defines personal services as "the reward or recompense made for personal services rendered for the State by an officer or employee of the State." Further, the Statewide Accounting Management System (SAMS) (Procedure 11.50.30) classifies charges for auditing and management consulting services as contractual services.

- The Commission recorded a current period adjustment of $2,283 to reduce its assessment revenues during the period to reflect a refund processed out of the Fund.

  Governmental Accounting Standards Board Statement No. 34 (Paragraph 92), *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, requires the presentation of proprietary funds, such the Fund, under the accrual basis of accounting and the economic resources measurement focus. Further, Governmental Accounting Standards Board Statement No. 34 (Footnote 11) notes transactions occur when something of value passes between two or more parties. Additionally, National Council on Governmental Accounting Statement No. 1 (Paragraph 59), *Governmental Accounting and Financial Reporting Principles*, states that under the accrual basis of accounting, transactions are generally recorded when the transaction occurs, regardless of when cash is received or disbursed. As such, exchange-like assessment revenues should be recognized net of refunds.

2016-001. **FINDING** (Inadequate Financial Accounting and Reporting) (continued)

Commission officials stated these exceptions were due to oversight.

The Fiscal Control and Internal Auditing Act (30 ILCS 10/3001) requires the Self-Insurers Advisory Board (Board) and Commission to establish and maintain a system, or systems, of internal fiscal and administrative controls to provide assurance revenues, expenses, resources, and funds applicable to operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial reports and to maintain accountability over the State's resources.

Failure to properly record and report the Fund's transactions resulted in an adverse opinion on the Fund's financial statements and hindered the usefulness and reliability of the Fund's financial statements. In addition, these deficiencies reduced the overall reliability of Statewide financial reporting and represent noncompliance with the Fiscal Control and Internal Auditing Act. (Finding Code No. 2016-001)

RECOMMENDATION

We recommend the Commission, in conjunction with the Board, take action to:

1) adopt written accounting policies which conform to accounting principles promulgated by the Governmental Accounting Standards Board for enterprise funds;
2) develop an appropriate process to estimate the claims liabilities of the Fund based upon sufficient and reliable evidence;
3) seek a formal, written opinion from the Attorney General regarding the treatment of an insolvent self-insurer's security under the Act, or seek a legislative remedy; and,
4) identify financial reporting problems and make any necessary adjustments to the financial statements and related notes prior to the post audit process.

COMMISSION RESPONSE

The Commission agrees with the recommendations.

However, the Commission disagrees with the cause statement concerning claims liabilities noted in the Finding above:

> *Commission officials stated this condition was the result of reevaluating the Commission's claims liabilities using the Governmental Accounting Standards Board's definition of a liability.*

2016-001. **FINDING** (Inadequate Financial Accounting and Reporting) (continued)

Commission officials explained the condition for misstating unpaid claims liabilities was the result of following the same calculation methods since at least 1998, which had not been challenged in any previous external audits overseen by the Office of the Auditor General.

Deficiencies in our methodology were first noted during the FY 2016 audit. Consequently, the Commission made significant adjustments to its claims liabilities prior to publication of the FY 2016 Financial Statements. Despite these adjustments, the Commission has found it necessary to hire outside expertise to ensure all future claims-related costs required to be included in unpaid claims liabilities are properly estimated and reported. The Commission has taken steps to hire such outside expertise for the following purposes:

1) Determine appropriate balances to report for FY 2016 and FY 2017 unpaid claims liabilities as well as appropriate footnote disclosure to ensure compliance with applicable accounting principles.
2) Update Self-Insurers Security Fund written procedures so they reflect an appropriate process to estimate and accrue unpaid claims liabilities in conformance with accounting principles promulgated by the Government Accounting Standard Board (GASB) for enterprise funds.

The Commission expects this work to be completed prior to publication of the FY 2017 Financial Statements.

The Commission has also taken steps to address the perceived ambiguity in the Workers' Compensation Act. On October 20, 2017, the Commission included a proposed amendment to Section 4a-6(a) as part of its *2018 Agency-Initiated Legislative Proposals* that it submitted to the Office of the Governor.

2016-002. **FINDING** (Inadequate Process to Determine Claims Liabilities)

The Illinois Workers' Compensation Commission (Commission) had an inadequate process to determine the claims liabilities of the Self-Insurers Security Fund (Fund).

Background

The Self-Insurers Advisory Board (Board) within the Commission was established by the Workers' Compensation Act (Act) to provide oversight of self-insurers (820 ILCS 305/4a-4), ensure the employees of insolvent self-insurers continue to receive their benefits due under the Act and the Workers' Occupational Diseases Act (820 ILCS 310) (together, the "Acts") by administering the Fund (820 ILCS 305/4a-5), and determining the assessments to levy against all private self-insurers to ensure resources are available to continue paying benefits due to employees of insolvent self-insurers (820 ILCS 305/4a-7).

If a self-insurer becomes insolvent and can no longer pay its workers' compensation obligations, the Board assumes the outstanding obligations under the Acts of the insolvent self-insurer and takes action to collect, recover, and enforce all of the various forms of security provided by the insolvent self-insurer (820 ILCS 305/4a-6). The Board then directs the Commission to deposit resources derived from the security into the Fund (820 ILCS 305/4a-6).

The Fund will continue to pay, in full, the insolvent self-insurer's obligations due under the Acts as long as the insolvent self-insurer's employees remain disabled (820 ILCS 305/4a-5). Due to the nature of workers compensation claims, these costs can extend out over several decades and remain subject to a wide variety of factors impacting the actual cost of the obligation due to the employees, including necessary medical procedures, cost inflation, and each employee's life expectancy.

Review of Accounting Principles Generally Accepted in the United States

Governmental Accounting Standards Board Statement No. 34 (Paragraph 92), *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, requires the presentation of proprietary funds, such as the Fund, under the accrual basis of accounting and the economic resources measurement focus. Further, Governmental Accounting Standards Board Statement No. 34 (Footnote 11) notes transactions occur when something of value passes between two or more parties. Additionally, National Council on Governmental Accounting Statement No. 1 (Paragraph 59), *Governmental Accounting and Financial Reporting Principles*, states that under the accrual basis of accounting, transactions are generally recorded when the transaction occurs, regardless of when cash is received or disbursed.

2016-002. **FINDING** (Inadequate Process to Determine Claims Liabilities) (continued)

Also, Governmental Accounting Standards Board Statement No. 62 (Paragraph 102), *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, requires estimated losses be accrued if both (1) information available prior to the issuance of the financial statements indicates it is probable a liability has been incurred as of the date of the financial statement and (2) the amount of the loss can be reasonably estimated. If either or both of these conditions cannot be satisfied, Governmental Accounting Standards Board Statement No. 62 (Paragraph 107), *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, requires the exposure be disclosed in the notes to the financial statements.

Further, the Codification of Statements on Auditing Standards (AU-C § 540.18) requires auditors to evaluate, based on audit evidence obtained, whether an accounting estimate in the financial statements is reasonable or misstated.

Application of the Accounting Literature to the Fund's Environment

As such, the Fund must develop an accounting methodology to properly account for incurred but not reported (IBNR) claims liabilities and the associated administrative costs necessary to continue processing the amounts due to the employees over time as of the date when it is both (1) probable a liability has been incurred and (2) the amount can be reasonably estimated or disclose the situation in the Fund's notes if one or both conditions are not met. This is necessarily an accounting estimate and impacts the Board's determination of assessments needed to ensure the Fund has sufficient resources to carry out its activities under the Act (820 ILCS 305/4a-7).

We noted the Commission's current methodology for its claims liability generally reflects cash basis or modified accrual basis accounting for the Fund's unpaid medical claims and unpaid administrative and legal expenses. These liabilities must be reported on the full accrual basis of accounting.

During the audit process, we recommended the Commission adopt a claims reserve analysis to properly estimate the Fund's net unpaid claims liability. This process would calculate both known claims (such as established rates for indemnity payments) and IBNR claims where actuarial techniques are used to calculate the total liability of each individual claim from an insolvent self-insurer's employees and recognize that expense in the period when it becomes probable a liability has been incurred. When these claims are ultimately paid from the Fund, the Fund would reduce its already recorded liability for unpaid claims.

2016-002. **FINDING** (Inadequate Process to Determine Claims Liabilities) (continued)

A formula for determining the Fund's net claims liability from each claim is:

Add:	Gross Unpaid Indemnity Claims
	Gross Unpaid Medical Claims
	Gross Unpaid Administrative and Legal Expenses
Less:	Excess Insurance Recoveries
	Security Collected from Insolvent Self-Insurers
	Recognized Net Unpaid Claims Liability

Material and Pervasive Misstatement

After extensive discussions between the auditors and the Commission, the Board and Commission ultimately did not adopt a claims reserve analysis approach to calculate claims liabilities in accordance with the accrual basis of accounting. The Board and Commission kept its prior claims methodology which did not reflect the accrual basis of accounting.

The Codification of Statements on Auditing Standards (AU-C § 705.07(a)) requires auditors to modify the opinion in the *Independent Auditor's Report* when the "auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are materially misstated."

Commission officials stated this condition was the result of reevaluating the Commission's claims liabilities using the Governmental Accounting Standards Board's definition of a liability.

Basis for an Adverse Opinion

As a result of the Commission not adopting a more robust process to determine the estimated claims liabilities of the Fund, the auditors expressed an adverse opinion on the Fund's financial statements as of and for the year ended June 30, 2016.

The Codification of Statements on Auditing Standards (AU-C § 705.09) states auditors "should express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements."

The Fiscal Control and Internal Auditing Act (30 ILCS 10/3001) requires the Board and Commission to establish and maintain a system, or systems, of internal fiscal and administrative controls to provide assurance revenues, expenses, resources, and funds applicable to operations are properly recorded and accounted for to permit the

2016-002. **FINDING** (Inadequate Process to Determine Claims Liabilities) (continued)

preparation of accounts and reliable financial reports and to maintain accountability over the State's resources.

Failure to calculate liabilities in accordance with the accrual basis of accounting and accounting principles promulgated by the Governmental Accounting Standards Board resulted in an adverse opinion on the Fund's financial statements and hindered the usefulness and reliability of the Fund's financial statements. Further, these deficiencies reduced the overall reliability of Statewide financial reporting and represent noncompliance with the Fiscal Control and Internal Auditing Act. (Finding Code No. 2016-002)

RECOMMENDATION

We recommend the Commission, in conjunction with the Board, take action to ensure its claims liabilities, including the Fund's unpaid medical claims and unpaid administrative and legal expenses, are properly presented in accordance with the accrual basis of accounting.

COMMISSION RESPONSE

The Commission agrees with the recommendation.

However, the Commission disagrees with the cause statement noted in the Finding above:

> *Commission officials stated this condition was the result of reevaluating the Commission's claims liabilities using the Governmental Accounting Standards Board's definition of a liability.*

Commission officials explained the condition for misstating unpaid claims liabilities was the result of following the same calculation methods since at least 1998, which had not been challenged in any previous external audits overseen by the Office of the Auditor General.

Deficiencies in our methodology were first noted during the FY 2016 audit. Consequently, the Commission made significant adjustments to its claims liabilities prior to publication of the FY 2016 Financial Statements. Despite these adjustments, the Commission has found it necessary to hire outside expertise to ensure all future claims-related costs required to be included in unpaid claims liabilities are properly estimated and reported. The Commission has taken steps to

2016-002. **FINDING** (Inadequate Process to Determine Claims Liabilities) (continued)

hire such outside expertise and expects their work to be completed prior to publication of the FY 2017 Financial Statements.

2016-003. **FINDING** (Uncertainty Regarding Statutory Interpretation)

The proper accounting treatment for an insolvent self-insurer's security collected by the Illinois Workers' Compensation Commission (Commission) is not determinable due to two different irreconcilable interpretations of the Workers' Compensation Act (Act) (820 ILCS 305).

Background

An employer can apply to the Self-Insurers Advisory Board (Board) within the Commission to become a self-insurer under the Act (820 ILCS 305/4(a)). During its review of the application, the Board considers several factors – including the applicant's financial viability, number of employees, the nature and hazard of the types of work performed by its employees, and claims experience factors – to reach its decision to approve or deny the application. If the Board approves the applicant, the Board will determine if the self-insurer has sufficient ability to adequately secure payment for its financial obligations under both the Act and the Workers' Occupational Diseases Act (820 ILCS 310) (together, the "Acts") or require the self-insurer to post a security (820 ILCS 305/4(a)). Typically, the Board requires the self-insurer to post some form of security – such as a surety bond, escrow agreement, or letter of credit – to allow the Commission to obtain resources to cover a self-insured employer's obligations under the Acts if it becomes insolvent (820 ILCS 305/4(a) and 50 Ill. Admin. Code 9100.40(c)(3)(D)).

If a self-insurer becomes insolvent and can no longer pay its workers' compensation obligations, the Board assumes the outstanding obligations under the Acts of the insolvent self-insurer and takes action to collect, recover, and enforce all of the various forms of security provided by the insolvent self-insurer (820 ILCS 305/4a-6). The Board then directs the Commission to deposit resources derived from the security into the Self-Insurers Security Fund (Fund) (820 ILCS 305/4a-6).

The Fund will continue to pay, in full, the insolvent self-insurer's obligations due under the Acts as long as the insolvent self-insurer's employees remain disabled (820 ILCS 305/4a-5). Due to the nature of workers' compensation claims, these costs can extend out over several decades and remain subject to a wide variety of factors impacting the actual cost of the obligation due to the employees, including necessary medical procedures, cost inflation, and each employee's life expectancy. As such, the security collected by the Commission from the insolvent self-insurer may or may not ultimately satisfy the insolvent self-insurer's workers compensation claims. In order to ensure the Fund can fulfill these obligations if the collected security is insufficient, the Act provides a procedure for the Board to assess each private self-insurer a pro rata share of the funding reasonably necessary to ensure

2016-003. **FINDING** (Uncertainty Regarding Statutory Interpretation) (continued)

the Board can fulfill its obligations to the insolvent self-insurer's employees (820 ILCS 305/4a-7).

At this point, two irreconcilable interpretations of the Act exist with regards to the proper treatment of the security collected by the Commission from the insolvent self-insurers. According to Commission officials, this issue has not been the subject of a ruling by a court within the State or the subject of a written opinion by the Attorney General.

Interpretation #1 – Liability Recognized Upon Receipt of the Security

Interpretation #1 assumes the Act has two separate and distinct refund criteria codified for insolvent self-insurers when its obligations have been satisfied (820 ILCS 305/4a-6(a)) and any remaining self-insurers when all of the Fund's remaining obligations have been satisfied (820 ILCS 305/4a-7(d)).

The Act (820 ILCS 305/4a-6(a)) states:

> Whenever a private self-insurer shall become an insolvent self-insurer and the surety, the guarantor, the excess insurance company and the holder of the securities, indemnities or bond provided by the insolvent self-insurer to secure its payment of compensation under this Act or the Workers' Occupational Diseases Act, are unwilling or unable to administer and defend the claims against the insolvent self-insurer, the Board is empowered to and shall assume on behalf of the Commission the outstanding workers' compensation and occupational disease obligations of the insolvent self-insured and shall take all steps necessary to collect, recover and enforce all securities, indemnity, insurance or bonds furnished by such self-insurer guaranteeing the payment of compensation provided in such Acts for the purpose of paying outstanding obligations of the insolvent self-insurer. Upon the direction of the Board, the Commission shall convert and deposit into the Fund such securities and any amounts received under agreements of surety, guaranty, insurance or otherwise. Any amounts remaining from such securities, indemnity, insurance, bonds, guaranties and sureties, following payment of all compensation costs and related administrative fees of the Board including attorneys' fees, and following exhaustion of all amounts assessed and received pursuant to Section 4a-7, shall be refunded by the Commission from the Fund as directed by the Board to the original holder one year thereafter, provided no outstanding liabilities remain against the Fund.

2016-003. **FINDING** (Uncertainty Regarding Statutory Interpretation) (continued)

Under Interpretation #1, this subsection calls for the Board and Commission, when a self-insurer becomes an insolvent self-insurer, to (1) collect the security, (2) deposit the security into the Fund, (3) pay all of the compensation due under the Acts and the Fund's administrative fees, and (4) pay the insolvent self-insurer's pro rata share of assessments under the Act (820 ILCS 305/4a-7(d)). After all of these costs have been paid and one year has passed after the last obligation of the insolvent self-insurer has been paid from the Fund, the Commission would refund the excess security to the original holder of the security.

This interpretation would result in the Fund adopting this accounting policy:

- If the insolvent self-insurer's security exceeds the total claim liability for the insolvent self-insurer, including incurred but not reported claims (IBNR) discussed in further detail within Finding 2016-002, and its estimated administrative and legal costs,
    a. the Fund would not recognize revenues or expenses for claims expected to be covered by the insolvent self-insurer's security;
    b. revenue from assessments charged against the insolvent self-insurers security under the Act (820 ILCS 305/4a-7(a)) are recognized as of the date the Board levies the assessment; and,
    c. for administrative and legal costs incurred by the Fund when the Board and the Commission handles an insolvent self-insurer's claims, the Fund would recognize revenue and expense equal to the cost incurred to process the insolvent self-insurer's obligations under the Acts; and,
    d. interest revenues on the security deposit would continue to accrue on the insolvent self-insurer's security deposit, which is the Board and the Commission's current practice.

- To the extent the total claim liability, including IBNR claims, for the insolvent self-insurer and its estimated administrative and legal costs is greater than the self-insurer's security,
    a. the Fund would not recognize revenues or expenses for claims expected to be covered by the insolvent self-insurer's security;
    b. the Fund would immediately recognize an expense for the claims liability, including IBNR claims, and its estimated administrative and legal costs to process the insolvent self-insurer's obligations under the Acts in excess of the security collected from the insolvent self-insurer;

2016-003. **FINDING** (Uncertainty Regarding Statutory Interpretation) (continued)

c. revenues from assessments charged against the insolvent self-insurers security under the Act (820 ILCS 305/4a-7(a)) are recognized as of the date the Board levies the assessment if a portion of the security deposit still remains, but this transaction would only result in a reduction of the remaining security deposit and an increase in the insolvent self-insurer's claims liability to be covered by the Fund;
d. for administrative and legal costs incurred by the Fund to process the insolvent self-insurer's obligations under the Acts and if a portion of the security deposit still remains, revenue and expense equal to the cost incurred, but this transaction would only result in a reduction of the remaining security deposit and an increase in the claims liability; and,
e. interest revenues on the security received would continue to accrue on the insolvent self-insurer's security deposit until it is exhausted.

- Interest revenues earned outside of security received from the insolvent self-insurers would continue to be recognized as non-operating revenue, which would help offset the amounts the Board and Commission would need to assess against private self-insurers to cover the liabilities of the Fund in excess of available assets (820 ILCS 305/4a-7(a)).

Under Interpretation #1, the Fund's payment of claims covered by the insolvent self-insurer's security is essentially an activity performed by the Board on behalf of the insolvent self-insurer for a fee that is equal to the actual cost to perform the service (if a balance remains from the collected security), as the amounts paid to settle claims of an insolvent self-insurer's employees are actually the expenses of the insolvent self-insurer. As such, the Fund would limit its recognition of revenue and expense to its actual administrative and legal costs in processing the insolvent self-insurer's obligations under the Acts and the Fund would not recognize revenue or expense from the payment of a claim covered by the insolvent self-insurer's security.

This accounting position would reflect the actual operating revenue of the Fund against operating expenses, where deficits represent amounts borne by (1) remaining solvent self-insurers to maintain the liquidity and solvency of the Fund and (2) non-operating interest revenue not allocated to the security, which is the Commission's current practice. If adopted, changes in the Fund's net position would reflect the usage of the resources provided by all of the private self-insurers through the assessment process to cover claims and the Board's operating expenses not covered by the insolvent self-insurer's security.

2016-003. **FINDING** (Uncertainty Regarding Statutory Interpretation) (continued)

This interpretation is supported by the fact the Commission maintains individual pools for each insolvent self-insurer, where the pool reflects claims obligations to be paid from the pool and interest revenues are allocated, in proportion to its proportion of the Fund, to each individual insolvent self-insurer's pool. Further, this position is bolstered by language within the Commission's standard forms noting one year after fulfilling the obligations owed to the employees of the insolvent self-insurer, any amounts remaining (1) from the surety bond will be returned to the surety (Self-Insurer's Surety Bond), (2) plus any interest accrued will be returned to the employer (Self-Insurer's Agreement to Post Letter of Credit), and (3) from the escrow deposit shall be returned to the employer (Self-Insurer's Escrow Agreement).

However, this interpretation is weakened by language in the Act (820 ILCS 305/4a-6(a)) which states:

> Any amounts remaining from such securities, indemnity, insurance, bonds, guaranties and sureties, following payment of all compensation costs and related administrative fees of the Board including attorneys' fees, and following exhaustion of all amounts assessed and received pursuant to Section 4a-7, shall be refunded by the Commission from the Fund as directed by the Board to the original holder one year thereafter, provided no outstanding liabilities remain against the Fund.

This language could establish a sequential nature for returning excess funds where excess funds must first be returned to the "solvent" self-insurers with priority over the insolvent self-insurers seeking a refund.

Interpretation #2 – Revenue Recognized Upon Receipt of the Security

Interpretation #2 assumes the Act has two separate refund criteria codified for insolvent self-insurers when its obligations have been satisfied (820 ILCS 305/4a-6(a)) and any remaining self-insurers when all of the Fund's remaining obligations have been satisfied (820 ILCS 305/4a-7(d)), but both criteria only occur when the entire Fund ceases operations and all obligations have been fully satisfied. It is readily assumed the complete cessation of the Fund is extremely remote, as businesses voluntarily choose to become self-insurers and participate in the assessment process for various economic reasons.

The Act (820 ILCS 305/4a-6(a)) states:

2016-003. **FINDING** (Uncertainty Regarding Statutory Interpretation) (continued)

> Whenever a private self-insurer shall become an insolvent self-insurer and the surety, the guarantor, the excess insurance company and the holder of the securities, indemnities or bond provided by the insolvent self-insurer to secure its payment of compensation under this Act or the Workers' Occupational Diseases Act, are unwilling or unable to administer and defend the claims against the insolvent self-insurer, the Board is empowered to and shall assume on behalf of the Commission the outstanding workers' compensation and occupational disease obligations of the insolvent self-insured and shall take all steps necessary to collect, recover and enforce all securities, indemnity, insurance or bonds furnished by such self-insurer guaranteeing the payment of compensation provided in such Acts for the purpose of paying outstanding obligations of the insolvent self-insurer. Upon the direction of the Board, the Commission shall convert and deposit into the Fund such securities and any amounts received under agreements of surety, guaranty, insurance or otherwise. Any amounts remaining from such securities, indemnity, insurance, bonds, guaranties and sureties, following payment of all compensation costs and related administrative fees of the Board including attorneys' fees, and following exhaustion of all amounts assessed and received pursuant to Section 4a-7, *shall be refunded by the Commission from the Fund as directed by the Board to the original holder one year thereafter, provided no outstanding liabilities remain against the Fund.* (*emphasis added*)

Further, the Act (820 ILCS 305/4a-7(d)) states:

> If there are monies remaining in the Fund after all outstanding obligations of all insolvent self-insurers have been satisfied and the costs of administration and defense have been paid, *such amounts shall be returned by the Commission from the Fund as directed by the Board to the then private self-insurers in that proportion which each said private self-insurer has contributed to the Fund one year thereafter, provided no outstanding liabilities remain against the Fund*. (*emphasis added*)

Under Interpretation #2, the phrase "provided no outstanding liabilities remain against the Fund" within both subsections means each insolvent self-insurer does not have a distinct pool within the Fund, but all insolvent self-insurers are grouped together into one pool. Further, Interpretation #2's single pool position may be bolstered by another section of the Act. The Act (820 ILCS 305/4a-5) states:

2016-003. **FINDING** (Uncertainty Regarding Statutory Interpretation) (continued)

> There is hereby created a Self-Insurers Security Fund. The State Treasurer shall be the ex-officio custodian of the Self-Insurers Security Fund. Monies in the Fund shall be deposited in a separate account in the same manner as are State Funds and any interest accruing thereon shall be added thereto every 6 months. It shall be subject to audit the same as State funds and accounts and shall be protected by the general bond given by the State Treasurer. *The funds in the Self-Insurers Security Fund shall not be subject to appropriation and shall be made available for the purposes of compensating employees* who are eligible to receive benefits from their employers pursuant to the provisions of the Workers' Compensation Act or Workers' Occupational Diseases Act, when, pursuant to this Section, the Board has determined that a private self-insurer has become an insolvent self-insurer and is unable to pay compensation benefits due to financial insolvency. Monies in the Fund may be used to compensate any type of injury or occupational disease which is compensable under either Act, and all claims for related administrative fees, operating costs of the Board, attorneys' fees, and other costs reasonably incurred by the Board. Payment from the Self-Insurers Security Fund shall be made by the Comptroller only upon the authorization of the Chairman as evidenced by properly certified vouchers of the Commission, upon the direction of the Board. (*emphasis added*)

While a court or the Attorney General has not written an opinion on what this section means, it is possible this section means the moneys within the Fund are available to compensate the employees of any insolvent self-insurer and that a refund can only be paid from the Fund if no employees remain eligible to obtain benefits under the Acts from an insolvent self-insurer.

This interpretation would result in the Fund adopting this accounting policy:

- Upon receipt of an insolvent self-insurer's security, the Fund:
  a. would recognize revenue to the extent of the collected security; and,
  b. the Fund would immediately recognize an expense for the claims liability, including IBNR claims, and its estimated administrative and legal costs to process the insolvent self-insurer's obligations under the Acts.

- All interest revenues would be the Fund's own non-operating revenues, which would offset the amounts the Board and Commission would need to assess against private self-insurers to cover the liabilities of the Fund in excess of available assets (820 ILCS 305/4a-7(a)). The Board and the

2016-003. **FINDING** (Uncertainty Regarding Statutory Interpretation) (continued)

Commission would not need to maintain separate pools for allocating costs and interest to the accounts of individual insolvent self-insurers.

Under Interpretation #2, the Fund recognizes revenue upon assumption of the obligations of an insolvent self-insurer because (1) it is highly unlikely a refund will ever be paid and (2) the Fund has met all of its obligations to the insolvent self-insurer because it both assumed and will process the insolvent self-insurer's claims due under the Acts.

This accounting position would result in the need to separate operating revenue of the Fund from the collection of security and the collection of assessments and operating expenses would be recognized only (1) when a self-insurer becomes insolvent and (2) any estimation changes for claims or administrative costs over the duration of the insolvent self-insurer's employees. Further, any deficit of the Fund would represent amounts borne by remaining solvent self-insurers to maintain the liquidity and solvency of the Fund.

This interpretation is supported by debates within the Senate surrounding Public Act 085-1385, which added the subsections for insolvent self-insurers when its obligations have been satisfied (820 ILCS 305/4a-6(a)) and any remaining self-insurers when all of the Fund's remaining obligations have been satisfied (820 ILCS 305/4a-7(d)). During the debates, attention was focused on ensuring the self-insurers as a whole were responsible, on a shared basis, for liabilities left by insolvent self-insurers. In addition, the Senate debates focused on ensuring the Commission had access to pay legitimate claims and avoid any situations where the Fund lacked sufficient cash to pay obligations due under the Acts. Further, this interpretation is supported by a strict reading of what the phrase "provided no outstanding liabilities remain against the Fund" means.

However, this interpretation is weakened by the fact that when a solvent self-insurer chooses to end their self-insurance participation, its liability for assessments continues only for obligations of the Fund that arose during its time as a self-insurer under the Act (820 ILCS 305/4a-7(b)). Therefore, the two different refund provisions for the insolvent self-insurers when its obligations have been satisfied (820 ILCS 305/4a-6(a)) and any remaining self-insurers when all of the Fund's remaining obligations have been satisfied (820 ILCS 305/4a-7(d)) may reflect that the insolvent self-insurers – or more likely, their sureties or lenders, will only incur obligations for the costs that arose during the period the insolvent self-insurer was a self-insurer. Those obligations would be limited to the direct liabilities of the insolvent self-insurer to its employees due under the Acts, the administrative costs associated with those liabilities, and its

2016-003. **FINDING** (Uncertainty Regarding Statutory Interpretation) (continued)

> pro rata share of assessments to cover losses while the insolvent self-insurer continues to participate in the self-insurance program until one year after all of its obligations have been satisfied. Finally, the ability of the Fund to meet its obligations is not limited by the adoption of Interpretation #1; the issue becomes which self-insurers – the insolvent self-insurers or the solvent self-insurers – will pay claims and associated processing costs where the security posted by a single insolvent self-insurer was unable to meet the entity's obligations.

Due to these two irreconcilable interpretations of the Act, we were unable to obtain sufficient, appropriate audit evidence to conclude the Commission's presentation of the Fund's financial statements complied with the Act. According to Commission officials, the implementation of the Interpretation #1 would result in the Fund reducing its recognition of revenue in current and prior periods of approximately $16.9 million, which would result in the Fund showing a negative net position of approximately $5.4 million.

Governmental Accounting Standards Board Statement No. 34 (Paragraph 92), *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, requires the presentation of proprietary funds, such the Fund, under the accrual basis of accounting and the economic resources measurement focus. Further, Governmental Accounting Standards Board Statement No. 34 (Footnote 11) notes transactions occur when something of value passes between two or more parties. Additionally, National Council on Governmental Accounting Statement No. 1 (Paragraph 59), *Governmental Accounting and Financial Reporting Principles*, states that under the accrual basis of accounting, transactions are generally recorded when the transaction occurs, regardless of when cash is received or disbursed. In addition, Concepts Statement No. 4 of the Governmental Accounting Standards Board (Paragraph 27), *Elements of Financial Statements*, states:

> The measurement focus of the resource flows statement is critical to determining the nature and period to which an outflow of resources is applicable. For resource flows statements prepared using the economic resources measurement focus, the period to which an outflow (or inflow) of resources is applicable is determined using the concept of interperiod equity. Interperiod equity is the state in which current period inflows of resources equal current period costs of services. For example, the burden of the cost of services is borne by present-year taxpayers and revenue providers. This burden is not shifted to future-year taxpayers or revenue providers through an increase in the level of borrowing, for example, and accumulated net resources are not used to provide current-period services. Interperiod equity is a relevant metric

2016-003. **FINDING** (Uncertainty Regarding Statutory Interpretation) (continued)

to assess accountability, rather than a goal that is expected to be met for any particular period of time.

Finally, the Codification of Statements on Auditing Standards (AU-C § 705.07(b)) requires auditors to modify the opinion in the *Independent Auditor's Report* when the "auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement."

Commission officials stated the audit brought to light two different interpretations of the Act.

Without a clear statutory interpretation of the provisions of the Act concerning the proper treatment of an insolvent self-insurer's security, it is not possible to issue an unmodified opinion on the Fund's financial statements and the Fund may not have sufficient assets available to satisfy its obligations. (Finding Code No. 2016-003)

RECOMMENDATION

We recommend the Board and the Commission seek a formal, written opinion from the Attorney General regarding the treatment of an insolvent self-insurer's security under the Act, or seek a legislative remedy.

COMMISSION RESPONSE

The Commission agrees with the recommendation to seek a legislative remedy.

The auditor perceives an ambiguity in Section 4a-6(a) of the Illinois Workers' Compensation Act. An ambiguity exists if the language used in the statute is susceptible to more than one equally reasonable interpretation. The auditor fails, however, to reasonably interpret this statute. It also misrepresents the Commission's interpretation of the statute and misunderstands several aspects of the self-insurance program. The Commission previously documented these issues in a letter responding to the audit findings that it sent to the auditor on December 27, 2017.

Even assuming the language of the statute could yield more than one reasonable construction, the Commission's interpretation should receive a substantial degree of deference because of the Commission's statutory role in administering the Illinois Workers' Compensation Act. It is commonly recognized that courts will give substantial weight and deference to an interpretation of an ambiguous statute by the agency charged with the administration and enforcement of the statute. *Ill. Landowners Alliance v. Ill. Commerce Comm'n*, 2017 IL 121302, ¶ 46. The courts

2016-003. **FINDING** (Uncertainty Regarding Statutory Interpretation) (continued)

accord such deference in recognition of the fact that agencies make informed judgments on the issues based upon their experience and expertise and serve as an informed source for ascertaining the legislature's intent. *Id*.

Nevertheless, the Commission agrees with the recommendation that it seek clarification of the Illinois Workers' Compensation Act's treatment of an insolvent self-insurer's excess security and has already taken proactive steps to address the perceived ambiguity. The legislative power of the State of Illinois is exclusively vested in the General Assembly making it the appropriate forum for clarifying a statute. Accordingly, the Commission included a proposed amendment to Section 4a-6(a) as part of its *2018 Agency-Initiated Legislative Proposals* that it submitted to the Office of the Governor on October 20, 2017. The Commission noted in its submission that the proposed amendment to Section 4a-6(a) was in response to questions that arose during this 2016 financial audit of the Self-Insurers Security Fund.