



STATE OF ILLINOIS

OFFICE OF THE AUDITOR GENERAL

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

FOR THE YEAR ENDED JUNE 30, 2005

WILLIAM G. HOLLAND

AUDITOR GENERAL

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OFFICE OF THE AUDITOR GENERAL
WILLIAM G. HOLLAND

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

Honorable Emil Jones, Jr., President of the Senate
Honorable Michael J. Madigan, Speaker of the House
Members of the General Assembly
Honorable Rod Blagojevich, Governor
Honorable Daniel Hynes, Comptroller

We have audited the financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the State of Illinois as of and for the year ended June 30, 2005 as listed in the Table of Contents for Section II of the Illinois Comprehensive Annual Financial Report, which collectively comprise the State of Illinois' basic financial statements and we have issued our report thereon dated June 16, 2006. 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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the State of Illinois' internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the State of Illinois' ability to record, process, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings as Findings 05-1, 5-02, and 05-3.

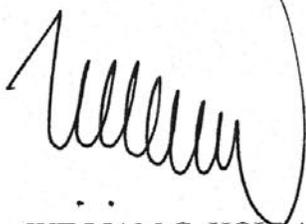
A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider Finding 05-1 to be a material weakness.

We also noted other matters involving the internal control over financial reporting, which we have reported to management of the Office of the Comptroller in a separate letter dated June 16, 2006.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of Illinois' financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

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



WILLIAM G. HOLLAND
Auditor General
State of Illinois



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

Springfield, Illinois
June 16, 2006

05-1. **FINDING** (Financial Reporting Weaknesses)

The Illinois Office of the Comptroller (IOC) did not have adequate controls to assess the risk that information reported by individual agencies would not be fairly stated and compliant with the generally accepted accounting principles (GAAP).

During our audits of individual agencies a wide range of financial reporting errors and noncompliance with the IOC's accounting and reporting policies were identified by the auditors and reported to management at various agencies. Among these issues were 29 findings for 16 agencies that were considered significant deficiencies in the internal controls over financial reporting. Of the 29 findings reported, 10 related to 7 agencies classified as part of the primary government and 19 related to 9 agencies classified as component units.

Of the issues reported for the primary government, one issue regarding the capital asset records at the Department of Natural Resources (DNR) has been reported since 2002. The total capital assets, net reported by DNR at June 30, 2005 were \$706,627,000 or 4% of the State's total governmental activities capital assets, net of \$17,372,460,000.

Good internal controls would require the IOC to have a formal system in place to identify the risk of inaccurate reporting and the risk of underlying source data not being reliable and properly maintained. Additionally, good internal controls would require the IOC to have a formal system in place to identify reporting errors and omissions material to the financial statements. These systems should be separate from the audit function to ensure appropriate levels of responsibility and independence are maintained during the preparation and auditing of the financial statements.

In discussing these conditions with IOC personnel, they indicated misstatements were caused by a separation in the responsibility for the State's internal control procedures among agencies and component units. The IOC has the statutory authority to develop and prescribe accounting policy for the State but there is no centralized automated system in place to capture all items necessary to provide underlying support to review agency financial activities. IOC estimates that the cost of a modernized state-wide system would exceed \$100 million. It is currently each State agency's Chief Executive Officer who maintains statutory responsibility for the proper functioning of accounting and other operating policies of the Officer's agency. (Finding Code No. 05-1, 04-1, 03-1, 02-1)

RECOMMENDATION

We recommend the IOC implement additional internal control procedures in order to assess the risk of material misstatements to the State's financial statements and identify such misstatements during the financial statement preparation process. The internal control procedures should include a formal evaluation of prior problems and implementation of procedures to reduce the risk of these problems reoccurring. Additionally, the IOC should enhance their periodic interaction with and assistance to

management of other agencies to correct significant deficiencies in internal controls over financial reporting.

AGENCY RESPONSE

Agreed. The IOC will implement additional internal control procedures to identify material misstatements of the State's financial statements. In addition, the IOC will continue its interaction with other State agency officials to correct significant deficiencies in internal control over financial reporting.

05-2 **FINDING** (Inefficient accounting system)

The Illinois Office of the Comptroller (IOC) did not have an efficient electronic system to compile the State's Comprehensive Annual Financial Report (CAFR). The IOC uses several different systems and methods to gather information and compile the financial information. The majority of these systems do not inter-relate electronically causing manual input and additional review.

The IOC electronically imports cash basis financial information from the statewide accounting management system (SAMS), a mainframe based application, into a separate database through a four step automated process. IOC personnel then review 100% of the data to ensure accuracy and completeness of the conversion. The database is accessed through the Web-based Electronic Data Gathering Environment (WEDGE) system, a front-end web-based data entry application. Adjustments and reclassifications are recorded in the database to convert the cash basis financial information to the appropriate basis of accounting (accrual or modified accrual) used in the State's fund financial statements. The majority of these adjustments and reclassifications are made by various State agency personnel to the funds administered by their respective agencies. The IOC then generates financial statements using several different programs to manage the database information, control the programming flow of the financial information, and produce final reports. Manual review indicated errors during the data conversion process. Additionally, related database tables were not synchronized requiring IOC personnel to manually update the same data in multiple locations.

The WEDGE system is supplemented by several other IOC systems. One of the electronic systems is used by the IOC to gather information from State agencies regarding intrafund activity (567/568 system). The information from this system is used to document adjustments and reclassifications made to the WEDGE system cash basis information for intrafund activity.

Another system gathers information regarding external grants and contracts using a web-based reporting form (SCO-563 form). This information is used to document adjustments and reclassifications to the WEDGE system cash basis information for external grant and contract activity. The information on the SCO-563 form is also communicated to the Office of the Auditor General for preparation of the State's Schedule of Expenditures of Federal Awards. Analysis of this information is conducted to evaluate the completeness and fair presentation of this required federal schedule for State reporting in accordance with OMB Circular A-133.

The IOC also maintains a separate electronic system to gather information regarding bond indebtedness of the State. Various electronic spreadsheets are maintained to supplement this system in order to calculate summarized accrual basis information for bond transactions (i.e. amortization of interest costs, premiums and discounts).

Most primary accounting information is communicated to the IOC through the WEDGE system. However, the process requires State university, the State pension system, investment trust fund, and private purpose trust fund information to be communicated to the IOC using manual reporting forms. In addition, manual forms are used to provide essential footnote disclosure information and to demonstrate various reconciliations of the information reported.

Good business practices and good internal controls would require a well-designed electronic system be used for financial reporting to reduce the potential for manual input errors and to provide electronic checks and balances.

In discussing these conditions with IOC personnel, they stated they agreed certain systems would benefit significantly from more electronic integration. However, they believed the relative affordability of the current manual inputs and related review processes outweighs the efficiency offered by a comprehensive, electronically interfaced statewide system due to the substantial overall costs of implementing such a system. (Finding Code No. 05-2, 04-2, 03-2)

RECOMMENDATION

We recommend the IOC implement an electronic CAFR accounting system that significantly reduces the need for manual input and provides electronic checks and balances.

AGENCY RESPONSE

Agreed. Also see 05-1 Finding response. The IOC will continue to replace manual inputs with electronic systems and to integrate these electronic systems as determined economically practical.

05-3. **FINDING** (Delays in Financial Reporting)

The Illinois Office of the Comptroller (IOC) did not prepare the Statewide financial statements for the year ended June 30, 2005 in a timely manner.

The majority of the initial draft financial statements and disclosures were provided for audit during a five-month period beginning in November 2005 and ending in March 2006. The deposit and investment note disclosure and certain required supplementary information were provided in late April 2006. Revised financial statements to address audit exceptions were provided in May 2006. The financial statements were not available to the public until June 30, 2006.

During the course of the audit, we experienced delays in receiving supporting documentation for the financial statements and the related disclosures. Lastly, it was noted that the IOC did not begin working with the Department of Natural Resources to resolve reporting problems until February 2006 (refer to Finding 05-1).

Good business practices would require financial statements be prepared in a timely manner to allow for a reasonable audit time-frame and timely final distribution. For state governments, it is generally accepted that financial statements distributed within six months of year-end are timely. In addition, late preparation of draft financial statements limits the State's ability to comply with the annual financial reporting requirements set forth by continuing disclosure undertakings.

In discussing these conditions with IOC personnel, they stated delays were caused by unexpected difficulties in implementing the GASB Statement #40, Deposit and Investment Risk Disclosures (an amendment of GASB Statement #3) and obtaining accurate capital asset information from the Department of Natural Resources. In addition, the IOC and the Governor's Office of Management and Budget were engaged in protracted discussions concerning the presentation of data related to deferred liabilities and the appropriate application of State Budget Law (15 ILCS 20/50-1 et seq.) and its impact on the State of Illinois statewide financial statements. Note- This issue is cited in greater detail in the *Other Matters Involving Internal Control Over Financial Reporting Which Have Been Reported To Management of the Office of the Comptroller* correspondence. (Finding Code No. 05-3)

RECOMMENDATION

We recommend the IOC implement policies and procedures necessary to ensure timely reporting.

AGENCY RESPONSE

Agreed. The IOC will continue to provide guidance to State agencies to implement new GASB pronouncements properly and to accurately record their financial transactions. In addition, the IOC will implement new procedures for responding to Office of the Auditor

General's requests for documentation and revisions to financial statements and related disclosures. The IOC will work with the General Assembly and the Governor's Office to implement appropriate changes to the State Budget Law to conform to the intent of the Legislature in preparing and approving budgets and to address any ambiguities perceived in existing law.

PRIOR FINDINGS NOT REPEATED

05-4 **FINDING** (Lack of internal controls over reporting of long-term debt transactions)

During the prior audit, the Illinois Office of the Comptroller (IOC) did not have adequate internal controls to ensure proper reporting of long-term debt transactions. (Finding Code No.04-3)

During the current audit, the IOC improved their controls to ensure the proper reporting of long-term debt transactions. No material adjustments were noted during our testing the long-term debt transactions.