2002 Annual

Illinois AuditAdvisory

Emerging and Potential Audit Issues

William G. Holland
Auditor General

AUDITOR GENERAL'S MESSAGE

Many changes this year have posed unique challenges for State agency managers. Budget constraints, early retirements, and revisions in reporting requirements for State finances have been but a few of the issues that we have had to address.

This edition of the Audit Advisory highlights some of the changes and challenges we face. One article examines the importance of strategic planning. Other articles examine the impact of law changes, including the Prompt Payment Act, the federal Health Insurance Portability and Accountability Act, and the early retirement legislation. An update is also provided on the status of the State's efforts to implement GASB Statements 34 and 35.

On a personal note, I am pleased that one item did not change this year. My first term as Auditor General ended in 2002. In May 2002, the General Assembly unanimously appointed me to a second ten-year term, effective August 1. It has been and will continue to be my goal to present fair and objective audit reports. That goal cannot be achieved without developing and maintaining sound working relationships with agency officials. I sincerely appreciate the cooperation you have provided to my Office over the past 10 years. Through our joint efforts, we can continue working to help improve the efficiency and effectiveness of State government and increase its accountability to the people of Illinois.

WILLIAM G. HOLLAND
September 2002

IMPLEMENTATION OF GASB STATEMENTS 34 AND 35

The Governmental Accounting Standards Board's (GASB) Statements 34 and 35 impose significant accounting and financial reporting changes on governments, including the State of Illinois. The new financial reporting model dramatically changes the presentation of government's external financial statements, for the intended purpose of enhancing their clarity and usefulness. The State of Illinois is required to implement Statement 34 for the fiscal year ending June 30, 2002.

This past year has seen a considerable amount of activity by personnel in State agencies, the State Comptroller's Office, and the Office of the Auditor General (OAG), as everyone finalizes their processes (i.e., forms and instructions) for the documentation, compilation, preparation, and audit of the State's FY2002 basic financial statements. A critical issue facing the OAG is the approach to auditing and rendering an opinion on these basic financial statements. The OAG's planned approach will continue the current practice of individual departmental audits and related departmental financial reporting issuance.

Although the past year has seen a second GASB *Implementation Guide - Questions and Answers* to assist the preparers in the production of the financial statements and related notes for compliance with the new reporting model, the American Institute of Certified Public Accountants (AICPA) has not yet issued its revision of the *Audit and Accounting Guide*. The *Audit and Accounting Guide* helps auditors understand Generally Accepted Accounting Principles (GAAP) applicable to financial statements of government and provides a tool to audit and report those financial statements in accordance with professional auditing standards. The audit community has been told to expect the revised *Audit Guide* in September 2002.

The OAG has been working to develop a FY2002 audit approach to the State's basic financial statements that permits multiple public accounting firms to participate in the annual financial audit process. The Office of the State Comptroller has developed a methodology and format under the new financial reporting model for certain State agencies to prepare and issue either departmental financial statements or financial statements on non-shared funds. The OAG has attended several financial reporting forums and consulted with a national public accounting firm and individual members of the AICPA Task Force who are revising the AICPA *Audit and Accounting Guide* to make sure that the approach for FY2002 will be in compliance with professional auditing standards and the new *Guide*.

ARE WE READY?

The implementation impact on State agencies will vary significantly. Based on agency training by the State Comptroller's staff, many agencies will not see a significant change in their year-end GAAP process if:

- The agency's expenditures are primarily from General Revenue Fund resources and the amount spent is not material;

cont. ➔

- The agency's expenditures are not a material amount from any other reported "major fund" activity in the State's basic financial statements; and
- The agency's receipts are not material to the General Revenue Fund (or other reported "major fund" activity in the State's basic financial statements).

The OAG has been planning for and identifying the needed changes to the audit of the departmental financial reporting process so that the major elements of each materiality unit are audited. This process includes monitoring the changes being made to the GAAP reporting process by the State Comptroller and agencies to comply with the new reporting model. The OAG has also drafted the appropriate auditor reports giving recognition to the special Illinois requirements of selected fund audits and departmental audits of less than the full fund activity.

The State began the transition to the new standards as part of the FY2001 GAAP reporting process by requiring agencies to complete two GASB 34 Interim Forms A and B. These forms provided the conversion of the amounts reported using the existing modified accrual fund model at June 30, 2001 to the full-accrual government-wide basis presentation. Specifically, the two forms documented: 1) the dollar effect of the restatement of certain balance sheet accounts; and 2) the dollar amount of property, plant and equipment to be recorded after reclassifying and following the new capitalization policies, along with a calculation of the "accumulated depreciation" amount to be reported as of July 1, 2001. Also, as part of the OAG's FY2001 post audit program, certain agreed-upon-procedures were performed on the Interim Forms which document the restatement of the June 30, 2001 ending balances to the FY2002 opening balances.

In conclusion, the financial staffs of individual agencies, the State Comptroller and the Office of the Auditor General have been very busy identifying and making the needed changes to implement the new financial reporting model. In the upcoming months, agencies will be completing the GAAP packages, which the Office of the Comptroller will review and use to compile and present the financial results in accordance with the new reporting model. The Office of the Auditor General will then audit those financial statements.

CHANGES TO THE PROMPT PAYMENT ACT

Public Act 92-0384, approved August 16, 2001, amended the procedures for processing payments to vendors and determining when interest penalties must be paid by the State. Emergency rules implementing these changes were published in the July 12, 2002 issue of the *Illinois Register*. These changes became effective for invoices paid from FY2003 and subsequent appropriations.

The emergency rules define a "proper bill" as a bill or invoice that contains sufficient and correct information necessary to process the payment for a liability of a State agency. The rules provide guidance on factors to consider when determining whether a bill is not proper (such as bill lacks sufficient and/or correct information required to process bill or it lacks the vendor's tax identification number). Under the emergency rules, the State agency has 30 days to approve or deny a bill after the date of receipt; a proper bill must be paid within 60 days of receipt. Under the old rules, an agency had 90 days to pay a bill (30 days for approval and 60 days for payment). Comptroller Accounting Bulletins 96 and 103 provide additional guidance to agencies regarding the revisions to the Prompt Payment Act (see Resource Library at www.ioc.state.il.us).

HIPAA LEGISLATION IMPACTS AGENCIES

The federal Health Insurance Portability and Accountability Act of 1996 (HIPAA) calls for a more efficient delivery of health care through the standardization of electronic data interchange, the protection of confidentiality, and the security of health data. The effect of this legislation requires major changes in most healthcare transactions and administrative information systems.

HIPAA affects all health plans, health care clearinghouses, and service providers who submit or receive health care transactions in an electronic format. This includes private health insurance plans and government medical assistance programs. In addition, businesses which view, manipulate, or otherwise handle protected health information on behalf of a covered entity are subject to HIPAA. Any entity that retains or passes along individual patient data needs to evaluate whether they are affected by this legislation.

There are currently two implementation deadline dates for HIPAA.

- Transaction and Code Set Standards are due by October 16, 2002. Health organizations must adopt standard codes to be used in all health transactions. A request for a one-year extension to this deadline must be submitted by October 15, 2002.
- Privacy Standards are due by April 14, 2003. The privacy rules cover all individually identifiable health information in the hands of covered entities, regardless of whether the information is or has been in electronic form.

Since this legislation will have an impact on State government, State agency HIPAA compliance efforts will be reviewed during many of the Office of the Auditor General's FY2002 financial and compliance audits. For additional information on HIPAA, please feel free to contact Randy von Liski, Deputy Technology Officer for the Illinois Technology Office (217-524-5113 or randy_von_liski@gov.state.il.us).

STRATEGIC PLANNING

As a program or agency manager, it is easy to get caught up in the day-to-day program operations, activities, and crises needing attention. However, especially in these difficult budgetary times, it is important to focus on the larger, ongoing issues that are important to the success of your agency and programs. The development of a strategic plan, collection of performance data, and evaluation of results, should provide agency managers with the information needed to effectively manage agency operations.

Planning

The development of strategic plans, goals and objectives should be the starting point for a program's performance measurement effort. Some best practices for planning are to:

- Develop a strategic plan that includes long-term goals, refining them as needed.
- Develop and prioritize goals and objectives for each year.
- Identify who your stakeholders are and involve them in the development of your goals and objectives to get their assistance in defining what you need to accomplish.
- Identify and be guided by legislative intent by reviewing statutory mandates at the State and federal level.
- Learn about and adapt the methods other similar programs (e.g., in other states) have taken when planning and setting up their programs.
- Develop policies specific to the program goals and objectives. Such policies need to be consistent with statutory provisions and updated as needed.

Data Collection

Collection of valid, reliable data is essential to assessing performance. To assess performance, input, output, and outcome data is needed. Some best practices in this area are to:

- Determine what data are needed to accurately reflect program operations over time and to assist management in making good decisions.
- Ensure that data collection activities: provide data in a reliable, timely manner; contribute to making good management decisions; are linked to goals and objectives; and are protected by physical and electronic security controls.

Evaluating

Using collected data to measure how well a program is achieving its goals and objectives is essential to performance. Some best practices for evaluating performance are to:

- Monitor program performance on a continuous basis.
- Evaluate whether the program is achieving its objectives.
- Use customer satisfaction surveys.

Source: "Best Practices for Good Management," State of Utah Office of Legislative Auditor.

2002 EARLY RETIREMENT

Public Act 92-566 creates an early retirement incentive program (2002 ERI) for State employees. Unlike the previous early retirement program passed in 1991 (1991 ERI), the 2002 ERI does not permit a State agency to contract with a person taking the early retirement incentive by filing an affidavit with the Auditor General stating the person has unique expertise or is essential to the agency's operations.

Specifically, a provision in the State Finance Act applicable to the 2002 ERI states:

> *The item 'contractual services' does not include any expenditures for professional, technical, or other services performed for a State agency under a contract executed after the effective date of this amendatory Act of the 92nd General Assembly [June 25, 2002] by a person who has received any early retirement incentive under Section 14-108.3 or 16-133.3 of the Illinois Pension Code based on retirement in 2002 or later. A contract not payable from the contractual services item because of this paragraph shall not be payable from any other item of appropriation. [30 ILCS 105/15a]*

Agency managers should be aware of this important prohibition in the 2002 ERI.

COMPLIANCE WITH STATUTES AND RULES

State and federal laws, rules, and regulations establish specific duties and responsibilities for State agencies. Adherence to and compliance with these legal requirements is vital to ensure that an agency is fulfilling its mission and purposes. Compliance with these legal requirements is also important in avoiding audit findings.

Audits released by the Office of the Auditor General in 2002 contained 136 findings where agencies had not complied with applicable legal requirements. Of these 136 findings, 44 (32 percent) were repeated from prior audits because the agency had not taken the action necessary to address the non-compliance. The Statewide single audit had the largest number of findings (36) dealing with agency non-compliance with applicable requirements. The Statewide single audit covers multiple State agencies that expend a significant amount of federal funds.

Both compliance and performance audits examine whether agencies are meeting their legal requirements. Compliance audit objectives include determining compliance with the mandates. Performance audit objectives also include a review of compliance, but may also examine program effectiveness.

Formal policies and procedures are an effective management control to guide agency actions. The policies and procedures establish the steps that agency staff need to follow to ensure that legal requirements are met. By periodically reviewing its legal requirements and the controls established to ensure that such requirements are being met, an agency may not only be able to more effectively accomplish the mission and purposes for which it was established, but also be able to reduce the number of audit findings.

STATEWIDE SINGLE AUDIT UPDATE

The single audit report for the year ended June 30, 2001 marked the second single audit performed by the Office of the Auditor General on a Statewide basis, rather than on a department-by-department basis.

The Schedule of Expenditures of Federal Awards (SEFA) for the FY 2001 audit totaled $12.2 billion, which represents an increase of $872 million from the prior year expenditures of $11.3 billion. The State of Illinois participated in 304 federal programs during FY2001. A total of 31 programs were selected as major programs for audit purposes using the risk-based approach as required by OMB Circular A-133. Twelve of the programs were related to human services, 9 were education-related, and the remaining 10 dealt with other program areas.

While a total of 39 agencies spent federal program resources, the 31 major programs selected were administered by 13 agencies.

The FY2001 Statewide single audit report contained 50 findings related to 12 different State agencies.

The annual Statewide single audit approach has achieved the benefits anticipated when the Office of the Auditor General decided to convert from a departmental approach. These benefits have included:

- Reduced costs to the State;
- Less audit effort for some agencies;
- More readily available information; and
- Annual audits of federal programs.

OAG PEER REVIEW

Every three years the Office of the Auditor General receives an external quality control review of our audit processes (a peer review). Members of the peer review are audit professionals chosen from across the United States by the National State Auditors Association. The purpose of the review is to examine the quality control policies and procedures used by our Office in performing audits of State agencies. The peer review team selects a representative sample of audits conducted by our Office and evaluates those audits to determine compliance with Government Auditing Standards.

We are happy to report that our most recent peer review conducted in August 2002 resulted in an unqualified opinion. Additionally, the peer review team did not note any deviations from professional standards that would have required a written letter of comments. Our two prior peer reviews, conducted in 1996 and 1999, likewise resulted in a clean opinion with no letter of comments.

AUDITOR GENERAL'S OFFICE RECEIVES NATIONAL AWARD

The National Conference of State Legislatures' National Legislative Program Evaluation Society (NLPES) awarded the Auditor General's Office the Certificate of Recognition of Impact for the Management Audit of the Illinois State Board of Education and Other State Agencies Providing Funding to Illinois' Regional Offices of Education. The award is given annually by NLPES for audit reports that demonstrate significant impact on public policy, such as resulting in program improvements or legislative changes. In June 2002, Public Act 92-544 was enacted into law which transferred the responsibility for the annual financial audits of Regional Offices of Education and Intermediate Service Centers from the State Board of Education to the Office of the Auditor General.

The Office previously received the NLPES Certificate of Recognition of Impact for the 1998 Management Audit of Tuition and Fee Waivers, the 1999 Management Audit of Pilsen-Little Village Community Mental Health Center, Inc. and the 2000 Management Audit of the Department of Public Aid's Child Support State Disbursement Unit.

Office of the Auditor General
Iles Park Plaza, 740 East Ash Street
Springfield, Illinois 62703-3154

State of Illinois Building, 160 N. LaSalle Street, Suite S-900
Chicago Illinois 60601-3109

Phone: 217-782-6046
Fax: 217-785-8222
TDD: 217-524-4646
E-mail: auditor@mail.state.il.us
Website: www.state.il.us/auditor