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ILLINOIS Audit ADVISORY

Emerging and Potential Audit Issues

William G. Holland
AUDITOR GENERAL

AUDITOR GENERAL'S MESSAGE

The State's financial reporting deficiencies, and their negative implications, have been well documented in prior editions of the Audit Advisory. In addition, my Office's routine financial/compliance audits, the statewide single audit, and even a 2011 performance audit have had findings and recommendations on this matter.

Recently, some progress has been made. Both the Comptroller's Office and the Governor's Office have taken steps to begin to tackle the problem. The General Assembly established the Financial Reporting Standards Board to "assist the State in improving the timeliness, quality, and processing of financial reporting for the State." (P.A. 97-1055, effective 8/23/12)

However, despite these positive steps, serious problems with financial reporting persist. In June 2013, I wrote a letter to the Governor and Comptroller discussing the issue and laying out my planned course of action should these problems persist. That letter is reproduced in this edition of the Audit Advisory.

The Advisory discusses audit findings at agencies due to noncompliance with State mandates. It also contains an article on the problems retirements/separations pose to agencies and ways to plan for more effective transitions. Finally, the Advisory discusses changes to GASB Statements related to the reporting of pensions.

WILLIAM G. HOLLAND
September 2013

COMPLIANCE WITH STATE LAWS

One of the most common findings in OAG audits is an agency's noncompliance with laws passed by the General Assembly. Reasons for noncompliance varied. Some of the noncompliance was simply due to the late filing of required reports. To help ensure that important filing dates are not forgotten, agencies should maintain an up-to-date tickler file as to when statutorily required reports are due.

The 2010 edition of the Audit Advisory contained a listing of dates when certain reports must be filed. If agencies filed the required reports on time, findings would be eliminated.

Other reasons for noncompliance included the lack of policies and procedures to implement required activities, failure to complete required analyses, lack of staffing to complete required reports, and inadequate controls over various processes.

Some agencies noted that the reason for not implementing the mandate was because it was outdated or obsolete. In those instances, the agencies need to work with the General Assembly so that if laws truly are no longer needed, they can be repealed. Such action will not only reduce audit findings, it will also help simplify the State's statutes.

One of the purposes of the Audit Advisory is to inform agency officials of findings occurring in other agencies so that they can take action to avoid similar findings at their own agencies. The following are areas where auditors have recommended corrective action for noncompliance with statutory requirements that are generally applicable to State agencies:

- Ensuring that the internal auditing program complies with the Fiscal Control and Internal Auditing Act;
- Ensuring that newly hired employees undergo required ethics training;
- Properly reporting fees on the Agency Fee Imposition Report;
- Adequately implementing the Identity Protection Act;
- Including fringe benefits for personal use of assigned vehicles in the employees' taxable income;
- Properly referring delinquent accounts receivables to the Comptroller's Offset System;
- Maintaining time sheets that comply with the State Officials and Employees Ethics Act; and
- Publishing required information in the Illinois Procurement Bulletin.

SUCCESSION PLANNING

With the large number of State government employees retiring in recent years, the loss of institutional knowledge is an ongoing problem for agencies. From 2002 to 2012, the state of Illinois went from 87,421 to 64,328 employees – a 26% reduction.

The loss of institutional knowledge not only has a detrimental effect on agency operations, it can also negatively impact the audit process. For example, in a recent audit, auditors needed to determine how certain costs were calculated by an employee who had left State government, but no one at the agency knew how those calculations were made. On another audit, the agency could not locate files maintained by a recently retired employee.

Agencies need to have a plan to ensure that knowledge of a retiring employee is effectively transferred to other employees. One way to accomplish that is to have the retiring employee write a narrative or flowchart of their work activities. The agency can also have the employee who will be taking over the retiree's responsibilities shadow the retiring employee to learn responsibilities. Using methods such as these will help ensure more effective agency operations as well as a more efficient audit process.

AUDITOR GENERAL'S LETTER ON FINANCIAL REPORTING

As discussed in the Auditor General's Message, the following letter was sent to the Governor and Comptroller in June 2013. The letter discusses the well documented problems with the State's financial reporting process and its detrimental impact on a timely audit process. The Auditor General concludes the letter by clearly informing all parties that financial reporting issues will no longer delay the post-audit process for an excessive amount of time. In those instances where sufficient audit evidence is not obtained in a timely manner, the audit will be concluded even if that conclusion ultimately results in the necessity of issuing a disclaimer or an adverse or qualified opinion on the Statewide financial statements.

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OFFICE OF THE AUDITOR GENERAL
WILLIAM G. HOLLAND

June 20, 2013

Honorable Pat Quinn
Governor
207 State House
Springfield, IL 62706

Honorable Judy Baar Topinka
State Comptroller
201 State House
Springfield, IL 62706

Dear Governor Quinn and Comptroller Topinka:

The processes followed by the State agencies in preparing individual financial reports, by the State Comptroller in compiling the Statewide financial statements, and by my auditors in auditing the Statewide financial statements are undoubtedly complicated, cumbersome and time-consuming. Each year we encounter numerous and significant problems during the course of our external post-audits. These issues are promptly communicated to the State's management. Yet each year many of those same or similar problems are repeated in the following engagements, resulting in continued untimely issuance of the Statewide financial audit.

This situation is unacceptable and must be addressed.

The current financial reporting process is overly reliant on errors and omissions being identified through the external post-audit process. Financial reporting errors should be avoided or minimized at the *front end* of the process - at the agencies - *before* the external post-audit process even begins. My audit process will never conclude in a timely manner as long as misstatements and restatements of financial information remain prevalent. In conjunction with the June 30, 2012 Statewide financial audit, we conducted financial audits of 25 agencies of the State's primary government. During the course of those audits, we identified a total of 22 material weaknesses and 27 significant deficiencies at 17 of those agencies (see Finding 12-2 in the *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*). Restatements were required at two agencies for correction of prior period errors, for a total adjustment of over $210 million. In addition, misstatements were identified at six different agencies, with adjustments ranging from a low of $184,000 to a high of $402 million.

Using this most recent reporting period as an example, the primary cause of delay in issuing the Fiscal Year 2012 Statewide financial audit was because of financial reporting issues at the Department of the Lottery. While certain issues were first identified by the auditors in December, 2012, we were still awaiting necessary financial information from the agency in May,

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2013. For purposes of perspective, Lottery's deadline for submitting *complete* and *accurate* financial reporting information to the State Comptroller for Fiscal Year 2012 was October, 2012. Between December, 2012 and May, 2013, a substantial number of hours was expended by my auditors in an effort to avoid issuing a disclaimer or qualified opinion on Lottery's financial statements and, by extension, the Statewide financial statements. Final resolution of Lottery's issues did not occur until late May, 2013, delaying issuance of the Statewide financial audit to June, 2013.

As you can see, a *single* financial reporting issue at a *single* State agency has the potential to delay the *entire* Statewide financial statement audit process since all material issues must be addressed before our opinion can be issued. Further, a *single* issue at a *single* State agency has the potential to result in a disclaimer or adverse or qualified opinion on the *Statewide* financial statements.

Although this year the audit delays occurred mostly because of issues at the Department of the Lottery, in past years delays have been caused by problems at other agencies and next year the problems could be at any one or more of the audited agencies of primary government. I also do not mean to minimize the auditors' role in the issue resolution process. One delay cascades into another and impacts the audit firms' schedules and their ability to timely follow-up on unanticipated issues. Further, some issues simply cannot be anticipated or identified by the agencies without the benefit of the external post-auditors' perspectives, and some - but not all - of the issues in the Lottery's case were of this nature. However, the fundamental problem of late, inaccurate and incomplete financial reporting by the individual State agencies must be addressed as a preliminary matter. I am hopeful that the newly-formed Financial Reporting Standards Board will bring some resources to bear on this basic and long-standing problem.

Devoting an inordinate amount of time to financial reporting issues uncovered by the external post-audit process has allowed us to avoid issuing an unfavorable opinion on the Statewide financial statements. The cost of the decision to persevere in the audit process, however, is delay. Prevailing guidance among government auditors is that, to maximize their value, financial statement audits should be released within six months of fiscal year end. Illinois' Statewide financial audit has not been released less than ten months after fiscal year end in any of the last six years.

While in the past I have personally prioritized achieving a "clean" opinion on the Statewide financial statements over timeliness of the audit's completion, moving forward I will no longer delay our external post-audit process for an excessive amount of time. In the future, if there are any engagements for which my auditors are not receiving sufficient audit evidence in a timely manner, I will instruct that the audit be concluded, even if that conclusion ultimately results in the necessity of issuing a disclaimer or an adverse or qualified opinion on the Statewide financial statements.

I do not make this decision lightly, given that a less than favorable opinion on the Statewide financial statements would very likely result in a further downgrading of the State's bond rating.

The Fiscal Year 2012 Statewide financial statement audit was released today. I felt it was important to fully communicate my change in perspective as soon as possible in case it impacts how the various agencies move forward as we anticipate the conclusion of Fiscal Year 2013.

If you have any questions, please give me a call at 217/782-3536.

Yours truly,

WILLIAM G. HOLLAND
Auditor General

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PENSION CHANGES ARE COMING

The efforts to reform the seriously underfunded State pension systems have received widespread attention over the past several years. As of June 30, 2012, the unfunded actuarial accrued liability of the five State-funded pension plans totaled $94.6 billion.

There are, however, other significant pension changes coming which have received less attention. These are changes which have been adopted by the Governmental Accounting Standards Board (GASB) in Statement Nos. 67 and 68. Statement No. 67, *Financial Reporting for Pension Plans*, addresses financial reporting for state and local government pension plans, including Illinois' five State-funded pension plans. Statement No. 68, *Accounting and Financial Reporting for Pensions*, establishes new accounting and financial reporting requirements for governments that provide their employees with pensions. Statement No. 67 is effective in FY14 and Statement No. 68 is effective in FY15.

These two Statements will change how governments calculate and report the costs and obligations associated with pensions in important ways. The changes are designed to improve the usefulness of reported pension information and to increase the transparency, consistency, and comparability of pension information across governments. The Statements relate to *accounting and financial reporting* issues only – how pension costs and obligations are measured and reported in audited external financial reports. The Statements do not address how governments approach pension plan *funding* – a government's policy regarding how much money it will contribute to its pension plans each year.

Significant changes made by the two GASB pension Statements include requiring:

- The total net pension liability (the amount of liability that exceeds net assets) be reported in the government's financial statements.
- The use of the Entry Age Normal (EAN) actuarial cost method to assign costs to years of service. Prior GASB guidance allowed for the use of several actuarial cost methods, including EAN and Projected Unit Cost (PUC). Illinois law requires the five State-funded retirement plans to use the PUC method.
- The use of a lower discount rate if current and projected plan assets are insufficient to cover projected future benefits. This may significantly increase the plan's net pension liability.
- Discontinued use of the smoothing period (typically 5 years) to determine asset levels. The new Statements require the valuing of the assets at their market value.

The American Institute of Certified Public Accountants (AICPA) strongly supports GASB Statement Nos. 67 and 68. However, the AICPA's State and Local Government Expert Panel (SLGEP) has raised significant concerns related to the implementation of the new GASB standards. A key concern is how employer governments participating in both cost-sharing and agent multiple-employer plans will obtain sufficient appropriate evidence to recognize their individual pension amounts, including net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense. Also, the SLGEP is concerned how employer auditors will be able to obtain sufficient, appropriate evidence in order to opine on the pension amounts included in employer financial statements. The SLGEP is working on a number of proposed recommendations related to these matters. The SLGEP is concerned that the above identified matters may potentially lead to a significant number of modified auditor opinions on the employer financial statements. ■

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