

2005 Annual

ILLINOIS Audit ADVISORY

Emerging and Potential Audit Issues



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AUDITOR GENERAL

AUDITOR GENERAL'S MESSAGE

This year's Audit Advisory includes several articles on topics discussed in prior editions of the Advisory. The past year has demonstrated that additional emphasis needs to be placed on these areas. For example, problems continue with the timeliness and accuracy of agencies' year end financial reporting.

This issue of the Advisory also expands upon prior years' discussions of various contracting issues. Audits completed this year have demonstrated the need for agencies to improve their contracting controls. Also, the Comptroller issued Accounting Bulletins 123 and 124 which provide further contracting guidance.

As agency managers, we have immense responsibilities regarding the safeguarding of confidential information. The Advisory discusses safeguards over the disposal of both electronic and paper records.

Other articles discuss the need for State agencies to comply with the employee timekeeping requirements found in the State Officials and Employees Ethics Act; the types of additional fraud-related testing auditors are doing; and new guidance issued by the Governmental Accounting Standards Board on required deposit and investment risk disclosures.

As always, my Office looks forward to working with you in a cooperative manner during this current audit cycle.

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IMPROVEMENTS NEEDED IN AGENCIES' CONTRACTING PROCESSES AND CONTROLS

Agencies contract for services for a variety of different reasons. Specialized expertise may be needed or in-house staff resources may be insufficient to accomplish the required tasks. Whatever the reason, however, the contracting process must be adequately documented and follow prescribed requirements. Many audits released in fiscal year 2005 contained findings related to contracting deficiencies.

A major issue was the inadequate documentation and review of contractor expenses. During the course of performing their services, contractors may incur expenses for which the State has agreed to reimburse them. The contract should clearly delineate the acceptable types of expenses and the maximum amount of expenses the State will pay.

The contract should also require the contractor to submit detailed support for expenses claimed. Once the expenses are submitted, an agency employee with adequate knowledge of the services being performed should review the expenses, as well as the supporting documentation, for reasonableness. Agency staff should immediately follow-up if adequate documentation is lacking or expenses are questionable.

Other contracting issues addressed in audits released this year included:

- Documentation in procurement files was incomplete and/or inconsistent among procurements.
- Criteria not included in the RFP were used to evaluate proposals.
- The required notice was not published in the Procurement Bulletin when contracts were awarded to other than the lowest priced vendor.
- Vendors initiated work without a formal written agreement in place.
- Contracts were signed after the beginning of the contract period.
- Information on subcontractors was not included in contracts.
- Some contractor disclosure forms were incomplete.
- Contracts paid from locally held funds were not filed with the Office of the Comptroller.
- Monitoring of contractors was not effective. For example: Services were provided before the contract was signed and approved; no on-site monitoring was conducted; no specific measurable performance criteria were included in the contracts; and there was insufficient fiscal monitoring of contract payments.
- Required deliverables were not produced by the contractor.
- Multiple contracts with the same vendor were awarded without using a competitive bidding process, contacting more than one vendor, or publishing the solicitation or contract award as required.

Outsourcing activities and functions to a contractor does not relieve the agency of the responsibility to have adequate controls in place. Agency managers need to have policies and procedures to ensure that contractors are performing the work they are supposed to be doing, working the number of hours they are supposed to be working, and incurring expenses that are allowable, under the terms of the contract.

COMPTROLLER ACCOUNTING BULLETINS 123 & 124

On May 6, 2005, the Office of the Comptroller issued Accounting Bulletins 123 and 124 which imposed and reinforced legal and statutory requirements associated with certain aspects of contracting. Bulletin 123 provided guidance regarding the following:

Filing of all Contracts and Modifications

Reiterates that the Illinois Procurement Code requires that when a contract liability (except contracts paid from personal services and contracts between the State and its employees to defer compensation) exceeding \$10,000 is incurred by any State agency, a copy of the contract liability must be filed with the Comptroller's Office. If the contract is a professional and artistic contract, the filing threshold is greater than \$5,000. These requirements are not limited to contract liabilities incurred against State appropriations only. Contract liabilities incurred **against locally held funds** and imprest funds, as well as State appropriated funds, **must** be filed. Finally, the Bulletin notes that **all** modifications to any contract must be filed with the Comptroller's Office. **This requirement is applicable to all modifications, whether or not the modification is of a fiscal or non-fiscal nature.**

Execution of Contract Modifications after the Ending Date of the Contract

Notes that all modifications (including, but not limited to, extensions and renewals) to a contract must be executed prior to the ending date of the contract. Failure to properly execute a modification prior to the ending date of the contract will require the

agency to initiate a new contract. If both parties do not agree to the modification prior to the ending date of the contract, the contract is expired per its terms and may not be modified. However, if both parties agreed to the modification prior to the ending date of the contract but failed to reduce it to writing prior to the ending date of the contract, the Bulletin details a series of conditions that must be met before the Comptroller's Office will accept the modification.

Late Filing Affidavit

Details the Illinois Procurement Code requirements for late filing affidavits. Late filing affidavits are required when a contract has not been filed within 30 days of execution. After 30 days, the agency is required to file an affidavit, along with the contract, before the Comptroller will issue a warrant for payment against the contract. The Bulletin lists the required contents of the late filing affidavit, which include:

- A detailed explanation as to why the contract liability was not filed within 30 days of execution. Non-specific explanations that do not meet this requirement will be returned to the Agency. The use of stock phrases such as "administrative delays", without elaboration, will also be returned.
- The chief executive officer's signature or a signature of his/her designee.
- Notary signature and seal.
- One original and one copy of each affidavit.

Professional & Artistic Service Affidavit

States that when a contract for services involving professional or artistic services is not reduced to writing prior to the commencement of the contract, the Comptroller will refuse to issue a warrant for payment against the contract until the required Professional & Artistic Service Affidavit is filed. The Affidavit must contain a statement that the services were agreed to before the commencement of the services. Similar to the Late Filing Affidavit, the Professional & Artistic Affidavit must contain a detailed explanation why the contract liability was not reduced to writing before the services commenced. Non-specific explanations will not be accepted. The Bulletin contains other requirements of this Affidavit.

Finally, a number of agencies have been submitting affidavits combining both the Late Filing Affidavit and the Professional & Artistic Service Affidavit. **The Bulletin notes that the Comptroller's Office will no longer accept any combined affidavits.** Each affidavit must be presented separately and must contain all the required data elements and signature.

Comptroller Accounting Bulletin 124 introduces new requirements effective for fiscal year 2006 contracts. The Bulletin discusses signature authority requirements for specific documents. It also requires that all Late Filing Affidavits be sequentially numbered by the agency for each fiscal year. It contains a similar requirement for Professional & Artistic Services Affidavits. ■

EMPLOYEE TIMEKEEPING

The State Officials and Employees Ethics Act contains specific requirements regarding employee timekeeping. As noted in the box to the right, the Act requires that employees submit time sheets documenting the time spent each day on official State business to the nearest quarter hour.

In several audits completed this year, we found that employees did not maintain time sheets in compliance with the Act. In some instances, the State's payroll system was used to track employee time. However, payroll systems are typically "negative" timekeeping systems, whereby the employee is assumed to be working unless noted otherwise. No time sheets documenting the time spent each day on official State business to the nearest quarter hour were maintained for many employees. Agencies should review their timekeeping policies to ensure that they meet the requirements of the Act. ■

STATE OFFICIALS AND EMPLOYEES ETHICS ACT

c) . . . The policies shall require State employees to periodically submit time sheets documenting the time spent each day on official State business to the nearest quarter hour; contractual State employees may satisfy the time sheets requirement by complying with the terms of their contract, which shall provide for a means of compliance with this requirement. The policies for State employees shall require those time sheets to be submitted on paper, electronically, or both and to be maintained in either paper or electronic format by the applicable fiscal office for a period of at least 2 years.

5 ILCS 430/5-5(c)

GAAP REPORTING

During our audits of individual agencies for fiscal year 2004 we again noted a wide range of financial reporting issues. Among these issues were 47 findings for 23 agencies that were considered significant deficiencies in the internal controls over financial reporting.

These problems included:

- Material misstatements of liabilities.
- Inaccurate capital asset data.
- Inadequate segregation of duties.
- Deficient accounting systems and records.
- Noncompliance with trust indenture bond agreements.
- Payments from improper line item appropriations and funds.

- Lack of appropriate reconciliations to sub-systems and bank accounts.

During the fiscal year 2005 audits, the Office of the Auditor General will again give close scrutiny to financial reporting information and internal controls over financial reporting. In addition, audits will not be delayed for extensive periods due to the lack of timely accurate information supported with sufficient evidential matter. If auditors are precluded from performing procedures considered necessary in a timely manner, the Auditor General's Office will determine there is a limitation on the scope of the audit and the audit opinion will be qualified or a disclaimer of opinion will be issued.

GASB STATEMENT #40: DEPOSIT AND INVESTMENT RISK DISCLOSURES

Deposit and investment resources represent significant assets of certain State agencies. In March of 2003, the Governmental Accounting Standards Board (GASB) issued *Statement #40: Deposit and Investment Risk Disclosures*, which establishes additional reporting requirements for deposit and investment resources.

This Statement is designed to inform financial statement users about deposit and investment risks that could affect a government's ability to provide services and meet its obligations as they become due. This Statement addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. As an element of interest rate risk, this Statement requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates. Deposit and investment policies related to the risks identified in this Statement also should be disclosed.

The provisions of this Statement are effective for financial statements for periods beginning after June 15, 2004. Additional information concerning GASB Statement #40 can be found at GASB's website (www.gasb.org).

DISPOSAL OF CONFIDENTIAL INFORMATION

Agency managers and staff are routinely provided with and process data that contains sensitive or confidential data on individuals, businesses, and other entities. This information is provided to us with the expectation that it will be adequately safeguarded. We need to implement controls to safeguard and properly dispose of such information, and ensure that such controls are working effectively.

Electronic Information

To prevent the disclosure of confidential and sensitive data stored on electronic data processing equipment, including computers and any form of magnetic storage media, the Data Security on State Computers Act (20 ILCS 450) was established. The Act requires agencies to certify in writing that such equipment has been cleared of **all data and software** before being sold, donated, or transferred. Hard drives must be cleared of all data by overwriting previously stored data at least 10 times prior to being surplus, to prevent disclosure of sensitive or confidential information to unauthorized entities.

The Department of Central Management Services, Division of Property Control established procedures that require agencies to affix a label to equipment that has been cleared of all data. The label should contain the following information:

- Agency name.
- Serial number of equipment.
- Application used to clear all data.
- Name and signature of individual clearing data.
- Date clearing of data was performed.

On June 28, 2005, the Department of Central Management Services issued a memo reemphasizing the need for State agencies to comply with the Act and CMS guidance. The memo states that computer equipment either delivered to the CMS warehouse or picked up by CMS Property Control personnel that do not have visible certification labels will be rejected. Guidance is provided as to where the label should be placed on the equipment. The memo notes that this practice applies to any storage device (computer, PDA, server, copier, etc.) that has the ability to store data and requires software to operate.

State agencies should review their policies and procedures to ensure compliance with the Data Security on State Computers Act and associated Department of Central Management Services requirements.

Paper Records

Paper records may also contain confidential and sensitive information. Agencies that dispose of documents containing confidential or sensitive information in the regular trash or recycling bins without shredding them or otherwise eliminating the confidential information run the risk of such information being disclosed to third parties. Recent news articles disclosed instances where paper documents containing sensitive or confidential information were placed in dumpsters or found in other public locations. State agencies need to ensure that sensitive paper records are properly disposed (e.g., shredded) to prevent the disclosure of confidential information.

SAFEGUARDING E-MAILED INFO

The electronic transfer of information (including e-mail and attachments sent over the Internet) continues to expand and is becoming a preferred method to communicate and perform routine business functions. In some instances, this includes the transfer of confidential or sensitive information. Agencies should review internal practices and determine if confidential or sensitive information is being transmitted electronically. If it is, the agency should ensure that secure methods (such as encryption) are used to protect the information during transfer.

SAS 99: CONSIDERATION OF FRAUD IN A FINANCIAL STATEMENT AUDIT

The past audit cycle was the first year that *Statement on Auditing Standards (SAS) No. 99, Consideration of Fraud in a Financial Statement Audit*, issued by the American Institute of Certified Public Accountants, was implemented on OAG audits. SAS 99 was issued to improve an auditor's ability to meet fraud-related responsibilities during financial statement audits.

Agencies that were not audited this past year should expect and be prepared for changes as a result of this new auditing standard. The new standard establishes additional audit procedures to assist in the assessment of risk and to communicate fraud risk and known or suspected fraud. This standard also increases the auditor's responsibility for designing procedures to detect material misstatements in the financial statements and requires the auditor to work from the premise that a material misstatement could be the result of fraud. As a result, more extensive procedures will be performed and more audit documentation will be required.

Further, auditors will acquire new and revised written representations from management about fraud. Agency management should promptly inform auditors of all known fraud and/or the potential risk for fraud.

Auditors will make more extensive

PROFESSIONAL SKEPTICISM AND AUDIT EVIDENCE

SAS 99 requires auditors to maintain an appropriate level of "professional skepticism" throughout the audit. Professional skepticism is defined as "an attitude that includes a questioning mind and a critical assessment of audit evidence." The auditor is required to always consider that fraud could occur in any audit engagement.

An Audit Risk Alert published by AICPA noted that allowing management to influence the scope of audit procedures was a common characteristic of recent litigation related to fraudulent financial statements. Consequently, when management takes action that could be perceived as influencing audit procedures, such as limiting routine access to staff, sitting in on interviews, "cleaning" files before they are provided to auditors, or giving misleading or incomplete responses to auditors' inquiries, auditors' professional skepticism is raised. If the auditors conclude that such actions are inappropriately limiting the scope of the audit, then the auditors need to consider various actions, such as adding a scope limitation to the audit report or withdrawing from the engagement.

inquiries of all levels of agency personnel. These interviews and inquiries will be broader both from the perspective of the number and type of persons interviewed and from the perspective of the types of questions asked. Interviews specifically related to fraud and the potential risk of fraud will be conducted with agency management, agency financial personnel, and with other personnel not necessarily directly involved with finance or management. Consequently, agencies may want to prepare their personnel for the increased scrutiny associated with the new requirements of SAS 99 by discussing these changes with their personnel.

Agencies should be prepared for auditors to perform more unexpected or surprise procedures or perform different procedures at varying locations than may have been performed in the past. In

addition, auditors will review journal entries and other adjustments, accounting estimates that would impact financial statement amounts, and significant unusual transactions.

SAS 99 applies to financial audits being conducted by the Office of the Auditor General. Although SAS 99 does not apply to State compliance attestation engagements (previously referred to as financial-related or compliance audits), Chapter 6 of the revised Government Auditing Standards contains requirements relating to planning and detecting fraud, illegal acts, violations of provisions of contract or grant agreements, and abuse that could have a material effect on the subject matter. Thus, State compliance attestation auditors will be planning and conducting the work to comply with these Government Auditing Standards. ■

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