2006 Annual

ILLINOIS

Audit ADVISORY

Emerging and Potential Audit Issues

William G. Holland
AUDITOR GENERAL

AUDITOR GENERAL'S MESSAGE

One purpose of this Audit Advisory is to re-cap the results of recent audits so that agencies can anticipate and address deficiencies that have been identified by the auditors. Some deficiencies, such as a lack of timeliness and accuracy in financial reporting and failure to monitor grant subrecipients, represent areas that continue to be repeated as insufficient progress has been made. Other areas, such as the failure to adequately protect confidential information, are new or evolving issues that should be recognized and rectified by State agencies before they become significant problems.

Another purpose of this Audit Advisory is to highlight new accounting standards that will impact State government. For instance, effective in FY08, State agencies will have to comply with Governmental Accounting Standards Board (GASB) Statement No. 45: *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.* Essentially, Statement No. 45 will require governments to report the costs and obligations associated with health and other benefits similar to how they now report costs and obligations associated with pension plans. While Statement No. 45 allows employers to continue to fund these other postemployment benefits (OPEB) on a pay-as-you-go basis, under the new Statement employers will be forced to monitor and report on unfunded liabilities associated with OPEBs. As a result, governments with large unfunded OPEB liabilities may find their credit ratings and interest costs negatively affected.

Understanding this and other items in this Audit Advisory will be useful as you go about fulfilling your obligations related to financial reporting, internal controls and statutory compliance.

WILLIAM G. HOLLAND
September 2006

STATEWIDE SINGLE AUDIT FOR FY2005

Illinois implemented its Statewide Single Audit in FY2000. Circular A-133, issued by the federal Office of Management and Budget (OMB), requires the State to prepare an annual report of federal expenditures that includes all agencies that make up its "primary unit of government." Prior to 2000, the Auditor General's Office conducted individual single audits of State agencies receiving federal funds.

The State's FY2005 Statewide Single Audit reported that 43 agencies expended \$15.9 billion of federal financial assistance. The 2005 Single Audit examined 53 federal programs having expenditures totaling \$15.1 billion (or 95% of all federal funds). To illustrate the growth of the Statewide Single Audit program, the FY2000 Single Audit examined 41 federal programs expending \$10.5 billion of federal assistance, or 93% of the \$11.3 billion in federal funds received in FY 2000.

A myriad of factors have delayed the completion of the Statewide Single Audit in recent years. Many of these same factors have also resulted in delays in completing the Statewide financial statements. The Statewide financial statements need to be completed before the Schedule of Expenditures of Federal Awards (SEFA) can be finalized, which is the financial schedule included in the Single Audit reporting package submitted to the Federal Audit Clearinghouse.

Some of the factors that impact the timely completion of the Statewide Single Audit include:

- The number of programs not receiving an unqualified opinion (i.e., received either an adverse, disclaimer or a qualified opinion) has grown from 7 in FY2000 to 17 in FY2005. The total expenditures in FY2005 not having unqualified opinions totaled \$9.0 billion or 57% of the total SEFA expenditures of \$15.9 billion.
- Beginning in FY2003, the Single Audit's (and the State's financial statements for the State of Illinois) SEFA disclosed reportable conditions in internal control. Accuracy of the original amounts being reported by certain agencies to the State Comptroller in its annual GAAP package reporting process have multiple errors such as:
  - Incorrect Catalog of Federal Domestic Assistance (CFDA) numbers.
  - Incorrect program names or incorrect or missing information on the forms.

See SINGLE AUDIT on Page 2

COMMON SINGLE AUDIT FINDING: INADEQUATE SUBRECIPIENT MONITORING

One of the more prevalent findings pertains to agencies failing to fulfill their responsibilities as a "pass through" entity when issuing sub-grants. The FY2005 Single Audit included 24 findings related to this problem area. The issues cover items such as:

- Not using a risk assessment approach in their monitoring.
- Failure to monitor subrecipient cash management.
- Failure to timely review OMB Circular A-133 reports when received (or failure of subrecipients to provide reports).
- Not verifying if subrecipient has adequately determined its major programs.
- Not conducting programmatic and fiscal review (to include on-site visits).
- Failure to inform the subrecipient that the award includes a federal program, the CFDA #, and program name.

SINGLE AUDIT

Continued from page 1

- Failure to include the subrecipient payment amounts on the form.
- Information reported on the form does not agree with other information provided by the agency.
- Information does not agree with agency's grant award and/or grant award ledger.
- Listing of payments by subrecipient is either missing or does not agree with the amount reported on the form.

These inaccuracies are documented by changes made by the State Comptroller's Office in its review of the GAAP accounting forms and the OAG's annual financial audits and attestation engagements of state agencies.

- Agencies do not finalize certain spending allocations until 4 to 6 months after year-end. The delay in finalizing spending allocations results in delays in the State's completion of the financial statements and SEFA, as well as delays in completion of the Statewide Single Audit.
- Delays in receiving the final SEFA data file from State Comptroller of adjusted and/or corrected federal expenditures and information gathered during the financial statement preparation process and needed for compiling the SEFA. For example, the OAG did not receive the final FY2005 data file to compile the State's SEFA until May 16, 2006.

State agencies need to continue to work to address the issues identified above so that Illinois can timely report on its use of federal assistance. ■

NOTIFICATION REQUIREMENTS: PERSONAL INFORMATION PROTECTION ACT

Too frequently there are headlines about personal information being inappropriately disclosed by a private or governmental entity. State agencies routinely receive personal information as part of carrying out their programs. Along with the authority to receive personal and confidential information comes the responsibility to ensure it is adequately safeguarded and to prevent its unauthorized disclosure.

On January 1, 2006, the Personal Information Protection Act became effective. The Act requires notification of Illinois residents if the security over their personal information is breached (815 ILCS 530/). Public Act 94-947 recently amended the Act to establish requirements specifically for State agencies.

Per the Act, personal information means an individual's first name or first initial and last name in combination with any one or more of the following data elements, when either the name or the data elements are not encrypted or redacted:

1. Social Security number.
2. Driver's license number or State identification card number.
3. Account number or credit or debit card number, or an account number or credit card number in combination with any required security code, access code, or password that would permit access to an individual's financial account.

The Act states, *"Any State agency that collects personal information concerning an Illinois resident shall notify the resident at no charge that there has been a breach of the security of the system data or written material following discovery or notification of the breach."* The Act goes on to provide guidance as to how that notification should occur. The Act also requires that a State agency that has had a breach of security shall submit a report within five business days of the discovery or notification of the breach to the General Assembly listing the breaches and outlining any corrective measures that have been taken to prevent future breaches.

Finally, the Act addresses State agencies' safe disposal of information. The Act states, *"Any State agency that collects personal data that is no longer needed or stored at the agency shall dispose of the personal data or written material it has collected in such a manner as to ensure the security and confidentiality of the material."*

To prevent the disclosure of personal information (or any confidential information), we recommend that State agencies identify all personal and confidential data and ensure that it is properly secured. The Act promotes the redaction (delete or remove data; e.g., only retain the last 4 characters of a SSN) or encryption (translation of data into an unreadable format) of such information. Information on the State's Digital Signature (encryption) project can be found at http://www.illinois.gov/pki/. ■

PAYMENT CARD INDUSTRY (PCI) DATA SECURITY STANDARDS

State agencies increasingly accept credit cards (or other payment cards) from the public to perform routine payment transactions. Recent news stories have called attention to the rising incidence of stolen cardholder data. To combat this growing problem, the Payment Card Industry (PCI) Data Security Standards were developed to govern the safekeeping of account information.

The following are some of the requirements of the PCI Data Security Standards:

- Build and maintain a secure network.
- Protect cardholder data.
- Maintain a vulnerability management program.
- Implement strong access control measures.
- Regularly monitor and test networks.
- Maintain an information security policy.

The PCI Data Security Requirements apply to all entities that store, process, or transmit cardholder data. Cardholder data is any personally identifiable data associated with a cardholder. Thus, State agencies that accept payment cards (even if they use a service provider and do not store, process, or transmit data) have a responsibility to ensure that cardholder data is protected in conformance with the Security Standards.

To ensure cardholder data is adequately protected, State agencies should:

- Ensure it protects data in conformance with PCI Data Security Standards if it stores, processes or transmits cardholder data.
- Obtain security assurance documentation, at least annually, from any service provider it uses, to confirm their compliance with PCI Data Security Standards.

If personal information is disclosed, the notification requirements of the Personal Information Protection Act would apply. ■

NEW RISK ASSESSMENT AUDITING STANDARDS

The AICPA's Auditing Standards Board (ASB) has issued eight Statements on Auditing Standards relating to the assessment of risk in an audit of financial statements. These new statements, SAS No. 104 through SAS No. 111, will be effective for audits of financial statements for periods beginning on or after December 15, 2006. The Statements establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement (whether caused by fraud or error) in a financial statement audit; design and performance of tailored audit procedures to address assessed risks; audit risk and materiality; planning and supervision; and audit evidence.

The primary objectives of these Standards are:

- A more in-depth understanding of the entity and its environment, including its internal control.
- A more rigorous assessment of the risks of where and how the financial statements could be materially misstated.
- Improved linkage between the auditor's assessed risks and the nature, timing and extent of audit procedures performed in response to those risks.

The Statements represent part of the ASB's ongoing effort to develop stronger and more specific auditing standards that are intended to enhance auditor performance and to improve audit effectiveness.

ASSESSING NEW ACCOUNTING STANDARDS

Over the past several years, State agencies have had to implement various new accounting standards issued by the Governmental Accounting Standards Board (GASB). In implementing these standards, agencies have encountered a variety of issues that often negatively impacted the financial reporting process, such as delays in finalizing financial reports.

To improve the financial reporting process, agencies should implement formal policies and procedures for assessing the effect future financial reporting changes will have on the agency's financial reporting process. The policies should address the responsibility for assessing the impact of the standards, required documentation, and an implementation plan. The appropriate upper management personnel should conduct a formal review and approval of the assessment and implementation plan.

Such assessments should not only include GASB statements with future effective dates, but also exposure drafts. Agencies should also periodically review current GASB projects and the GASB technical plan to determine the status of items that may have a significant impact on the Agency's financial reporting process. The technical plan, exposure drafts and GASB project information are available via the "Technical Issues" link on the GASB web-site (www.gasb.org).

RECENTLY ISSUED GASB STATEMENTS

The Governmental Accounting Standards Board (GASB) has issued the following Statements that are applicable to the FY06 audit period:

- GASB Statement No. 40, *Deposit and Investment Risk Disclosures,* an amendment to GASB Statement No. 3. Effective for financial statements for periods beginning after June 15, 2004.
- GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries.* Effective for financial statements for periods beginning after December 15, 2004.
- GASB Statement No. 44, *Economic Condition Reporting: The Statistical Section – an amendment of NCGA Statement 1.* Effective for financial statements for periods beginning after June 15, 2005.
- GASB Statement No. 46, *Net Assets Restricted by Enabling Legislation, an amendment of GASB Statement No. 34.* Effective for financial statements for periods beginning after June 15, 2005.
- GASB Statement No. 47, *Accounting for Termination Benefits.* For benefits provided through Defined Benefit Plans - implement with GASB Statement No. 45, all other termination benefits effective for financial statements for periods beginning after June 15, 2005.

These GASB Statements are applicable to future audit periods:

- GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans.* Effective for financial statements for periods beginning after December 15, 2005 (Phase I government).
- GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.* Effective for financial statements for periods beginning after December 15, 2006 (Phase I government).

RECENT FINDINGS *Continued from page 4*

Information Systems

- No written policies and procedures existed related to systems development by external developers and to assure that all systems were consistently developed, thoroughly tested, and adequately documented.
- An adequate and tested comprehensive disaster contingency plan did not exist to ensure critical computer systems can be recovered in the event of a disaster.
- Independent reviews of an externally controlled computerized system were not obtained.
- Procedures for the disposal of confidential information were inadequate.

Timekeeping/Personnel

- Prior approval of all overtime worked was not documented.
- Employees' time spent on official State business was not adequately documented as required by the State Officials and Employees Ethics Act.
- Employee performance evaluations were not conducted on a timely basis.

Vehicles

- Agency employees were assigned State vehicles without documentation of a business need.
- Adequate records for State vehicles assigned to employees were not maintained.

GASB STATEMENT #45

In June 2004, the Governmental Accounting Standards Board (GASB) issued Statement #45: *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*, which establishes standards for the measurement and recognition of Other Post-Employment Benefits (OPEB)expenditures. Typically, OPEB includes post-retirement healthcare (health, prescription, vision, and dental coverage) as well as life insurance programs. Overall, this Statement will align the recognition of these other benefits with the recognition standards in effect for pension/retirement plans.

In current practice, most OPEB plans are financed on a pay-as-you-go basis (paying an amount equal to the benefits distributed or claimed that year) and financial statements, therefore, do not report the financial effects of OPEB until the costs of the benefits are actually paid. Furthermore, most governments typically report only their cash outlays for OPEB in a given year rather than the cost to the employer of OPEB attributed to services received in that year from employees.

Under the new standard, governmental entities will be required to report annual OPEB costs, based on actuarial studies, for the first time. Governmental entities will need to utilize actuaries in order to determine required annual OPEB payment amounts, known as an annual required contribution, based on a number of factors including the number of retirees and any past unfunded amounts. If the annual required contribution is not paid, the government will have to recognize a liability known as a 'net OPEB obligation' in its government-wide financial statements.

The net OPEB obligation amount can increase rapidly over time if the amounts paid for OPEB are less than the annual required contribution. In addition to requiring financial statement changes, the standard requires a number of new footnote disclosures to the government-wide financial statements including plan descriptions, funding policies, annual OPEB costs and information about the funded status of the plan.

GASB #45 is effective for the State of Illinois' financial statements beginning in FY08. Additional information about GASB Statement #45 can be found at GASB's website (www.gasb.org). ■

RECENT AUDIT FINDINGS

One of the purposes of the Audit Advisory is to inform agency managers of findings that are occurring at other agencies, so that action can be taken to correct these matters before they become problems at your agency. The following are some findings in audits released by the Office of the Auditor General in 2006 that address issues that many agencies face.

Contracts:

- Written contracts were not timely executed after the announcement of the awards; vendors were allowed to initiate work without a formal written agreement in place.
- Information on subcontractors was not included in the contract.
- Notice of contracts awarded to a vendor that was not the lowest priced proposer was not published in the Procurement Bulletin as required by the Procurement Code for professional and artistic contractors.
- Professional services contracts in excess of $20,000 were not bid.
- Certain contracts and leases were not filed as required with the State Comptroller's Office.
- All required certifications were not included in State contracts.
- Documentation to adequately support payments made to contractors was not obtained and maintained, and expenditures submitted for payment were not adequately reviewed.

Financial Reporting

- Support for amounts reported in its Generally Accepted Accounting Principles (GAAP) packages was not provided timely and some estimated amounts differed materially from actual amounts.
- Reconciliation of expenditure and fund records to the Illinois Office of the Comptroller records was not timely or accurate.
- Weaknesses existed in procedures related to reviewing final grant expenditures reported by providers and the subsequent recovery of unspent grant funds.

See RECENT FINDINGS on Page 3

Office of the Auditor General

- Iles Park Plaza, 740 East Ash Street
  Springfield, Illinois 62703-3154
- Michael A. Bilandic Building,
  160 N. LaSalle Street, Suite S-900
  Chicago, Illinois 60601-3109

Phone: 217-782-6046
Fax: 217-785-8222
TTY: 1-888-261-2887
E-mail: auditor@mail.state.il.us
Website: www.state.il.us/auditor