STATE OF ILLINOIS

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, 2007

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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 R. Blogojevich, Governor
Honorable Daniel Hynes, Comptroller

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of Illinois as of and for the year ended June 30, 2007 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 25, 2008. 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 for the purpose of expressing an opinion on the effectiveness of the State of Illinois' internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the State of Illinois' internal control over financial reporting.

Our consideration of the internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the deficiencies described as findings 07-1 and 07-2 in the accompanying schedule of findings to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, of the significant deficiencies described above, we consider finding 07-1 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 25, 2008.

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*.

The Office of the Comptroller's responses to the findings identified in our audit are described in the accompanying schedule of findings. We did not audit the Office of the Comptroller's response and, accordingly, we express no opinion on it.

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

Springfield, Illinois
June 25, 2008

07-1. **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 generally accepted accounting principles (GAAP). Below is a description of problems noted.

Restatements – Correction of Errors

The financial statements have been restated as of July 1, 2006 for the following prior reporting errors:

- Overstatement of accumulated depreciation of several buildings which are a part of the Capitol complex used for governmental activities.

- Overstatement of sales and public utility tax revenues in the General Fund and understatement of assets and amounts due to local governments in the Home Rule Municipal ROT Fund and the Municipal Telecommunications Fund, agency funds.

- Understatement of education expenditures in the General Fund.

Generally accepted accounting principles and the Statewide Accounting Management System (SAMS Procedure 03.30.40) requires, for financial reporting purposes, the depreciation of capital assets over the estimated useful life of the asset. Good internal control procedures require adequate management oversight and review of accounting policies and procedures.

Good internal controls over financial reporting would require tax allocation methodologies and fund balances to be monitored on a continual basis in order to detect errors and irregularities timely.

Misstatements Identified by Auditors

The following misstatements were noted by the auditors:

- Investments in commercial paper of $98.7 million were misclassified as cash equivalents for investments held in the State Treasury.

- Adjustments were made to the Road Fund and the State Construction Account to correct errors in accounting for liabilities and revenues for federal reimbursements. The Road Fund adjustments increased assets $37 million, liabilities $124 million and expenditures $74 million and decreased revenues $13 million and fund balance $87 million. The State Construction Account adjustments increased liabilities and expenditures $2 million and decreased fund balance $2 million.

- Total adjustments were made to the Water Revolving Fund of $7.5 million to correct account classification errors for restricted net assets for debt service ($1.9 million) and restricted interest receivable ($5.6 million).

- Numerous errors/adjustments were identified during the audit of the Illinois Designated Account Purchase Program (IDAPP). The errors noted related to incorrect account classifications and inaccurate disclosures.

Governmental Accounting Standards Board Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, states that generally, only investments with original maturities of three months or less meet the definition of cash equivalents. Generally accepted accounting principles require revenues and liabilities to be recognized in the accounting period in which the liability is incurred. Lastly, generally accepted accounting principles require amounts to be appropriately classified in the financial statements.

<u>Internal Service Funds</u>

The following internal control issues related to internal service funds were noted by the auditors:

- Advance billings were not in compliance with Illinois Administrative Code;
- Pursuant to an interagency agreement, workers' compensation claims of approximately $20 million were paid from the internal service fund designated for Health Insurance Reserve fund and not the Workers' Compensation Revolving Fund; and
- Insufficient supporting documentation for consolidated services billings.

The Illinois Administrative Code allows advance billings based on estimated charges for goods and services to be received by the Agency during the year. The Code prohibits advance billings that create undocumented credit balances or intentionally circumvent fiscal year limitations. (74 Ill. Adm. Code 1000.20 -.30) The Intergovernmental Cooperation Act prohibits agencies from entering into an agreement if the agreement's intent or effect is to circumvent any limitation established by law on State appropriation or State expenditure authority with respect to health care and employee benefit contracts. (5 ILCS 220/4.5) Good internal controls require adequate supporting documentation to determine the legality and propriety of transactions.

<u>Unemployment Compensation Trust Fund</u>

An independent internal control review of bank trustees involved with the processing of cash receipts and other data for the Unemployment Compensation Trust Fund was not obtained. Without such review there is not adequate assurance that information system controls to prevent errors or irregularities are established.

Good internal controls require that third party service providers arrange to have a periodic independent review of internal controls placed in operation and issue a report on the results of this review commonly known as a SAS70 report.

Illinois Designated Account Purchase Program & Illinois Prepaid Tuition Trust

Timely internal audits were not performed for the following areas (last FY audited):

- Revenues, Cash Receipt & Payment Posting (FY2005)
- US Department of Education – Reporting of Due Diligence:
    a. General (FY2004)
    b. Default Prevention (FY2004)
    c. Default Collection (FY2004)

Good business practice requires that significant internal controls be periodically evaluated and assessed to determine that the controls are sufficient and operating effectively.

Deficiencies in internal controls allowed errors in the preparing of financial information to go undetected by management, in the normal course of performing their assigned functions. These inaccuracies resulted in delays in completing audits and issuing audited 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 statewide system would exceed $100 million. It is currently each State agency's Chief Executive Officer who maintains statutory responsibility for the proper function of accounting and other operating policies of the Officer's agency. (Finding Code No. 07-1, 06-1, 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 to 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

IOC will continue to attempt to work with the Governor's Office of Management and Budget, the Illinois Office of Internal Audit, and the various agencies identified in this finding to resolve this matter.

07-2. **FINDING** (Delays in Financial Reporting)

The Statewide financial statements for the year ended June 30, 2007 were not finalized timely.

Certain disclosures (long-term debt) were available for audit in October, 2007. However, the majority of the CAFR was not made available to audit until March, 2008. Reporting issues at various individual agencies caused further delays in finalizing the financial statements which did not occur until June, 2008.

Additionally, the State was not in compliance with annual financial reporting requirements set forth in continuing disclosure undertakings. We noted that audited or unaudited financial statements were not submitted with annual financial information submitted to repositories as required by the continuing disclosure undertakings for 18 (100%) of the bond issues tested during the audit period.

Continuing disclosure undertakings require the State to submit annual financial information to each repository within specified timelines which ranged from 210 to 270 days after the end of the fiscal year. The State is required to submit audited financial statements to each repository at the same time. However, if audited financial statements are not available at the time the annual financial information is filed, unaudited financial statements are required to be filed, and audited financial statements are to be filed when available.

Concepts Statement of the Governmental Accounting Standards Board (GASBCS 1, paragraph 66) states, "if financial reports are to be useful, they must be issued soon enough after the reported events to affect decisions."

In discussing these conditions with IOC personnel, they indicated delays 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 request submission of financial information but does not have the ability to enforce submission. In order for the State of Illinois to have financial statements in accordance with generally accepted accounting principles for the year ended June 30, 2007, the State needed to implement GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. IOC did not receive actuarial reports necessary to implement GASB Statement No. 43 from the Department of Healthcare and Family Services until after the close of business on March 4, 2008.

Delays in financial reporting decrease the usefulness of such information and affect the State's ability to comply with continuing disclosure requirements. (Finding Code No. 07-2)

RECOMMENDATION

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

AGENCY RESPONSE

The IOC will continue to work with State agencies to ensure such agencies' financial transactions are properly reported in a timely manner in order that annual financial information is available for each repository within specified timelines.

PRIOR FINDINGS NOT REPEATED

07-3. **FINDING** (Inefficient Accounting System)

During the prior audit, we noted 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. (Finding Code No.06-2, 05-2, 04-2, 03-2)

Finding is not repeated. This issue has been reported to the IOC the last four audits and the IOC had deemed that a significant change to its methods for compiling financial information would not be economically practical. We did not note errors or misstatements that were directly related to the system used by the IOC to compile the State's financial statements.

07-4 **FINDING** (Failure to identify major fund)

During the prior audit, we noted the Illinois Office of the Comptroller (IOC) did not have adequate controls for identifying major funds for inclusion in the Comprehensive Annual Report (CAFR). During testing, we noted the IOC did not properly identify and separately report a major fund – the Prepaid Tuition Trust Fund – in the CAFR. (Finding Code No.06-3)

Finding is not repeated. Our current testing results concluded the IOC properly identified and separately reported each major fund.