2004 Annual

ILLINOIS

Audit ADVISORY

Emerging and Potential Audit Issues

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AUDITOR GENERAL

AUDITOR GENERAL'S MESSAGE

Important audit-related changes have occurred over the past year. New auditing standards have been adopted that impact governmental auditors, including the Office of the Auditor General. In addition, a new standard adopted by the American Institute of Certified Public Accountants addresses consideration of fraud in a financial statement audit and requires additional audit procedures. This issue of the Advisory highlights these recent changes in audit standards.

With the establishment of the Illinois Office of Internal Audits, the structure of internal auditing has changed. What has not changed, however, is that agency management continues to be responsible for establishing an effective system of internal controls over agency operations. The Audit Advisory discusses this management responsibility, as well as the various representations that management is required to make to auditors.

Unfortunately, another important audit-related issue has not changed this past year. Agencies continue to experience significant problems in their financial reporting in accordance with GAAP, resulting in the need for increased audit testing and delays in completion of audits. Agency management needs to aggressively address these reporting issues.

WILLIAM G. HOLLAND
September 2004

DEFICIENCIES CONTINUE IN FINANCIAL REPORTING IN ACCORDANCE WITH GAAP

During our audits of individual agencies for fiscal year 2003, we continued to note a wide range of financial reporting errors and noncompliance with the Illinois Office of the Comptroller's accounting and reporting policies. Our audits had 41 findings at 17 agencies that were considered significant deficiencies in the internal controls over financial reporting. These problems included:

- inaccurate, incomplete, and untimely GAAP forms;
- late revisions to federal expenditure information;
- inadequate segregation of duties;
- inaccurate calculations of federal grant receivables;
- improper revenue recognition;
- noncompliance with trust indenture bond agreements;
- lack of appropriate reconciliations to sub-systems and bank accounts; and
- improper valuations of inventories.

These problems had a widespread impact, including increased audit testing and delays in completion of audits. During upcoming audits, the Office of the Auditor General will again give close scrutiny to State agencies' financial reporting information and internal controls over financial reporting.

In addition, **upcoming 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. ■

CHANGES IN AUDIT STANDARDS AND THE ILLINOIS STATE AUDITING ACT

In 2003, the Comptroller General of the United States revised the Government Auditing Standards (GAS). These revisions include widespread changes and are generally effective for audits beginning January 1, 2004.

The revision makes changes to these standards in the following three areas: 1) redefining the types of audits and services covered by the standards, including adding attestation as a separate type of audit; 2) providing consistency in the fieldwork and reporting requirements among all types of audits defined under the standards; and 3) strengthening the standards and clarifying the language in areas that, by themselves, do not warrant a separate amendment to the standards.

One of the more significant changes was the elimination of the term "financial related audits." Further, the new Government Auditing Standards expressly incorporate, for the first time, attestation engagements as a separate type of audit. Attestation engagements are services

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SAS 99: CONSIDERATION OF FRAUD IN A FINANCIAL AUDIT

In October 2002, the American Institute of Certified Public Accountants issued Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit*. The standard was issued to improve an auditor's ability to meet fraud-related responsibilities during financial statement audits. It is effective for fiscal year 2004 OAG financial audits.

Fraud is not limited to the private sector, but affects governments as well. Because audits of state and local governments performed under the GAO Yellow Book standards (GAGAS) incorporate the AICPA fieldwork and reporting standards, SAS 99 applies to the audits of the financial statements of state and local governments. There are two types of fraud that result in misstatements that are relevant to financial audits: misstatement arising from fraudulent financial reporting, and misstatement arising from the misappropriation of assets.

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. State agencies should expect and be prepared for changes to financial statement audits as a result of this new auditing standard.

Further, auditors will be required to acquire certain new and revised written representations from management about fraud. 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.

Auditors are now required to:

- Make more extensive 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. Auditors are required to ask questions that pertain not only to fraud that may be occurring, but that pertain to the risk that fraud may occur;
- Consider any unusual or unexpected relationships resulting from analytical procedures performed that may indicate an increased risk of fraud;
- Consider identifiable fraud risk factors that may exist, including incentives and pressures, opportunities, and attitudes and rationalizations; and
- Conduct brainstorming sessions among audit team members prior to or in conjunction with the information gathering procedures described above to aid in identifying potential fraud risk. Such sessions may be conducted multiple times during the course of the audit.

Based on the results of information gathered while conducting the above procedures, auditors will respond to any fraud risk identified by altering the nature, timing and extent of procedures to be performed. State 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 is effective for financial audits being conducted by the Office of the Auditor General this year. 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 of 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 new Government Auditing Standards. ■

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performed under the AICPA's Attestation Standards and the related Statement on Standards for Attestation Engagements. The revised Government Auditing Standards spell out the additional fieldwork and reporting standards for compliance with Generally Accepted Government Auditing Standards (GAGAS). For many years, Illinois State Compliance audits were performed under the umbrella of "financial related audits." Thus, this change had an immediate impact on the operations of the Illinois Office of the Auditor General.

An amendment to the Illinois State Auditing Act became necessary to address the revisions made to Government Auditing Standards. Public Act 93-630 made the appropriate changes. These changes, among other things, incorporated attestation engagements as a type of compliance audit. Further, the Act was amended to address agency management representations, assertions, and supporting evidence on various compliance matters and internal controls.

What does this all mean for State agencies? Overall, management officials and fiscal personnel at State agencies should not see a major change in how the Office of the Auditor General interacts with them on a day-to-day basis to perform our audit work. However, in accordance with the new standards, representations and assertions will be required from agency management. Further, certain auditor reports on compliance and internal control will be revised to address required technical changes.

COMMON FINDINGS FROM AUDITS

One purpose of the Audit Advisory is to discuss recent audit findings. If similar deficiencies are prevalent within your agency, corrective action can be taken to address the problem before it becomes an audit finding. The conditions listed below resulted in findings from audits conducted by the Office of the Auditor General during fiscal year 2004. Take a few minutes to review the list of conditions and determine if your agency has any problems that need to be addressed.

Monitoring of Grants
- Adequate documentation was not maintained for grant agreements;
- Monitoring of grantee use of funds was not performed;
- Financial information was not obtained by the grantor to evaluate activity;
- The grant agreement did not establish performance measures or quantifiable goods;
- No written formal procedures or rules existed for the grant program; and
- Grant compliance audits were not performed on an annual basis.

Contracts
- The contractor began working before the contracts were reduced to writing;
- Contracts were not filed with the Comptroller on a timely basis;
- Contractors providing services were insufficiently monitored;
- No specific measurable criterion was written in contracts to evaluate contractor performance; and
- Insufficient fiscal monitoring of contract payments existed.

Controls Over Property and Equipment
- Property items purchased were not added to the property records in a timely manner;
- Capital assets were incorrectly adjusted in the property records;
- Items were inadvertently deleted from property records;
- Property items on record could not be located;
- Physical inventory counts were not performed on a periodic basis;
- Property records lacked information such as cost, acquisition date, or location of property and equipment;
- Property and equipment listing did not contain acquisition date or cost; and
- Report of State Property (C-15) was not properly completed.

Timekeeping Controls
- Noncompliance with overtime and compensatory time policies and procedures;
- Weaknesses in timekeeping system for temporary employees;
- No written documentation of when employees began and ended their workday;
- Required forms such as Form I-9 and employment verification were not completely filled out;
- Time clocks did not function correctly;
- Alterations were made to employees' timesheets with no notation or documentation as to why the hours were changed or who approved changes; and
- Employees worked overtime without prior approval from supervisor.

AWARENESS AND COMPLIANCE WITH THE *DATA SECURITY ON STATE COMPUTERS ACT*

Public Act 93-0306 (Data Security on State Computers Act) requires agencies to develop policies and certify in writing that all electronic data processing equipment has been cleared of all data and software before being sold, donated, or transferred.

The Dept. of Central Management Services, Division of Property Control, established procedures that require agencies to affix a label to equipment that have been cleared of all data. The label should be placed on the left-hand face side of a desktop processor and on the topside cover of a laptop and contain the following information:

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

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

AGENCY MANAGEMENT REPRESENTATION LETTERS

As part of a financial audit or a compliance attestation engagement, agency directors are required to sign a management representation letter. In the letter, agency management is giving the auditor important representations about the operations of the agency. These include areas such as completeness of financial records, adequacy of internal controls, and compliance with laws and regulations.

By signing the representation letter, management is asserting that management is knowledgeable in the matters referenced in the letter, and that management has appropriately informed the auditors of all of the conditions delineated in the letter. As such, even though signing the representation letter may be a routine action, signing the letter should not be taken lightly.

The representation letter, and the assertions management is making, cover important aspects of an agency's operations and include:
- The agency has made available to the auditors all financial records and related data;
- All material transactions have been recorded in the accounting records;
- There are no undisclosed violations or possible violations of laws or regulations whose effects should be considered for disclosure in the basic financial statements or as a basis for recording a loss contingency;
- There are no significant deficiencies in the design or operation

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MANAGEMENT'S RESPONSIBILITY FOR INTERNAL CONTROLS

With the consolidation of most of the State's internal auditors into the Illinois Office of Internal Audits, pursuant to Executive Order Number 10, a question that has been asked is, "How will this impact the Office of the Auditor General's testing of internal controls at State agencies?" In the past, our audits have reviewed – and in many instances relied on – the work the agency's internal auditors performed on internal controls. To the extent that the new Illinois Office of Internal Audits has conducted, or is in the process of conducting, audits at agencies the Office of the Auditor General is auditing, we will continue to review the testing done and, if possible, place reliance on that work.

However, agency management has always been, and continues to be, responsible for ensuring that an adequate system of internal controls has been established within the agency and that the system is properly functioning. This was true prior to the consolidation of internal auditors, and it remains true after the consolidation. Consequently, our audits will continue to examine an agency's internal controls and will hold agency management accountable for establishing and maintaining an effective system of internal controls.

AUDITOR GENERAL'S OFFICE RECEIVES AWARDS

In June 2004, the Auditor General's Office was awarded the first-ever **Excellence in Accountability Award** by the National State Auditors Association (NSAA) for our Management Audit of the Illinois State Toll Highway Authority.

NSAA established the Excellence in Accountability Awards Program last year to recognize outstanding performance audits and special projects. The Office's report was one of two winning entries selected from 16 submissions by audit organizations across the nation.

Also in June, the National Conference of State Legislatures' National Legislative Program Evaluation Society (NLPES) presented the Auditor General's Office with a **Certificate of Recognition of Impact** for our Tollway Management Audit.

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of internal controls which could adversely affect the agency's ability to record, process, summarize, and report financial data, and that the agency has not identified any material weaknesses in internal controls;

- There has been no fraud involving management or employees who have significant roles in internal control, or fraud by others that could have a material effect on the financial statements; and
- Related party transactions, such as leasing arrangements, purchases, and loans, have been properly recorded or disclosed in the financial statements.

In addition to management representation letters, at the conclusion of the compliance attestation examination, the Office will obtain a written assertion letter from agency management. In this letter, management asserts that it has performed an evaluation of, and that the agency has materially complied with, several matters. More specifically, management shall assert that funds have been obligated, expended, received and used in accordance with the purpose for which such funds have been appropriated or otherwise authorized by law; that State revenues and receipts collected are in accordance with applicable laws and regulations; and that the accounting and recordkeeping of such revenues and receipts are fair, accurate and in accordance with law.

The management assertion letter will be included in the compliance attestation report issued by the Office of the Auditor General.

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