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ILLINOIS Audit ADVISORY

Emerging and Potential Audit Issues

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AUDITOR GENERAL

AUDITOR GENERAL'S MESSAGE

Timely and accurate financial information is essential for State leaders to make informed decisions regarding the State's finances. In times of financial difficulties, the need for timely financial information becomes even more critical. Unfortunately, financial reporting in Illinois in recent years has become increasingly less timely.

This edition of the Audit Advisory discusses Illinois' recent experience in financial reporting and what must be done in the future to improve it. Included are excerpts from a finding related to the State's Comprehensive Annual Financial Report (CAFR) that details financial reporting problems that face the State.

Also included is a discussion of the American Recovery and Reinvestment Act of 2009 (ARRA) which provides significant new revenue to the State, but also provides significant new challenges regarding the reporting and oversight of those funds. Finally, increased pressure from the federal government for even shorter time frames in which to complete the State's Single Audit – which impacts both State agencies and the Office of the Auditor General – is examined.

As those responsible for the accounting, reporting, and auditing of the State's financial information, we share responsibilities to ensure that our work is completed in a timely manner. It will take increased efforts on all of our parts to effectively address this issue.

WILLIAM G. HOLLAND
September 2009

FUNDAMENTAL DEFICIENCIES STILL IMPACT TIMELY FINANCIAL REPORTING

The State of Illinois' current financial reporting process does not allow the State to prepare a complete and accurate Comprehensive Annual Financial Report (CAFR) or the Schedule of Expenditures of Federal Awards (SEFA) in a timely manner. Reporting issues at various individual agencies caused the State's financial statements to not be finalized until June of the subsequent year, in each of the past two fiscal years.

Problems with accurate and timely financial reporting continue to exist even though the auditors have: 1) continuously reported numerous findings on the internal controls (material weaknesses and significant deficiencies); 2) commented on the inadequacy of the financial reporting process of the State; and 3) regularly proposed adjustments to financial statements year after year. These findings have been directed primarily toward the Office of the State Comptroller and major State agencies under the organizational structure of the Office of the Governor.

The State has not been able to solve these problems or make substantive changes to the system to effectively remediate these financial reporting weaknesses. The process is overly dependent on the post audit program being a part of the internal control for financial reporting even though the Office of the Auditor General continues to inform State agency officials that the post audit function is not and should not be an internal control mechanism for any operational activity related to financial reporting.

The State of Illinois has a highly decentralized financial reporting process. The system requires State agencies to prepare a series of complicated financial reporting forms (SCO forms) designed by the Comptroller's Office to prepare the CAFR. For the most part, these SCO forms are completed for each of the State's 786 active funds. The forms are completed within each State agency by accounting personnel who have varying levels of knowledge, experience, and understanding of generally accepted accounting principles (GAAP) and of the State's accounting policies and procedures.

Agency personnel involved with this process are not under the organizational control or jurisdiction of the Comptroller's Office. Further, these agency personnel may lack the qualifications, time, support, and training necessary to timely and accurately report year end accounting information to assist the Comptroller's Office in the preparation of the statewide financial statements in accordance with GAAP.

Although the deficiencies relative to the CAFR and SEFA financial reporting processes have been reported by our Office for a number of years, problems continue with the State's ability to provide accurate and timely external financial reporting. Corrective action necessary to remediate these deficiencies continues to be problematic.

In discussing these conditions with the Office of the Governor, they stated the lack of an automated accounting system and decentralized agencies with over 100 separate financial systems results in wide and varied controls instead of a uniform set of controls to carry out the accounting policy set by the Comptroller's Office.

The Comptroller's Office, to some degree, would have the ability to better analyze the financial activities of State agencies from a financial reporting

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AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009

On February 17, 2009, the President signed into law the American Recovery and Reinvestment Act of 2009 (ARRA). The Act is expected to provide the State of Illinois with over $9 billion in additional direct funding from the federal government for infrastructure, fiscal stabilization, and other programs over the next several years. ARRA is designed to create or save jobs, and invest in science, health care, transportation, education, and energy efficiency.

While ARRA provides critical funding to the State of Illinois, it has serious implications for the State agencies that administer these funds, as well as the Office of the Auditor General which is responsible for auditing those funds.

Some of the ARRA funds will be for new programs; in other cases, the funding will supplement or expand existing programs. For new programs, agencies may need to establish a new system of internal controls over the receipt and disbursement of these funds. For existing programs, internal controls should already be in place, but new or additional controls may be needed if the funding is significantly greater than current funding, or if new program requirements are added.

Since a main purpose of ARRA is job retention and creation, agencies need to also ensure that accurate and reliable tracking and reporting mechanisms are established. These significant new responsibilities to State agencies come at the same time agency budgets are being cut and headcount is being reduced.

A cornerstone of the ARRA funding is a strong emphasis on accountable and transparent use of these funds. The expenditure of the ARRA funds, along with the outcomes of such expenditures, (such as jobs retained or created) will be closely scrutinized by various entities. The federal Government Accountability Office (GAO) is taking a lead role in overseeing these accountability efforts. The GAO selected 16 states for detailed review and monitoring of the use of the ARRA funds. These states contain about 65 percent of the U.S. population and are estimated to receive about two-thirds of the intergovernmental grant funds available through the Recovery Act. Illinois was one of the 16 states selected for the GAO's ongoing analysis.

The Inspector General offices in the various federal agencies administering the ARRA funding will also be very active participants in overseeing the use of the ARRA funding.

While these federal entities will be doing their own auditing, monitoring, and reporting, they are also relying heavily on the audit work done by the Auditor General's Office, primarily the Statewide Single Audit of federal funds. Each year, the Auditor General conducts a Statewide Single Audit of federal funds received by the State of Illinois. Beginning with the Single Audit for the year ending June 30, 2009, the Single Audit will include the ARRA funds. The federal Office of Management and Budget has issued, and will continue to issue, guidance and requirements that the Single Audits of ARRA funding must meet.

As part of the increased emphasis on accountable, transparent use of these ARRA monies, there is increased pressure being put on states to complete their Single Audits in a more timely manner (see inset). Historically, due largely to the inability to get timely, accurate financial information needed to complete the Single Audit from State agencies, the timeliness of the Single Audit has been problematic. The federal Single Audit Act requires Single Audits to be completed within 9 months of the fiscal year end. However, since 2001, the Statewide Single Audits in Illinois have been completed during the time period June through August. The Single Audit for 2008 was issued by the Office of the Auditor General on August 11, 2009.

Complicating the matter is that before the Single Audit can be finalized, the State's Comprehensive Annual Financial Report (CAFR) must be completed. In recent years, release of the

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perspective if the State had a centralized automated financial reporting system. The estimated cost of such a system would well exceed $100 million. This lack of automated systems and lack of a general ledger system requires labor intensive manual tabulations by accounting personnel who lack the qualifications and systems to report accurate financial information on a timely basis.

In discussing these conditions with Comptroller 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 Office of the Comptroller has the statutory authority to request submission of financial information but does not currently have the ability to enforce those submissions on a timely basis from other State agencies.

For example, in order for the State to have financial statements in accordance with generally accepted accounting principles for the year ended June 30, 2008, the State needed to implement GASB Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions. The Department of Healthcare and Family Services failed to submit needed data in the form of accurate actuarial reports necessary to implement GASB Statement No. 45 until March 19, 2009. In order for timely financial statements to be prepared and audited, the correct information should have been submitted by the Department in October of 2008.

Failure to establish effective internal controls at all State agencies regarding financial reporting for the preparation of the CAFR and the SEFA prevents the State from completing an audit in accordance with timelines set forth in OMB Circular A-133 which may result in the suspension of federal funding. Delays in financial reporting decrease the usefulness of such information and affect the State's ability to comply with continuing disclosure requirements. ■

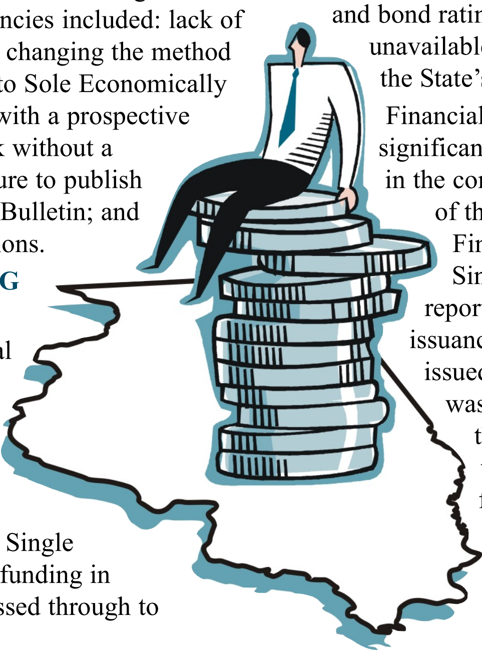
HIGH RISK AREAS

Our compliance examinations identify certain aspects of State government that expose the State to an unacceptable level of risk. The four high risk areas highlighted in this issue of the Audit Advisory are: 1) Contracting Processes; 2) Subrecipient Monitoring; 3) Untimely Financial Reporting; and 4) Fraud and Abuse.

1. CONTRACTING PROCESSES

The contracting process poses significant risks for State agencies and is susceptible to fraud and abuse. There are a myriad of ways the contracting process can be manipulated or abused. Consequently, an agency's system of internal controls related to contracting needs to be strong, monitored, and enforced.

Contracting deficiencies have been routine findings in OAG audits. Examples of contracting deficiencies included: lack of documentation in the procurement file; changing the method of procurement from Invitation to Bid to Sole Economically Feasible method after communicating with a prospective bidder; allowing vendors to begin work without a formal written agreement in place; failure to publish the required notice in the Procurement Bulletin; and contracts lacking all required certifications.



2. SUBRECIPIENT MONITORING

State agencies' failure to adequately monitor subrecipients has been a central finding in the State's Single Audit for years. The FY 2007 Single Audit included 26 findings and the FY 2008 Single Audit had 27 findings related to agencies' deficiencies in monitoring subrecipients. Agencies covered by the Single Audit received $17.3 billion in federal funding in FY 2008, of which $3.7 billion was passed through to grantees.

It is not sufficient for agencies to simply pass funding on to third parties. Rather, a system must be established to monitor how those funds are being spent and ensure these monies are being spent for the specified purpose. Subrecipient monitoring includes many aspects, such as reviewing and receiving grant or audit reports, as well as some level of on-site reviews or inspections.

3. UNTIMELY FINANCIAL REPORTING

Untimely financial reporting poses significant risks to the State of Illinois. These risks occur in several critical key areas.

First, if reporting on the State's financial position is delayed, State decision makers lack critical information necessary to manage the operations of the State. In times of funding shortfalls as currently being experienced by the State, the need for timely and accurate financial information is even more important.

Second, the federal government is in the process of imposing new, more restrictive time requirements on states' financial reporting and auditing. If the State's financial reporting continues to be delayed, the risk increases that federal funding to the State may be delayed or withheld.

Finally, untimely financial information may have an adverse impact if public users are not getting needed information. For example, bond rating agencies use information in the State's financial reports as part of their assessment of the overall risk and bond rating for the State. If needed financial information is unavailable, it may have an adverse, and costly, impact on the State's bond rating and related borrowing costs.

Financial reporting delays and errors result in several significant effects, including increased audit testing, delays in the completion of audits, and delays in the preparation of the Comptroller's Comprehensive Annual Financial Report (CAFR), as well as the Statewide Single Audit. Problems with agencies' financial reporting were directly responsible for the delay in the issuance of the State's most recent CAFR, which was issued in July 2009. By contrast, in 2007 the CAFR was issued in February. As noted in this Advisory, the federal government is considering reducing the time period for completing Single Audits from 9 months after the end of the fiscal year, to 6 months after fiscal year end. This will require not only an earlier completion of the Single Audit, but also of the State's CAFR.

Deficiencies in financial reporting included late preparation of financial statements and other financial reporting forms (GAAP forms) and improper recording or misclassification of transactions, requiring significant revisions and adjustments to financial statements.

4. FRAUD AND ABUSE

Each State agency needs to have a fraud detection program. Recent audits have identified several instances where, due to a lack of adequate internal controls and oversight, public funds have been used for undocumented or improper purposes.

One area identified in audits as being susceptible for fraud and abuse deals with the use of credit cards or P-cards. Auditors

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CAFR has also been delayed. Several factors contribute to the delay in completing the CAFR, including the State's financial reporting system which is cumbersome and antiquated, as well as a lack of cooperation provided by State agencies and a lack of experienced financial staff at agencies to complete financial reports in a timely and accurate manner.

To be successful at releasing more timely CAFRs and Single Audits will take a concerted effort by the three key players: State agencies who prepare and provide the necessary financial data; the Comptroller's Office which prepares the financial statements; and the Office of the Auditor General which audits the information. ■

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found instances in which it appeared that employees were making personal purchases with these cards and were not reimbursing the agency for the personal use.

Controls circumvented in these instances included the failure to require documentation or receipts to show what was purchased as well as the business purpose of the purchase. Also, there was an inadequate segregation of duties and/or inadequate independent supervision or review of the purchases to ensure they were for government purposes.

Agency managers have the responsibility to conduct internal vulnerability assessments of their operations to identify areas where misappropriation of State assets could occur. Once those areas are identified, then the controls need to be periodically reviewed and tested to ensure that they are properly designed and working. ■

SINGLE AUDIT: Revisions to Filing Deadlines and Extensions

The federal Single Audit Act requires that the reporting package, which includes the audited financial statements, schedule of expenditures of federal awards, corrective action plan, and auditor's reports, must be submitted to the federal clearinghouse and made available for public inspection within 9 months after the end of the period audited, or within a longer timeframe authorized by the federal agency when the 9-month timeframe would place an undue burden on the non-federal entity.

Over the past several months, there has been increased pressure to not only limit the ability of federal agencies to grant extensions to the 9 month completion requirement, but also to significantly reduce the 9 month period to complete the Single Audit. Several federal entities, including the Government Accountability Office, federal Office of Management and Budget, the Recovery Accountability and Transparency Board, and certain members of Congress, have taken the position that 9 months to complete Single Audits (let alone any additional time granted by an extension) does not provide for timely oversight information on the use of federal funds.

The Inspector General of the federal Dept. of Health and Human Services recently issued a notice that the "granting of an extension for the filing [of Single Audits] is in conflict with the principles of transparency and accountability as contained in the Recovery Act. Therefore, effective immediately, we are unable to recommend the granting of extensions for the filing of [Single Audits]."

Furthermore, revisions to the Single Audit Act are currently being considered that would reduce the time period in which Single Audits must be completed from 9 months to 6 months, with no option for the federal agency to grant an extension, except in conjunction with a federal disaster declaration.

These proposed changes, if and when implemented, will have a dramatic impact on the operations of the Office of the Auditor General and the conduct of the Single Audit in Illinois. More timely, more accurate financial information, as well as a higher level of cooperation from the State agencies, will be needed to successfully meet these new time demands. ■

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