STATE OF ILLINOIS
ILLINOIS STATE UNIVERSITY

Report Required under *Government Auditing Standards*
For the Year Ended June 30, 2017
Performed as Special Assistant Auditors
for the Auditor General, State of Illinois

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State of Illinois
Illinois State University

Report Required Under *Government Auditing Standards*
For the Year Ended June 30, 2017

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Other Reports Issued Under a Separate Cover

- The annual financial statements of the University as of and for the year ended June 30, 2017, have been issued under a separate cover.
- The University's compliance examination (including the Single Audit) for the year ended June 30, 2017, has been issued under a separate cover.

State of Illinois
Illinois State University

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Agency Officials

University Officials

Chair of the Board of Trustees	Mr. Rocky Donahue
President	Dr. Larry Dietz
Vice President for Finance and Planning	Mr. Dan Stephens (04/03/17 – Present)
Vice President for Finance and Planning	Mr. Greg Alt (07/01/16 – 04/02/17)
Interim Vice President for Academic Affairs and Provost	Dr. Jan Murphy (01/01/17 – Present)
Vice President for Academic Affairs and Provost	Dr. Janet Wessel Krejci (07/01/16 – 12/31/16)
Vice President for Student Affairs	Dr. Levester Johnson
Vice President for University Advancement	Mr. Pat Vickerman
Interim Comptroller	Mr. Doug Schnittker (04/03/17 – Present)
Comptroller	Mr. Greg Alt (07/01/16 – 04/02/17)
Legal Counsel	Ms. Lisa Huson
Director – Internal Audit	Mr. Robert Blemler

Board of Trustees

Member	Mr. Rocky Donahue
Member	Mr. Bob Churney
Member	Dr. Mary Ann Louderback
Member	Mr. Robert Dobski
Member	Ms. Julie Annette Jones (01/20/17 – Present)
Member	Ms. Anne Davis (07/01/16 – 01/19/17)
Member	Mr. John Rauschenberger (01/20/17 – Present)
Member	Mr. Jay D. Bergman (07/01/16 – 01/19/17)
Member	Ms. Sharon Rossmark (01/20/17 – Present)
Member	Ms. Betty Kinser (07/01/16 – 01/19/17)
Student Member	Mr. Ryan Powers (07/01/16 – 06/30/17)
Student Member	Mr. Zach Schaab (07/01/17 – Present)

Agency Officials

Office Locations

The University's administrative offices are located at:

Hovey Hall
Campus Box 1100
Normal, Illinois 61790-1100

State of Illinois
Illinois State University

Report Required Under *Government Auditing Standards*
For the Year Ended June 30, 2017

Summary

The audit of the financial statements of the Illinois State University was performed by RSM US LLP in accordance with *Government Auditing Standards*. This report is an integral part of that audit.

Based on their audit, the auditors expressed an unmodified opinion on the Illinois State University's basic financial statements, issued under a separate cover.

Summary of Findings

Number of	Current Report	Prior Report
Findings	3	1
Repeated findings	0	0
Prior recommendations implemented or not repeated	1	0

SCHEDULE OF FINDINGS

Item No.	Page	Description	Finding Type
		FINDINGS (*GOVERNMENT AUDITING STANDARDS*)	
2017-001	7	Inadequate Control over Reporting Restricted Accounts	Material Weakness
2017-002	9	Noncompliance with Bond Covenants	Material Weakness and Noncompliance
2017-003	11	Inadequate Control over Accounting and Financial Reporting	Material Weakness
		PRIOR FINDING NOT REPEATED	
A	14	Inadequate Control over Revenue Recognition	

State of Illinois
Illinois State University

Report Required Under *Government Auditing Standards*
For the Year Ended June 30, 2017

Summary

Exit Conference

The finding and recommendation appearing in this report were discussed with University personnel at an exit conference on November 22, 2017. Attending were:

Illinois State University:	
Dan Stephens	Vice President for Finance and Planning
Doug Schnittker	Interim Comptroller
JoEllen Bahnsen	Senior Associate Comptroller
Erika Jones	Accounting Associate
Office of the Auditor General:	
Daniel J. Nugent, CPA	Senior Audit Manager
RSM US LLP:	
Joseph Evans, CPA	Partner
Dan Sethness, CPA	Manager
Erik Ginter, CPA	Supervisor

The responses to the recommendations were provided by Ms. JoEllen Bahnsen, Senior Associate Comptroller, in correspondence dated February 28, 2018.

RSM

Independent Auditor's 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*

RSM US LLP

Honorable Frank J. Mautino
Auditor General
State of Illinois

and

Board of Trustees
Illinois State University

As Special Assistant Auditors for the Auditor General, we have audited, in accordance with the 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, the financial statements of the business-type activities of the Illinois State University and its discretely presented component unit, collectively a component unit of the State of Illinois, as of and for the year ended June 30, 2017, and the related notes to the financial statements, which collectively comprise the Illinois State University's basic financial statements, and have issued our report thereon dated March 1, 2018. Our report includes a reference to other auditors who audited the financial statements of the Illinois State University's discretely presented component unit, as described in our report on the Illinois State University's financial statements. This report does not include the results of the other auditors' testing of internal control over financial reporting or compliance and other matters that are reported on separately by those auditors.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Illinois State University's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Illinois State University's internal control. Accordingly, we do not express an opinion on the effectiveness of the Illinois State University's internal control.

A *deficiency in internal control* 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 and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and, therefore, material weaknesses or significant deficiencies may exist that were not identified. We did identify certain deficiencies in internal control, described in the accompanying schedule of findings as items 2017-001, 2017-002, and 2017-003, that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Illinois State University's financial statements are free from 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 instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and which are described in the accompanying schedule of findings as item 2017-002.

Illinois State University's Responses to Findings

The Illinois State University's responses to the findings identified in our audit are described in the accompanying schedule of findings. The Illinois State University's responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on the response.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Illinois State University's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Illinois State University's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

SIGNED ORIGINAL ON FILE

Schaumburg, Illinois
March 1, 2018

Current Findings – *Government Auditing Standards*

Finding 2017-001. Inadequate Control over Reporting Restricted Accounts

The Illinois State University (University) did not ensure restrictions from revenue bond covenants were properly reflected within the University's financial statements.

As of June 30, 2017, the University's Auxiliary Facilities System (System) consisted of certain facilities across campus which are not directly related to the University's instruction, research, or service units, including:

- athletic-related facilities, such as Redbird Arena and Hancock Stadium;
- recreation-related facilities, such as the Student Fitness Center, Center for Performing Arts, and the Bone Student Center;
- resident halls and apartments, except for Cardinal Court;
- student services facilities, including the Student Services Building; and,
- parking facilities.

As of June 30, 2017, the University had outstanding revenue bond issues (Series 2008, Series 2012A, Series 2012B, and Series 2016) where the proceeds from these bonds had been used to finance certain projects within the System. These bond issues established a "closed system" where the revenues generated by the System could only be used for the following purposes:

1) expenses necessary for the operation and reasonable upkeep and repair of the System;
2) payment of principal and/or interest amounts when due;
3) amounts set aside limited to and used for financing the costs of renovating or replacing capital assets of the System beyond ordinary maintenance and operation of the System; and,
4) amounts set aside limited to and used for constructing new space or additions to existing facilities within the System;

with any excess funds, after maximum deposits have been made to fund the foregoing purposes, being set aside to either fund the redemption of previously issued bonds when callable or the purchase of the University's bonds on the open market. Notably, resources within the System are unavailable for use by the University outside of the System.

During testing, we noted the University had controls to segregate the System's assets and include its net position with the University's financial statements; however, the University had not designed its internal controls to ensure accurate reporting of restricted assets and restricted net position under generally accepted accounting principles. The University originally designed the control due to the implementation of Governmental Accounting Standards Board Statement No. 34 by drawing inferences from the implementation guidance published by the Governmental Accounting Standards Board that was not necessarily on point with the University's unique "closed system" situation and from discussions with other universities with closed systems.

Historically, auditors did not take exception to the design flaw until the current year. After this issue was noted during the current year, the Auditor General's Office and the Office of the State Comptroller consulted with staff of the Governmental Accounting Standards Board. After this consultation, the University (and all universities with closed systems) changed its accounting presentation in its final financial statements to show all non-capital assets associated with the System, totaling $170.28 million, as restricted assets and reclassified the System's portion of the University's net position to expendable restricted net position, totaling $164.36 million.

Current Findings – *Government Auditing Standards*

Finding 2017-001. Inadequate Control over Reporting Restricted Accounts *(Continued)*

Governmental Accounting Standards Board Statement No. 34, Paragraph 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, requires net position should be reported as restricted when constraints imposed upon the use of the net position are externally imposed by creditors, such as through debt covenants. Further, Governmental Accounting Standards Board Statement No. 34, Paragraph 99, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, requires the reporting of restricted assets when constraints imposed upon the use of the net position are externally imposed by creditors change the nature or normal understanding of the availability of the asset, such as assets that cannot be used to extinguish liabilities outside of those allowed by the bond covenants.

In addition, the Fiscal Control and Internal Auditing Act (30 ILCS 10/3001) requires the University establish and maintain a system, or systems, of fiscal and administrative controls to provide assurance that revenues, expenses, resources, and funds applicable to operations are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over the State's resources.

University officials stated that the misstatement was due to a misinterpretation of the requirements of the Governmental Accounting Standards Board.

Failure to report the non-capital assets and net position related to the System as restricted resulted in a material misstatement of the University's financial statements and reduced the overall reliability of Statewide financial reporting. (Finding Code No. 2017-001)

Recommendation

We recommend the University periodically review its internal controls over financial reporting to provide assurance accounts are properly classified under generally accepted accounting principles.

University Response

The University agrees and has corrected the financial statements to segregate the restricted and unrestricted assets and net position.

Current Findings – *Government Auditing Standards*

Finding 2017-002. Noncompliance with Bond Covenants

The Illinois State University (University) did not comply with its revenue bond covenants.

As of June 30, 2017, the University's Auxiliary Facilities System (System) consisted of certain facilities across campus which are not directly related to the University's instruction, research, or service units, including:

- athletic-related facilities, such as Redbird Arena and Hancock Stadium;
- recreation-related facilities, such as the Student Fitness Center, Center for Performing Arts, and the Bone Student Center;
- resident halls and apartments, except for Cardinal Court;
- student services facilities, including the Student Services Building; and,
- parking facilities.

As of June 30, 2017, the University had outstanding revenue bond issues (Series 2008, Series 2012A, Series 2012B, and Series 2016) where the proceeds from these bonds had been used to finance certain projects within the System. These bond issues established a "closed system" where the revenues generated by the System could only be used for the following purposes:

1) expenses necessary for the operation and reasonable upkeep and repair of the System;
2) payment of principal and/or interest amounts when due;
3) amounts set aside limited to and used for financing the costs of renovating or replacing capital assets of the System beyond ordinary maintenance and operation of the System; and,
4) amounts set aside limited to and used for constructing new space or additions to existing facilities within the System;

with any excess funds, after maximum deposits have been made to fund the foregoing purposes, being set aside to either fund the redemption of previously issued bonds when callable or the purchase of the University's bonds on the open market. Notably, resources within the System are unavailable for use by the University outside of the System.

In addition, we noted the System's activities were subject to *University Guidelines* adopted by the Legislative Audit Commission. The *University Guidelines* (Chapter V) requires the University, after fulfilling all of the reserve and debt service requirements of a revenue bond's indentures, determine if any of the excess funds exist under Chapter IV of the *University Guidelines*. The *University Guidelines* (Chapter IV) includes a calculation methodology (Figure 2) for determining if the System has current excess funds required to be transferred into the University's locally-held Income Fund. However, the *University Guidelines* (Chapter V, Section C) provides a priority order that in the case of a conflict between the University's bond indenture and the *University Guidelines*, the University's bond indenture will prevail.

During testing, we noted the University calculated excess funds under the *University Guidelines* and transferred moneys out of the System to the University's Income Fund in violation of its debt covenants. We reviewed the University's financial audits and compliance examinations dating back to Fiscal Year 1982 and concluded the following:

- $1,763,614 was calculated as excess funds within the System at the end of Fiscal Year 2016 and transferred from the System to the University's Income Fund during Fiscal Year 2017; and,
- $8,318,521 was calculated as excess funds within the System at the end of Fiscal Year 2017 and transferred from the System to the University's Income Fund during Fiscal Year 2018.

Current Findings – *Government Auditing Standards*

Finding 2017-002. Noncompliance with Bond Covenants *(Continued)*

In order to remedy this matter, the University returned $10,082,135 on January 17, 2018, to the System from the University's Income Fund. University management corrected the Fiscal Year 2016 error on its Fiscal Year 2017 financial statements by reclassifying $1,763,614 in unrestricted cash and cash equivalents within the Income Fund to restricted cash and cash equivalents for the System.

The Illinois State University Revenue Bond Law (110 ILCS 676/21-25) states the provisions of any resolution or other proceedings authorizing the issuance of bonds constitute a contract with the holders of the bonds, with the provisions thereof "enforceable by civil action, mandamus, injunction or other proceeding in the appropriate circuit court to enforce and compel the performance of all duties required by this Article and by any resolution authorizing the issuance of bonds." Good internal controls over compliance include ensuring all bond covenants are strictly adhered to by the University.

University officials stated that the calculation and subsequent payments were due to a misinterpretation of the Legislative Audit Commission excess funds guidelines and the University's bond covenants.

Failure to ensure all bond covenants were strictly adhered to by the University resulted in noncompliance with the University's revenue bond covenants. (Finding Code No. 2017-002)

Recommendation

We recommend the University review its bond covenant compliance on a routine basis to identify and rectify any noncompliance conditions.

University Response

The University agrees with the finding and has corrected the situation by returning the excess fund payments from the University's Income Fund to the System.

Current Findings – *Government Auditing Standards*

Finding 2017-003. Inadequate Control over Accounting and Financial Reporting

The Illinois State University (University) did not ensure certain transactions were properly reported within the University's financial statements.

During testing, we noted the following:

- Throughout the fiscal year, the Illinois State University Foundation (Foundation) pays certain costs on behalf of the University. Frequently, these transactions arise when departments across the University choose to submit an invoice for payment by the Foundation instead of charging the expense against their University accounts. The auditors noted the University and Foundation did not have a process in place to identify and report the revenues and expenses associated with these on-behalf nonexchange transactions within the University's financial statements, which totaled $4,257,836 during Fiscal Year 2017. University management corrected this error in the University's final financial statements.

- During our review of the University's grant accounting at June 30, 2017, we noted the University netted the accounts receivable portion of several grants against the unearned revenue portion of other grants. This error resulted in the University understating both accounts receivable and unearned revenue by $907,636. This amount was deemed immaterial by University management and was not corrected in the University's final financial statements; however, the auditors determined this exception represented a significant deficiency in the University's internal control over financial reporting.

  Governmental Accounting Standards Board Statement No. 33, Paragraph 21, *Accounting and Financial Reporting for Nonexchange Transactions*, requires the University recognize revenues from voluntary nonexchange transactions when all eligibility requirements are met. Further, Governmental Accounting Standards Board Statement No. 65, Paragraph 10, *Items Previously Reported as Assets and Liabilities*, requires the University report unearned revenue liabilities where resources from nonexchange transactions were transmitted to the University prior to the University meeting all of the eligibility requirements.

- During the academic year, the faculty members of the University's laboratory schools spend time observing the University's College of Education's student teachers. Initially, the laboratory schools incur the expense associated with these transactions. At the end of the academic year, the University performs an internal transaction to charge these expenses against the College of Education's accounts, which was not eliminated for financial reporting purposes. As such, the revenues and expenses recorded in the University's draft financial statements were overstated by $1,300,492. University management corrected this error in the University's final financial statements.

  Governmental Accounting Standards Board Statement No. 34, Paragraph 59, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, states eliminations should be made to remove the doubling-up effect of internal events on the financial statements.

Current Findings – *Government Auditing Standards*

Finding 2017-003. Inadequate Control over Accounting and Financial Reporting *(Continued)*

- During analytical reviews of the University's accounts, we noted the University improperly capitalized demolition costs associated with the University's South Campus Complex (the former Atkin-Colby and Hamilton-Whitten residence halls and the attached Feeney Dining Center), totaling $4,223,295, as land improvements. After discussions with the University, it appears these costs were capitalized because the University viewed the demolition as necessary to construct a new building for the Mennonite College of Nursing at this location upon receiving State capital appropriations in a future period. This amount was deemed immaterial by University management and was not corrected in the University's final financial statements; however, the auditors determined this exception represented a significant deficiency in the University's internal control over financial reporting.

  Governmental Accounting Standards Board Statement No. 34, Paragraph 18, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments, notes the cost of a capital asset should include ancillary charges, such as site preparation, necessary to place a capital asset into its intended location and intended condition for use. Typically, demolition costs are only capitalized when those costs are necessary to construct a capital asset on a property acquired by the University for construction of the capital asset, while costs associated with the disposal of current capital assets (except for certain environmental remediation or asset retirement obligations) are expensed during the period incurred.

- One of 44 (2%) tested cash disbursements subsequent to fiscal year end, totaling $327,929, was not split between Fiscal Year 2017 activity occurring before June 30, 2017, totaling $196,757, and Fiscal Year 2018 activity occurring after June 30, 2017, totaling $131,172. This invoice pertained to interior painting at the South Tower of the Watterson Towers over the summer. University management corrected this error in the University's final financial statements.

  Governmental Accounting Standards Board Statement No. 34, Paragraph 92, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, requires enterprise funds use the economic resources measurement focus and the accrual basis of accounting. Under the accrual basis of accounting, transactions are generally recognized when the transaction occurred, regardless of when cash is received or disbursed.

- During our review of the University's cash reconciliations at June 30, 2017, we noted an unsupported reconciling error, totaling $235,581. After discussions with the University, it appears this amount represents an unrecorded equity adjustment from a prior period. This amount was deemed immaterial by University management and was not corrected in the University's final financial statements; however, the auditors determined this exception represented a significant deficiency in the University's internal control over financial reporting.

  The State Records Act (5 ILCS 160/8) requires the University to make and preserve records containing adequate and proper documentation of the essential transactions of the University to protect the legal and financial rights of the State and of persons directly affected by the University's activities.

Current Findings – *Government Auditing Standards*

Finding 2017-003. Inadequate Control over Accounting and Financial Reporting *(Continued)*

In accordance with generally accepted accounting principles (GAAP), all of the University's assets, liabilities, revenues, and expenses should be properly reported in the University's financial statements. Further, the Fiscal Control and Internal Auditing Act (30 ILCS 10/3001) requires the University establish and maintain a system, or systems, of fiscal and administrative controls to provide assurance that revenues, expenses, resources, and funds applicable to operations are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over the State's resources. Finally, a significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is important enough to merit attention by those charged with governance of the University.

University officials stated that the errors were due to employee oversight.

Failure to ensure all transactions are properly reported could result in a material misstatement of the University's financial statements and reduces the overall reliability of Statewide financial reporting. (Finding Code No. 2017-003)

Recommendation

We recommend the University enhance its internal control over financial reporting to ensure transactions with the Foundation are properly reported, accounts receivable and unearned revenue from grants are properly reported, internal activity is eliminated, demolition costs are properly recorded, transactions split among fiscal years are properly recorded, and bank reconciliations are prepared with proper documentation to support reconciling items.

University Response

The University agrees with the recommendation. Procedures relative to each of the noted exceptions have been modified to ensure against future occurrence.

Prior Finding Not Repeated

A. Finding – Inadequate Control over Revenue Recognition

During the prior engagement, the Illinois State University (University) did not exercise adequate internal control over revenue recognition.

During the current engagement, our audit procedures did not identify any similar issues regarding revenue recognition and accounts receivable. (Finding Code No. 2016-001)