
Secretary of State

State of Oregon
WATER RESOURCES DEPARTMENT
WATER DEVELOPMENT
LOAN PROGRAM
Special Review



Audits Division

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Auditing for a Better Oregon

The Honorable John Kitzhaber
Governor of Oregon
State Capitol Building
Salem, Oregon 97310

Martha Pagel, Director
Water Resources Department
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This report encompasses a review of selected activities at the Water Resources Department, Water Development Loan Program (program) for the period July 1, 1995, through June 30, 1996. This review was requested by the Water Resources Department (department). The objectives of the audit were to determine whether controls were in place to safeguard assets and whether selected transactions complied with pertinent laws, rules, and regulations.

The results of our review found that procedures used to record loan account transactions in the accounting records did not properly reflect the amount of principal and interest being received, although they were correctly recorded in subsidiary records. As a result, the accounting records did not provide accurate information for financial reporting purposes. We also noted that \$252,735 in administrative expenditures was not correctly recorded as administrative costs. This understated administrative costs charged to the program's legislatively established budget.

In addition, we followed up on previous audit findings on a review of the recalculation of loan balances and found that one error had not been properly corrected. This report contains recommendations for improving operations. The department concurs with our recommendations.

We conducted the audit in accordance with generally accepted government auditing standards. In this regard, we inquired of department personnel, reviewed policies and procedures, tested relevant reports, and evaluated management controls as required to accomplish the objectives of our audit.

Our audit was limited to the specific matters described above, and was based on tests and procedures we considered necessary in the circumstances.

OREGON AUDITS DIVISION

John N. Lattimer
Director

Fieldwork Completion Date:
February 21, 1997

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SUMMARY

The Water Resources Department (department) administers and enforces laws concerning the water resources of this state, subject to the policy direction by the Water Resources Commission. The department's powers and responsibilities include the Water Development Loan Program (program). The program was enacted by the 1977 Legislative Assembly to finance long-term, low interest loans for irrigation and drainage projects in Oregon. The loans were financed through the sale of general obligation bonds of the state of Oregon.

The program was the subject of a class action lawsuit beginning in 1991. A preliminary settlement was reached on January 25, 1996. The court placed a moratorium on all collection procedures until a settlement was complete. The court ordered that all loan balances be recalculated, and that the program refund any overpayments and pay the attorney fees.

The objectives of the audit were to determine whether controls were in place to safeguard assets and whether selected transactions complied with pertinent laws, rules, and regulations for the period July 1, 1995, to June 30, 1996. The results of our review found that procedures used to record loan account transactions in the accounting records did not properly reflect the amount of principal and interest being received, although they were correctly recorded in subsidiary records. Also, we noted that \$252,735 in administrative expenditures was not correctly recorded in the account for administrative costs, thus understating costs charged to the program's legislatively established budget.

In addition, we followed up on previous audit findings on a review of the recalculation of loan balances and found one error that had not been properly corrected. This report contains recommendations for improving operations. The department concurs with our recommendations.

INTRODUCTION

ORGANIZATION AND FUNCTIONS

A seven-member Water Resources Commission, the position of Water Resources Director, and the Water Resources Department (department) are created under provisions of *Oregon Revised Statutes* (ORS) 536.022, 536.032, and 536.039. The commission members and the director are appointed by the governor, subject to confirmation by the Senate.

The Water Resources Commission establishes policies for the operation of the department. One of the department's responsibilities is to administer the Water Development Loan Program (program).

The program was enacted by the 1977 Legislative Assembly to finance long-term, low interest loans for irrigation and drainage projects in Oregon. The loans were financed through the sale of general obligation bonds of the state of Oregon. The program operates under the authority of Article XI-I(1) of the Oregon Constitution and ORS 541.700 through 541.855. The Constitution was amended to allow the funding of loans for community water supply projects, fish protection, and watershed enhancement. From 1979 through 1991, the program issued approximately \$43.5 million in bonds to fund 180 loans for various water development projects. Most of these loans were made to private individuals, except for five loans that were made for community water supply projects. At June 30, 1996, there were 55 outstanding loans and contracts. Due to the 1986 federal Tax Reform Act, the department no longer has the authority to make tax-exempt loans to entities that do not have taxing authority (i.e., private individuals). The department has not made any new loans since 1984.

FINANCIAL ACTIVITIES

The Water Development Loan Program has two separate cash accounts. The Water Development Administration and Bond Sinking Fund Account is used to account for administrative costs, collections on loans, and retirement of bonds and payment of interest. The administrative costs

are subject to an expenditure limitation established by the Legislature and the payment of bond principal and interest are not subject to an expenditure limitation. The Water Development Fund Account is used to account for bond sale proceeds, certain bond issuance costs, and distribution of bond proceeds.

The program was the subject of a class action lawsuit beginning in 1991. A preliminary settlement was reached on January 25, 1996. The court placed a moratorium on all collection procedures until a settlement was complete. The court ordered that all loan balances be recalculated, and that the program refund any overpayments and pay the attorney fees. In March 1996, the program refunded \$948,098 in overpayments and paid \$200,000 in attorney fees. Additional interest set by the court was added to those amounts.

The principal amount of bonds outstanding on the June 30, 1996, financial statements is \$7,438,000. The amount of loans receivable on those financial statements is \$5,228,986.

The program's administrative expenditures include refunds of overpayments on loans and the payment of the court ordered attorney fees and interest. Listed below are administrative expenditures for the year ending June 30, 1996, compared the amounts budgeted for the 1995-97 biennium.

Category	Recorded Expenditures at June 30, 1996	Budgeted Expenditures for 1995-97 Biennium	Percent of Biennial Budget Expended
Personnel	\$ 115,331	\$ 217,218	53%
Services and Supplies	\$ 53,324	\$ 111,769	48%
Other Expenditures	\$ 1,415,793	\$ 1,392,000	102%
Total	\$ 1,584,448	\$ 1,720,987	92%

The accounting records for the program are maintained by the Department of Administrative Services, Fiscal Services Section.

**SCOPE AND
METHODOLOGY**

At the request of the Water Resources Department, we reviewed the internal controls at the Water Development Loan Program (program) and tested transactions for the period July 1, 1995, to June 30, 1996. Included in the review were the transactions related to the settlement of the class action lawsuit. The transactions were tested to evaluate the effectiveness of internal controls and compliance with laws and regulations. We tested receipts and revenue, refunds to borrowers, and expenditures. We also followed up on audit findings from a previous review of loan balance calculations.

Specifically, transactions were tested to verify whether receipts and revenues were properly recorded in the accounting records and properly applied to the loan balances. Also, we reviewed the methods used to determine the loans receivable at June 30, 1996.

For refunds to borrowers, we traced from the court-ordered payment to the actual payment, verifying that the correct attorney fees were deducted and the interest due the borrower was calculated correctly.

For other expenditures, we selected a sample of transactions to verify that the amount paid was accurate, that it was properly classified and recorded. We also verified that the debt service payments agreed to schedules prepared by the Oregon State Treasurer's office.

We conducted our audit in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States. Our audit was limited to the areas specified in this section of the report.

AUDIT RESULTS

REPORT ON INTERNAL CONTROL

The management of the Water Development Loan Program (program) is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control. The objectives of internal control are to provide management with reasonable assurance regarding the reliability of financial reporting, the effectiveness and efficiency of operations, and compliance with laws and regulations. Because of inherent limitations in any system of internal control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that procedures may become inadequate because of the changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit, we obtained an understanding of the internal control. With respect to the internal control, we obtained an understanding of the design of relevant controls and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures and not to provide an opinion on the internal control. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control and its operation that we consider to be reportable conditions under the standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control system that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data.

A material weakness is a reportable condition in which the design or operation of one or more of the specific control activities does not reduce to a relatively low level the risk that errors or irregularities may occur and not be detected

within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. Reportable conditions are reported in the FINDINGS AND RECOMMENDATIONS section of the report.

**REPORT ON COMPLIANCE
WITH LAWS AND
REGULATIONS**

Compliance with laws and regulations applicable to the program is the responsibility of management. As part of our audit, we performed tests of the program's compliance with certain provisions of laws and regulations relating to selected transactions. The objective of our audit, however, was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed one area of noncompliance that is required to be reported herein under *Government Auditing Standards*. The instance of noncompliance is reported in the FINDINGS AND RECOMMENDATIONS section of the report.

FINDINGS AND RECOMMENDATIONS

RECORDING LOAN PAYMENTS

The procedures that the department and Department of Administrative Services Fiscal Services Section used to record loan account transactions in the accounting records did not properly reflect the amount of principal charges, interest charges, interest credits, administrative charges, and late fees received during the audit period. The subsidiary records, however, did correctly reflect those transactions. As a result, the accounting records did not provide accurate cumulative information for accounting and financial reporting purposes. For example, on June 30, 1996, an adjusting entry was made to the accounting records amounting to \$1,443,065 that reclassified interest income to principal payments. This adjustment left the interest income from loans at a negative \$889,051 on the accounting records at June 30, 1996. According to the program's financial statements, interest income was \$527,000.

We recommend that the department develop procedures to provide the Department of Administrative Services with information to properly record the receipt transactions.

ADMINISTRATIVE EXPENDITURES CHARGED TO THE WRONG ACCOUNT

ORS 541.830 requires that all administrative expenses be paid from the Water Development Administration and Bond Sinking Fund (administration account). Instead, \$252,735 in administrative costs has been paid from the Water Development Fund account (development account).

The department transferred \$252,735 in attorney fees related to the class action lawsuit from one administration account that has a budget limitation to another account that does not have a budget limitation without proper authority. ORS 541.785 designates the use of the development account for the receipt and disposition of bond proceeds. There is no authority to use the account for any other purposes. ORS 541.830 provides that all administrative expenses will be paid from the administrative account.

The department understated its administrative costs charged to its legislatively established budget limitation by \$252,735. The

department thought it had the authority to charge nonbudgeted items to accounts other than its administrative cost limitation. To do this, however, the department would need to have the legislature authorize a nonlimited account for such costs.

We recommend that the department use the development account only for the receipt and disposition of bond proceeds. The department has subsequently transferred the administrative expenditures charged to the development account to the budgeted administrative cost limitation.

RECORDING ERRORS IN LOAN BALANCE CALCULATIONS

At the department's request, in March 1995 we prepared a "Special Report on Litigation Case" in which we reported the results of our tests of the loan account transactions and calculations. In a test of 25 account files, we identified 24 accounts with errors. During the current audit, we selected eight of these errors to verify that they had been properly corrected. Seven of the files had been corrected properly and one was changed incorrectly, resulting in an overstatement on a loan by \$4,560. This account was corrected during the audit.

Because many of these loans are being paid off early, the department needs to review all of the transactions posted to the loan balances to verify the final payoff amount is correct.

We recommend that the debt service manager review and certify that the transactions recorded against outstanding loans are properly recorded prior to determining what the final payoff amount will be. This would include tracing recorded payments back to the receipt documents.

REPORT DISTRIBUTION

This report is a public record and is intended for the information of the Water Resources Department's management, the governor of the state of Oregon, the Oregon Legislative Assembly, and all other interested parties.

COMMENDATION

The courtesies and cooperation extended by the officials and employees of the Water Resources Department and Department of Administrative Services during the course of our audit were very commendable and sincerely appreciated.

AUDIT TEAM

Gary Colbert, CGFM, CFE, Audit Administrator
Dale Schneider, CPA
Nancy Young

AGENCY'S RESPONSE TO THE AUDIT REPORT

October 20, 1997

John N. Lattimer
Director
Audits Division, Secretary of State
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WATER
RESOURCES
DEPARTMENT

Dear Mr. Lattimer:

We appreciate this opportunity to respond to your report of the Water Resources Department, Water Development Loan Program, Special Review. Below is our response to each specific finding in the report.

Recording Loan Payments.

We recommend the department develop procedures to provide the Department of Administrative Services with information to properly record the receipt transactions.

Response:

We concur the General Ledger and subsidiary totals per SFMS did not agree to the spreadsheets prepared by the department. The audit reviewed transactions which occurred during a lengthy loan holder lawsuit addressing issues related to principal, interest and other charges against loans. Before the lawsuit, the accounting for this program was complex, but during and after the lawsuit, the accounting became even more complex. Information changed continually throughout the lawsuit and would not provide accurate information. Instead of providing the accountant with information that changed frequently, the Debt Service Manager and accountant agreed that after the class action suit, the accountant would be provided with up to date information to be recorded into SFMS and after fiscal year end the books would be adjusted to agree with the subsidiary. The specific amounts referred to in the finding were the result of a prior period adjustment not being recorded when the Statewide Financial Report was prepared but the adjustment was made in time for the agency prepared financial statements and they were correct. The Water Resources Department and Department of Administrative Services, Internal Support Division requested Audits Division to provide us the correct amount that should have been recorded at fiscal year end and they were not able to provide us that information because they had not audited the financial statement amounts.*

The procedures have been changed and the process is now substantially different. Since July 1, 1997, the Debt Service Manager has provided the accountant with a spreadsheet that contains the information needed to record account activity as it occurs into the accounting system in both electronic and hardcopy forms each time a payment is made. This spreadsheet includes information such as payment amount received, interest credit, late charge, administrative expense, principal, interest, payoff amount, as well as other pertinent information. The Debt Service Manager and the accountant are also exploring how a general ledger control account may be set up on SFMS for each bond series, showing each series asset, liability and equity accounts. The spreadsheets prepared by the Debt Service Manager provides the necessary subsidiary ledger information.



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* See Audit Division's Reply to Agency's Response on page 15.

Administrative Expenditures Charged to the Wrong Account.

We recommend the department use the development account only for the receipt and disposition of bond proceeds. The department has subsequently transferred the administrative expenditures charged to the development account to the budgeted administrative cost limitation.

Response:

We concur. The Department needed additional expenditure limitation to cover all costs associated with the class action lawsuit settlement and requested \$1,302,000.00 from the Emergency Board in January 1997. The Department mistakenly used non-limited limitation to pay the additional expenses even after the Emergency Board request had been approved.

After the lawsuit was concluded, the actual amount needed to settle the entire litigation was in excess of \$1,400,000. The Department requested and was approved a 1995-97 Other Fund limitation increase by the Ways & Means sub-committee during the 1997 legislative session to provide for these additional expenditures as well as others.

The Department will take care to ensure that account is used properly in the future.

Recording Errors in Loan Balance Calculations.

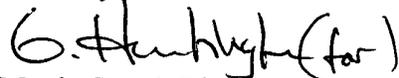
We recommend the debt service manager review and certify that the transactions recorded against outstanding loans are properly recorded prior to determining what the final payoff amount will be. This would include tracing recorded payments back to the receipt documents.

Response:

We concur. The error was to be corrected during the litigation accounting process but was apparently missed. All payoffs are now double checked by the Debt Service Manager against payment receipts. When a loan payoff is calculated the hard copy file is pulled and each payment on the account is double checked against the respective receipts. The loan receivables are also double checked by Department of Administrative Services, Internal Support Division agency accounting staff.

We appreciate the courtesies of the audit staff and look forward to working with them in the future.

Sincerely,


Martha Pagel, Director
Water Resources Department


Coyne Smith, Administrator
Department of Administrative Services
Internal Support Division

AUDIT DIVISION'S REPLY TO AGENCY'S RESPONSE

It is the department's responsibility to ensure the accuracy of its financial statements. Also, the scope of the audit was not to audit the department's financial statement amounts, but to do a review of the internal controls and selected transactions as stated on page 3 of the report.

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Deputy Director

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This report is intended to promote the best possible management of public resources.



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