



# Secretary of State Audit Report

## Departments of Forestry and State Lands: Review of Common School Fund Forest Land Management Costs

### Summary

#### PURPOSE

The purpose of this audit was to determine whether costs the Department of Forestry charged for management of Common School Fund forest lands were reasonable and in compliance with the Interagency Agreement between the Department of State Lands, Oregon Department of Forestry and State Land Board.

#### BACKGROUND

The Oregon Constitution dedicated revenues from the sale and management of some state-owned rangelands, forest lands, waterways and other types of lands to the Common School Fund (CSF), with earnings distributed to Oregon's public schools. The CSF is managed by the State Land Board, with the Oregon Department of State Lands (State Lands) serving as its administrative arm. State Lands has an agreement with the Oregon Department of Forestry (Forestry) for the management of approximately 124,000 acres of CSF forest lands. In exchange, State Lands pays a portion of Forestry's administrative and program costs. In fiscal year 2006, State Lands paid Forestry approximately \$5.2 million to manage this forest land.

#### RESULTS IN BRIEF

In reviewing whether costs charged to the CSF were reasonable and in compliance with the Interagency Agreement, we identified \$432,000 in estimated overcharges Forestry billed to State Lands. The costs we reviewed fell into two categories—administrative and program.

We reviewed about 90 percent of the \$771,500 in administrative costs Forestry billed to State Lands during fiscal year 2006 and identified an estimated \$333,000 in overcharges. The overcharges occurred because Forestry used an outdated cost study to allocate administrative costs. Forestry management told us they did not use a more recent cost study because the funds needed for implementation did not receive legislative approval.

We also reviewed a sample of program costs billed to State Lands and found errors in charges for personal services, services and supplies, and capital outlay that occurred during the 18-month time period of July 2005 through December 2006. We identified approximately \$99,000 in net overcharges for these costs. Several of the overcharges occurred because some Forestry offices used an inaccurate allocation basis or omitted activities from the allocation process. The other overcharges resulted from a variety of factors, such as spreadsheet formula errors.

Forestry chose not to fully utilize the detailed coding available in the statewide accounting system. Thus, Forestry's accounting records do not identify whether a program charge is direct or indirect. This made it impractical for us to calculate the total overcharge to the CSF. Therefore, the \$99,000 in estimated net program overcharges could be understated. Forestry also lacked written procedures over the allocation process and did not regularly monitor the process to ensure accuracy.

#### RECOMMENDATIONS

We recommend the Department of Forestry take the following actions:

- Work with the Department of State Lands to clearly define and implement a current basis for allocating administrative costs to the Common School Fund.
- Develop and implement procedures to:
  - require that all programs benefiting from an allocated activity be included in the administrative and program allocations;
  - document the basis used for each program allocation type and require that the basis be regularly updated; and
  - centrally monitor compliance with the allocation process in the district and area offices.
- Add the accounting codes necessary to identify direct and indirect charges.

We recommend the Department of Forestry and Department of State Lands jointly develop a plan to identify and recover any significant overcharges and undercharges made to the Common School Fund.

#### OTHER MATTERS

During the course of our audit, we found instances in which Forestry and State Lands did not comply with the billing and payment terms outlined in the Interagency Agreement. Specifically, Forestry billed in advance for administrative costs and State Lands delayed payments for disputed billings for long periods of time.

#### RECOMMENDATIONS

We recommend the following actions:

- the Department of Forestry either bill actual costs periodically, such as monthly, or work with State Lands to modify the agreement;
- the Department of State Lands use the Interagency Dispute Resolution Process for any disputed billings; and

- the Department of Forestry and Department of State Lands jointly agree on an invoice presentation that clarifies charges.

We also identified other issues that were not directly related to our audit objective or were of lesser significance. We conveyed these issues to Forestry in Management Letter No. 629-2008-11-01.

#### AGENCIES' RESPONSES

*The Department of Forestry generally concurs with the findings of the audit, and agrees with most of the recommendations. Forestry's response letter is attached to this report beginning on page 7. Forestry's complete response, which includes a corrective action plan, can be found on the Audits Division's website.*

*The Department of State Lands agrees with the recommendations.*

## Background

### Common School Fund Benefits From State Lands

As specified in the Oregon Constitution, the Common School Fund (CSF) receives revenues from the sale and management of some state-owned rangelands, forest lands, waterways and other types of lands. These lands, which were granted to the state to benefit Oregon's public schools, are managed by the State Land Board (Board), with the Oregon Department of State Lands (State Lands) serving as its administrative arm.

Forest lands generate more CSF land based revenue than any other source, with approximately \$9.7 million generated during fiscal year 2006. Other CSF revenue sources, such as rangelands and waterways, generated approximately \$3.3 million during the same fiscal year.<sup>1</sup>

<sup>1</sup> The \$3.3 million figure is cited in the Department of State Land's Asset Management Plan 2006-2016.

### Oregon Department of Forestry Manages Most CSF Forest Lands

The Board and the State Lands have an interagency agreement (agreement) with the Oregon Department of Forestry (Forestry) that assigns Forestry responsibility for managing most CSF forest lands. The most recent agreement was signed in June 2005 with clarifying provisions authorized in April 2006. The agreement covers the daily management of approximately 124,000 acres of CSF forest lands. State Lands manages the remaining 7,000 acres of CSF forest lands.

Forestry manages other state forest lands in addition to CSF forest lands. These other lands, known as Board of Forestry lands, and the CSF forest lands are managed under Forestry's State Forest Program. Forestry uses three area and nine district offices located throughout the state to manage forest program lands. These offices handle the management of forestry program activities related to their location. Certain administrative activities that benefit all of Forestry, such as payroll services or human resources

functions, are located in Forestry's main office in Salem.

### Forestry's Costs for Managing CSF Forest Lands Paid from CSF

Forestry's costs for managing the CSF forest lands are billed to and paid by State Lands on behalf of the CSF. Forestry received approximately \$5.2 million for managing these forest lands in fiscal year 2006. Forestry's costs include both direct program costs and indirect costs. Direct program costs would include work that can be identified as having been performed directly on CSF land. Indirect costs include administrative costs that benefit the entire Department of Forestry and program costs that benefit all lands under the forest program. Examples of indirect administrative costs include processing payroll or managing Forestry's information technology or human resources divisions. Costs for supplies such as seedlings and planting shovels used for reforestation on multiple lands (Board of Forestry and CSF lands) are examples of indirect program costs.

Forestry uses several methods to allocate indirect costs. Forest land acreage is the basis used for allocating most indirect program costs, while other bases, such as the number of employees or accounting transactions processed, are used to allocate administrative costs.

## Audit Results

In reviewing whether costs charged to the CSF were reasonable and in compliance with the Interagency Agreement, we identified approximately \$432,000 in overcharges Forestry billed to State Lands. We also found that Forestry's accounting records lacked the coding detail necessary to quantify the full extent of overcharges and undercharges related to program allocation errors.

Most of the overcharges occurred because Forestry used either outdated or inaccurate data as a basis to allocate costs, or under-allocated costs to other Forestry programs.

### Administrative Cost Overcharges

In fiscal year 2006, State Lands paid Forestry approximately \$771,500 for administrative costs. We reviewed approximately 90 percent of these costs and identified an estimated \$333,000 in overcharges. These overcharges occurred because Forestry used an outdated cost study to allocate administrative costs and excluded or limited administrative costs that should have been allocated to other programs.

Forestry management told us that implementing more current cost studies would have required additional general funds. Management added that Forestry submitted a policy option package during the last Legislative session requesting additional funds to implement the 2006 cost study, but the package was not approved. Thus, Forestry management

continued allocating costs using the outdated study. This deviates from best practices, which recommend that indirect costs be allocated based on current and accurate data to all activities benefiting from the services in question.

Approximately every two years, Forestry examines administrative costs to identify appropriate rates for allocating the costs to Forestry's various activities. According to Forestry management, had the more recent 2006 cost study been implemented, State Lands would have paid approximately 5 percent of Forestry's total administrative overhead instead of the approximate 9 percent it did pay.

### Incorrect Program Costs

We reviewed a sample of transactions for personal services, services and supplies, and capital outlay that occurred during the 18-month time period of July 2005 through December 2006. Based on testing, we identified many program costs that were inappropriately billed to State Lands, resulting in approximately \$99,000 in net overcharges. Forestry has since initiated procedures to reimburse State Lands for some of the identified overcharges.

We found that some overcharges occurred because several offices used an inaccurate allocation basis or omitted activities from the allocation process, while other factors, such as formula errors in a spreadsheet, resulted in other overcharges.

For example, Forestry officials told us land acreage is used as the basis to allocate indirect costs for managing the CSF and Board of Forestry lands. Thus, a Forestry employee working in a district or area office whose primary responsibility is to manage both CSF and Board of Forestry lands would have costs, such as vacation leave, allocated to CSF based on

the percentage of CSF land in that district or area.

However, we found that some of Forestry's district and area offices used incorrect acreage numbers or a basis other than acreage to allocate indirect program costs. For instance, incorrect acreage numbers resulted in the Salem State Forests Program office consistently overcharging the CSF 1 percent for its indirect costs for at least a nine-year period. We also found that three Forestry field offices used incorrect acreage figures resulting in one 13 percent and two 1 percent overcharges to the CSF.

In addition to incorrect acreage basis numbers, we also found other methods used to allocate indirect program costs. For instance, one field office used projected timber sales in lieu of acreage ownership, resulting in a 13 percent undercharge to the CSF. Although this may have been a reasonable method, it was not consistent with the agreed upon procedure of allocating these costs based on acreage ownership.

Further, in some instances, certain Forestry activities or programs, such as Forestry's Nursery and the Private Forests Program, were not allocated their share of district and area costs. These types of omissions force other activities to overpay for their portion of services.

Other miscellaneous errors we identified included a \$42,500 overcharge to the CSF for contracted services performed on non-CSF forest land and a \$16,500 overcharge caused by formula errors in a spreadsheet used to allocate legal fees. After we brought these errors to Forestry's attention, both of these charges were reimbursed to State Lands.

## Forestry's Accounting Records Precluded Identification of Indirect Program Charges

Forestry chose not to fully utilize the level of detailed coding available in the statewide accounting system. Thus, Forestry's accounting records do not identify whether a charge is direct or indirect without viewing each transaction's corresponding invoice. Therefore, although we identified isolated indirect program allocation errors using sample invoices, the accounting system's limitations made it impractical for us to identify all indirect allocations errors. For example, in the case of the 1 percent overcharge for at least a nine-year period for work performed in the Salem State Forests Program office, the inability to readily identify all allocated charges made it impractical for us to calculate an aggregate total overcharge.

## Forestry Lacks Written Procedures for Allocation Process

Forestry lacked written procedures for the allocation process. For example, Forestry does not have written procedures that identify the appropriate allocation basis. In fact, one field office manager told us she had limited knowledge of how the budget was developed, which included the information used in the allocation process. We were also told that in some instances funding availability drove certain allocation decisions, another practice not reflected in written procedures. Further, Forestry's Salem office does not have written procedures in place to regularly monitor the allocation processes, which could help to ensure accuracy.

## Recommendations

**We recommend** the Department of Forestry work with the

Department of State Lands to clearly define and implement a current basis for allocating administrative costs to the Common School Fund.

### Agency's Response:

*The Department of Forestry partially agrees with the finding and generally agrees with the recommendation. Forestry's response letter is attached to this report beginning on page 7. Forestry's complete response, which includes a corrective action plan, can be found on the Audits Division's website.*

**We recommend** the Department of Forestry develop and implement procedures to:

- require that all programs benefiting from an allocated activity be included in the administrative and program allocations;
- document the basis used for each program allocation type and require that the basis be regularly updated; and
- centrally monitor compliance with the allocation process in the district and area offices.

### Agency's Response:

*Forestry generally agrees with the finding and recommendations. Forestry's complete response, which includes a corrective action plan, can be found on the Audits Division's website.*

**We recommend** the Department of Forestry add the accounting codes necessary to identify direct and indirect charges.

### Agency's Response:

*Forestry generally disagrees with this finding and the recommendation. Forestry's complete response, which includes a corrective action plan, can be found on the Audits Division's website.*

**We recommend** the Department of Forestry and Department of State Lands jointly develop a plan

to identify and recover any significant overcharges and undercharges made to the Common School Fund.

### Agencies' Responses:

*Forestry generally agrees with the finding and recommendation. Forestry's complete response, which includes a corrective action plan, can be found on the Audits Division's website.*

*The Department of State Lands agrees with the recommendation and is currently working with key staff members at the Department of Forestry to achieve the recommendation.*

## Other Matters

In addition to the overcharges we identified, we found other instances in which Forestry and State Lands did not comply with the terms outlined in the Interagency Agreement. Specifically, Forestry charged the CSF in advance for administrative costs and State Lands withheld payment from Forestry for long periods when billing disagreements arose, instead of using the Interagency Dispute Resolution Process.

## Advance Billing for Administrative Costs

The Interagency Agreement stipulates that payments to Forestry for management of CSF forest lands should be "based on actual costs." In August 2006, Forestry billed State Lands approximately \$888,000 for the entire fiscal year's administrative cost allocation. Forestry's intention was to collect this amount up-front and then make any necessary adjustments at year end based on actual administrative costs. Forestry management told us they initiated this process to reduce staff workload associated with monthly billing. However, the process change was not consistent with the Interagency Agreement and resulted in potential lost interest earnings for the CSF.

## Extensive Payment Delays by State Lands

A provision within the Interagency Agreement requires State Lands to pay undisputed billings within 30 days. For any disputed billings, the agreement follows Oregon Accounting Manual requirements, which direct agencies to use the Interagency Dispute Resolution Process administered by the State Controller's Division. However, when State Lands questioned invoice charges, staff withheld payment from Forestry, sometimes up to five months, instead of using the Dispute Resolution Process.

Two factors led to the significant payment delays. First, State Lands' management was not familiar with the Interagency Dispute Resolution Process. Second, Forestry's invoices were complex and did not clearly identify the precise land management charges billed. Therefore, State Lands' management often withheld payment for the entire bill until the questioned charges were resolved. Withholding payments for extended periods could negatively impact Forestry's cash flow.

### Recommendations

**We recommend** the Department of Forestry either bill actual costs periodically, such as monthly, or work with State Lands to modify the agreement.

**We recommend** the Department of State Lands use the Interagency Dispute Resolution Process for any disputed billings.

**We also recommend** the Department of Forestry and Department of State Lands jointly agree on an invoice presentation that clarifies charges.

#### Agencies' Responses:

*The Department of Forestry partially agrees with these findings and generally agrees with the recommendations. Forestry's complete response, which includes*

*a corrective action plan, can be found on the Audits Division's website.*

*The Department of State Lands agrees with the recommendation. The Department of State Lands will use the Interagency Dispute Resolution Process for any disputed billings and is working with key staff at Forestry to develop and implement an invoice format that meets the needs of both agencies.*

### Objectives, Scope and Methodology

The purpose of this audit was to determine whether costs the Department of Forestry charged for management of Common School Fund forest lands were reasonable and in compliance with the Interagency Agreement between the Department of State Lands, Oregon Department of Forestry and State Land Board. To accomplish this we:

- reviewed the June 2005 Interagency Agreement, including clarifying provisions, between the State Land Board, the Department of State Lands, and the Department of Forestry;
- reviewed pertinent sections of the Oregon Constitution, laws, rules, and statewide and agency policy and procedures;
- identified best practices for cost allocation and contracting for services, and interviewed officials of other states with significant forest land holdings to learn about their programs, including management cost tracking and cost allocation methods;
- interviewed Forestry, State Lands, Oregon Department of Administrative Services, and Oregon Legislative Fiscal Office staff to gain an understanding of the issues, including billing, payment, and allocation methods and processes; and

- reviewed Forestry's annual reports on the CSF, State Land's asset management plans, State Land Board meeting minutes, and the Secretary of State Audits Division's 1995 audit and subsequent 2000 follow-up audit of Forestry's state forest management program cost allocation processes.

Given the significance of district and area office operations in the administration of Forestry's State Forests Program, we also conducted site visits to district and area offices responsible for significant CSF forest land management.

For our review of the department's allocation of administrative costs and direct and indirect program related transactions, we used Oregon's Statewide Financial Management Application (SFMA) transaction data from July 2005 through December 2006, which was extracted from the state's DataMart. We determined the data extracted from the DataMart was sufficiently reliable for our audit purposes based upon prior application control reviews our office performed and comparisons of DataMart expenditure data to invoices.

For our review of Forestry's direct and other indirect program related transactions, we also used transaction data from July 2005 through December 2006 extracted from the Oregon State Payroll System (OSPS). We determined the data was sufficiently reliable for our audit purposes based upon reconciliation testing between SFMA and OSPS data to ensure detailed payroll data agreed to SFMA data. This was necessary because SFMA data is the basis for amounts billed to State Lands. Further, to test the appropriateness of personal services charges, we reviewed employees' timesheets.

We also used land ownership data maintained by Forestry. We

determined the ownership data for total CSF acreage was sufficiently reliable for our audit purposes based upon reconciliations with other State Land and Forestry acreage publications. We did not determine the reliability of the data at the district level or the total acreage for Board of Forestry land. Forestry uses a combination of land deeds and geographic information system data to determine acreage splits between Board of Forestry and CSF lands. We limited our review to total acreage amounts for the CSF lands. If the acreage splits determined by Forestry are not accurate, our overcharge estimates that use acreage as a basis for allocating management costs could be affected.

The audit scope included CSF forest land management costs incurred during the period July 2005 through December 2006. We identified management costs using Forestry prepared invoices, which we compared to SFMA data. Costs included both central services administrative costs billed to State Lands for the fiscal year beginning July 1, 2005, and program related direct and indirect costs billed to State Lands from July 2005 through December 2006.

We used Forestry's 2006 administrative prorated cost study as a basis to determine the reasonableness of administrative expenses billed to State Lands. We obtained the cost study's measures and data for each of the 16 central service units that fed into the administrative prorated. Of the 16 units, we reviewed 13, which represented approximately 90 percent of total administrative costs.

For our review of Forestry's direct and other indirect program transactions, we judgmentally selected a sample of 116 personal services, services and supplies, and capital outlay transactions totaling approximately \$540,000. We selected approximately 91 percent of the transactions based on risk

and other factors (e.g. questionable vendor name, high dollar amount, payment frequency to any single vendor, and coverage across field offices) and randomly selected approximately 9 percent. Since our sample was selected on a transaction basis, we extended our testing when necessary to include other transactions noted on the related invoice or timesheet.

We identified and tested key controls Forestry established to approve and allocate expenses. Specifically, we determined whether each transaction was adequately supported and accurately allocated. To do so, we reviewed supporting documentation and processes used to account for and report program expenses. We also verified the basis (e.g. acreage ownership, budget information) and allocation method used for the various types of transactions processed (e.g. payroll, vehicle use, and contract payments).

In addition to the transaction-level review, for recurring district or area level indirect charges, we performed limited testing and verification of the underlying allocation bases used.

We conducted this performance audit in accordance with generally accepted government auditing standards. These auditing standards require auditors to be independent of the audited organization to avoid an actual or perceived relationship that could impair the audit work performed or findings reported. The Secretary of State is the constitutional Auditor of Public Accounts and also serves as a member of the State Land Board, the trustee of the CSF. Because the Secretary did not play a role in determining the objectives or scope of our audit, or the information presented in this report, we do not believe his membership on the State Land Board constitutes an organizational impairment.



# Oregon

Theodore R. Kulongoski, Governor

## Department of Forestry

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"STEWARDSHIP IN FORESTRY"

October 28, 2008

Charles A. Hibner, CPA, Director  
Audits Division, Office of the Secretary of State  
255 Capitol Street NE, Suite 500  
Salem, OR 97310

RE: Final Draft Report No. 2008-00, Departments of Forestry and State Lands: Review of Common School Fund Forest Land Management Costs

Dear Mr. Hibner:

This letter is in response to the draft Review of Common School Fund Forest Land Management Costs transmitted to us as Report No. 2008-00 dated September 18, 2008, and final draft transmitted October 17, 2008. The following, plus enclosure, constitutes our response to and corrective action plan for the items identified in this audit.

In summary, we generally concur with the findings of the audit, and agree with most of the recommendations. Please see the enclosed agency response and corrective action plan for our response and plan for each of the specific findings and recommendations. Note that one of the central issues of this audit relates to the Department of Forestry's biennial budget, and as you know from the course of this audit and the previous audits of 1995 and 2000, proper alignment of our budget with work performed is essential to correct cost allocation for providing land management services.

We do believe it is important to place the general financial findings of the report in context, and we note that the draft audit report did not provide this relative framework. This is particularly important as we examine the amount of revenue generated for the Common School Fund by the management of these lands, and the total costs of management. As stated in the summary of the audit report (page 1), the auditors "...found errors in program costs billed to State Lands for personal services, services and supplies and capital outlay that occurred during the period of July 2005 through December 2006. We identified approximately \$99,000 in net overcharges for these costs." For this 18-month period, the total revenue generated from these lands was approximately \$24,015,000, and the costs billed for management to the Department of State Lands was approximately \$7,946,000. The chart in Attachment 1 of this letter shows both the amount of gross revenue generated and the total amount of Department of Forestry management costs for Common School Forest Lands for the fiscal years 1998 through 2008. While any error in cost accounting is important to address, the context for the findings is important.

We also believe it is important to note the nature of the samples chosen for review in this audit. The sampling used was heavily weighted to transactions that directly affected the Common School Forest Lands side of the State Forests Program, and less so to transactions that may have directly affected the Board of Forestry Lands of the Program. Using a sampling method that pulled transactions from across both types of lands may have identified either over or under charges across both types of lands. We will be examining this possibility further in our ongoing



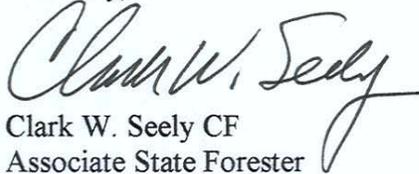
work with the Department of State Lands staff as we modify and improve our interagency agreements and processes.

As we conclude this phase of the process with your staff, we will be preparing a detailed agency action plan with the responsible managers to implement and monitor our own response efforts. We will then be prepared to review our progress with your staff on all findings in future years as part of follow-up or the annual financial audit.

As we have shared with the Audits Division in recent years during other periodic or special audits, this audit process, and the subsequent results, have been very productive for the Department of Forestry, and I believe will serve us well in the years to come, particularly in our ongoing working relationship with the Department of State Lands. On behalf of the agency staff who worked directly with your audit team, I would like to thank you, Will Garber, and the audit team of Sandra Hilton, Nicole Miller, Tenzin Choephel, and Karen Peterson for the professional approach that they took for this assignment, and the genuine interest that they demonstrated in making this a very positive, collaborative process that will truly assist us in making improvements to our business management practices. We recognize that auditing is a valuable tool and your audit team's approach and attitude during this process has been helpful and supportive in creating possibilities for practical improvements for the Department.

Please contact me if you have any questions regarding our response. We look forward to our continued working relationship with the Audits Division.

Sincerely,

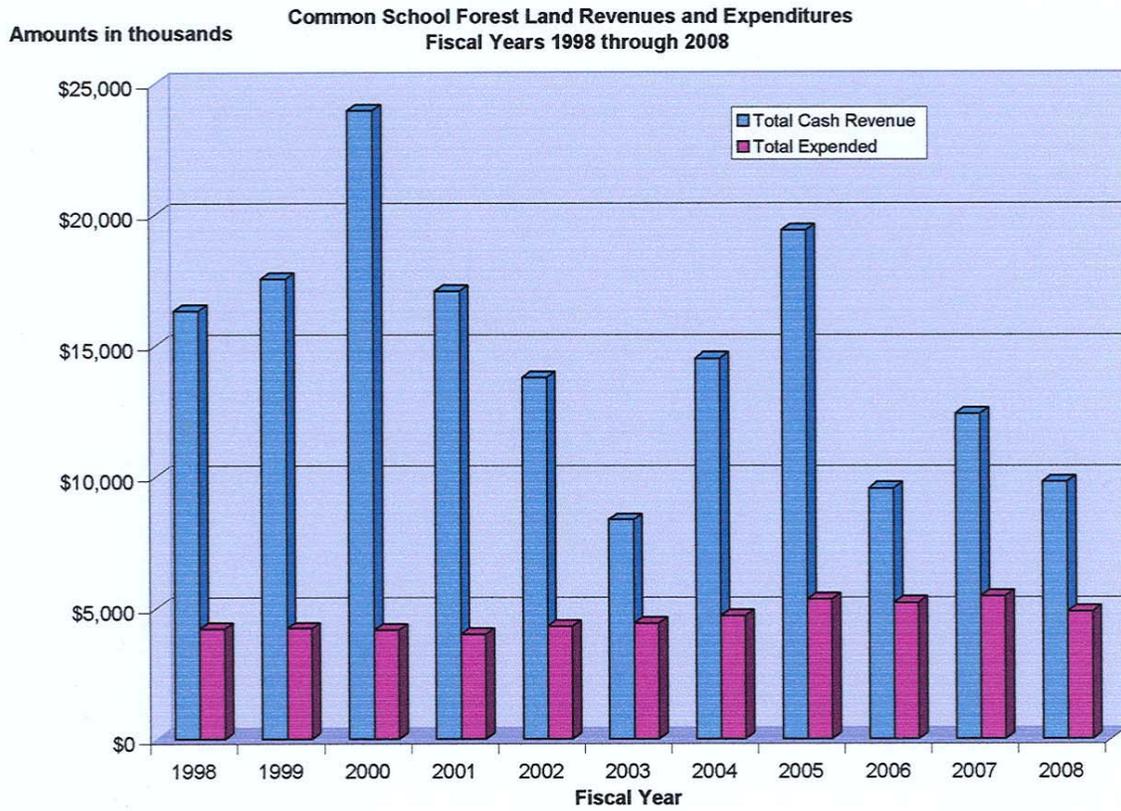


Clark W. Seely CF  
Associate State Forester

Enclosure – Agency Response

cc: Sandra Hilton, CPA, Audit Manager  
Nicole Miller, MPA, Senior Auditor  
Scott Harra, Director, Oregon Department of Administrative Services  
Mike Carrier, Governor's Natural Resources Policy Director  
Louise Solliday, Director, Oregon Department of State Lands  
Pamela J. Valencia, CPA, CIA, Chief Audit Executive, DAS  
Kathryn Ross, Statewide Accounting and Reporting Services, DAS  
Oregon Board of Forestry  
Agency Audit Committee  
Agency Leadership Team  
David Clouse, Chief Audit Executive, ODF  
Satish Upadhyay, Budget Analyst, Budget and Management Division, DAS

ATTACHMENT 1





**Secretary of State  
Audits Division**

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**Auditing to Protect the  
Public Interest and Improve  
Oregon Government**

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*Courtesies and cooperation extended by officials and staff of the  
Department of Forestry and Department of State Lands were  
commendable and much appreciated.*

*This report, a public record, is intended to promote the best possible  
management of public resources. Copies may be obtained:*

*Internet: <http://www.sos.state.or.us/audits/index.html>*

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