



Oregon

Theodore R. Kulongoski, Governor

Department of Forestry

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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



"STEWARDSHIP IN FORESTRY"

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 worked 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,

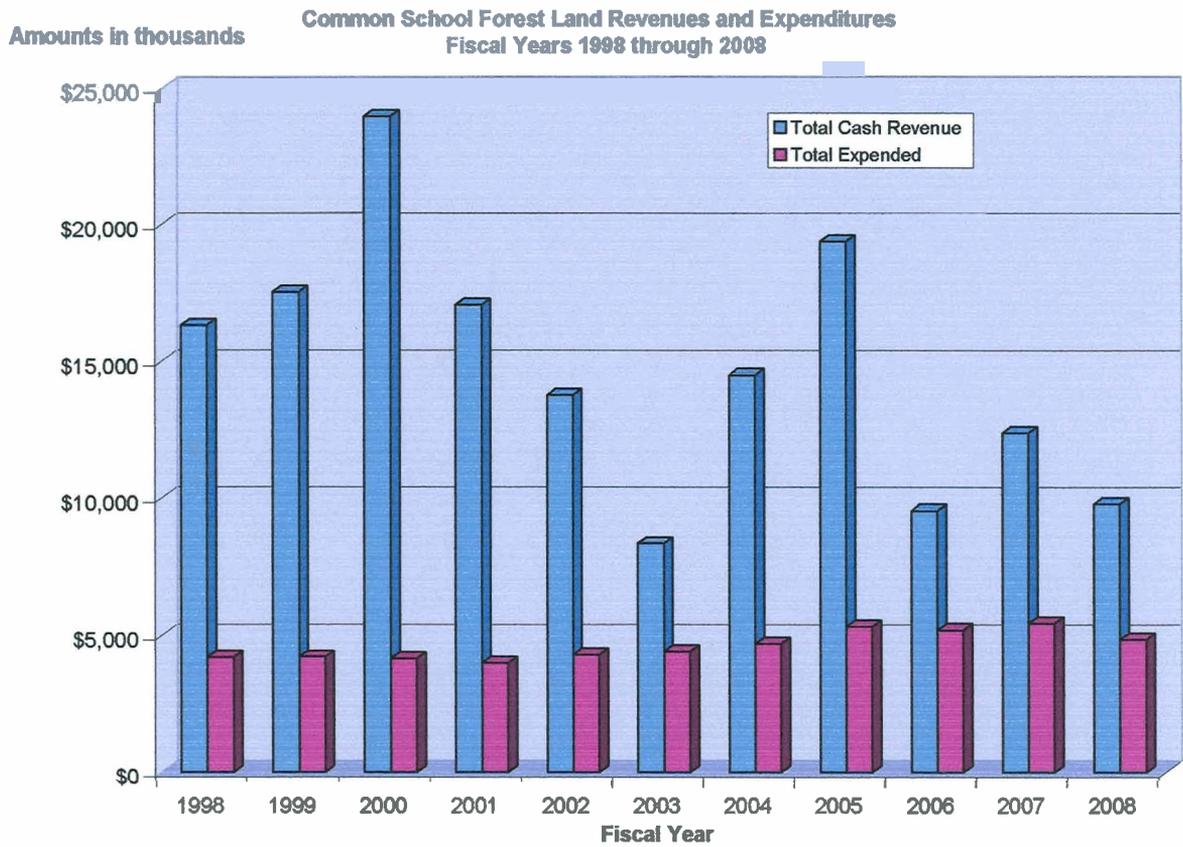
Clark W. Seely CF
Associate State Forester



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



Oregon Department of Forestry
Review of Common School Fund Forest Land Management Costs
Agency Response – Corrective Action Plan
Final Draft Audit Report No. 2008-00 (October 17, 2008)
October 22, 2008

FINDING 1

Administrative Cost Overcharges

RECOMMENDATION

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 Oregon Department of Forestry (ODF or the Department) partially agrees with the finding and generally agrees with the recommendation. However, until the Oregon legislative process produces a biennial budget cost distribution for the Department's Agency Administration Program that establishes, by law, different funding to reflect the current administrative activity, the Department is unable to change the allocation rates and therefore, is not able to fully implement the recommendation. To do so, absent of a legislative change, would violate state law. It is only for this reason that, in the words of the audit report, "administrative cost overcharges" exist.

The Department's Agency Administration Program is funded with a mix of state General Funds (GF), Other Funds (OF), and Federal Funds (FF) revenues established in the biennial budget process. The ratio between these revenue types is determined by a biennial evaluation of the work performed by each administrative function on behalf of the operating programs, e.g. payroll work for the Fire Protection Program, accounting work for the State Forests Program, or information technology work for the Private Forests Program. This evaluation then results in a distribution of the revenue types on a percentage basis from the operating programs.. When the evaluation results determine that the distribution has changed, the agency must request that the new funding distribution be approved in the legislative process during budget completion. If approved, the new distribution would be implemented in the upcoming biennium. If not approved, the current distribution must continue to be used. This method was implemented in the mid-1990's in response to a Secretary of State audit (#95-30, August 18, 1995) and a subsequent State Treasurer review, and was affirmed in the early 2000's by a follow-up Secretary of State audit (#2000-08, February 28, 2000). Although evaluation and biennial budget requests have been submitted three times (to-date) by the Department during the development of the Agency Request Biennial Budget, the legislative process has not approved a change. Therefore, the distribution has not been adjusted to reflect the updated administrative work distribution, and in particular, was not changed for the period of this audit.

Oregon Department of Forestry
Review of Common School Fund Forest Land Management Costs
Agency Response – Corrective Action Plan
Final Draft Audit Report No. 2008-00 (October 17, 2008)
October 22, 2008

In order to comply with the prior audit findings of 1995 and budget approval process, the biennial budget package for realignment of the administrative revenues must be approved by passage of a budget bill, becoming Oregon law. For the 2009-11 budget cycle, the Department conducted the work evaluation, and requested a Base Budget Exception to make this change, with a rationale that the rebalance is not a policy issue, but rather a technical revenue realignment. However, this request was denied by the Department of Administrative Services, Budget and Management Division. Upon denial of the budget exception, the agency placed the realignment need into a Policy Option Package and included that package in the Agency Request Budget, reviewed and approved by the Oregon Board of Forestry on July 24, 2008, and submitted to the DAS Budget and Management Division on September 1, 2008. Budget realignment during the 2009 legislative session is now the only resolution available to the Department to implement changes to the funding ratio for the Agency Administration Program.

The Department fully agrees that percentages applied to each operating program should reflect the associated work completed by the Agency Administration Program staff and ideally, we believe, should be adjusted each biennium. However, until legislative action aligns the funding distribution correctly, the Department has no other option than to continue to use the last approved distribution. Given the circumstances, in accordance with the biennial budget established in Oregon law, the Department concludes that the Common School Fund revenue source was appropriately accessed.

Timeline:

The anticipated completion date is June 30, 2009, with the passage of the Department's 2009-11 biennial budget by the 2009 Legislative Assembly.

Contact Person:

Mark Hubbard, Business Services Program Director for the Department of Forestry, 503-945-7231.

FINDING 2

Incorrect Program Costs

RECOMMENDATION

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;

Oregon Department of Forestry
Review of Common School Fund Forest Land Management Costs
Agency Response – Corrective Action Plan
Final Draft Audit Report No. 2008-00 (October 17, 2008)
October 22, 2008

- 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

The Department of Forestry generally agrees with the finding and recommendations. The Department plans to implement the recommendations by:

1. *Working jointly with the Department of State Lands (DSL) to come to agreement on a basis for indirect cost allocation and document that basis in the Common School Forest Land Management Agreement or Sub-Agreement.*
2. *Agency management will institute a policy that requires all operating programs be included in all relevant indirect cost allocations.*
3. *The Department is in the process of developing a formal methodology and a system to allocate all operating program (Fire Protection, State Forests, Private Forests) costs to appropriate budget categories and cost centers. This system will be used for the allocation of all costs across the Department that are shared by more than one cost center, program, project, or grant. The policies and processes surrounding the allocation of costs will be developed as a part of the design of this system. The methodology will lay out the basis for allocating specific types of costs and will be based on current best practices in the field. The Department has already hired a limited duration Business Analyst who will assist with designing the methodology, policies, procedures and help in the actual design, training and implementation of the new system. Following analysis and general design, the Department will contract with outside resources to build and implement the automated system, making necessary linkages and to other agency subsystems or systems external to ODF. The Department has established a workgroup to respond to the audit findings, and this workgroup will also be utilized to help guide development of this allocation methodology and system.*
4. *As part of the new allocation system, monitoring of the allocation process for compliance with the policies and procedures will take place centrally by the Business Services Program.*

Timeline:

The anticipated completion date for implementation of these recommendations is July 1, 2009

Contact Person:

Ed DeBlander, State Forests Program Asset Unit Manager for the Department of Forestry, 503-945-7348, regarding corrective action on the State Forests Program cost allocation changes;

Oregon Department of Forestry
Review of Common School Fund Forest Land Management Costs
Agency Response – Corrective Action Plan
Final Draft Audit Report No. 2008-00 (October 17, 2008)
October 22, 2008

Mark Hubbard, Business Services Program Director for the Department of Forestry, 503-945-7231, regarding corrective action on the Department-wide cost allocation system.

FINDING 3

Forestry's Accounting Records Precluded Identification of Indirect Program Charges

RECOMMENDATION

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

AGENCY'S RESPONSE

The Department of Forestry generally disagrees with this finding and the recommendation.

In financial accounting, costs can be categorized in a number of different ways, e.g. variable/fixed/mixed costs; controllable/non-controllable costs; standard/incremental/sunk/opportunity costs; or direct/indirect costs, to name a few. There is no GAAP requirement to use direct/indirect costs. The Department has utilized the State Financial Management Application (SFMA) accounting system in the method that has most efficiently met the business and performance needs of the organization over the years, with an accounting focus on programs, activities, cost objects, and projects. This gives us the information we need to account for costs at a level of detail that we can manage efficiently.

Our business needs do not drive an accounting focus on direct and indirect costs in any agency program other than our Federal Funds program – and even here, to comply with federal regulations, we do not categorize our costs by direct/indirect, but rather report them in that way - a subtle distinction, but an important one from an efficiency standpoint. Our cooperative work over the years with the Department of State Lands for forest management has also not driven a business need for direct/indirect accounting distinction. At one point in the early conversion to the SFMA, the agency had separate cost centers for direct and indirect costs, but use of the coding structure became so cumbersome, complex and time-consuming that coding was not accomplished correctly, and even the basic program and activity data was compromised. The coding structure was then simplified to make sure we collected the statutory and programmatic data necessary to fulfill the needs of management. That approach continues to be the most appropriate methodology today.

The revised agency cost allocation system that the Department is implementing will allow us to report costs that will be directly charged to a fund from a cost that is charged to more than one cost center. It will contain the backup data needed to assess whether the methodology chosen for a specific allocation is valid or not. It will allow the agency to correctly allocate it's costs to

Oregon Department of Forestry
Review of Common School Fund Forest Land Management Costs
Agency Response – Corrective Action Plan
Final Draft Audit Report No. 2008-00 (October 17, 2008)
October 22, 2008

all cost centers including Common School Fund forest management work in the correct amount based on the activity performed.

Contact Person:

Mark Hubbard, Business Services Program Director for the Department of Forestry, 503-945-7231.

FINDING 4

Forestry Lacks Written Procedures for Allocation Process

RECOMMENDATION

We recommend 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.

AGENCY'S RESPONSE

The Department of Forestry generally agrees with the finding and recommendation. For resolution of the written procedures for allocation, see responses above for Finding 2. Relative to planning to identify and correct charges to the Common School Fund, the Department is working jointly with the Department of State Lands to developing such a plan. Those discussions and plans have already been underway for more than a year, and the two agencies have developed documentation and initial processes to provide a framework for examination of charges.

Timeline:

The anticipated completion date is July 1, 2009

Contact Person:

Nancy Hirsch, State Forests Division Chief for the Department of Forestry, 503-945-7204.

OTHER MATTERS

FINDING 5

Advance Billing for Administrative Costs

FINDING 6

Extensive Payment Delays By State Lands

Oregon Department of Forestry
Review of Common School Fund Forest Land Management Costs
Agency Response – Corrective Action Plan
Final Draft Audit Report No. 2008-00 (October 17, 2008)
October 22, 2008

RECOMMENDATIONS

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

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

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

AGENCY'S RESPONSE

The Department of Forestry partially agrees with these findings and generally agrees with the recommendations. The Department of Forestry will review the method of advanced billing for administrative costs and develop a mutually agreeable method with the Department of State Lands. The Department has already made considerable changes to the format and content of the backup information and documentation provided to DSL with the invoice, as well as the layout of the invoice itself. The Department will continue to work with DSL to mutually agree on the acceptable format for all data and bills that are sent between the two agencies.

Timeline:

The anticipated completion date is July 1, 2009

Contact Person:

Lorene Judge, Fiscal Manager for the Department of Forestry, 503-945-7230.