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Auditing for a Better Oregon

May 5, 2003

Marty Brantley, Director
Oregon Economic and
Community Development Department
775 Summer Street NE
Salem, Oregon 97301

Dear Mr. Brantley:

We have completed our financial statement audit of the Oregon Economic and Community Development Department (department) Special Public Works Fund (SPWF) and Water Fund (WF) bond programs for the fiscal year ended June 30, 2002. During our audit, we did not identify any reportable conditions related to internal control or to noncompliance with applicable laws and regulations. Professional auditing standards define reportable conditions as matters relating to significant deficiencies in the design or operation of internal control over financial reporting that, in our judgment, could adversely affect your ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. We did identify the following issues that we determined were not reportable conditions, but did require management's attention. We previously met with department fiscal staff to discuss these issues.

Loan Compliance

SPWF and WF may provide financial assistance for project activities including the construction, improvement or expansion of certain publicly owned infrastructure facilities and publicly owned drinking water and wastewater systems, respectively. The department has developed a project management handbook to assist recipients of the SPWF and WF program awards to comply with requirements governing each program. The guidelines specifically address financial management, monitoring objectives and the documentation requirements for the project files.

During our audit, we reviewed selected SPWF and WF projects both completed and under development to determine whether projects were managed as intended. Review of project files identified the following weaknesses:

- Coordinators did not always perform the required monitoring activities in a timely manner.

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- Project phases and monitoring activities were not clearly defined for each project.

- In a few instances, coordinators did not always file supporting documentation for expenditures listed on cash requests. For example, invoices were not in the file to support the expenditures on the cash request form.

- In one instance, managers did not follow the stated process to amend a WF contract, but instead created a new contract. As a result, the project may be over the financing limits by $205,175.

This situation exists, in part, because management has not ensured that established policies and procedures are adhered to. In addition, management stated that budget constraints have limited the number of staff available to complete all project requirements.

We recommend that management:

1. Define and document in its guidelines what constitutes various monitoring activities, project phases and the timing for on-site monitoring. The on-site monitoring should ensure that problems are identified and corrected early, before the project's success is jeopardized.

2. Consider as a deliverable, documenting the requirements for monitoring activities, project phases and the timing of on-site monitoring for each individual project at the beginning of each project. At a minimum, the following should be considered when determining the appropriate monitoring activities to perform on each project:

   - Project complexity
   - Project size
   - Prior relationships with the municipality/contractor
   - Project duration
   - Monies involved

3. Ensure that regional teams and other staff implement the changes and follow the project requirements, including obtaining all necessary supporting documentation for the project files.

Interest Receivable Calculation

The department issues loans to municipalities for approved project activities. Repayment of these loans includes principal and interest. Because loan payments are due after the fiscal year's end, interest on those loan payments must be accrued. We reviewed the department's calculation of interest receivable and interest income for the SPWF and WF to ensure that the accrual and income amounts were accurately calculated and recorded.

For both funds, we found that interest receivable was incorrectly calculated. As a result, the SPWF was originally understated and the WF was originally overstated on the financial statements for the year ending June 30, 2002. Those amounts, however, did not have a material effect on the financial statements, and department management made adjustments to the accounts before the financial statements were issued. This situation also was communicated during the fiscal year 2001 audit.

This condition exists because department staff were not recording all of the interest earned in the proper accounting period for both funds, thus causing the interest income to be understated for the SPWF and overstated for the WF by an immaterial amount.

We recommend that department management implement policies and procedures to ensure that interest receivable and interest income calculations are reasonable, accurate and verified by an internal independent review.

In addition, we noted issues regarding deposits not being made by the next business day and internal control concerns regarding segregation of duties, which will be reported in our forthcoming report on Oregon Tourism Commission and Oregon Economic and Community Development Loss of Funds.

We will follow up on the department's progress in addressing these issues during our audit of the fiscal year 2003 SPWF and WF financial statements. Should you have any questions, feel free to contact Michelle Rock or me at (503) 986-2255.

Sincerely,
OREGON AUDITS DIVISION

Nancy L. Young, CPA, CISA
Audit Administrator

Fieldwork Completion Date:
April 1, 2003

NLY:bk
cc: Janet Rafalovich, Fiscal Services Manager
Gary Weeks, Director, Department of Administrative Services

May 14, 2003

ECONOMIC & COMMUNITY DEVELOPMENT DEPARTMENT
OREGON

Cathy Pollino, CGFM
Director, Audits Division
Office of the Secretary of State
225 Capitol Street NE Suite 500
Salem, Oregon 97310

Dear Ms. Pollino,

We are in general agreement with the concerns raised in your management letter, but do not agree with all issues involving loan compliance. In response to your suggestions, the department has undertaken corrective actions that are addressed in greater detail below:

Loan Compliance

> Coordinators did not always perform the required monitoring activities in a timely manner.

Management reviewed projects examined by the auditors and disagrees with the determination that required monitoring activities were not performed in a timely manner. The auditor's concern relates to formal, on site monitoring visits specified in the department project management handbook and does not take into consideration other monitoring practices such as review of each cash request and oversight of special contract conditions. A universal element of all projects is careful review of each cash request. In this monitoring process, invoices are required and are compared with project budgets to ensure expenditures are appropriate. This allows the agency to track the progress of all projects and see that the terms and conditions of agreements are fulfilled. This typically happens on a monthly basis, but may be more frequent than that. Also, depending on the scale of a project, other project oversight activities are prerequisites to commencement of construction and are made part of the agreement as special contract conditions. They include such items as review of project construction plans and contracts between the recipient of state funds and the businesses designing and building the project. Collectively these activities contribute to oversight and constitute monitoring activities in addition to on-site visits.

The project management handbook states that the department sees monitoring as an ongoing process involving continuous recipient communication and evaluation and will be performed once during the project period. The guidebook also states that monitoring visits will be timed to "coincide with the various phases of each project." Due to overall budget cuts by legislative sessions, management made a deliberate change in practice reducing all travel budgets which resulted in a reduced number of on-site visits.

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Management directed staff to limit routine on-site visits to once per project and to time these visits near the end of a project to ensure that the recipient met its various obligations under the project agreement. The auditors suggest that if there is a single on-site visit, it would be useful to conduct that visit early on in a project to allow the recipient to adjust any faulty practices or approach. Management sees this as a trade off and understands the value of the suggested approach. We are willing to modify our practice per the auditors' suggestion. The department is currently reviewing its monitoring practices and will be adopting new procedures and subsequently will modify the project monitoring handbook.

In addition, projects reviewed by the auditor's are, for the most part, still under construction and construction on one project had not yet started. On-site monitoring has either been conducted since the audit concluded or is planned in the future so that under the current approach, monitoring is consistent with management's direction and is not cause for concern. Management believes staff consistently fulfills required monitoring activities based on the factors discussed above and as defined in the project management handbook.

Project phases and monitoring activities were not clearly defined for each project.

Given that management has responded to the budget crisis and directed that routine on-site visits be limited to minimize travel costs, the need for on site monitoring in conjunction with phases of the project is no longer relevant. The department is redesigning its monitoring practices and will update its policies and procedures manuals to ensure manuals reflect both current and proposed practice. Any new processes will incorporate the recommendations of the auditors as communicated in the management letter.

- In a few instances, coordinators did not always file supporting documents for expenditures listed on cash requests. For example, invoices were not in the file to support the expenditures on the cash request form.

These concerns fall into two types. In one case, the cash request was not supported by documentation in the file. That documentation has been collected and added to the project file. The other type of concern occurred in two of the reviewed cases. Management reviewed the projects and found that there were multiple funding sources comprising each project. The department currently maintains separate files for each funding source used in a project. Examination of the corollary files for these projects found the documentation for the cash request was contained in the project file for the other funding sources. Either a memo directing examiners to the other file or a copy of the documentation should have been placed in each file. This situation has been corrected.

> In one instance, managers did not follow the stated process to amend a Water Fund contract, but instead created a new contract. As a result the project may be over financing limits by $205,175.

Management agrees with the conclusions drawn by the auditors. The department has created a new step in the review process between project approval and contract issuance to address the underlying issue in the case identified above. That step is now a part of the approved process. The issue above arose because the amendment included a loan and the original project elements were all grant. The additional provisions required for the loan were extensive enough so the staff involved created an entirely new contract document to address the new loan. While the line of reasoning applied by staff can be followed, steps taken were outside the approved process.

The final paragraph under the loan compliance section of the letter suggests that management has not ensured adherence to established policies and principles. As stated above, management believes this is generally not the case. Management has communicated policies to staff and staff has been diligent, with limited exceptions as those noted above. Management has not been diligent in requiring that policy and procedure manuals be updated as frequently as policy is changed in the area of project monitoring. Management is addressing this shortcoming and manuals will be updated as the current process refinement effort takes place.

Interest Receivable Calculation

The department agrees with the concern that errors were made on some loans' interest receivable accrual calculation. An accrual partitions revenue between two fiscal year periods. Interest receivable accrual requires individual calculations for over 400 loans and cash disbursements using the number of days between the last loan payment due date and the end of the financial statement's fiscal year. In most cases, errors were caused by date formulas being "off" by a day or less than a month. For direct loans, the method used by staff was reasonable however auditors recommended a different approach. As soon as interest receivable accrual issues were identified, financial statements for Special Public Works Fund and Water Fund were corrected before they were issued. Management agrees with the auditor's recommendation to independently verify interest receivable accrual calculations in the future. We appreciate the professional work of your team involved in the audit. If you have any questions about our response, please do not hesitate to contact me.

Sincerely,

Marty Brantley

Marty Brantley, Director