Office of the Secretary of State

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Secretary of State

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February 7, 2008

The Honorable Randall Edwards
Oregon State Treasurer
159 State Capitol
Salem, Oregon 97301

Dear Mr. Edwards:

We have completed our review of internal controls over financial reporting for the Office of the State Treasurer (Treasury). Our review was limited to evaluating the design of controls relevant to an audit of the financial statements of state agencies who rely upon Treasury for financial information and to determine whether these controls were implemented as of June 30, 2007. Our review was not designed to express an opinion on the effectiveness of Treasury's internal control. Accordingly, we do not express an opinion on the effectiveness of Treasury's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

Based on our audit, we identified one significant deficiency and two other matters. We do not consider these deficiencies to be material weaknesses. The significant deficiency requires a corrective action plan. Our findings and recommendations are presented in the enclosed Audit Findings and Recommendations Summary accompanying this letter.

The significant deficiency, along with your response, will be included in our statewide single audit report. Including your response satisfies the federal requirement that management prepare a Corrective Action Plan (CAP) covering all reported audit findings. Satisfying the federal requirement in this manner, however, can only be accomplished if the response to each significant deficiency includes the information specified by the federal requirement, and only if the responses are received in time to be included in the audit report. The following information is required for each response:

1. Your agreement or disagreement with the finding. If you do not agree with an audit finding or believe corrective action is not required, include in your response an explanation and specific reasons for your position.
2. The corrective action planned.
3. The anticipated completion date.
4. The names of the contact persons responsible for corrective action.

We will follow up on Treasury's progress in addressing these deficiencies during the next fiscal year audit.

Please respond by February 14, 2008.

This communication is intended solely for the information and use of management, others within the organization, and the Oregon Investment Council and is not intended to be and should not be used by anyone other than the specified parties.

Should you have any questions, please contact Jean Hodges or me at (503) 986-2255.

Sincerely,
OREGON AUDITS DIVISION

Julianne Kennedy, CPA
Audit Manager

JK:brk
cc: Linda M. Haglund, Deputy State Treasurer
Curt Hartinger, Internal Audit Manager / IT Security Officer
Richard B. Solomon, Chair, Oregon Investment Council
Kris Kautz, Acting Director, Department of Administrative Services

Audit Findings and Recommendations Summary
Office of the State Treasurer Internal Control Review
State Fiscal Year 2007

SIGNIFICANT DEFICIENCY

Controls Over Reasonableness of Alternative Equity Valuations in Accordance with GAAP

The Office of the State Treasurer (Treasury) plays an important role in the state's reporting entity and is responsible for managing the state's investments and for maintaining accurate accounting records in accordance with generally accepted accounting principles (GAAP). Treasury is responsible for providing adequate investment information to enable state agencies and the Statewide Accounting and Reporting Services to complete the Comprehensive Annual Financial Report of the State of Oregon in accordance with GAAP.

The Oregon Investment Council contracts with external managers to create partnerships to invest in alternative equities, primarily for the Oregon Public Employees Retirement Fund (OPERF). These alternative equities do not have readily determinable market values, but are required to be reported at fair value.[1]

One type of alternative equity investments in OPERF are private equity partnerships. Pacific Corporate Group, a private consultant, monitors the performance of these investments and reports to Treasury.

State Street Bank is the book of record for investment values reported in the state's annual financial report. As part of this service, State Street Bank compiles information from the partnerships to derive the alternative equity investment balances. Treasury receives reports from State Street Bank and distributes them to appropriate state agencies for reporting in the state's annual financial report.

The American Institute of Certified Public Accountants recently issued a practice aid for auditors that was developed by the Alternative Investment Task Force. This guidance emphasizes that, because of their nature, alternative investments can be complex and involve significant judgment in determining their fair value and that the investment entity (Treasury) is responsible for the valuation process and related internal controls. The guidance goes on to emphasize, "although the investor entity's management may look to the fund manager for the mechanics of the valuation, management must have sufficient information to evaluate and independently challenge the fund's valuation." Prudent business practices also suggest that management have adequate controls in place to ensure the proper valuation of the state's investments in accordance with GAAP.

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[1] GASB Pe5.116

While Treasury management appears to have implemented controls over the management of these investments, we found Treasury does not have sufficient controls in place to ensure the alternative equity investment valuations are reported in accordance with GAAP.

Alternative Equity Valuations

Private equity partnerships within the alternative equity investments account totaled approximately $7.5 billion of the pension trust investments at June 30, 2007. Although management has knowledge of the nature of the investments and the portfolio strategy, we found that Treasury relies on State Street Bank for the valuation that is reported to state agencies and does not have a process in place to evaluate and independently challenge the valuation. We reviewed the information prepared by State Street Bank for the quarter ended June 30, 2007, as it was provided by Treasury for OPERF. We found that State Street Bank did not record the market values for three of the 147 partnerships, resulting in a $104.8 million understatement. Treasury management corrected all known misstatements in subsequent reports to OPERF.

Application of Discounts

State Street Bank values investments in accordance with their clients' instructions. During fiscal year 2007, Treasury modified their discount policies in accordance with FASB 157, which allows consideration of the effect of all sales restrictions when calculating the fair value of equity investments. Consequently, Treasury instructed and State Street Bank applied discounts to public equity investments within the Private Equity Portfolio. The Governmental Accounting Standards Board (GASB), which is the highest source of GAAP for state governments, requires these equity investments to be recorded at fair value, that is, without the discounts. We identified a $52 million understatement that occurred due to Treasury incorrectly reporting the discounts. Treasury management corrected all known misstatements in subsequent reports.

We recommend Treasury management document an understanding of the valuation process used by the partnerships and State Street Bank and establish controls sufficient to evaluate and challenge the valuations on a periodic basis, and provide assurance that the investment information provided by Treasury to state agencies will enable the agencies to report investments in accordance with GAAP.

OTHER MATTERS

Capital Call Verification

Treasury policy on alternative equity investments for the Oregon Public Employee Retirement Fund requires Treasury staff to verify that funding to partnerships does not exceed the maximum amount authorized by the Oregon Investment Council (OIC) or the Private Equity Committee. We found that Treasury staff is not performing this control.

Prior to approval for payment, management expects capital calls to be reviewed by investment staff to ensure that capital commitments are not exceeded. This verification was thought to be performed through access to the Pacific Corporate Group website. Without verification procedures in place, funding provided to Private Equity Partnerships could exceed the commitment authorized by the OIC or the Private Equity Committee and management may not be alerted to the situation.

We recommend Treasury management ensure compliance with their policy by developing and maintaining a process to ensure funding to partnerships does not exceed the maximum amount authorized by the OIC or the Private Equity Committee.

Site Visits to External Fixed Income Managers

Treasury policy requires that Investment Division staff visit each fixed income investment manager on-site, at least annually, to review portfolio results, as well as to discuss guidelines and expectations. We found that Treasury staff did not visit any of the five external fixed income managers during fiscal year 2007.

Over the past three years, we have found that the length of time between site visits varied from twelve months to almost two years. While the term “annually” could be interpreted as once in a calendar year, this interpretation could result in visits as far apart as twenty-three months.

Site visits are one of the controls established to monitor the performance of external managers. Without timely site visits, information that is valuable for identification of issues could be missed.

We recommend Treasury management evaluate the intent of this policy and clarify the frequency of site visits that would appropriately fulfill the monitoring function. We recommend Treasury management ensure compliance with the policy as intended.