

Office of the Secretary of State

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February 24, 2009

The Honorable Ben Westlund
Oregon State Treasurer
159 State Capitol
Salem, Oregon 97301

Dear Mr. Westlund:

We have completed our review of internal controls over financial reporting for the Office of the State Treasurer (OST). Our review was limited to evaluating the design of controls relevant to an audit of the financial statements of state agencies that rely upon the OST for financial information and to determine whether these controls were implemented as of June 30, 2008. Our review was not designed to express an opinion on the effectiveness of OST's internal control. Accordingly, we do not express an opinion on the effectiveness of OST'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. As discussed below, we identified a deficiency in internal control that we consider to be a material weakness.

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.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. We believe that the following deficiency constitutes a material weakness.

Material Weakness – Internal Controls Over Financial Reporting

The Office of the State Treasurer (OST) 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). OST is responsible for providing investment balances in accordance with GAAP for state agencies that have investments held at OST such as the Public Employee Retirement System (PERS) and the Department of State Lands.

The accuracy of reported investments depends on the accuracy and completeness of the OST's investment accounting activities. OST management is responsible for establishing and maintaining internal controls that provide reasonable assurance of the reliability of the financial reporting of investments. These controls include ensuring that information provided to agencies is sufficient to allow agencies to adhere to accounting and reporting policies and procedures included in the Oregon Accounting Manual and governmental accounting and financial reporting standards issued by the Governmental Accounting Standards, Board.

During our review of investment balances for state fiscal year 2008, we noted that OST's controls over its financial reporting of fiscal year 2008 investment balances related to derivatives, short sales, and reverse repurchase agreements were not sufficient to ensure balances were adequately supported and appropriately reported in accordance with GAAP. As a result, OST reported fiscal year 2008 investment related balances that were materially misstated and not in accordance with GAAP to PERS and the Department of State Lands. For PERS, OST reported investment, investment receivable, and investment payable balances that were overstated by \$1.2 billion, \$14.2 billion, and \$15.4 billion, respectively. After adjustment, the account balances were \$60.6 billion, \$3.4 billion and \$3.8 billion, respectively. For the Department of State Lands, OST reported investment, investment receivable, and investment payable balances that were overstated by \$34.6 million, \$101.8 million and \$136.5 million, respectively. After adjustment, the account balances were \$1.01 billion, \$9.5 million and \$8.0 million, respectively. Specifically, we noted misstatements due to the following:

- Forward positions, including To-Be Announced and foreign exchange positions, were reported at notional value instead of fair market value.
- Short sale positions were incorrectly classified as a reduction of investments instead of as liabilities.
- The assets and liabilities of reverse repurchase agreements were netted instead of separately disclosed.

We communicated these errors to OST investment accounting, who took the time to research the issues and ensure their revised fiscal year 2008 investment balances were appropriately reported in accordance with GAAP. Consequently, OST was not able to provide timely investment balance information to state agencies due to the nature of the misstatements and the research involved.

We recommend OST management establish and maintain internal controls over financial reporting of investments to ensure the OST provides state agencies investment balances that are fairly stated in accordance with GAAP. Further, OST management should ensure that sufficient investment accounting resources are allocated to timely provide investment information to state agencies.

Prior Audit Finding

In the prior fiscal year, we reported a significant deficiency to the department in a letter dated February 7, 2008, related to the department's controls over alternative equity valuations. This finding was also included in the Statewide Single Audit Report for the fiscal year ended June 30, 2007; see Secretary of State Audit Report number 2008-03, finding number 07-15. During the current fiscal year, the department made progress in correcting this finding. This finding will be reported in the Statewide Single Audit Report for the fiscal year ended June 30, 2008, with a status of partial corrective action taken.

The material weakness, along with your response, will be included in our Statewide Single Audit Report For the Fiscal Year Ended June 30, 2008. 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 the material weakness includes the information specified by the federal requirement, and only if the response is received in time to be included in the audit report. The following information is required for the 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 name(s) of the contact person(s) responsible for corrective action.

Please respond by March 4, 2009.

This communication is intended solely for the information and use of management, others within the Office of the State Treasurer, 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 me at (503) 986-2255.

Sincerely,
OREGON AUDITS DIVISION

Ben Westlund, State Treasurer
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Julianne Kennedy, CPA
Audit Manager

JK/KO:brk

cc: Andrea Belz, Chief Audit Executive
Katherine Durant, Chair, Oregon Investment Council
Geoff Guilfooy, Office of the State Treasurer Audit Committee
Mike Mueller, Chair, Office of the State Treasurer Audit Committee
Scott Harra, Director, Department of Administrative Services