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February 25, 2010

Dr. Bruce Goldberg, Director
Department of Human Services
500 Summer St. NE, E15
Salem, OR 97301-1097

Dear Dr. Goldberg:

We have completed audit work of selected financial accounts at the Department of Human Services (department) for the year ended June 30, 2009.

This audit work was not a comprehensive audit of the department. Instead, the audit work performed allowed us, in part, to achieve the following objectives: (1) express an opinion on whether the financial statements contained in the State of Oregon's Comprehensive Annual Financial Report were fairly presented, in all material respects, in conformity with generally accepted accounting principles; (2) determine whether the state's internal controls provided reasonable assurance of proper accounting, financial reporting, and legal compliance of transactions; and (3) determine whether the state has complied with applicable legal requirements that may have a direct and material effect on the state's financial statements.

In planning and performing our audit of the selected financial accounts at the department as of and for the year ended June 30, 2009, in accordance with auditing standards generally accepted in the United States of America, we considered the department's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements of the State of Oregon, but not for the purpose of expressing an opinion on the effectiveness of the department's internal control. Accordingly, we do not express an opinion on the effectiveness of the department's internal control.

We audited the following accounts at the department to determine their fair presentation in accordance with generally accepted accounting principles in relation to the statewide financial statements.

SFMA Account	Description	Audit Amount
GAAP Fund 0001 - General Fund		
6900	Other Special Payments	$ 185,034,686
1215	Accounts Payable	(49,987,722)
6800	Distribution To Individuals	625,796,364
GAAP Fund 1108 - Health and Social Services Fund		
0065	Unreconciled Deposit	$ 10,995,197
0070	Cash on Deposit with Treasurer	84,392,732
0503	Accounts Receivable - Other Unbilled	61,026,229
0542	Accounts Receivable - Federal - Unbilled	173,434,979
0300	Federal Revenue	(3,308,963,925)
1105	Other Revenue	(160,379,017)
1215	Accounts Payable	(195,586,528)
1804	Transfers Out To OECDD	19,171,319
6800	Distribution To Individuals	2,918,238,352
GAAP Fund 1109 - Nutritional Support Fund		
0300	Federal Revenue	$ (759,522,169)
6800	Distribution To Individuals	772,429,869
GAAP Fund 4007 - State Hospitals Fund		
1301	Transfers In From Other Funds	$ (147,365,660)

Our consideration of internal control was for the limited purpose described above and would not necessarily identify all deficiencies in internal control. As discussed below, we identified a deficiency in internal control that we consider to be a significant deficiency and another deficiency 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. We consider the following deficiency to be a significant deficiency in internal control.

Strengthen Knowledge, Skills and Abilities

Management's responsibility for the department's control environment includes ensuring key staff have the requisite knowledge, skills and abilities to perform their duties. Specifically, department management should ensure that accounting personnel responsible for preparing and approving transactions, including adjustments and year-end closing entries, possess the requisite knowledge, skills, and abilities to perform their duties in accordance with Generally Accepted Accounting Principles (GAAP) and Governmental Accounting and Financial Reporting Standards.

During the audit, we noted that accounting staff did not always appear to have the necessary understanding of GAAP to properly record transactions for financial reporting purposes. For example, we noted several errors that fell into each of the following categories.

- We found instances where transactions were not accurately reported. For example, when the department made adjustments to correct general ledger accounts from prior years, instead of recording a prior period adjustment, the department adjusted revenue and expenditure accounts in the current fiscal year. The error resulted in a $6 million overstatement of expenditures in fiscal year 2009.
- We found instances where year-end liability and expenditure accruals were not considered, or were not recorded in accordance with GAAP. For example, the department did not record interest payable associated with a short term loan outstanding at year end, nor did the department consider whether a year-end adjustment was needed to correctly reflect outstanding receivables from third party insurance carriers.
- We found instances where the timing of revenues, expenditures and reductions of expenditures were not recorded in compliance with GAAP or state and department policy. For example, the department recorded expenditures when benefits were authorized rather than when the benefits were used. This overstated expenditures by $6.8 million in fiscal year 2009.

Without management efforts to ensure staff have the requisite knowledge, skills and abilities to perform their assigned duties, department management runs the risk that errors could result in material misstatement to the financial statements and non-compliance with state and federal requirements. This is a recurring finding.

We recommend department management ensure accounting personnel have the requisite knowledge, skills, and abilities to accurately perform their assigned duties and ensure the resulting accounting records are in accordance with GAAP. Management should emphasize the importance of understanding GAAP to personnel who are responsible for recording transactions, calculating year-end accruals, and making adjustments that cross fiscal years. Management should also create a better awareness of the differences between budgetary accounting and GAAP, and when each is applicable.

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.

<u>Lack of Assurance that Controls Exist and are Effective over a Significant Financial System</u>

The Oregon Accounting Manual describes management's responsibility for ensuring internal controls are adequate to provide reasonable assurance that transactions are accurate and properly recorded and executed in accordance with management's objectives. That same level of assurance is required for services and financial information provided to the department by independent service providers.

During the audit, we noted that department management does not have adequate assurance that information processed for the Medicaid program is accurate and reliable. During fiscal year 2009, the department relied on an independent service provider to develop and maintain a new Medicaid Management Information System (MMIS). The MMIS processes Medicaid eligible claims including payments to providers and individuals, capitated payments for managed care, and other non-claim payments and transactions. Between system implementation in December 2008 and June 2009, the MMIS processed $1.3 billion in expenditures.

We inquired of department management regarding internal controls over transactions processed through the MMIS. We were provided with limited information related to some controls performed by the department, and management directed us to pre-implementation testing of the MMIS by department staff and an independent review performed by a contracted quality assurance vendor. However, none of these activities provided the department with adequate assurance that information provided by the MMIS service provider was accurate and reliable. Further, the contracted quality assurance vendor identified seven "system functional areas" that were not ready to process live data due to "severity 1 defects," and recommended the MMIS not be approved to process live data until significant system defects were adequately addressed.

Furthermore, management has not ensured that all contracts for significant financial services include a clause requiring an independent review of controls. Significant service contracts are those that provide significant financial information to management and upon which management must rely for the accuracy of that information. Without an adequate understanding and documentation of the controls implemented by service providers, or an independent review of these controls, department management does not have adequate assurance that the MMIS financial information is accurate and reliable. Specifically, management lacks assurance that the service provider for MMIS has adequate controls to ensure the $1.3 billion in expenditures processed through the system in fiscal year 2009 was accurately reported.

We recommend department management seek adequate assurance for the accuracy of all financial information they report. Management should have a documented understanding of the controls involved in transactions, whether automated or manual, to ensure the integrity of the information. When necessary, such as for significant financial systems operated by service providers, department management should obtain independent assurance over the reliability and accuracy of the information. This may be accomplished, in part, by ensuring contracts for significant services require internal control reviews and that the reviews are performed periodically as determined necessary.

Prior Years Finding

In the prior fiscal years, we reported a material weakness to you related to the department's lack of assurance over the Drug Rebate services provided by a third party vendor. This finding can be found in the Statewide Single Audit Report for the Fiscal Years Ended June 30, 2008 and 2009; see reports numbered 2009-07, and 2008-03, finding number 07-2. During the fiscal year 2009, the department made progress in correcting this finding. The finding will be reported in the Statewide Single Audit Report for the Fiscal Year Ended June 30, 2009, with a status of partial corrective action taken.

The significant deficiency and material weakness, along with your responses, will be included in our Statewide Single Audit Report for the Fiscal Year Ended June 30, 2009. Including your responses satisfies the federal requirement that management prepare a Corrective Action Plan covering all reported audit findings. Satisfying the federal requirement in this manner, however, can only be accomplished if the responses to the significant deficiency and material weakness include 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 name(s) of the contact person(s) responsible for corrective action.

Please respond by the date previously agreed upon.

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

We appreciate your staff's assistance and cooperation during this audit. Should you have any questions, please contact Amy Palacios or me at (503) 986-2255.

Sincerely,
OREGON AUDITS DIVISION

Julianne Kennedy, CPA
Audit Manager

JK:AIP:sms

cc: Jim Scherzinger, Deputy Director for Finance
Shawn Jacobsen, Acting Controller
Dave Lyda, Chief Audit Officer
Scott Harra, Director, Department of Administrative Services