

Office of the Secretary of State

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Audits Division

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September 22, 2010

The Honorable Ted Wheeler, State Treasurer
Office of the State Treasurer
159 State Capitol Building
900 Court Street NE
Salem, Oregon 97310

Dear Mr. Wheeler:

We have completed our financial statement audit of the Oregon State Treasury's (Treasury) Oregon Short-Term Fund (OSTF) for the year ended June 30, 2010.

This audit work was not a comprehensive audit of Treasury. Instead, the audit work performed allowed us to express an opinion on whether the OSTF financial statements were fairly presented, in all material respects, in conformity with generally accepted accounting principles.

In planning and performing our audit of the financial statements of the OSTF for the year ended June 30, 2010, we considered Treasury's internal controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Treasury's internal control.

Our audit identified one significant deficiency in internal control as previously reported in Secretary of State Audit Report 2010-30. This letter does not affect our report dated August 30, 2010, on the financial statements of the Oregon Short Term Fund.

During our audit we became aware of another matter that is an opportunity to strengthen internal controls and increase transparency. This matter is not significant to the financial statements and accordingly has not been categorized as a material weakness or a significant deficiency. A written response from management is not required for this other matter.

Weighted Average Credit Quality Methodology

The Oregon State Treasury (Treasury) is responsible for managing the Oregon Short-Term Fund (OSTF), which is a short-term cash and investment pool used by all state agencies and some local governments. Oregon Revised Statutes, the Oregon Short Term Fund Board (Board), and the Oregon Investment Council (Council) govern the OSTF's investments. Based on recommendations from the Treasurer and Treasury investment staff, and the Board, the Council approves investment policies for the OSTF.

Through the use of daily compliance reports, the Treasury monitors the OSTF to ensure compliance with approved OSTF investment policy. The month end daily compliance report is made available to the Board, Council, and participants to use in decision-making. Included in the compliance report is the Treasury's weighted average credit quality for the OSTF pool.

We reviewed Treasury's methodology for calculating the weighted average credit quality of the OSTF pool. We found that the methodology was not clearly documented. Furthermore, some of the assumptions used by Treasury were not clearly communicated to pool investors. For example, the use of expected credit ratings when actual ratings were not available; the use of issuer credit ratings when a position did not receive an issuance level credit rating; and, the exclusion of the defaulted Lehman Brothers securities from the calculation. The various assumptions can cause significant differences in the calculation of the weighted average credit quality.

Treasury currently calculates separate weighted average credit qualities for both S&P and Moody's. A single weighted average credit quality that considers ratings from all three credit rating agencies would better reflect OSTF policy, which allows a security to be purchased using any of the three credit rating agencies.

We recommend Treasury management document its methodology and assumptions for calculating the weighted average credit quality of the OSTF pool so that the inputs are sufficiently clear to users of the compliance report. We also recommend Treasury management consider reporting a single weighted average credit quality.

This communication is intended solely for the information and use of management, others within the organization, the Oregon Investment Council and the Oregon Short-Term Fund Board 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 me at (503) 986-2255.

Sincerely,
OREGON AUDITS DIVISION

Kelly L. Olson, CPA
Audit Manager

cc: Darren Bond, Deputy State Treasurer
Andrea Belz, Internal Audit Executive
Oregon Short Term Fund Board
Harry Demorest, Chair, Oregon Investment Council
Geoff Guilfooy, Oregon State Treasury Audit Committee
Scott Harra, Director, Department of Administrative Services