Office of the Secretary of State

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January 18, 2011

Elizabeth Harchenko, Director
Department of Revenue
955 Center St. NE
Salem, OR 97301

Dear Ms. Harchenko:

We have completed audit work of selected financial accounts at the Department of Revenue (department) for the year ended June 30, 2010.

This audit work was not a comprehensive audit of the department. We performed this audit work as part of our annual statewide financial audit. The objective of the statewide audit was to 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.

In planning and performing our audit of the selected financial accounts at the department as of and for the year ended June 30, 2010, 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 and determined 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		
0111	Personal Income Taxes	$ 4,936,722,703
0115	Corporate Income and Excise Taxes	360,561,894
0410	Taxes Receivable – Current	235,561,635
0411	Allowance for Uncollectible Taxes – Current	28,677,704
0420	Taxes Receivable – Noncurrent	583,079,929
0937	Allowance for Uncollectible Taxes Receivable – Noncurrent	67,589,625

SFMA Account	Description	Audit Amount
3003	Reserved for Noncurrent Receivables – Other	$ 515,490,304
1301	Transfer in from Other Fund	33,042,585
GAAP Fund 8500 – Government-Wide Reporting Fund		
0410	Taxes Receivable – Current	148,403,232
0420	Taxes Receivable – Noncurrent	148,403,232

A deficiency in internal control 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 and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit the attention of those charged with governance.

Our consideration of internal control was for the limited purpose described above and was not designed to 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.

Material Weakness

Taxes Receivable – Year End Financial Reporting Misstatements

Department management is responsible for ensuring the accuracy and completeness of the information that supports its year-end adjustments. The quality of the state's Comprehensive Annual Financial Report depends on the accuracy and completeness of year-end closing activities, including the preparation of accruals.

Each year, as part of its annual financial reporting process, the department prepares estimates as of June 30 of the taxes receivable accrual for tax programs under its purview. The estimates involve many separate calculations and are based on several sources of data, including historical trends, uncollectible taxes, estimated refunds payable, and other information contained in the department's subsidiary accounting system.

In reviewing the taxes receivable estimates prepared for state fiscal year 2010, we found multiple errors in the department's calculation, such as incorrectly calculated percentages and omitted amounts. As a result of these errors, the net General Fund current and noncurrent taxes receivable accounts were overstated by approximately $75 million and $67 million, respectively; and the current and noncurrent taxes receivable accounts in the government wide statements were misstated by approximately $129 million each. In addition, as a result of the calculation errors, the Personal Income Taxes, Corporate Excise and Income Taxes, and Inheritance Taxes revenue accounts were overstated by approximately $35 million, $33 million and $6 million, respectively. The taxes receivable accounts and Corporate Excise and Income Taxes account required audit adjustments to be fairly stated in accordance with generally accepted accounting principles. The department's review process did not detect these errors. We reported a similar finding for fiscal year 2008.

We recommend department management perform effective reviews over the year-end calculations of the taxes receivable estimates to ensure accrual calculations are accurate.

<u>Controls for Recording Accounting Transactions Need Improvement</u>

Management is responsible for establishing, maintaining and improving internal controls over accounting processes. Management's responsibility for the department's control environment includes ensuring key staff have the requisite skills and knowledge to perform their duties, as well as receive necessary formal and on-the-job training. Furthermore, internal controls over revenue should provide evidence that revenue is properly classified as to source, mathematically correct, and entered appropriately into the accounting system.

During our audit, we found multiple instances when revenue transactions were recorded incorrectly. For example, approximately $5 million of inheritance taxes revenue was incorrectly recorded as corporate excise and income taxes revenue. In addition, a correction to a taxes receivable accrual incorrectly understated personal income taxes revenue and overstated corporate excise and income taxes revenue by approximately $12 million.

We also identified accrual errors made in the Transfers accounts and related Due To/Due from accounts resulting from improper entry into the accounting system. These errors resulted in misstatement of approximately $2 million in the Transfer in from Other Fund, Transfer out to Other Fund, Due to Other Funds, and Due from Other Funds accounts.

These errors occurred because the department's accounting staff work primarily with the department's subsidiary accounting systems and less frequently with the state's accounting system. This infrequent exposure to the state's accounting system provides fewer opportunities for gaining a thorough understanding about the requirements for recording transactions.

We recommend department management ensure accounting staff have the requisite knowledge and skills to perform their assigned duties and ensure accounting transactions are accurately recorded to the proper accounts.

<u>Prior Year Finding</u>

In fiscal year 2008, we reported a material weakness related to the department's taxes receivable year-end financial reporting in a letter dated February 10, 2009. This finding can also be found in the Statewide Single Audit Report for the fiscal year ended June 30, 2008; see Secretary of State audit report number 2009-07, finding number 08-3. This finding will be reported in the Statewide Single Audit Report for the fiscal year ended June 30, 2010, with a status of partial corrective action taken. A current year finding will also be reported for errors identified in the current fiscal year.

The material weakness, along with your responses, will be included in our Statewide Single Audit Report for the fiscal year ended June 30, 2010. 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 material weakness 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 findings. If you do not agree with the audit findings 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 January 28, 2011.

This communication is intended solely for the information and use of management, 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 Michelle Searfus or me at (503) 986-2255.

Sincerely,
OREGON AUDITS DIVISION

V. Dale Bond, CPA, CISA, CFE
Audit Manager

VDB:MNS:nmj

cc: Karen Gregory, Deputy Director
Jason Robinson, Internal Auditor
Tracy Ringering, Internal Auditor
John Paul Jones, ASD Administrator
Priyanka Shukla, Financial Services Unit Manager
Kris Kautz, Acting Director, Department of Administrative Services