Office of the Secretary of State

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January 27, 2011

The Honorable Ted Wheeler
Oregon State Treasurer
159 Oregon State Capitol
900 Court Street NE
Salem, OR 97301

Dear Mr. Wheeler:

We have completed audit work of selected financial accounts at the Oregon State Treasury (Treasury) for the year ended June 30, 2010.

This audit work was not a comprehensive audit of the Treasury. 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 Treasury 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 Treasury'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 Treasury's internal control. Accordingly, we do not express an opinion on the effectiveness of the Treasury's internal control.

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 significant deficiency.

Strengthen Internal Controls over Financial Reporting – Significant Deficiency

Oregon State Treasury (Treasury) management is responsible for establishing, maintaining, and improving internal controls over the reporting of investments held at the Treasury for state agencies such as the Public Employees Retirement System (PERS). Treasury management is responsible for ensuring that investment balances and financial disclosures are fairly presented to state agencies in conformity with generally accepted accounting principles.

During our audit, we noted opportunities for Treasury to strengthen controls over its financial reporting process related to investment classification and investment disclosures. The Treasury's current process relies heavily on the manual preparation, adjustment, and review of a large volume of information provided by the custodial bank. For the PERS portfolio alone, the custodian's records showed over 13,000 positions at fiscal year end. Manually reviewing this amount of data limits the Treasury's ability to perform an effective and timely review. We noted reporting errors including the following: five Private Equity positions were classified as Real Estate, the credit quality of the fund for mutual fund positions was misreported, and the duration for the Common School Fund portfolio was incorrectly stated. In addition, fiscal year 2010 was the first year of implementation for new accounting standards related to the disclosure of derivative information. The Treasury's financial reporting process was not adequate to ensure proper disclosure of this information. We identified the following errors:

- Several required derivative disclosures were omitted including interest rate risk, foreign currency risk for positions other than foreign currency forward contracts, and custodial credit risk.
- The fair market values disclosed in the foreign currency forwards, futures, and forwards tables were incorrectly stated.
- Certain manual financial statement adjustments to derivative fair values were not carried through to the disclosed fair value of these positions.

We recommend Treasury management strengthen internal controls over its financial reporting process to ensure that Treasury provides state agencies investment balances and disclosures that are fairly stated in accordance with generally accepted accounting principles. We also recommend that management improve the efficiency and effectiveness of its financial reporting process over information received from the custodian bank.

Prior Year Finding(s)

In the prior fiscal year, we reported a significant deficiency related to the Treasury's internal controls over investment valuations in a letter dated February 23, 2010. This finding can also be found in the Statewide Single Audit Report for the fiscal year ended June 30, 2009, see Secretary of State audit report number 2010-19, finding number 09-07. During fiscal year 2010, the Treasury increased the level of review performed over investments. 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.

The significant deficiency along with your response, will be included in our Statewide Single Audit Report for the fiscal year ended June 30, 2010. Including your response 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 response to the significant deficiency 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 each response:

1) Your agreement or disagreement with the finding. If you do not agree with the 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 February 8, 2010.

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.

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

Sincerely,
OREGON AUDITS DIVISION

Kelly Olson, CPA
Audit Manager

KLO:BAW:nmj

cc: Darren Bond, Deputy State Treasurer
Ron Schmitz, Chief Investment Officer
Andrea Belz, Chief Audit Executive
Members of the Oregon Investment Council
Geoff Guilfoy, Office of the State Treasurer Audit Committee
Kris Kautz, Acting Director, Department of Administrative Services