

Office of the Secretary of State

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February 16, 2011

Matthew Garrett, Director
Oregon Department of Transportation
1158 Chemeketa Street NE
Salem, OR 97301

Dear Mr. Garrett:

We have completed audit work of selected financial accounts at the Oregon Department of Transportation (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.

<u>SFMA Account</u>	<u>Description</u>	<u>Audit Amount</u>
<u>GAAP Fund 1111 – Public Transportation Fund</u>		
0065	Unreconciled Deposit	\$ 36,366,139
0070	Cash on Deposit with Treasurer	812,340,041
0240	Investments – Designated	150,425,000
0245	Investment Valuation Account – Designated	513,035
0350	Securities Lending Cash Collateral	54,175,973

SFMA Account	Description	Audit Amount
1600	Obligations Under Securities Lending	\$ 54,175,973
1503	Revenue Bonds	580,285,000
0122	Motor Fuels Tax	405,726,275
0126	Vehicle Registration Taxes	245,921,691
0300	Federal Revenue	637,703,700
0542	Accounts Receivable – Federal Unbilled	80,477,187
1404	Transfer to Cities	112,420,704
1405	Transfer to Counties	162,788,480
3111	Regular Employees	218,437,901
3210	Public Employees Retirement Contribution	18,912,195
3212	Pension Bond Assessment	13,525,134
3221	Social Security Taxes	18,042,314
3263	Medical, Dental, Life Insurance	60,544,022
1215	Accounts Payable	112,908,245
4500	Professional Services – Non IT	167,054,692
4975	Agency Program Related Services	735,154,692
<u>GAAP Fund 2001 – Revenue Bond Fund</u>		
1301	Transfer In From Other Fund	167,142,430
<u>GAAP Fund 8500 – Government-Wide Reporting Fund</u>		
1276	Bonds Payable – Current	62,501,248
1714	Bonds Payable – Noncurrent	2,692,610,327
0815	Equipment and Machinery	263,881,920
0850	Land	1,541,822,458
0852	Buildings and Building Improvements	147,716,669
0869	Accumulated Depreciation – Equipment and Machinery	(145,909,872)
0875	Accumulated Depreciation – Bldgs and Bldg Improvements	(79,045,351)
0840	State Highways	11,583,472,263
0842	Tunnels and Bridges	3,193,280,433
0861	Construction in Progress	1,731,113,136
0880	Accumulated Depreciation – State Highways	(8,158,641,913)
0881	Accumulated Depreciation – Tunnels and Bridges	(1,034,587,616)
3111	Regular Employees	(66,321,218)
4975	Agency Program Related Services	(612,756,373)
7476	Depreciation Expense	682,516,882

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 and another deficiency that we consider to be a significant deficiency.

Infrastructure Reporting (Material Weakness)

A significant amount of state resources are used to construct and maintain Oregon's network of state highways, tunnels, and bridges. Accounting standards require that these assets, collectively termed infrastructure, be recorded in the state's financial statements and be depreciated over their estimated useful lives. Furthermore, the quality of the state's Comprehensive Annual Financial Report (CAFR) depends upon the accuracy and completeness of the accounting records maintained by each state agency. We have reported a material weakness over the financial reporting of infrastructure assets every year since fiscal year 2004. While some of the issues have been addressed and resolved, several significant issues remained unresolved during fiscal year 2010, including the following:

- During the audit of fiscal year 2009, we proposed several audit adjustments to bring the infrastructure account balances to the appropriate values in accordance with accounting standards. However, when the department posted the entries, they reported the transactions as adjustments to fiscal year 2010, rather than as prior period adjustments. As a result, payroll, program services, and depreciation expense in fiscal year 2010 were understated by \$48 million, \$518 million, and \$36 million, respectively. Significant audit adjustments were again required to avoid materially misstating these accounts in the fiscal year 2010 CAFR.
- Prior to fiscal year 2010, the department used a data query application called the "GASB 34 Tool" to identify the costs to be capitalized as part of the infrastructure assets. In fiscal year 2010, the department switched to a new application named "Pentaho" to address some of the reporting weaknesses in the GASB 34 Tool. Based upon our review, Pentaho has addressed some of the weaknesses in the GASB 34 Tool, and it provides more complete data. However, in preparing the accounting entries based upon Pentaho, department staff did not compare reports from the two applications, by individual project, to ensure the information was consistent. As a result, we found that approximately \$558 million of infrastructure assets were not consistently classified as completed projects or construction in progress in reports from the two applications. As a result, the financial statements were misstated and required significant adjustments to the State Highways, Tunnels and Bridges, and Construction in Progress accounts to be reported accurately.
- In tracking and monitoring ongoing infrastructure projects, the department uses multiple computer applications including the Project Control System (PCS) and the Contractor Payment System (CPS). In preparing the year end accounting entries for the

infrastructure accounts, accounting staff relied on information from the PCS application to determine which projects had been completed. We identified numerous projects that had been completed and placed into operation and where final payments had been made to contractors according to CPS data, but these projects had not been coded as completed in PCS. Accordingly, approximately \$1 billion of assets had not been reported as completed in the financial statements, and were therefore not appropriately capitalized and depreciated.

The department's process for reviewing entries into the state's accounting system did not identify these errors.

We recommend department management ensure that accounting transactions are posted to the correct reporting period and prior period adjustment entries are made when appropriate. Further, we recommend department management provide effective review of year-end balances to ensure balances are reasonable and material reporting errors are identified.

We recommend department management thoroughly review the information produced by Pentaho and the GASB 34 Tool to identify and resolve inconsistencies in project status.

We recommend department management identify the data available from its internal systems that are relevant to infrastructure reporting and identify which systems have the best and most accurate data for reporting purposes. Additionally, we recommend that when significant differences between multiple data sources are identified, department management investigate the differences and ensure department data are updated timely to provide correct, accurate, and relevant data for infrastructure reporting purposes.

Internal Controls over Financial Reporting (Significant Deficiency)

The Oregon Accounting Manual requires that each department have adequate internal controls to provide reasonable assurance that transactions are accurate and recorded properly in the state's accounting systems. Divisions that provide information to the financial unit of an agency also need to have effective controls to ensure the financial information is accurate and complete. We noted instances within the department when internal controls were not sufficient to identify, detect, or prevent some accounting errors. For example:

- A year-end expenditure accrual was made to the Deposit Liability account instead of the Deferred Revenue account, resulting in a \$7 million error in the state's CAFR. Although the two accounts are in the liabilities section of the financial statements, the accounts appear separately and represent dissimilar transactions.
- One of the spreadsheets department staff used to calculate distributions of certain tax revenues to cities and counties was not updated correctly, in some cases, to reflect recent changes to tax rates and percentages to be distributed to the cities and counties. As a result, distributions were not always in the correct proportion for periods of one to eight months. Management informed us that appropriate corrections were made to the distributions to the cities and counties after we brought these errors to staff's attention.

- The department appropriately made year-end accruals to ensure that revenues collected were reported in the proper period in accordance with accounting standards. A portion of these revenues were required by statute to be distributed to cities and counties. For proper reporting, accounting standards require that a liability be accrued and an expenditure be reported in the period when the department is legally obligated to distribute those funds. However, the department did not accrue all the liabilities and expenditures that corresponded to the revenue accruals. As a result, liabilities and expenditures were each understated by approximately \$200,000.
- ODOT has not adequately separated responsibilities for entering financial transactions in the state's accounting system. Two individuals can enter, approve, and release transactions without an independent review. This practice increases the possibility of undetected errors or irregularities in the financial records.

We recommend department management ensure adequate controls are implemented to prevent and detect errors in financial reporting.

Prior Year Findings

During the fiscal year 2008 audit, we reported a significant deficiency related to the department's internal controls over financial reporting in a letter dated February 5, 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 08-15. This finding was also included in the Statewide Single Audit Report for the fiscal year ended June 30, 2009 with a status of partial corrective action taken; see Secretary of State audit report number 2010-19, finding number 08-15. During fiscal year 2010, the department made further progress in addressing the weaknesses in internal controls over financial reporting. Department management has reported to the Department of Administrative Services that prior finding number 08-15 has been corrected. While we agree the department took actions to correct the specific instances described in this prior audit finding, we do not believe the overall weaknesses in controls have been fully addressed, as is evidenced by the significant deficiency identified in this year's audit. Accordingly, we will discuss in the Statewide Single Audit Report for the fiscal year ended June 30, 2010 our position that the finding is partially corrected.

In the fiscal year 2009 audit, we reported a material weakness related to the department's financial reporting for infrastructure in a letter dated March 15, 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 09-05. During fiscal year 2010, the department made progress in addressing the finding relating to infrastructure reporting, although the issues have not been fully resolved, as discussed in the material weakness section of this letter. Finding number 09-05 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 and 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 response to the significant deficiency and 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 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 March 3, 2011.

This communication is intended solely for the information and use of management, others within the organization, and the Oregon Transportation 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 Geoff Hill or me at (503) 986-2255.

Sincerely,
OREGON AUDITS DIVISION

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

VDB:GMH:nmj

cc: Clyde Saiki, Deputy Director of Central Services
Jerri Bohard, Deputy Director of Operations
Les Brodie, ODOT Chief Financial Officer
Deb Tennant, ODOT Deputy Chief Financial Officer
ODOT Audit Committee
Oregon Transportation Council
Kris Kautz, Acting Director, Department of Administrative Services