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September 12, 2012

Michael J. Jordan, Director
Department of Administrative Services
155 Cottage Street NE
Salem, Oregon 97301-3966

Dear Mr. Jordan,

We have completed audit work at the Department of Administrative Services (department) for the most recent Central Services Statewide Cost Allocation Plan.

We performed this audit work as part of our annual statewide single audit. The audit work performed allowed us to achieve the following objectives: (1) determine whether the department's statewide cost allocation plan complied with the provisions of the Office of Management and Budget Circular A-87 and (2) determine whether the department has effective internal controls over compliance requirements for central services costs.

In planning and performing our audit, we considered the department's internal control over compliance with requirements for central services cost allocation plans to determine the auditing procedures to be performed for determining the department's compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the department's internal control over compliance.

Our consideration of internal control over compliance was for the limited purpose described in the paragraph above and was not designed to identify all deficiencies in internal control over compliance that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control over compliance that we consider to be material weaknesses and a deficiency that we consider to be a significant deficiency.

A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement on a timely basis. A *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement will not be prevented, or detected and corrected, on a timely basis.

A *significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Material Weaknesses

Unallowable Payments for Fines, Penalties, Damages, and Other Settlements

According to OMB Circular A-87, attachment B section 16, fines, penalties, damages, and other settlements resulting from violations (or alleged violations) of, or failure of the governmental unit to comply with, Federal, State, local, or Indian tribal laws and regulations (e.g. civil rights violations) are unallowable, as are associated legal costs and directly associated costs of the unallowable fines, penalties, damages, or settlement costs.

We reviewed the department's fiscal year 2011 net asset reconciliation. As part of our review, we looked at the department's methodology for identifying unallowable costs and determined it correctly identified claims and costs associated with fiscal year 2011. We also noted the department reported $2 million in unallowable costs related to civil rights violations; based on further review, we found that similar claims and unallowable costs had not been reported for several prior years even though these are standard unallowable costs for the department to report on its net asset reconciliations.

We extended our review to fiscal year 2010 claims and using the methodology developed and used by the department for fiscal year 2011, we found the department did not properly report as unallowable an estimated $2.8 - 3.5 million in claims coded as civil rights violations. We also found that the department's methodology could be improved as it only includes costs incurred in the year of settlement and not any prior year costs related to the unallowable claims. For example, one unallowable claim that was settled in 2011 incurred over $240,000 in unallowable costs in fiscal year 2010 that were not reported as unallowable.

We recommend department management review and update its methodology to include prior year costs related to unallowable claims.

Service Charges Exceeded Rate for Federal Surplus Property

Federal surplus property is property declared surplus by the federal government that may be transferred to other government units. Costs are recovered from organizations that receive the surplus property through a service charge. According to the cost allocation plan and state rules, for federal surplus property with an acquisition value of less than

$5,000, the service charge can range between 0-30% of the acquisition value. Additional charges may be added to cover shipping and handling.

Based on our review, we found the department was not complying with the terms of its cost allocation plan. We randomly selected three invoices that contained charges for 20 surplus items and identified 7 items that exceeded the allowable service charge percentage. According to surplus management, the excess service charge is a result of incorrect acquisition values provided to them by the federal government. Department staff stated that federal approval is required to change these values, which they have not sought because the approval process is time consuming and the values still may not change even though they are clearly not correct. In some instances, many items are purchased together as one item with one value. The department's process is to equally distribute the acquisition amount to all items received; as a result, the acquisition value assigned may not be accurate and may not be within the allowable range.

We recommend department management ensure the service charge is within the percentage range as documented in the cost allocation plan. Specifically, department management should (1) contact the federal agency to verify what authority, if any, the department has to change acquisition values without federal approval; (2) reevaluate whether the current methodology of equally allocating the acquisition amount to multiple items is always appropriate; and (3) determine if there are any changes that should be made to the cost allocation plan.

PEBB Costs Not Fully Captured as Part of the Cost Allocation Plan

The Public Employees' Benefit Board (PEBB) provides medical, dental, life, accident, disability, and long-term care insurance. Due to increasing premium rates, PEBB started fully self-insuring medical and dental benefits in calendar year 2010. According to OMB Circular A-87, state governments with billed central service activities, which include fringe benefit and self-insurance funds, must separately account for all revenues, expenses, and the profit or loss of providing the service. Additionally, for billed costs, state governments are required to submit a reconciliation of net assets for the year.

We reviewed the fiscal year 2011 A-87 reconciliation of net assets for PEBB. We found that the reconciliation only included the PEBB operations fund and excluded the PEBB stabilization and insurance funds. As a result, for fiscal year 2011, the reconciliation excluded more than $600 million in PEBB revenues and expenses.

We recommend department management fully capture all PEBB funds as part of the statewide cost allocation plan.

Significant Deficiency

Monitoring of Administrative Funds Should Be Improved

The department provides services to a multitude of state agencies and charges the agencies for these services through the use of the Statewide Cost Allocation Plan (CAP). All department programs providing services are to be included in the CAP and, therefore, subject to federal payback requirements if estimated allocated amounts are inaccurate. Through our review of the department's CAP, we noted five administrative funds that were not included in the CAP. Based on inquiry of department staff, the federal government has allowed them to exclude these administrative funds from the CAP since 2009. We noted, however, that programs in the CAP transfer money on a monthly basis to these administrative funds for expenses incurred.

We inquired of the department as to how it monitors the administrative funds to ensure it does not transfer excess monies to the funds. According to the department, they monitor the funds on an ongoing basis and staff work together to determine whether adjustments are needed. The department does not have procedures in place to ensure sufficient and consistent monitoring of these funds and their net asset balances is performed.

We reviewed the change in the ending net asset balance for each of the five administrative funds for the last three fiscal years to determine whether management was monitoring the funds. For four of the five funds, the net asset balance increased over the three years. The remaining fund's net asset balance declined over this period. To determine the reasonableness of each fund's net asset balance, we determined whether the balance complied with the 60 day working capital reserve allowed under OMB Circular A-87. In reviewing the five administrative funds for fiscal year 2011, we found all five funds exceeded the working capital reserve requirement, ranging from an excess of $55 thousand to $1.6 million. Additionally, we noted one administrative fund transferred $1 million to the State's General Fund. If this fund was part of the CAP, this transfer would have been classified as an unallowable transfer.

We recommend department management establish guidelines and monitor the administrative funds on an annual basis to ensure excessive funds are not being retained. Additionally, the department should ensure transfers to the State's General Fund are made by programs within the CAP instead of the administrative fund.

The significant deficiency and material weaknesses, along with your responses, will be included in our Statewide Single Audit Report for the fiscal year ended June 30, 2012. 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 each 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 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 names of the contact persons responsible for corrective action.

Please respond by September 24, 2012.

This communication is intended solely for the information and use of management, others within the organization, federal awarding agencies, and pass-through entities 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 Rock or me at (503) 986-2255.

Sincerely,
OREGON AUDITS DIVISION

Kelly L. Olson, CPA
Audit Manager

KLO:MLR:jas

cc: Bret West, Business Services Division Administrator
Shawn Waite, Chief Financial Officer, Shared Financial Services
Jan Dean, Shared Financial Services Administrator
Sarah Jo Chaplen, DAS Deputy Director, Service Delivery Office
Pam Stroebel, Chief Audit Executive
Kathy Ross, Statewide Accounting and Reporting Services Manager

Oregon
John A. Kitzhaber, MD, Governor

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September 24, 2012

Kelly L. Olson, CPA
Audit Manager
Office of the Secretary of State
255 Capitol Street NE, Ste 500
Salem, OR 97310-1362

RE: Management Letter 107-2012-09-01

Dear Ms. Olson,

This letter provides our response to the management letter referenced above covering the results of the recent Central Services Statewide Cost Allocation Plan audit.

Acknowledgement
Department management is in agreement with the material weakness related to Unallowable Payments for Fines, Penalties, Damages, and Other Settlements.

OAD Recommendation
"*We recommend department management review and update its methodology to include prior year costs related to unallowable claims.*"

Corrective Action
The following corrective action is proposed in response to your finding:

- The Shared Financial Services (SFS) will coordinate with Risk Management to generate a report that reflects unallowable costs associated with claims coded as civil rights violations. Procedures will be developed that will include clarification of the methodology used to identify unallowable costs and how the department correctly determines claims and associated costs in a fiscal year.

Anticipated Completion Date
The corrective action plan will be implemented by June 30, 2013.

Contact Persons
Shawn Waite, DAS Chief Financial Officer, Shared Financial Services, 503-378-3553
Penny Evans, Interim Risk Manager, Risk Management, 503-373-7814

Acknowledgement
Department management is in agreement with the Material Weakness relating to Service Charges Exceeding Rate for Federal Surplus Property.

OAD Recommendation
"We recommend department management ensure the service charge is within the percentage range as documented in the cost allocation plan. Specifically, department management should (1) contact the federal agency to verify what authority, if any, the department has to change acquisition values without federal approval; (2) reevaluate whether the current methodology of equally allocating the acquisition amount to multiple items is always appropriate; and (3) determine if there are any changes that should be made to the cost allocation plan."

Corrective Action
The following corrective action is proposed in response to your finding:

- The Surplus Property Program will ensure that federal surplus items are not grouped prior to calculating the service charge to ensure the acquisition value is not overstated and that the service charge associated with items will not exceed the allowable 0-30% of acquisition value. Additionally, the department will seek clarification from the Federal Government on thresholds.

Anticipated Completion Date
Department management will meet no later than December 31, 2012, to develop a plan and implement new methodology by June 30, 2013.

Contact Persons
Shawn Waite, DAS Chief Financial Officer, Shared Financial Services, 503-378-3553
Jeanette Fish, Deputy Director, State Services Division, 503-378-5093
Sven Anderson, Surplus Property Manager, Surplus Program, 503-378-6057

Acknowledgement
Department management is in agreement with the finding relating to exclusion of the PEBB stabilization and insurance funds when conducting the reconciliation of net assets for PEBB.

OAD Recommendation
"We recommend department management fully capture all PEBB funds as part of the statewide cost allocation plan."

Corrective Action
The following corrective action is proposed in response to your finding:

- Department management has determined that the DAS is no longer responsible for conducting a reconciliation of net assets for PEBB. PEBB was transferred to the Oregon Health Authority in FY 2012. Corrections of prior calendar year 2010 and fiscal year 2011 will be made upon Department of Health and Human Services (DHHS) Division of Cost Allocation direction.

Anticipated Completion Date
The Shared Financial Services will make corrections for calendar year 2010 and fiscal year 2011 upon agreement between SFS and DHHS Division of Cost Allocation.

Contact Person
Shawn Waite, DAS Chief Financial Officer, Shared Financial Services, 503-378-3553

Acknowledgement
Department management is in agreement with the finding relating to inaccurate allocation amounts of CAP.

OAD Recommendation
"We recommend department management establish guidelines and monitor the administrative funds on an annual basis to ensure excessive funds are not being retained. Additionally, the department should ensure transfers to the State's General Fund are made by programs within the CAP instead of the administrative fund."

Corrective Action
The following corrective action is proposed in response to your finding:

- As per the request from DHHS, department management reviewed overhead allocation methodology in fiscal year 2009. According to department management, the over and under overhead transfers was part of the biennial rate calculation. In 2012, department management implemented a review of the administrative transfers as part of the fiscal year end close process.

Anticipated Completion Date
In fiscal year 2012, department management implemented a review to ensure that there is no more than a 60 day working capital balance. This finding has been resolved.

Thank you for your audit team's effort over the past several months to perform this audit work. If you have any questions regarding this response or our corrective action plan, please contact Shawn Waite, Chief Financial Officer at the above number.

Sincerely,

Michael J. Jordan, Director
Department of Administrative Services

cc: Bret West, Business Services Division Administrator
Renee Klein, Senior Internal Auditor
Shawn Waite, DAS Chief Financial Officer
Jan Dean, Enterprise Goods & Services Administrator
Sarah Jo Chaplen, DAS Deputy Director, Service Delivery Office
Kathy Ross, Statewide Accounting and Reporting Services Manager