Office of the Secretary of State

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January 24, 2012

Karen Gregory, Acting Director
Department of Revenue
955 Center Street NE
Salem, Oregon 97301-2555

Dear Ms. Gregory:

We have completed audit work of selected financial accounts at the Department of Revenue (department) for the year ended June 30, 2011.

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, 2011, 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	$ 5,531,681,765
0115	Corporate Income and Excise Taxes	475,196,081
0410	Taxes Receivable – Current	270,394,575
0411	Allow for Uncollectible Taxes – Current	30,411,469
0420	Taxes Receivable – Noncurrent	676,219,523
0937	Allow for Uncollectible - Taxes Noncurrent	77,776,447
3037	Nonspendable Fund Balance - Other Noncurrent Receivables	598,443,076

GAAP Fund 0054 – GASB 54 General Fund

0410	Taxes Receivable – Current	1,991,279
0411	Allow for Uncollectible Taxes – Current	1,021,375
0420	Taxes Receivable – Noncurrent	20,113,684
0937	Allow for Uncollectible-Taxes Noncurrent	1,081,758
3037	Nonspendable Fund Balance - Other Noncurrent Receivables	19,031,926

GAAP Fund 8500 – Government-Wide Reporting Fund

0410	Taxes Receivable - Current	$ 124,956,107
0420	Taxes Receivable - Noncurrent	124,956,107

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 deficiencies in internal control that we consider to be material weaknesses.

Material Weaknesses

Unrecorded Financial Transactions

Department management is responsible for the fair presentation of financial statements. In representing that the financial statements are fairly presented in conformity with generally accepted accounting principles, management asserts that all transactions that should have been recorded have been recorded.

While reviewing the department's year-end transactions and account balances for fiscal year 2011, we found that the current taxes receivable and related revenue accruals were not recorded in the state accounting system. We also noted that the prior year's allowance for uncollectible taxes receivable was not reversed in the current year and that multiple disbursements to other entities, such as distributions to counties for electric cooperative tax revenues, were also not recorded.

The department has procedures in place to review transactions entered in the state accounting system, but lacks procedures to identify transactions not yet recorded. We identified the following misstatements, which required audit adjustments to fairly state the related accounts in accordance with generally accepted accounting principles:

- Taxes receivable understated by $243 million
- Personal Income Taxes revenue understated by $194 million
- Corporate Excise and Income Taxes revenue understated by $14 million
- Inheritance Taxes revenue understated by $7 million
- Accounts payable understated by $29 million,
- Disbursements understated by $9.5 million

We recommend department management develop and implement effective monitoring procedures to ensure all accounting transactions are entered in the state accounting system for financial reporting purposes.

Cash Reconciliations Not Performed

During fiscal year 2011, the department received, processed and deposited just under $6 billion in revenues from various tax programs. To facilitate more efficient accounting, the department has set up specific cash accounts for these tax programs. Much of the cash received is processed through the Revenue Suspense Account at the Oregon State Treasury before being transferred to the General Fund or other funds, as appropriate. State policy recommends agencies reconcile cash accounts on a regular basis and, if an agency uses a subsidiary accounting system, reconcile the subsidiary system to the state accounting system. Cash reconciliations are an important internal control that provides assurance that existing assets agree to recorded amounts.

The department's typical process is, on a monthly basis, to reconcile cash accounts in its subsidiary system to related accounts at the Oregon State Treasury and the state accounting system. We requested the department's cash reconciliations for its suspense account and noted that the reconciliations for fiscal year 2011 had not been prepared. In bypassing the control of a monthly reconciliation, the department was not in compliance with state policy and had less assurance that financial errors would be detected and corrected in a timely manner.

We recommend department management comply with state policy and ensure the cash accounts in its subsidiary system are routinely reconciled to the state accounting system and to the Oregon State Treasury accounts.

Strengthen Knowledge, Skills, and Abilities

Department management is responsible for the department's control environment, which includes ensuring key staff have the necessary skills to perform their duties. Specifically, department management should ensure that accounting personnel responsible for preparing and approving financial transactions, including adjustments and year-end entries, possess the requisite knowledge, skills, and abilities to perform their duties in accordance with Generally Accepted Accounting Principles (GAAP) and Governmental Accounting and Financial Reporting Standards.

During the audit, we noted that accounting staff did not always appear to have the necessary understanding of GAAP and the state accounting system to properly record transactions for financial reporting purposes. In addition to the other weaknesses previously discussed, we identified the following:

- Suspense account activity for fiscal year 2011, related to receipts and distributions for multiple revenue accounts, was not accounted for properly. The distribution amounts were calculated incorrectly, resulting in a $177.5 million overstatement to cash and $72.7 million, $82.8 million, $11.7 million, and $10.3 million overstatements to personal income tax, corporate excise and income tax, inheritance tax, and cigarette tax revenues, respectively;

- Data entry errors that resulted in a total of $14 million in audit adjustments to multiple cash and revenue accounts; and

- Cigarette taxes receivables were recorded in a separate governmental fund from where revenues were recorded, resulting in net misstatements of $8 million for current taxes receivable and cigarette tax revenue and $11.5 million for noncurrent taxes receivable in the General Fund and Health and Social Services Fund.

These errors occurred because the department's accounting staff work primarily with the department's subsidiary accounting system and do not have a clear understanding of how coding in the state accounting system affects financial reporting. We reported a similar finding in fiscal year 2010.

We recommend department management ensure accounting staff have the requisite knowledge and skills to perform their assigned duties and ensure all accounting transactions result in accurate financial reporting.

<u>Prior Year Findings</u>

In the prior fiscal year, we reported material weaknesses related to the department's taxes receivable year-end financial reporting and controls over recording accounting transactions in a letter dated January 18, 2011. These findings can also be found in the Statewide Single Audit Report for the fiscal year ended June 30, 2010; see Secretary of State audit report number 2011-06, finding numbers 10-02 and 10-03. During fiscal year 2011, the department made progress in correcting these findings. These findings will be reported in the Statewide Single Audit Report for the fiscal year ended June 30, 2011, with a status of partial corrective action taken. A current year finding related to controls over recording accounting transactions and staff's knowledge, skills and abilities will also be reported for errors identified in the current fiscal year.

The material weaknesses, along with your responses, will be included in our Statewide Single Audit Report for the fiscal year ended June 30, 2011. Including your responses satisfies the federal requirement that management prepare a <u>Corrective Action Plan</u> covering all reported audit findings. Satisfying the federal requirement in this manner, however, can only be accomplished if the response to each 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 February 2, 2012.

This communication is intended solely for the information and use of management and 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

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