Office of the Secretary of State

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February 20, 2014

Erinn Kelley-Siel, Director
Department of Human Services
500 Summer Street NE
Salem, Oregon 97301

Tina Edlund, Acting Director
Oregon Health Authority
500 Summer Street NE
Salem, Oregon 97301

Dear Ms. Kelley-Siel and Ms. Edlund:

We have completed audit work of selected financial accounts at your agencies for the year ended June 30, 2013. This audit work was not a comprehensive financial audit of your agencies, but was performed as part of our annual audit of the State of Oregon's financial statements. We audited accounts that we determined to be material to the State of Oregon's financial statements.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements of the State of Oregon as of and for the year ended June 30, 2013, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, we considered the departments' internal control over financial reporting as a basis for designing auditing procedures that are appropriate in the circumstances 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 departments' internal control. Accordingly, we do not express an opinion on the effectiveness of the departments' 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 a combination of deficiencies, in internal control, 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 material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that have not been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies. The following deficiencies are directed to the Department of Human Services (department) as the department is responsible for accounting services for both the department and the Oregon Health Authority.

Material Weaknesses

Controls in Receipting Unit Should Be Strengthened

The department receipts millions in revenues in paper checks annually. The Oregon Accounting Manual 10.20.00 PR .123 specifies the fundamental rules for attaining control over cash and checks (hereafter referred to as checks), which includes separating check handling from record keeping.

Although two administrative employees within the department's Office of Financial Services pick up the checks from the mailroom, sort them into category types, and write down the number of checks received, they do not write down the amounts of the checks by category type or in total. The administrative staff deliver the checks by category type to individuals in the Receipting Unit who are each solely responsible for the custody and recording of checks for their category type in the accounting records. The number of checks received is not reconciled to the number of checks deposited nor is the dollar amount of checks received, either in total or by category type, independently reconciled to amounts deposited.

Department management is responsible for establishing adequate controls and safeguards to ensure all checks are properly accounted for and controlled. Due to the weakness in the design of controls over the receipting process, management lacks assurance that all checks received are deposited into the bank and appropriately recorded in the financial records.

We recommend department management improve controls in the Receipting Unit to ensure all checks are safeguarded, properly tracked and accounted for in the financial records.

Ensure Expenditures are Recorded in the Proper Fiscal Year

The department routinely adjusts revenues and expenditures by making transfers between funds. These adjustments (balance transfers) are inherent in the department's business processes and are often due to budgetary refinancing events. Department policy is to move expenditures out of the General Fund and into the Health and Social Services Fund when other revenue sources become available. When making adjustments that cross fiscal years, the department routinely moves expenditures without the use of prior period adjustments that would ensure expenditures are recorded in the proper accounting period; this practice often results in large misstatements of expenditures. Governmental accounting standards require expenditures to be recognized in the period in which the liability is incurred.

The department adjusted expenditures in fiscal year 2013 that were originally recorded in fiscal year 2012 without the use of a prior period adjustment, causing an understatement in General Fund expenditures and a related overstatement in Health and Social Services fund. An audit adjustment was required to correct the misstatement of $306.3 million in fiscal year 2013.

We recommend department management align policies and procedures with governmental accounting standards to record expenditures in the proper period and we recommend management provide training to staff to ensure that prior period adjustments are utilized when appropriate.

Improve Revenue and Expenditure Accrual Methodologies

Governmental funds such as the Health and Social Services (HSS) fund should recognize revenues and expenditures and their related receivables and liabilities using the modified accrual basis of accounting. When actual amounts cannot be determined an estimate should be used. Revenues are susceptible to accrual if they are available to finance current period expenditures. For the State, the availability period is 90 days from fiscal year end. Likewise, governmental fund expenditures should also be accrued to the extent they are normally expected to be liquidated with available financial resources.

We reviewed the reasonableness of significant revenue and expenditure accruals by comparing the accruals to the actual amounts of revenues and expenditures recorded within the HSS fund in the 90 days following fiscal year end (accrual period). Our review showed the following significant differences:

- The healthcare provider tax (HPT) revenues are a quarterly revenue stream. The fourth quarter HPT revenue was received within the fiscal year 2013 accrual period, and therefore, was a known amount. Management focused on budgetary cash flow projections rather than following accounting principles and chose not to record an accrual for the fourth quarter revenue; thus, resulting in an understatement of the HPT revenue and related receivable of $119.4 million.
- The department records the total amount of drug rebate revenue receivable, which is allocated between current and long-term, using an estimate of how much the department believes it will be receive in the accrual period. Again, the department focused on budgetary cash flow projections, resulting in underestimating the receivable by $10.1 million.
- The department's accrual methodologies overestimated special payments expenditures during the accrual period by approximately $17.4 million and underestimated the services and supplies expenditure accrual by approximately $7.5 million.
- The accrual for the expenditures processed through the Medicaid Management Information System was incorrectly comprised of expenditures occurring 60 days after year-end rather than the full 90 day accrual period, resulting in a $3.4 million understatement.

Furthermore, we also found that the agency does not have a process in place to retrospectively review the reasonableness of their accrual estimates. Department management is responsible for establishing, maintaining and improving department internal controls. Internal controls must be adequate to provide reasonable assurance that transactions are accurate.

We recommend department management review and revise accrual methodologies for revenues and expenditures, as necessary, and perform periodic retrospective comparisons of accruals to actual amounts to ensure the accrual methodologies are reasonable.

Significant Deficiencies

Improve Controls Over Insurance Premium Revenue

Department management is responsible for establishing and maintaining adequate internal controls over revenue. At a minimum, these controls should provide evidence that all revenue transactions are recorded, nothing has been excluded, and revenue is properly classified in the accounting system.

The department collects insurance premiums for the Oregon Medical Insurance Pool and the Federal Medical Insurance Pool programs. The calculation, billing, collection, and remittance of these insurance premiums are performed by a service organization, Regence BlueCross BlueShield (Regence). Regence remits the insurance premiums to the department and the department records the premiums in the accounting records as revenue. Although the department performs a cash reconciliation to ensure all cash remitted by Regence is completely recorded in its accounting system, the department does not have adequate assurance that all insurance premiums due to the department are remitted by Regence. Additionally, internal controls are not adequate to determine the source of cash remitted by Regence and how to appropriately record the cash received.

We also found that $5 million in repayments of overpayments were recorded in the insurance premium revenue account that should have been recorded as reductions of expenditures.

We recommend department management implement internal controls to ensure that all insurance premium revenue due to the department is received, properly classified, and properly recorded.

Improve Accounting Controls Over Buildings and Accumulated Depreciation

The Oregon State Hospital grounds have several buildings, many of which have been in existence for decades. The department uses a spreadsheet to track buildings, related improvements to buildings and accumulated depreciation. The amounts recorded in the financial records for buildings, improvements and related accumulated depreciation did not agree to the amounts on the spreadsheet. As a result, the building and building improvement account was overstated by $3.6 million and the accumulated depreciation account was overstated by $2 million. Department management was unable to determine the nature of the differences, although they suspect the differences were due to the demolition of certain buildings.

Agency management is responsible for ensuring the proper accounting and reporting of capital assets and ensuring that disposed assets are appropriately removed from the accounting records and any related accumulated depreciation.

We recommend department management improve controls to ensure account balances are accurately stated and reconciled to supporting documentation.

Improve Year-end Financial Reporting

The department instituted OR-Kids, a new information technology system, during fiscal year 2012 to process child welfare related information and transactions. Since the inception of OR-kids, there has been a data processing error resulting in certain transactions being incorrectly funded between federal, general, or other funds. This processing error resulted in a liability to the federal government for the amount incorrectly funded with federal funds. As early as March 2013 the Office of Financial Services became aware of the data processing error; preliminary estimates of the magnitude of the error were not made until August 2013 and a final estimate was not made until February 2014.

Department management is responsible for designing and maintaining internal controls that provide reasonable assurance regarding the reliability of financial reporting, including reporting liabilities as soon as they are incurred. In the absence of known amounts, liabilities should be estimated.

The exact amount of the data processing error is not known, but in August 2013 OR-Kids project management estimated the error to be between $10 and $30 million. As of December 31, 2013, department management responsible for financial reporting had not recorded the liability in the department's financial records.

We recommend department management timely estimate and properly record liabilities in the department's financial records. We also recommend department management implement adequate internal controls to ensure all liabilities are appropriately reported in the financial statements.

Improve Controls Over Drug Rebate Revenues

The department receives drug rebate revenues for prescription drugs purchased for department clients. Department management is responsible for establishing and maintaining adequate internal controls over revenue. At a minimum, these controls should be designed to ensure that all revenue transactions are completely and accurately recorded in the accounting system. Drug rebate revenues are determined in two different ways.

First, for clients of the CAREAssist program, a program operated within the Public Health Division, the program compiles drug utilization information and supplies the pharmaceutical companies with this information. The pharmaceutical companies calculate and remit the rebate to the program. The program does not have adequate controls in place to ensure the pharmaceutical companies are calculating or remitting the correct amounts to the program. Program management stated that a federal oversight agency performs reviews of the pharmaceutical companies, but program management does not receive the results of these reviews because the federal oversight agency treats the rebates for the CAREAssist products as confidential and does not make them available to the state.

Second, for prescriptions filled by pharmacies paid through the Medicaid Management Information System (MMIS), a service provider, Hewlett Packard, determines the drug rebates and sends invoices to the pharmaceutical companies on behalf of the department. As the rebates are received, the department inputs rebate revenue into the MMIS, which matches it to the invoices and calculates any expected future receivables. To determine how the MMIS calculates, records, and tracks drug rebate revenues we had to contact Hewlett Packard representatives because the department does not maintain an adequate understanding of the controls over this process, nor receive adequate assurance over the design and effectiveness of these controls from a third party.

Of the drug rebate revenue recorded for fiscal year 2013, $7.5 million was for the CAREAssist program and $133.4 million was processed through the MMIS. Without adequate internal controls in place, drug rebate revenue could be incomplete or incorrectly recorded.

We recommend department management gain a better understanding of the controls already in place and implement the necessary complimentary controls to provide assurance that all drug rebate revenue is correctly calculated, invoiced, received, and recorded in the accounting system.

Prior Year Findings

In the prior fiscal year, we reported a material weakness related to the Oregon Health Authority's insufficient understanding of a new program (PEBB) in a letter dated March 5, 2013. This finding can also be found in the Statewide Single Audit Report for the year ended June 30, 2012, see Secretary of State audit report number 2013-07, finding number 12-03. During fiscal year 2013, the department partially corrected the finding by ensuring GAAP-compliant classification of PEBB activity. However, the department did not alter their accrual methodology to ensure that PEBB activity was completely and accurately reported in the financial statements. This finding will be reported in the Statewide Single Audit report for the fiscal year ended June 30, 2013, with a status of partial corrective action taken.

The above significant deficiencies and material weaknesses, along with your response for each finding, will be included in our Statewide Single Audit Report for the fiscal year ended June 30, 2013. Please prepare a response to each finding and include the following information as part of your corrective action plan:

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 names of the contact persons responsible for corrective action.

Please respond by March 3, 2014.

The purpose of this letter is solely to describe the scope of our testing of internal control and the result of that testing, and not to provide an opinion on the effectiveness of the departments' internal control. This communication is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the departments' internal control. Accordingly, this letter is not suitable for any other purpose.

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

Sincerely,
OREGON AUDITS DIVISION

Julianne Kennedy, CPA
Audit Manager

JK:SAA:jas

cc: James R. Scherzinger, Department of Human Services COO
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