Office of the Secretary of State

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Secretary of State

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Deputy Secretary of State

Audits Division

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February 29, 2016

George Naughton, Interim Chief Operation Officer and DAS Director
Department of Administrative Services
155 Cottage Street NE, U20
Salem, Oregon 97301-3972

Dear Mr. Naughton:

We have completed audit work of selected financial accounts at your department for the year ended June 30, 2015. This audit work was not a comprehensive financial audit of the department, 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, 2015, 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 department's 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 department's internal control. Accordingly, we do not express an opinion on the effectiveness of the department'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 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. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses. However, as discussed below, we identified a deficiency in internal control that we consider to be a significant deficiency.

Significant Deficiency

Operating Lease and Moving Costs Should Not Be Capitalized

The department owns and operates approximately three million square feet of building space that is generally occupied by state agencies. The department's management is responsible for rehabilitation projects and maintaining the buildings in operating order with the expectation they provide a safe working environment for state employees and members of the public while continuing to serve the state through the term of their established useful lives. During significant rehabilitation and remodeling projects, staff may be temporarily relocated to another building. According to accounting standards, rental costs associated with ground or building operating leases that are incurred during a construction period shall be recognized as rental expense. Costs should only be capitalized if they relate specifically to the long-term value of the building or structure.

During our audit we found the department capitalized costs totaling approximately $2.2 million that should have been expensed. These costs included temporary operating leases, moving costs, monthly telecommunication services, and miscellaneous items at the temporary location such as cleaning services and ergonomic assessments for staff. The capitalization of these activities is not in accordance with generally accepted accounting standards as they do not extend the useful life or add value to the building undergoing rehabilitation.

Management's capitalization policy is too broad to ensure project level decisions of whether work should be capitalized or expensed are appropriate. Management does not exhibit a clear or comprehensive understanding of generally accepted accounting principles or financial reporting requirements in relation to the capitalization of fixed assets.

This is a repeat finding.

We recommend financial management receive training and seek guidance from appropriate accounting standards and resources to obtain a better understanding of how to properly record costs related to capital assets. We further recommend management develop a clear and detailed capitalization policy that ensures proper capitalization decisions and improves the review process prior to recording capitalization transactions for financial reporting purposes.

Prior Year Findings

In fiscal years 2014 and 2013, we reported significant deficiencies related to the department's capitalization of repair and maintenance costs, inadequate review of estimated useful lives associated with buildings, and inadequate accounting procedures around buildings and building improvements in letters dated January 13, 2015, and February 12, 2014. These findings can also be found in the Statewide Single Audit Reports for the fiscal years ended June 30, 2014 and 2013; see Secretary of State audit report numbers 2015-05, finding numbers 2014-003 and 2014-004, and audit report number 2014-09, finding number 2013-009. During fiscal year 2015, the department took some steps to correct these findings, including drafting new capitalization policies; however, we still identified instances in fiscal year 2015 where costs were inappropriately capitalized.

These findings will be reported in the Statewide Single Audit Report for the fiscal year ended June 30, 2015, with a status of partial corrective action taken.

The above significant deficiency, along with your response, will be included in our Statewide Single Audit Report for the fiscal year ended June 30, 2015. Please prepare a response to the 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 name(s) of the contact person(s) responsible for corrective action.

Please respond by Wednesday, March 9, 2016.

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 department's internal control. This communication is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the department's 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 Kari Mott or Julianne Kennedy at (503) 986-2255.

Sincerely,

Office of the Secretary of State, Audits Division

cc: Barry Pack, Chief Administrative Officer
Zachary Gehringer, Chief Audit Executive
Bret West, Administrator, Enterprise Goods and Services
Brian King, Interim Enterprise Asset Management Administrator
Brad Cunningham, Shared Financial Services, Chief Financial Officer