Office of the Secretary of State

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Dr. Bruce Goldberg, Director
Department of Human Services
500 Summer St. NE, E15
Salem, Oregon 97301-1097

Dear Dr. Goldberg:

We have completed the statewide single audit that included selected financial accounts at the Department of Human Services (department) for the year ended June 30, 2007.

This audit work was not a comprehensive audit of the department. Instead, the audit work performed allowed us, in part, to achieve the following objectives: (1) 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; (2) determine whether the state's internal controls provided reasonable assurance of proper accounting, financial reporting, and legal compliance of transactions; and (3) determine whether the state has complied with applicable legal requirements that may have a direct and material effect on the state's financial statements.

In planning and performing our audit of the selected financial accounts at the department as of and for the year ended June 30, 2007, 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 and transactions at the department to determine their fair presentation in accordance with generally accepted accounting principles in relation to the statewide financial statements.

SFMA Account	Description	Audit Amount
General Fund – GAAP Fund 0001		
3111	Salaries and Wages - Regular Employees	$ 95,744,071
6300	Distribution to Counties	150,491,125
6800	Distribution to Individuals	716,744,418

SFMA Account	Description	Audit Amount
Special Revenue Fund – GAAP Fund 1108		
0065	Unreconciled Deposit	$ 13,110,657
0070	Cash on Deposit with Treasurer	17,405,193
0542	Accounts Receivable – Federal – Unbilled	112,769,625
1215	Accounts Payable	(116,530,162)
1635	Loans Payable – Current	(22,000,000)
0300	Federal Revenue	(2,503,117,716)
1105	Other Revenue	(148,434,656)
3111	Salaries and Wages – Regular Employees	186,854,531
6300	Distribution to Counties	250,806,118
6800	Distribution to Individuals	2,148,185,557

Our consideration of internal control was for the limited purpose described in the preceding paragraphs and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies and deficiencies that we consider to be material weaknesses.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. Based on our audit, we identified three significant deficiencies, two of which we consider to be material weaknesses. In addition, we identified other matters that warrant management's attention. We consider the following deficiency to be a significant deficiency in internal control:

Other Revenue Accrual (Significant Deficiency)

Revenue must be recognized in government funds when it is both measurable and available to finance current period expenditures. If the amount of the revenue is known or can be reasonably estimated (measurable) and is received within 90 days of year end (available) it should be accrued.

To develop the other revenue account accrual, the department queried the accounting system to identify revenue posted after year end that was earned in fiscal year 2007. The department's query inappropriately excluded a revenue control accrual account. As a result, the department accrued an extra $3,489,525 causing the other revenue account to be overstated by that amount. Management's review of the accrual transactions did not identify the error.

We recommend department management ensure appropriate query limits are used and communicate the importance of management reviews to ensure other revenue is properly accrued at fiscal year end.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. We believe that the following two deficiencies constitute material weaknesses:

Expenditure Accrual (Material Weakness)

The department's largest expenditure account is Distributions to Individuals and includes payments made to, or on behalf of, clients. During fiscal year 2007, the department's Distribution to Individuals account totaled approximately $2.86 billion. Though the department has consistently applied an accrual methodology for expenditures, they have not performed a review to verify whether the methodology is reasonably accurate. Further, the department has not considered the impacts of the accrual at a federal grant level.

According to the Oregon Accounting Manual, and in compliance with generally accepted accounting principles (GAAP), expenditures are subject to accrual if they are expected to be paid within 90 days after fiscal year end. To determine the reasonableness of the department's expenditure accrual we compared the accrual with expenditures paid during the accrual period. Specifically, we reviewed accrual period detail for 12 grants which comprised 91.8 percent of the total accrual or $65 million. We determined the department incurred $103 million in expenditures that were subject to accrual. As a result, the Distributions to Individuals account and related accounts receivable account were understated by $38 million.

Our review indicated that, overall, expenditures subject to accrual were greater than the amount accrued. The difference was most apparent for the Medicaid grant, which comprised 72.6 percent of the total accrual; the department accrued $51.8 million but accrual period expenditures totaled $92.1 million. However, we also noted instances where the accrual for an individual grant was significantly more than accrual period expenditures. For example, the department accrued $1.3 million for one grant which incurred only $.3 million in expenditures during the accrual period.

To facilitate year end closing, the Oregon Accounting manual encourages agencies to use accounting estimates if actual accrual amounts are not available in a timely manner. Using estimates is an acceptable accounting practice, provided the basis on which the estimates are made is fundamentally sound and conforms with GAAP.

We recommend department management review their accrual methodology, and compare estimated accruals with actual accrual period results. This will allow management to make any necessary adjustment to their methodology to ensure it is fundamentally sound and results in accruals that are reasonably accurate.

Other Revenue – Drug Rebate (Material Weakness)

According to the Oregon Accounting Manual, a department's internal controls must be adequate to provide reasonable assurance that transactions are accurate and properly recorded and executed in accordance with accounting principles. That same level of assurance should be required for services and financial information provided to the state by independent service providers.

The department relies on an independent service provider to provide them with accurate drug rebate revenue and related accounts receivable information. During fiscal year 2007, the department recorded $57.6 million in drug rebate revenue. We inquired of the department as to how they ensure the service provider has adequate controls in place over the accounting information being provided to the department. The contract between the department and the service provider does not require a periodic review of the provider's controls, performed either by an independent party or by the department. As a result, the department does not have a high-level of assurance that the service provider has internal controls in place to ensure the accounting information being provided to them is accurate.

The department recorded an accounts receivable for drug rebate revenues due as of June 30, 2007, using information provided by the independent service provider. The department did not seek additional supporting documentation or clarification from the service provider and did not follow generally accepted accounting principles as discussed below:

- First, the department recorded a $17.8 million accounts receivable balance to current period revenue rather than considering whether some of the revenue was earned in prior fiscal years.
- Then, when the department received a revised accounts receivable balance from the service provider, the department incorrectly recorded the $4.3 million increase in accounts receivable and revenue accounts to fiscal year 2008.
- Finally, the department did not record an allowance for doubtful accounts associated with the receivable balance or inquire of the service provider as to whether it would be appropriate to consider recording an allowance.

When auditors inquired of the service provider to determine the amount of the receivable balance that was for revenue earned in prior periods and the portion of the balance that should be recorded as doubtful, the service provider submitted documentation showing that $11.3 million was for revenue earned in fiscal years prior to 2007 and that a $2.3 million allowance for doubtful account should have been recorded.

We recommend department management ensure future contracts with service providers require the service providers to have periodic independent internal control reviews performed. Further, **we recommend** department management ensure adequate supporting documentation is obtained for all transactions posted to the accounting system. Management should provide training as necessary to help ensure staff and supervisors post all transactions in accordance with the revenue recognitions principles identified by GAAP.

In fiscal year 2006, we reported significant deficiencies to the department in a letter dated February 20, 2007, related to the department's cash reconciliations, lack of knowledge, skills and abilities, and lack of supporting documentation for Other Revenue transactions, Distributions to Individuals, and Salaries and Wages accounts. These findings can also be found in the Statewide Single Audit Report for the fiscal year ended June 30, 2006; see audit report number 2007-06, finding numbers 2006-02 to 04 and 2005-03. During fiscal year 2007, the department made progress in correcting these findings. They will be reported in the Statewide Single Audit Report for the fiscal year ended June 30, 2007, which will be issued in March 2008, with a status of partial corrective action taken.

In addition to the significant deficiency and material weaknesses identified above, we identified other matters that warrant management's attention.

IT – Logical Security (Other Matter)

System access is not always provided based on need. Auditors noted that assigned access to the Integrated Information System (IIS) and the Combined Check Reconciliation System and the Accounting Interface (CCRS/AI) do not always restrict users based on need.

Users are granted access to screens through group permissions even though not all users within the group may need access to all screens associated with that group profile. Further, management has a policy that system access be periodically reviewed; however, there is no mechanism to ensure such a review is being performed.

This weakness likely exists because executive management had not formally assigned system or data owners responsible for making logical access decisions, established access requirements, or ensured that access expectations were clearly defined in the Service Level Agreement with the hosting State Data Center.

Overly broad access granted to users effectively reduces control of the operating environment and increases the risk that unauthorized changes could be made by users who have no business need to access sensitive screens/data. User access rights to systems and data should be inline with defined and documented business needs and job requirements. Further, the department should ensure that requesting, establishing, suspending, modifying and closing user accounts and related user privileges are addressed by user account management. An approval procedure outlining the data or system owner granting the access privileges should be included. The department should also perform regular management reviews of all user accounts and related privileges.

We recommend department management establish access based on need-to-know or need-to-do, which may require restructuring group permissions, and ensure that periodic reviews of access are being performed as required. Further, **we recommend** that system owners, which have recently been identified by department management, are aware of their responsibilities for making logical access decisions, establishing access requirements, and ensuring that access expectations are clearly defined in future Service Level Agreements with the hosting State Data Center.

IT – Change Management (Other Matter)

The department's procedures regarding technical change management are not sufficient. Specifically, procedures are insufficient to ensure the following:

- Independent review of changed code and documentation of test results; and
- Protection of code (in all phases, specifically after it is approved and prior to promotion to production).

According to the Information Security Handbook, "the primary purpose of an independent code review is to identify and correct potential software code problems that might affect the integrity, confidentiality, or availability once the application has been placed into production." By not requiring and documenting an independent code review, management runs the risk that incorrect or unapproved code could be implemented that would compromise the system and the integrity, confidentiality, or availability of system data.

Further, the department's information technology management should ensure that change management and software control are properly integrated with a comprehensive configuration management system. The system used to monitor changes to application systems should be automated to support the recording and tracking of changes made to large, complex information systems. Formal procedures should be implemented to control the handover of the system from development to testing to operations.

We recommend department management develop technical policies and procedures regarding the mechanics of change control and ensure that the areas noted above are included.

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, 2007. 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 name(s) of the contact person(s) responsible for corrective action.

Please respond by March 7, 2008. The other matters do not require a written response. We will follow up on the department's progress in addressing these issues during the next fiscal year audit.

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.

Should you have any questions, please contact Amy Palacios or me at (503) 986-2255.

Sincerely,
OREGON AUDITS DIVISION

Kelly L. Olson, CPA
Audit Manager

KLO:brk
cc: Clyde Saiki, Deputy Director of Operations
Jim Scherzinger, Deputy Director of Finance
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Betty Gambone, Internal Audits
Kris Kautz, Interim Director, Department of Administrative Services