United States Department of the Interior

Office of Inspector General
Washington, D.C. 20240

March 31, 2003

Memorandum

To: Assistant Secretary for Policy, Management and Budget

From: Roger La Rouche
Assistant Inspector General for Audits

Subject: Independent Auditors' Report on the Departmental Offices' Financial Statements for Fiscal Years 2002 and 2001 (No. 2003-I-0041)

We contracted with KPMG LLP (KPMG), an independent certified public accounting firm, to audit the Departmental Offices' financial statements as of September 30, 2002 and for the year then ended. The contract required that KPMG conduct its audit in accordance with the Comptroller General of the United States of America's *Government Auditing Standards*, the Office of Management and Budget's Bulletin 01-02 *Audit Requirements for Federal Financial Statements*, and the General Accounting Office/President's Council on Integrity and Efficiency's *Financial Audit Manual*.

In its audit report dated January 17, 2003 (Attachment), KPMG issued a qualified opinion on the Departmental Offices' financial statements for fiscal year 2002 and unqualified opinion on the fiscal year 2001 financial statements. KPMG issued a qualified opinion on the fiscal year 2002 financial statements because Departmental Offices did not adequately maintain its Interior Franchise Fund accounting records for accounts receivable and advances from others. KPMG identified seven reportable conditions related to the following internal controls and financial operations: (1) trust funds; (2) reconciling transactions and balances with trading partners; (3) property, plant and equipment; (4) financial reporting; (5) Interior Franchise Fund; (6) application and general controls over financial management systems; and (7) costing methodology. KPMG considered the first five reportable conditions to be material weaknesses. With regard to compliance with laws and regulations, KPMG found the Departmental Offices' noncompliant with portions of the *Federal Financial Management Improvement Act of 1996* (FFMIA). Specifically, KPMG reported the Departmental Offices' financial management systems did not in substantially comply with Federal financial management systems requirements and Federal accounting standards. In regard to compliance with laws and regulations exclusive of those referred to in the FFMIA, KPMG found the Departmental Offices to be noncompliant with Section 113 of Public Law 104-208 regarding advances for the Interior Franchise Fund.

In connection with the contract, we monitored the progress of the audit at key points, reviewed KPMG's report and selected related working papers, and inquired of its representatives. Our review, as differentiated from an audit in accordance with the *Government Audit Standards*, was not intended to enable us to express, and we do not express, an opinion on the Departmental Offices' financial statements, conclusions about the effectiveness of internal controls, conclusions on whether the Departmental Offices' financial management systems substantially complied with the three requirements of FFMIA, or conclusions on compliance with laws and regulations. KPMG is responsible for the auditors' report and for the conclusions expressed in the report. Our review disclosed no instances where KPMG did not comply in all material respects with the *Government Auditing Standards*.

Management's responses to the findings and recommendations are incorporated in KPMG's report. Management concurred with all of the recommendations. As a result, we consider all of the recommendations to be resolved but not implemented. The recommendations will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation.

Section 5(a) of the *Inspector General Act* (5 U.S.C. App. 3) requires the Office of Inspector General to list this report in its semiannual report to the Congress.

Attachment

2001 M Street, NW
Washington, DC 20036

Attachment

INDEPENDENT AUDITORS' REPORT

Assistant Secretary for Policy, Management and Budget and Inspector General
U.S. Department of the Interior:

We have audited the accompanying consolidated balance sheets of the Departmental Offices as of September 30, 2002 and 2001, and the related consolidated statements of net costs for the years then ended, and the related consolidated statement of changes in net position, combined statement of budgetary resources, and consolidated statement of financing for the year ended September 30, 2002 (hereinafter referred to as the financial statements). The objective of our audit was to express an opinion on the fair presentation of these financial statements. In connection with our audit, we also considered the Departmental Offices' internal control over financial reporting and tested the Departmental Offices' compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements.

SUMMARY

As stated in our opinion on the financial statements, except for the effects on the 2002 financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to apply adequate procedures to accounts receivable and advances from others, we concluded that Departmental Offices' financial statements, presented herein, as of and for the years ended September 30, 2002 and 2001, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 29 to the financial statements, Departmental Offices restated its fiscal year 2001 consolidated balance sheet and statement of net cost. Also, as discussed in Note 22, Departmental Offices changed its method of accounting for allocation transfers as of October 1, 2001. Furthermore, as discussed in Note 28 to the financial statements, part of the Interior Franchise Fund will be transferred to the Minerals Management Service effective October 1, 2002. The financial statements do not include any adjustments that might result from this transfer.

Our consideration of internal control over financial reporting resulted in the following conditions being identified as reportable conditions:

Reportable Conditions That Are Considered to be Material Weaknesses

A. Controls over trust funds

B. Controls to reconcile transactions and balances with trading partners

C. Controls over property, plant, and equipment

D. Controls over financial reporting

E. Controls over Interior Franchise Fund

Other Reportable Conditions

F. Application and general controls over financial management systems

G. Costing methodology

The results of our tests of compliance with certain provisions of laws and regulations disclosed the following instances of noncompliance that are required to be reported herein under *Government Auditing Standards,* issued by the Comptroller General of the United States, or Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements:*

H. Section 113 of Public Law 104-208 – Advances for Interior Franchise Fund

I. *Federal Financial Management Improvement Act of 1996* (FFMIA)

The following sections discuss our opinion on Departmental Offices' financial statements, our consideration of the Departmental Offices' internal control over financial reporting, our tests of the Departmental Offices' compliance with certain provisions of applicable laws and regulations, and management's and our responsibilities.

OPINION ON THE FINANCIAL STATEMENTS

We have audited the accompanying consolidated balance sheets of Departmental Offices as of September 30, 2002 and 2001, and the related consolidated statements of net cost for the years then ended, and the related consolidated statement of changes in net position, combined statement of budgetary resources, and consolidated statement of financing for the year ended September 30, 2002.

Departmental Offices did not maintain its Interior Franchise Fund accounting records during fiscal year 2002, particularly with respect to accounts receivable and advances from others, thus requiring reconciliation and adjustment of these accounts subsequent to year end. As a result, management was unable to provide timely evidential matter to support the Interior Franchise Fund's accounts receivable and advances from others prior to the end of our audit. It was not practicable to extend our audit procedures sufficiently to satisfy ourselves as to the fairness of accounts receivable and advances from others, stated at $118,730 thousand and $494,414 thousand, respectively, in the accompanying financial statements as of September 30, 2002. Such amounts enter into the determination of financial position, net costs, budgetary resources, and the reconciliation of net costs to budgetary obligations as of and for the year ended September 30, 2002.

In our opinion, except for the effects on the 2002 financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to apply adequate procedures to accounts receivable and advances from others, as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of Departmental Offices as of September 30, 2002 and 2001, and its net costs for the years then ended, and its changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the year ended September 30, 2002, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 29 to the financial statements, Departmental Offices restated its fiscal year 2001 consolidated balance sheet and statement of net cost. Also, as discussed in Note 22, Departmental Offices changed its method of accounting for allocation transfers as of October 1, 2001. Furthermore, as discussed in Note 28 to the financial statements, part of the Interior Franchise Fund will be transferred to the Minerals Management Service effective October 1, 2002. The financial statements do not include any adjustments that might result from this transfer.

The information in the Management's Discussion and Analysis, Required Supplementary Stewardship Information and Required Supplementary Information sections is not a required part of the financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information in the Other Supplementary Information section is presented for purposes of additional analysis of the consolidated balance sheet, rather than to present the financial position of Departmental Offices' components individually. The consolidating information has been subjected to the auditing procedures applied in the audits of the financial statements and, in our opinion, except for the effects on the 2002 financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to apply adequate procedures to the accounts receivable and advances from others, as discussed above, is fairly stated in all material respects in relation to the financial statements taken as a whole.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect Departmental Offices' ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal control, misstatements, due to error or fraud may nevertheless occur and not be detected.

In our fiscal year 2002 audit, we noted certain matters involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that reportable conditions A through E are material weaknesses.

A. Controls Over Trust Funds

The U.S. Congress has designated the Secretary of the Interior as the primary fiduciary with responsibility for monetary resources held in trust on behalf of American Indian Tribes, Individual Indians, and Other Trust Funds (hereafter collectively referred to as the Indian Trust Funds). The Secretary carries out this fiduciary responsibility through the Office of the Special Trustee (OST), the Bureau of Indian Affairs (BIA), and other Interior bureaus. OST is a component of Departmental Offices.

The Indian Trust Fund balances include balances considered federal funds and balances considered non-federal funds. The amounts considered federal funds are reflected in the Departmental Offices' financial statements, while the non-federal trust funds are not reflected in the Departmental Offices' financial statements. However, the Indian Trust Funds' transactions and balances are disclosed in a footnote to the Departmental Offices' financial statements, in accordance with federal accounting standards.

We noted that the procedures and internal controls are not adequate to ensure that the Indian Trust Fund activity and balances are recorded properly or timely. We noted the following weaknesses:

1. <u>Cash Balances</u> – OST is unable to reconcile the Indian Trust Fund cash balances that are disclosed in the footnotes to Departmental Offices' financial statements with the cash balances reported by the U.S. Treasury. The Indian Trust Fund cash balances are approximately $33 million greater than balances reported by the U.S. Treasury as of September 30, 2002 and 2001. In addition, OST needs to resolve approximately $12.6 million of balances in Treasury suspense and budget clearing accounts as of September 30, 2002 and 2001.

2. <u>Trust Fund Balances</u> – OST is unable to provide accounting records to properly support the Indian Trust Fund balances. For example, the Individual Indian Monies (IIM) trust fund balances in the subsidiary ledger exceed the balance in the control account by approximately $6 million and $6.7 million as of September 30, 2002 and 2001, respectively. In addition, the Individual Indian Monies subsidiary ledger contains negative trust fund balances of approximately $44 million as of September 30, 2002 and 2001. OST also is in the process of investigating and resolving undistributed interest. Furthermore, certain account holders do not agree with the trust fund balances and have filed claims against the U.S. Government and Department of the Interior, that remain unresolved.

3. <u>Special Deposit Accounts</u> – In accordance with section 25 of the Code of Federal Regulations, OST records receipts into a special deposit account within the IIM subsidiary ledger when the recipient trust fund account is unknown at time of receipt. When BIA identifies the proper trust fund account, OST transfers the amount from the special deposit account to the proper trust fund account in accordance with BIA instructions. During fiscal years 2002 and 2001, OST in conjunction with BIA and a contractor, developed a formal plan to address special deposit accounts. The Department needs to resolve approximately $62 million and $67 million of special deposit accounts included in the IIM subsidiary ledger as of September 30, 2002 and 2001, respectively. A significant number of special deposit accounts have remained inactive for the past several years and new accounts continue to be established.

4. Trust Fund Information Systems – Interior needs to improve security and general controls over the Trust Fund information systems. Specifically, Interior needs to develop and implement a security policy and program, improve segregation of duties, accredit and certify its general and application systems, strengthen controls to prevent unauthorized access, and establish formal application software development and change controls.

5. Appraisal Compacts – One of the key elements in performing realty trust transactions is the requirement of obtaining appraisals for realty transactions. OST has a fiduciary duty to land title owners and monetary property recipients (e.g., life estate holders) to establish the fair value of property transactions, including establishing the fair value of property leases, before entering into lease agreements or sales transactions on behalf of the owners. Current laws allow the appraisal function to be compacted to tribes, who are often the named parties involved in realty transactions. As a result, transactions are consummated based on prices established or influenced by the eventual beneficial owners of the property. Controls are not in place to ensure that the fair value of property transactions are established by parties independent of the transaction.

6. Entering and Maintaining Trust Fund Information – The regional and agency offices of BIA perform a critical role in the initial input and subsequent changes to the Indian Trust Funds information disclosed by Departmental Offices. We noted the following weaknesses related to the internal controls performed by regional and agency offices:

   a. Segregation of Duties – The responsibilities for trust fund processing are not properly segregated to prevent or detect errors. Specifically, in some locations an individual employee has the ability to initiate lease agreements; generate annual billings for property leases; collect payment for leases; send instructions to OST to create IIM accounts; and send instructions to OST via a change order directing OST to change the named monetary property recipients and IIM accounts to which future collections should be posted.

   b. Probate Backlog – The probate orders for land title are not entered into the trust management systems timely. One location has a probate backlog that is over a year old. This results in the potential for inaccurate distributions of lease income to the Indian Trust Fund account holders.

   c. Untimely Deposits – We determined that agency offices did not consistently forward trust receipts to OST in a timely manner. Some of these delays occurred at agency offices where OST and BIA personnel reside and other delays occurred at agency offices occupied by BIA personnel only.

Recommendation

We recommend that Interior develop and implement procedures and internal controls to address these deficiencies.

Management Response

Management concurs with this finding. A variety of actions are underway within the Department of the Interior to correct these deficiencies.

B. Controls to Reconcile Transactions and Balances with Trading Partners

Departmental Offices needs to improve controls to reconcile the intra-departmental and non-fiduciary intra-governmental activity and balances as follows:

1. Intra-departmental Transactions – Departmental Offices provides products and services to the other components of the Department of the Interior. Departmental Offices does not reconcile transactions and balances with other components of the Department of the Interior in accordance with the Department of the Interior's *Fiscal Year 2002 Financial Statement Preparation Guidance,* OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements,* and Treasury's *Federal Intragovernmental Transactions Accounting and Policies Guide* in a timely manner. This occurred because the reconciliation is performed manually and Departmental Offices does not have the necessary resources focused on the reconciliation process.

2. Reconciliation of Non-Fiduciary Intra-governmental Transactions – Departmental Offices provides products and services to other Federal entities. The Department of the Interior reconciles the fiduciary intra-governmental transactions and balances; however, the Department of the Interior has not fully reconciled its non-fiduciary intra-governmental transactions and balances. As a result, Departmental Offices does not fully reconcile its non-fiduciary transactions with other Federal entities. Therefore, Departmental Offices' transactions and balances with other federal entities may not properly eliminate on the government-wide financial statements.

Recommendations

We recommend that Departmental Offices improve the process to identify and reconcile the non-fiduciary intra-departmental and intra-governmental activity and balances as follows:

1. Intra-departmental Transactions – We understand that the Department of the Interior is developing an automated process to facilitate the reconciliation of intra-Departmental transactions. We recommend that the Department of the Interior complete and implement this automated process. Until the automated process is implemented, we recommend that Departmental Offices improve the manual process to reconcile transactions and balances with the other components of the Department of the Interior.

2. Reconciliation of Non-Fiduciary Intra-governmental Transactions – We recommend that Departmental Offices in conjunction with the Department of the Interior establish procedures to reconcile non-fiduciary transactions and balances with other federal entities.

These reconciliation processes should be completed quarterly and should include procedures to timely resolve any identified differences.

Management Response

Management concurs with this finding. Interior will continue to improve intra-governmental transaction processing begun in 2002. This effort includes addressing the issues identified above.

C. Controls Over Property, Plant, and Equipment

During our fiscal year 2002 audit we observed various fixed assets that Departmental Offices has been constructing over the past several years related to the Central Utah Project Completion Act (CUPCA) and the Utah Reclamation Mitigation and Conservation Commission (Commission). As a result of our observation, we recommended that Departmental Offices re-assess whether the fixed assets are properly capitalized in accordance with federal accounting standards. Departmental Offices completed the analysis and concluded that $199 million of fixed assets as of September 30, 2001 should have been expensed when the costs were incurred. Departmental Offices determined that these costs should be expensed as they represented stewardship land, stewardship land improvements, investments in non-federal physical property, or projects that had been cancelled and therefore would not provide any future benefit.

Recommendations

We recommend that Departmental Offices in conjunction with CUPCA and the Commission develop internal controls and procedures relating to the recording and reporting of property, plant and equipment and expense transactions. These internal controls and procedures should include:

1. Policies defining transactions that should be capitalized, expensed as acquisition and improvements to stewardship land, and expensed as investments in non-federal physical property.

2. Monthly reviews of the general ledger and financial reports to ensure that transactions are properly expensed or capitalized in accordance with the policies.

3. Monthly reviews of the construction in progress accounts to ensure that projects will continue to provide future benefit and to ensure that completed projects are transferred to other property accounts.

Management Response

Management concurs with this finding.

D. Controls Over Financial Reporting

Transactions should be promptly recorded, properly classified, and properly accounted for in order to prepare reliable financial and other reports. The documentation for transactions, management controls, and other significant events must be clear and readily available. Departmental Offices needs to improve controls over the recording and reporting of financial transactions, as discussed below.

1. Transaction Entry – Departmental Offices recorded over 100 adjustments after October 23, 2002 and needs to improve the review process to ensure year-end adjustments are properly recorded. Specifically, we determined that Departmental Offices incorrectly recorded a prior period adjustment of $155 million as current year activity, an accounts payable adjustment of $7 million for expenses that had not been incurred, and accounts receivable of $94 million that had already been collected. In addition, we identified transactions that were incorrectly recorded during the fiscal year related to CUPCA and the Commission. Specifically, Departmental Offices incorrectly recorded recoveries of prior year obligations of $10 million and incorrectly classified other financing sources of $6 million. As a result of our recommendations, Departmental Offices adjusted the balances appropriately.
2. Aged and Suspense Accounts – Departmental Offices does not consistently resolve aged or suspense accounts in a timely manner. We noted Departmental Offices had approximately $2 million of aged accounts receivable balances, $2 million of unnatural accounts receivable and advances from others balances, which are associated to specific agreement numbers, and approximately $2 million of natural accounts receivable and advances from others balances that are not currently associated with customer agreements.
3. Communication with Solicitor – Departmental Offices' financial management department does not consistently communicate with the solicitor's office regarding claims and assessments. As a result, the financial management department generally does not receive or review any formal reports on the status of claims and assessments until after the end of the year.
4. Policies and Procedures – Departmental Offices has not fully developed and adopted policies and procedures for recording and monitoring transactions at CUPCA and the Commission.

Recommendation

We recommend that Departmental Offices perform the following to improve the recording and reporting of financial transactions:

1. Transaction Entry – We recommend that Departmental Offices record transactions throughout the year at the time the financial event occurs to minimize the adjustments recorded at the end of the year. Departmental Offices should utilize automated posting models throughout the year as well as during the year-end reporting process. For manual journal entries, we recommend that Departmental Offices have a second individual review the journal entries to ensure that they are accurate and complete.

2. Aged and Suspense Accounts – We recommend that Departmental Offices develop and implement formal month-end financial reporting processes to resolve aged and unnatural balances. Departmental Offices should ensure that there is appropriate staffing to complete and review this activity.

3. Communication with Solicitor – We recommend that Departmental Offices' financial management department request from the solicitor's office a quarterly analysis of all legal claims and assessments and record an accrual or prepare a disclosure for inclusion in the interim and year-end financial statements. In addition, the solicitor's office should provide updates, more timely than quarterly, on the status of major cases to the Departmental Offices' financial management department.

4. Policies and Procedures – We recommend that Departmental Offices in conjunction with CUPCA and the Commission develop and implement policies and procedures for recording and monitoring revenue, accounts receivable, advances, expenses, accounts payable, budgetary recoveries, as well as property and equipment.

Management Response

Management concurs with this finding.

E. Controls Over Interior Franchise Fund

Departmental Offices needs to improve the procedures and internal controls over the Interior Franchise Fund (IFF). Specifically we noted:

1. Organizational Structure – IFF is a "virtual organization" that utilizes personnel from both of its service providers. Although several personnel are fully dedicated to working on IFF activity, there are several personnel who only spend part of their time working on IFF activity. As a result of utilizing personnel from different service organizations, IFF does not have clear lines of responsibility or reporting. This causes delays in processing of IFF transactions because IFF activity does not consistently receive the same priority as the other activity processed by the service providers.

2. Financial Reporting – IFF does not consistently reconcile transactions and balances with its trading partners in a timely manner. In addition, IFF did not record financial transactions through out the year and recorded numerous adjustments during the year-end closing process. IFF also does not consistently resolve aged accounts or accounts with abnormal balances in a timely manner. Furthermore, IFF has not properly designed its fund balance with Treasury reconciliation procedures or fully segregated fund balance with Treasury responsibilities as the IFF representative responsible for performing the reconciliations, may also process transactions in the Intra-governmental Payment and Collection System and record transactions into the accounting system. As a result, IFF analyzed these accounts and adjusted the balances.

3. Revenue Process – IFF improperly recorded $60.5 million of adjustments at the customer level instead of at the agreement level. In addition, IFF had over 300 customer agreements with both an accounts receivable ($11 million) and an advances from others balance ($19 million). We also noted during our testing of a sample of accounts receivable and advance balances that IFF increased accounts receivables instead of reducing advances and recorded the incorrect amount of IFF fees, funds collected, agreement amounts, and revenue earned. Furthermore, we noted that the IFF fees are not consistently recorded in the proper period and that the IFF fees are not consistently documented in the customer agreements. As a result, IFF analyzed these accounts and adjusted the balances.

Recommendation

We understand that Department of the Interior is in the process of re-organizing responsibilities of IFF. We recommend that Department of the Interior complete this re-organization process, ensure there is appropriate staffing to complete the day-to-day accounting processing during the year, and establish internal controls to ensure transactions are recorded properly.

Management Response

Management concurs with this finding. The Department is taking the appropriate action to implement this recommendation.

F. Application and General Controls Over Financial Management Systems

Security and general controls over the information systems, administered by the National Business Center (NBC), have not been fully implemented. The NBC, a component within Departmental Offices, administers several of the Department's financial management systems, including the: Federal Financial System (FFS); Federal Personnel and Payroll System (FPPS); and the Interior Department Electronic Acquisitions System (IDEAS).

Although NBC is working towards improving the security and controls over the information systems, controls need to be improved in the areas described below, as required by OMB Circular A-130, *Management of Federal Information Resources.* These conditions could affect Departmental Offices ability to prevent and detect unauthorized changes to financial information, control electronic access to sensitive information, and protect its information.

1. Entity-wide Security Program – An entity-wide security program, including security policies and a related implementation plan, is the foundation of an entity's security control structure and a reflection of senior management's commitment to addressing security risks. As outlined in OMB Circular A-130, an effective security program includes a risk assessment process, certification process, and effective incident response and monitoring capabilities. NBC is making progress towards establishing a security infrastructure, however, continued efforts need to made in assigning security responsibilities, developing and implementing security policies and procedures, conducting security awareness training, and in monitoring the security program. Without a clear security program, the systems are vulnerable to unauthorized access, use, or loss of sensitive information.

2. Access Controls – Access controls should provide reasonable assurance that computer resources such as data files, application programs, and computer-related facilities and equipment are protected against unauthorized modification, disclosure, and loss. NBC needs to improve controls over the process of granting, terminating, and monitoring system access in specific applications. In addition, the NBC has not fully limited access to system information and has not finalized and communicated guidelines regarding posting of information on the Internet.

3. System Software Controls – Controls over the modification of system software change controls should provide reasonable assurance that operating system controls are not compromised. Without proper system software controls, unauthorized individuals using the system software could circumvent controls to read, modify, or delete critical or sensitive information or programs. NBC should complete the implementation of the automated system for managing NBC's software library and the automated process for reviewing and securing the implementation of changes to software. Once these systems have been fully implemented, NBC needs to develop procedures and assign responsibility for monitoring these systems to ensure that system software is adequately protected.

4. Software Development and Change Controls – Establishing controls over the modification of application software programs helps ensure that only authorized programs and modifications are implemented. Without proper change controls, there is an increased risk that either intentional or unintended changes are made to the system's processing functionality, the wrong version of a program could be implemented, a virus could be inserted, or built-in security features could be disabled. NBC has not fully developed policies and procedures for controlling bureau-customized changes over application software. In addition, duties are not properly segregated as application programmers responsible for making changes to customized bureau application software also approve these changes and move them to production.

Recommendation

We recommend that Departmental Offices develop and implement a formal action plan to improve the security and general controls over the financial management systems. This plan should address each of the areas discussed above, as well as other areas that might impact the information technology control environment to ensure adequate security and protection of the Department of the Interior's information systems.

Management Response

Management concurs with this finding.

G. Improve Costing Methodology

Departmental Offices through its Working Capital Fund (WCF) provides certain central services including aircraft, building delegation funds, communications, reproduction, supplies and other services that are performed more advantageously centrally on a reimbursable basis. The Office of the Inspector General performed a review of the WCF and noted that Departmental Offices does not consistently code transactions in the accounting system to facilitate activity-based costing at the customer level. As a result, Departmental Offices utilizes a manual process to allocate the costs of central services to its customers. The Office of the Inspector General also noted that the centralized billing does not provide a detailed description of services and related costs. Furthermore, we noted that Departmental Offices does not consistently allocate accrued expenses, such as accrued Federal Employee Compensation Act expenses, to all funds.

Recommendations

We recommend that Departmental Offices develop and implement an activity-based costing process to accumulate and assign costs to outputs at the customer level. This costing process should include policies and procedures for assigning and allocating costs to customers. We also recommend that Departmental Offices either (1) establish an account code structure to track costs consistent with activity-based costing, as recommended in the Cost Accounting Team Report dated July 2, 2002 or (2) conduct a study to identify an alternative means for recording costs to meet the requirements of activity-based costing. This will help ensure that customers are properly allocated costs and enable Departmental Offices to include a detailed description of services and related costs on its bills.

Management Response

Management concurs with this finding.

A summary of the status of prior year reportable conditions is included as Exhibit I. We also noted other matters involving internal control over financial reporting and its operation that we have reported to the management of Departmental Offices' in a separate letter dated January 17, 2003.

COMPLIANCE WITH LAWS AND REGULATIONS

Our tests of compliance with certain provisions of laws and regulations, as described in the Responsibilities section of this report, exclusive of the FFMIA, disclosed an instance of noncompliance with the following laws and regulations that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, and are described below.

H. Section 113 of Public Law 104-208 – Advances for Interior Franchise Fund

In accordance with Section 113 of Public Law 104-208, the Interior Franchise Fund is required to obtain advances from customers before costs are incurred to provide goods or services to the customer. We determined that Interior Franchise Fund does not consistently obtain advances from customers as Interior Franchise Fund reported accounts receivable of approximately $78 million as of September 30, 2002.

Recommendation

We recommend that the Interior Franchise Fund require customers to pay in advance, in accordance with the law or consider requesting the U.S. Congress to change the law governing this requirement.

Management Response

Interior developed, with approval of the Office of Management and Budget, appropriation language establishing the Interior Franchise Fund applying the Government Management Reform Act that created the franchise fund pilot program and guidelines provided by the Office of Management and Budget. The intent of the pilot program was to allow these franchise funds to provide quality services at reduced costs to Federal agencies through competition. The Department does not believe the recommended appropriation language was intended to require advances for all services, but was intended to allow the pilot program to receive advances so that the organizations could operate in a more business like manner. However, the Department could see how the existing language could be interpreted as described above. The Department is working with the Office of Management and Budget and Congress to adjust the appropriation to support the intent of the Government Management Reform Act objectives.

The results of our tests of FFMIA section 803(a) disclosed instances, described below, where the Departmental Offices' financial management systems did not substantially comply with the Federal financial management systems requirements and the federal accounting standards. The results of our tests of FFMIA section 803(a) disclosed no instances in which the Departmental Offices' financial management systems did not substantially comply with the United States Standard General Ledger at the transaction level.

I. Federal Financial Management Systems Requirements

1. Federal Financial Management Systems Requirements – As discussed in the section of our report entitled "Internal Control over Financial Reporting," Departmental Offices needs to improve its EDP security and general control environment. Departmental Offices has not fully implemented an entity-wide security program; has not fully implemented controls over the process of granting and monitoring system access; has not fully limited access to system information; has not finalized and communicated guidelines regarding data posting on the Internet; has not fully established system software controls that limit and monitor access to the programs and sensitive files; and has not fully developed or segregated procedures for controlling changes over application software. As a result, Departmental Offices does not substantially comply with the security and general control requirements of OMB Circular A-130, *Management of Federal Information Resources*.

2. Federal Accounting Standards – Departmental Offices is required to prepare its financial statements in accordance with Federal accounting standards. As discussed in the section of our report entitled "Internal Control Over Financial Reporting," we identified material weaknesses that affected Interior's ability to prepare its financial statements and related disclosures in accordance with Federal accounting standards. Specifically, we determined that Departmental Offices needs to improve its trading partner reconciliation process as well as improve procedures and controls over property, plant, and equipment, financial reporting, and the Interior Franchise Fund.

Recommendations

1. Federal Financial Management Systems Requirements – We recommend that Departmental Offices take the necessary actions to improve the application and general controls over its financial management systems in accordance with requirements set forth in OMB Circular A-130 in fiscal year 2003.

2. Federal Accounting Standards – We recommend that during fiscal year 2003, Departmental Offices strengthen its procedures and internal controls that ensure the financial statements and related disclosures are prepared in accordance with the Federal accounting standards.

Management Response

Management concurs with this finding.

RESPONSIBILITIES

Management's Responsibilities

The Government Management Reform Act (GMRA) of 1994 requires each Federal agency to report annually to Congress on its financial status and any other information needed to fairly present its financial position and results of operations. To assist the Department of the Interior in meeting the GMRA reporting requirements, the Departmental Offices prepares annual financial statements.

Management is responsible for:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal controls over financial reporting, preparation of the Management's Discussion and Analysis (including the performance measures), required supplementary information, and required supplementary stewardship information; and
- Complying with laws and regulations, including FFMIA.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies.

Auditors' Responsibilities

Our responsibility is to express an opinion on the financial statements of the Departmental Offices based on our audits. Except as discussed in our opinion, we conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards* and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall financial statement presentation.

We believe that our audits provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2002 audit, we considered the Departmental Offices' internal control over financial reporting by obtaining an understanding of the Departmental Offices' internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982. The objective of our audit was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin No. 01-02, we considered the Departmental Offices' internal control over required supplementary stewardship information by obtaining an understanding of the Departmental Offices' internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. Our procedures were not designed to provide assurance on internal control over required supplementary stewardship information and, accordingly, we do not provide an opinion thereon.

As further required by OMB Bulletin No. 01-02, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal control over performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether the Departmental Offices' fiscal year 2002 financial statements are free of material misstatement, we performed tests of the Departmental Offices' compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws and regulations applicable to the Departmental Offices. Providing an opinion on compliance with laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 01-02 and FFMIA, we are required to report whether the Departmental Offices' financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

DISTRIBUTION

This report is intended for the information and use of Department of the Interior's management, Department of the Interior's Office of the Inspector General, OMB and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

January 17, 2003

Exhibit I

Departmental Offices
Summary of the Status of Prior Year Findings
September 30, 2002

Ref	Condition Area	Status
A	Improve Controls Over Tribal and Other Trust Funds	This condition has not been corrected and is repeated in fiscal year 2002. See finding A.
B	Improve Controls Over Undelivered Orders and Accruals	This condition has been corrected.
C	Improve Controls to Reconcile Transactions with Other Interior Components	This condition has not been corrected and is repeated in fiscal year 2002. See finding B.
D	Improve Controls Over Interior Franchise Fund Financial Reporting	This condition has not been corrected and is repeated in fiscal year 2002. See finding E.
E	Improve Controls Over Costs Charged to Construction in Progress and Investigations and Development	This condition has not been corrected and is repeated in fiscal year 2002. See finding C.
F	Improve Application and General Controls Over Financial Management Systems	This condition has not been corrected and is repeated in fiscal year 2002. See finding F.
G	Document Policies and Procedures for Certain Areas	This condition has been partially corrected and is repeated in fiscal year 2002. See finding D.
H	Section 113 of Public Law 104-208 - Advances for Interior Franchise Fund	This condition has not been corrected and is repeated in fiscal year 2002. See finding H.
I	Provide Adequate Application and General Controls Over Financial Management Systems	This condition has not been corrected and is repeated in fiscal year 2002. See finding I.
J	Federal Accounting Standards	This condition has not been corrected and is repeated in fiscal year 2002. See finding I.