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Independent Auditors' Report

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

We have audited the accompanying balance sheets of the U.S. Department of the Interior (Interior) as of September 30, 2006 and 2005, and the related statements of net cost, changes in net position, budgetary resources, financing, and custodial activity (hereinafter referred to as "financial statements") for the years then ended. The objective of our audits was to express an opinion on the fair presentation of these financial statements. In connection with our fiscal year 2006 audit, we also considered Interior's internal controls over financial reporting, Required Supplementary Stewardship Information, and performance measures, and tested Interior's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on these financial statements.

SUMMARY

As stated in our opinion on the financial statements, we concluded that Interior's financial statements as of and for the years ended September 30, 2006 and 2005, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.

As discussed in our opinion, in fiscal year 2006, Interior changed its method of accounting for and reporting of earmarked funds, heritage assets, stewardship land, and certain allocation transfers to adopt changes in accounting standards and Office of Management and Budget (OMB) requirements.

Our consideration of internal controls over financial reporting, Required Supplementary Stewardship Information, and performance measures resulted in the following conditions being identified as reportable conditions:

Reportable Condition Considered to be a Material Weakness
A. Controls over the Indian Trust funds

Other Reportable Conditions
B. Application and general controls over financial management systems
C. Controls over property, plant, and equipment
D. Reporting the Sport Fish Restoration and Boating Trust Fund
E. Controls over the U.S. Park Police Pension Plan
F. Controls over charge cards
G. Control assessment and assurance statement process
H. Controls over spending authority

We also noted the following deficiency in internal control over Required Supplementary Information that, in our judgment, could adversely affect Interior's ability to collect, process, record, and summarize this information.

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I. Museum Collections

The results of our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements disclosed the following instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and OMB Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*:

J. *Single Audit Act Amendments of 1996*
K. Potential non-compliance with the *Anti-Deficiency Act*, acquisition regulations, and leasing laws and regulations
L. *Federal Financial Management Improvement Act of 1996*

The following sections discuss our opinion on Interior's financial statements; our consideration of Interior's internal controls over financial reporting, Required Supplementary Stewardship Information, and performance measures; our tests of Interior's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements; and management's and our responsibilities.

OPINION ON THE FINANCIAL STATEMENTS

We have audited the accompanying balance sheets of the U.S. Department of the Interior as of September 30, 2006 and 2005, and the related statements of net cost, changes in net position, budgetary resources, financing, and custodial activity for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the U.S. Department of the Interior as of September 30, 2006 and 2005, and its net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activity for the years then ended, in conformity with U.S. generally accepted accounting principles.

As discussed in Notes 24 and 26 to the financial statements, Interior changed its method of accounting for and reporting of earmarked funds in fiscal year 2006 to adopt the provisions of the Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards (SFFAS) No. 27, *Identifying and Reporting Earmarked Funds*. Also, as discussed in Note 10 to the financial statements, Interior changed its method of reporting for heritage assets and stewardship land in fiscal year 2006 to adopt the applicable provisions of SFFAS No. 29, *Heritage Assets and Stewardship Land.* Finally, as discussed in Note 26 to the financial statements, Interior changed its method of accounting for and reporting certain allocation transfers in fiscal year 2006, to adopt new OMB requirements.

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 U.S. generally accepted accounting principles and OMB Circular No. A-136, *Financial Reporting Requirements*. 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. As a result of such limited procedures, we believe that the Required Supplementary Information for museum collections is not presented in conformity with U.S. generally accepted accounting principles because the Required Supplementary Information disclosures for museum collections are not complete and disclose the condition of the facility that houses the museum collection, rather than the condition of the underlying museum collection.

Our audits were conducted for the purpose of forming an opinion on the financial statements taken as a whole. The consolidating information in the Other Supplementary Information section is presented for purposes of additional analysis of the financial statements rather than to present the financial position and changes in net position of Interior's components individually. The consolidating information has been subjected to the auditing procedures applied in the audits of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole. The Performance Data and Analysis section, the Other Accompanying Information section, and the special account funds in the Other Supplementary Information within the Financial section are presented for purposes of additional analysis and are not required as part of the financial statements. This information has not been subjected to auditing procedures and, accordingly, we express no opinion on it.

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 Interior's 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 caused by error or fraud, 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 2006 audit, we noted certain matters, described below, involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that reportable condition A is a material weakness. Exhibit I presents the status of prior year reportable conditions.

We noted certain additional matters that we have reported to management of Interior in a separate letter dated November 15, 2006.

A. **Controls over the Indian Trust Funds**

The United States Congress has designated the Secretary of the Interior as the trustee delegate with responsibility for the monetary and non-monetary resources held in trust on behalf of American Indian Tribes (Tribal Trust Funds), 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 for American Indians (OST), the Bureau of Indian Affairs (BIA), other Interior bureaus, and agreements with American Indian Tribes.

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The Indian Trust Funds' balances include appropriated accounts that are considered Federal funds and non-Federal accounts that belong to beneficiaries of the Indian Trust Funds. The Federal accounts are reflected in Interior's financial statements, while the non-Federal accounts, which represent the majority of the Indian Trust Funds, are not reflected in Interior's financial statements. However, the Indian Trust Funds' transactions and balances are disclosed in Note 23 to Interior's financial statements, in accordance with Federal accounting standards.

Interior has invested a significant amount of resources to improve its controls over Indian Trust Funds; however, we noted that Interior needs to continue its efforts to resolve historical differences for items 1, 2, 3, and 4 below, and to improve procedures and internal controls for item 5 below, to ensure that the Indian Trust Funds' activity and balances are recorded properly and timely, as follows:

1. *Trust Fund Balances*

   The financial information systems and internal control procedures used in the processing of Indian Trust Funds' transactions and determination of the Indian Trust Funds' balances have suffered historically from a variety of system and procedural internal control weaknesses. In addition, Interior is burdened with the ongoing impact of decades of accumulated discrepancies in the accounting records. Furthermore, certain Indian Trust Funds' beneficiaries do not agree with the trust fund balances and/or have requested an accounting of the Indian Trust Funds. Interior has invested a significant amount of resources identifying historical records and preparing an accounting of the Indian Trust Funds' balances and will continue with this historical accounting effort.

2. *Individual Indian Monies Subsidiary Ledger*

   The control account for Individual Indian Monies (IIM) account holders represents the aggregate net balance of trust funds held on behalf of IIM account holders, as reflected in the detailed subsidiary ledger of IIM accounts (subsidiary ledger). The control account balance has historically not agreed to the sum of the balances from the subsidiary ledger, and it cannot be determined which balance, if either, is correct. As of September 30, 2006 and 2005, the aggregate sum of all positive balances included in the subsidiary ledger exceeded the control account by approximately $6 million. Accordingly, IIM account holders with positive balances may have received lower interest earnings. In addition, as of September 30, 2006 and 2005, the subsidiary ledger contained negative account balances totaling approximately $44 million (of which approximately $164,000 and $192,000 was attributed to individual Indian accounts as of September 30, 2006 and 2005, respectively).

3. *Special Deposit Accounts*

   As of September 30, 2006 and 2005, there were approximately 22,000 and 20,000 special deposit accounts reflected in the subsidiary ledger with balances totaling approximately $36 million and $40 million, respectively. In accordance with Title 25 of the Code of Federal Regulations and as directed by BIA, OST records receipts into special deposit accounts within the subsidiary ledger when the recipient trust fund account is unknown at the time of receipt. When BIA identifies the trust fund account(s), OST transfers the amount from the special deposit account(s) to the designated trust fund account(s) in accordance with BIA instructions. A significant number of special deposit accounts have remained inactive for the past several years and new special deposit accounts were

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established during fiscal year 2006 and 2005. A significant number of special deposit accounts continue to require resolution.

4. *Undistributed Interest and Unusual Balances*

   OST and/or BIA have not been able to determine the proper recipients of undistributed interest of approximately $5.2 million and $4.3 million as of September 30, 2006 and 2005, respectively. Furthermore, there were Tribal Trust Funds' accounts with negative cash balances totaling approximately $721,000 and $724,000 as of September 30, 2006 and 2005, respectively, that required resolution.

5. *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 Interior. We noted weaknesses in the following areas:

   a. *Trust Fund Systems*

      BIA had not completed implementation of an automated system for tracking and processing activities of the Indian trust assets. Agency offices use "off-the-shelf" software, internally developed software, in-house databases, and manual processes to manage ownership records, track lease activity, account for receivables/revenue, and determine distribution amounts. BIA has developed an automated system for certain activities and completed the first phase of the roll-out in September 2006. The second phase of the rollout is expected to be completed in all agency offices by September 30, 2007. This situation increases the risk that transactions are recorded inaccurately and untimely.

   b. *Accounts Receivable*

      BIA had not fully developed and communicated standardized policies and procedures for establishing, tracking, and pursuing accounts receivable for the Indian Trust Funds. This resulted in inconsistent processes and increases the risk that amounts due to Indian Trust Funds are not identified and ultimately collected.

   c. *Probate Backlog*

      BIA did not consistently enter probate orders for land title into the trust management systems timely. Although BIA made progress in reducing the backlog, BIA indicated that it had probate orders that had not been prepared, adjudicated, recorded, and/or encoded. BIA expects to have the backlog resolved by September 2008. This increases the potential for untimely distributions of income to the account holders of the Indian Trust Funds.

   d. *Supervised and Restricted Accounts*

      BIA did not consistently perform reviews over active supervised accounts, nor did it maintain documentation for supervised accounts, including social service assessment and evaluation forms, disbursement documentation, annual review documentation, court orders, and notification of restriction letters. Additionally, BIA did not consistently perform reviews over activc supervised accounts for contracted or compacted tribes. Finally, although each of the regions that we visited had compiled a listing of active supervised accounts, the regions expended significant efforts generating the listing. BIA has since identified a report from the Trust Fund Accounting System (TFAS) which lists all active supervised accounts and needs to work with OST to validate the completeness of this report and, once validated, ensure its timely distribution to the appropriate agency offices.

Recommendation

We recommend that Interior develop and implement procedures and internal controls to address the deficiencies in controls related to Indian Trust Funds.

Management Response

Management has prepared an official response presented as a separate attachment to this report. In summary, management disagreed with the significance of our findings because management believes that the controls are operating effectively and the differences between the supported records and recorded transactions are not widespread or systemic based on the work completed to date. Therefore, management believes that this is a reportable condition.

Auditors' Response to Management's Response

As summarized above, management had not resolved significant financial reporting differences from prior periods and weaknesses in BIA trust-related systems and processes continue to exist at September 30, 2006. Therefore, we continue to believe that the weaknesses identified constitute a material weakness.

B. **Application and General Controls over Financial Management Systems**

Interior continues to improve the security and controls over its information systems; however, we determined that Interior needed to improve controls in the areas described below, as required by OMB Circular No. A-130, *Management of Federal Information Resources.* These conditions could have affected Interior's ability to prevent and detect unauthorized changes to financial information, to control electronic access to sensitive information, and to protect its information.

1. *Entity-wide Security Program and Planning*

   An entity-wide security program, including security policies and a related implementation plan, is the foundation of an entity's security control structure. Interior did not have policies in place to require entity-wide segregation of duties within certain information system functions. In addition, Interior needs to improve its certification and accreditation documentation to ensure it includes all required information and considers changes made to systems and processes. Additionally, Interior did not perform all needed steps in the risk assessment process for certain systems. Furthermore, Interior components did not follow the Interior implementation requirements for two financial applications, resulting in an incomplete certification and accreditation of such financial applications.

   Interior did not consistently perform appropriate background checks for information technology and security personnel. In addition, Interior did not ensure new employees signed acknowledgements of the responsibilities for computer use forms before receiving access to systems and applications and the forms for one system did not indicate corrective actions for violations. Furthermore, Interior needs to improve its monitoring process to ensure that information technology employees complete Interior's required training programs.

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2. *Access Controls*

Access controls protect computer resources from unauthorized modification, disclosure, and loss. Interior did not fully establish controls to prevent and detect unauthorized access. In addition, Interior had not fully documented the process for requesting, granting, monitoring, and terminating user access for two of its financial applications. Interior also did not consistently review systems and applications to ensure that all users are authorized and the level of access rights is appropriate or maintain evidence that such reviews were performed. Furthermore, Interior did not always review and approve access rights for individuals that transferred within Interior or consistently maintain user access forms for system access. Although terminated employees' system access was disabled or scheduled to be disabled, Interior did not remove access of certain terminated employees in a timely manner. Furthermore, Interior needs to improve exit clearance procedures and process.

Although, Interior has processes to grant and approve physical and logical access to contractors, Interior needs to improve its processes to verify that contractors have appropriate background investigations, completed security training and non-disclosure agreements, and to verify that separated contractors' access was revoked in a timely manner.

Interior had not consistently implemented policies that require management to monitor security violations and inactive accounts. In addition, Interior did not generate or review security profile changes and activity logs for certain systems and applications.

3. *System Software Controls*

System software controls protect computer resources from unauthorized modification, disclosure, and loss. Interior had not formally documented policies and procedures for restricting access to certain system software and needs to improve system software change controls for one system. Although Interior documented a change management methodology to control changes to such operating system software, the policies do not include detailed testing procedures or separate procedures for addressing emergency changes. Additionally, Interior did not test changes to the operating system software. Furthermore, Interior did not have controls in place to prevent system software from being installed without management approval.

Interior did not have formal procedures for limiting administrator access to three of its financial applications or appropriately segregate system software responsibilities for one financial application. Interior also did not implement controls to prevent and detect unauthorized access to one financial application or perform audit logging over access to and modification of sensitive or critical files for the financial application. Furthermore, Interior did not fully implement a process to ensure that unauthorized modifications by system administrators are detected and reported.

4. *Software Development and Change Controls*

Software development and change controls ensure that only authorized programs and modifications are implemented. Interior has not formally developed, documented, or implemented data processing procedures to control and standardize the maintenance of one financial application. In addition, Interior has not developed formal change

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management procedures for one financial system, which includes a database and operating system. Although Interior documented program changes to financial applications, the documentation is not consistent and standardized for program changes and emergency changes to financial applications. Furthermore, Interior did not prepare and maintain change request forms, plans or testing documentation and Interior did not complete a post-change management review after installing emergency operating system patches for one financial system.

Interior did not use library management software to control changes to one of its financial systems. Furthermore, certain system configurations did not adequately segregate duties as the configurations provided individuals, who are involved with programming, testing and migrating changes to production, access to the source code, test, and production libraries.

5. *Service Continuity*

Service continuity plans protect information resources, minimize the risk of unplanned interruptions, and recover critical operations should interruptions occur. Interior had not fully developed and documented a comprehensive contingency plan for certain financial applications. In addition, Interior has not updated its continuity of operations plan for one information technology environment. Although Interior has contingency plans, one data center contingency plan did not indicate emergency processing priorities and was not approved by management. Interior did not have sufficient evidence of contingency plan testing for one of its systems and has not recently tested one of its contingency plans. Furthermore, Interior had not developed processes to ensure that employees are periodically trained on their roles and responsibilities in regards to certain contingency plans.

Interior did not consistently test the backup files for certain financial applications. In addition, Interior had not fully documented procedures that require periodic testing of a data center's equipment and disposing of electronic media that are not required to be maintained. Furthermore, Interior did not maintain a tape library log of all the tapes for one of its data centers or maintain all approvals for individuals' access to a tape storage facility.

6. *Segregation of Responsibilities*

Proper segregation of responsibilities helps prevent and detect unauthorized actions. Interior did not formally document application-specific roles or access privileges that should be segregated for certain financial systems or formally document compensating controls when access privileges cannot be segregated. In addition, Interior did not consistently require management to review the design and operation of segregation of responsibility controls.

Recommendation

We recommend that Interior continue to improve the security and general controls over its financial management systems. These improvements should address each of the areas discussed above and include the specific recommendations that we provided to management, as well as other areas that might affect the information technology control environment to ensure adequate security and protection of the information systems.

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Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings, and its comments were responsive to our recommendations.

C. **Controls Over Property, Plant, and Equipment**

Interior needs to continue improving controls over accounting for property, plant, and equipment, to ensure that transactions are promptly recorded and properly classified and accounted for, to prepare timely and reliable financial reports. We noted control weaknesses in the following areas:

1. Interior capitalized costs that should have been expensed; recorded transactions in the current year that occurred in prior years; and recorded dates, costs, asset type, and other information that did not agree with the supporting documentation for 41 of the 394 park property amounts that we tested. In addition, Interior did not transfer construction projects from the construction-in-progress account to real property accounts at the time of completion for certain construction projects.
2. Interior capitalized $93 million of costs related to water and power structures that should have been expensed, because costs related to research and development, environmental studies, or were assets owned by other parties.
3. Interior did not have formally documented procedures to ensure that interest during construction of water and power structures and related interest on investment are accurately calculated and recorded. In addition, Interior did not have a complete listing of projects that should have interest applied during construction of water structures. Furthermore, Interior did not consistently demonstrate that management reviewed and approved such projects or did not perform the reviews of such projects, timely.

As a result of our observations, Interior analyzed and adjusted its property, plant, and equipment balances accordingly.

Recommendations
We recommend that Interior implement the following recommendations to improve controls over its property, plant, and equipment balances:

1. Continue to train personnel on the difference between costs that should be capitalized versus expensed.
2. Implement procedures requiring supervisors to review disbursement transactions and the related source documents to ensure that transactions are properly expensed or capitalized and to ensure that the dates, asset type, and amounts recorded match the supporting documentation.
3. Implement procedures requiring personnel to review items in the construction-in-progress subsidiary ledger to identify projects, or components of projects that have been completed and therefore should be moved to the real property subsidiary ledger or should be expensed because they do not meet the capitalization criteria.
4. Formally document procedures to ensure that interest applied during construction of water and power structures are accurately calculated and recorded.
5. Maintain a current listing of projects that should have interest applied during construction of water and power structures.
6. Require managers to review project listings that have interest applied during construction in a timely manner and document approval on the project listings.

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Management Response

Management has prepared an official response presented as a separate attachment to this report. In summary, management disagreed with our findings because management believes that procedures to establish cost structures were in place and differences were identified and corrected.

Auditors' Response to Management's Response

As summarized above, Interior has significant internal control weaknesses because we identified that Interior recorded transactions in error at a rate of approximately 11% for the sample of transactions tested, incorrectly recorded $93 million of costs, and did not have certain controls in place related to property balances of approximately $14 billion as of September 30, 2006. Therefore, we continue to believe that the weaknesses identified constitute a reportable condition.

D. **Reporting the Sport Fish Restoration and Boating Trust Fund**

In fiscal year 2006, Interior adopted the Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards (SFFAS) No. 27, *Identifying and Reporting Earmarked Funds*, which became effective October 1, 2005. SFFAS No. 27 defines earmarked funds and requires separate reporting for earmarked fund activity and balances in the financial statements and note disclosures. SFFAS No. 27 also indicates that an agency should report their portion of a trust fund on the financial statements if that portion of the trust fund can be clearly identified to the agency. The Sport Fish Restoration and Boating Trust Fund (SFRBTF) has multiple benefiting agencies, including Interior, U.S. Army Corps of Engineers and the U.S. Coast Guard. Although, Interior properly identified the SFRBTF as an earmarked fund, Interior did not fully establish controls to properly record Interior's portion of the SFRBTF in the financial statements. As a result of our observations, Interior analyzed and adjusted the financial statements as of and for the year ended September 30, 2006.

Recommendations

We recommend that Interior:

1. Enhance internal controls to ensure that new accounting standards are implemented properly and in a timely manner.
2. Continue to provide the U.S. Army Corps of Engineers and the U.S. Coast Guard their respective account balances and activity related to the SFRBTF on a monthly basis.

Management Response

Management has prepared an official response presented as a separate attachment to this report. In summary, management disagreed with our findings because management believes that Interior was required to report the balances because the other agencies did not cooperate.

Auditors' Response to Management's Response

As summarized above, Interior has significant internal control weaknesses because Interior did not properly record the SFRBTF, which has assets totaling approximately $1 billion, and Interior adjusted its financial statements as a result of our observations. Therefore, we continue to believe that the weaknesses identified constitute a reportable condition.

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E. Controls over the U.S. Park Police Pension Plan

Interior is required to determine and record a liability for the actuarial present value of the future benefits of the U.S. Park Police Pension Plan (USPP Pension Plan). Because Interior is not the plan administrator, Interior obtained the census data to calculate the liability from the District of Columbia, the plan administrator. As part of our testing of the USPP Pension Plan liability, we recalculated a sample of the annuity payments and identified differences between the census data file and the supporting documentation for 90 of the 112 annuity participants tested. These differences included both under and over payments and netted to approximately 1% of the total annuity payments that we tested. In addition, we compared the census data file to the supporting documentation for 145 annuity and active participants and identified 5 differences in gender, age, and other factors. Interior in consultation with its actuaries, evaluated the differences identified and concluded that the USPP Pension Plan liability was fairly stated as of September 30, 2006. However, all census data differences need to be resolved so as not to affect future actuarial projections and to ensure pension payments for retirees are not adversely affected.

Recommendation
We recommend that Interior work with the District of Columbia to investigate and resolve differences between the census data and the supporting documentation to ensure that pension liabilities and costs are properly presented in Interior's financial statements.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management disagreed with our findings because management believes that the differences are small and are in the process of being resolved.

Auditors' Response to Management's Response
As summarized above, Interior has significant internal control weaknesses related to pension liabilities of approximately $708 million as of September 30, 2006, because we identified numerous differences between the census data, including benefit payments, and the supporting documentation that have not been resolved. Specifically, we identified individual benefit payment differences that ranged from underpayments of 69% to overpayments of 41% for 81% of the benefit payments tested. Therefore, we continue to believe that the weaknesses identified constitute a reportable condition.

F. Controls over Charge Cards

Interior issues purchase, fleet, and travel charge cards to its employees to streamline acquisition and payment procedures and to reduce the administrative burden associated with traditional and emergency purchasing of travel items, supplies, and services. Interior uses charge cards to purchase goods and services totaling several hundred million dollars. In conjunction with the issuance of these cards, Interior published the *Integrated Charge Card Program Guide*. This guide sets forth restrictions on the use of the cards as well as certain internal control procedures such as timely and complete reconciliation of billing statements by the cardholders and approving officials.

However, we determined that Interior did not consistently follow these internal control procedures because we identified 125 exceptions in the 470 statements that we tested at five of the nine Interior components. For example, cardholders and supervisors did not always sign and date the charge card statements, did not consistently sign and date the charge card in a timely manner, did not consistently maintain charge card receipts to support the charges, and split purchase transactions to be under the charge card limit. In addition, Interior did not routinely investigate and resolve transactions on the unusual charge card transaction reports. Furthermore, Interior had not consistently terminated cards of former employees.

Recommendations

We recommend that Interior perform the following:

1. Continue to provide training to personnel on proper charge card procedures.
2. Require approving officials to be more diligent in monitoring and enforcing compliance with Interior's charge card policies.
3. Allocate sufficient resources to oversee compliance with DOI charge card policies and procedures, including investigating and resolving transactions on the unusual charge card transaction reports.
4. Terminate charge cards at the time an employee separates from Interior employment.

Management Response

Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings, and its comments were responsive to our recommendations.

G. **Control Assessment and Assurance Statement Process**

The Federal Managers' Financial Integrity Act (FMFIA) requires Interior to establish and maintain effective internal control and annually evaluate and report on the effectiveness of the internal control. OMB Circular No. A-123, Management's *Responsibility for Internal Control*, Appendix A, provides the methodology for management to assess, document, test, and report on the internal controls over financial reporting in accordance with section 4 of FMFIA.

Although Interior established an effective plan to assess, document, test, and report on internal controls over financial reporting, certain Interior components did not fully execute the plan. As a result, Interior did not consistently identify, document and test key financial controls for its custodial revenue and disbursements, accounts receivable, custodial liabilities, state liabilities, certain journal entries, property and equipment, and other financial balances; did not fully document the procedures performed to test the design and operating effectiveness of certain controls; did not consistently document its evaluation of the test results; and did not adequately document the population tested, sample size tested, or the period tested. As a result of our observations, management performed additional controls testing and improved its assessment documentation. However; Interior needs to improve its assessment process to ensure key controls are identified, documented, and tested.

In addition, the material weakness reported for Controls over the Indian Trust Funds was not reflected in Interior's FMFIA assurance statement because management did not believe it constituted a material weakness.

Recommendations

We recommend that Interior improve its assurance process to:

1. Identify, document, and test key financial controls over significant financial statement balances.
2. Document procedures performed to test the design and operating effectiveness of the controls and the evaluation of testing results.
3. Document the population tested, sample size tested, and the period tested.

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4. Require management to review the documentation supporting the assurance statement before signing the assurance statement.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management partially agreed with our findings and indicated that Interior focused its resources on the items most material and at risk to the financial reporting process, and agreed with our recommendations.

Auditors' Response to Management's Response
As summarized above, Interior has significant internal control weaknesses because Interior needs to improve its assessment process to ensure key controls are identified, documented, and tested. In addition, Interior identified and tested additional controls and improved its documentation after we had identified the deficiencies and after management had signed assurance statements indicating that they had completed the testing and evaluation. Therefore, we continue to believe that the weaknesses identified constitute a reportable condition.

H. **Controls over Spending Authority**

Interior needs to improve its procedures and controls over spending authority, to ensure that funding documentation consistently demonstrates that Interior met the appropriate regulations, including the bona fide need requirements. The Interior Office of Inspector General (OIG) conducted an audit of the Interior purchases made on behalf of the Department of Defense and determined that 5 of the 12 funding documents it selected from fiscal year 2006, and 19 of the 49 funding documents selected from fiscal year 2005, may not have met the appropriate regulations, including the bona fide need requirements. In addition, we identified 3 funding documents that Interior accepted after the period of availability of the referenced appropriations. As a result, Interior may have spent expired funds. The OIG also indicated that Interior obligated the government in advance of receiving funding for one contract and that Interior awarded a 10-year $94 million sole source contract primarily related to office space that may have violated procurement and leasing laws and regulations. Interior is working with the OIG and OMB to resolve these matters.

Recommendations
We recommend that Interior improve controls over spending authority as follows:

1. Implement controls to ensure bona fide need is established before accepting funding documents.
2. Improve the funding documentation obtained to ensure that the documentation demonstrates Interior has met the appropriate regulations, including the bona fide need requirements, and does not spend expired funds.
3. Review related funding and obligation documents to ensure that obligations are not recorded in advance of receiving funding.
4. Require the Solicitor's Office to formally review and approve contracts related to office space prior to entering into the contract.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our recommendations; however, management did not agree with the conclusions, including that a potential *Anti-Deficiency Act* violation may have occurred.

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Auditors' Response to Management's Response

As summarized above, Interior should continue working with the OIG and OMB to resolve these matters. Therefore, we continue to believe that the weaknesses identified constitute a reportable condition.

INTERNAL CONTROLS OVER REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION AND PERFORMANCE MEASURES

Under OMB Bulletin No. 06-03, the definition of material weaknesses is extended to other controls as follows. 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 caused by error or fraud, in amounts that would be material in relation to the Required Supplementary Stewardship Information or material to a performance measure or aggregation of related performance measures, 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.

Our consideration of the internal control over the Required Supplementary Stewardship Information and the design and operation of internal control over the existence and completeness assertions related to performance measures reported in the Management's Discussion and Analysis section would not necessarily disclose all matters involving the internal control and its operation related to Required Supplementary Stewardship Information or the design and operation of the internal control over the existence and completeness assertions related to key performance measures that might be reportable conditions.

In our fiscal year 2006 audit, we noted no matters involving the internal control and its operation related to Required Supplementary Stewardship Information that we considered to be material weaknesses as defined above.

Further, in our fiscal year 2006 audit, we noted no matters involving the design and operation of the internal control over the existence and completeness assertions related to key performance measures that we considered to be material weaknesses as defined above.

INTERNAL CONTROLS OVER REQUIRED SUPPLEMENTARY INFORMATION

We noted a deficiency in internal control over Required Supplementary Information described in the following paragraphs that, in our judgment, could adversely affect Interior's ability to collect, process, record, and summarize Required Supplementary Information.

I. **Museum Collections**

Interior has museum collections at over 1,000 locations across the United States that include art, millions of ethnography, archeology, documents, history, biology, paleontology, and geology items. Interior did not establish controls to determine and disclose the condition of museum collections in accordance with applicable accounting standards, because Interior disclosed the condition of only the facility that houses the collection, rather than the condition of the underlying museum collections. In addition, Interior has not assessed the condition of all the facilities housing its collections.

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Interior considers museum collections to be in stable condition if the facility housing the museum collection is in stable condition. If a collection is housed in a poor facility, the condition of the collection would be considered "poor", regardless of the actual condition of the collection itself. If that same collection is moved to a new facility which is in good condition, the collection would then be considered in "good" condition because the surrounding environment is in "good" condition, and any environmental problems contributing to the deterioration of the collection would improve because of the condition of the new facility. SFFAS No. 29 requires entities to report the condition of museum collections as required supplementary information and defines condition as the physical state of an asset. SFFAS No. 29 also indicates that the condition of an asset is based on an evaluation of the physical status/state of an asset, its ability to perform as planned, and its continued usefulness. Therefore Interior's policy for museum collection disclosure is not in accordance with the applicable accounting requirements.

Recommendation
We recommend that Interior assess and disclose the condition of the museum collections, rather than the facility that houses the collections.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management disagreed with our findings because management believes that its disclosures are in accordance with SFFAS No. 29 and museum industry practices.

Auditors' Response to Management's Response
As summarized above, Interior needs to establish controls to determine and disclose the condition of museum collections in accordance with applicable accounting standards. SFFAS No. 29 defines condition as the physical state of an asset and indicates that the condition of an asset is based on an evaluation of the physical status/state of an asset, its ability to perform as planned, and its continued usefulness. By only disclosing the condition of the facility housing the collection, Interior did not inform financial statement users of the condition of the underlying museum collections. Therefore, we continue to believe that the weaknesses identified constitute a reportable condition.

COMPLIANCE AND OTHER MATTERS

Our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, as described in the Responsibilities section of this report, exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed three instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 06-03, and are described below.

J. ***Single Audit Act Amendments of 1996***

Interior is required to monitor its grantees in accordance with the *Single Audit Act Amendments of 1996,* and the related OMB Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Although Interior has improved its processes of monitoring grantees, Interior did not obtain Single Audit reports within 9 months of the grantee's fiscal year-end for certain grantees in fiscal year 2006 and did not issue management decisions on audit findings within six months after receipt of audit reports or ensure that the grantees completed appropriate and timely corrective action on such findings for 30 of the 38 grantees tested at certain components.

Recommendation
We recommend that in fiscal year 2007, Interior obtain single audit reports and issue management decisions on audit findings in accordance with the requirements of the *Single Audit Act Amendments of 1996* and the related OMB Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations.*

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings, and its comments were responsive to our recommendations.

K. **Potential Non-compliance with the *Anti-Deficiency Act*, Acquisition Regulations, and Leasing Laws and Regulations**

As further discussed in the Internal Control Over Financial Reporting section of this report, Interior may have violated the *Anti-Deficiency Act* because Interior spent potentially expired funds and obligated the government in advance of receiving funding for one contract. In addition, Interior awarded a contract related to office space potentially in violation of 40 USC 101, which provides General Services Administration exclusive authority for leases; section 8020 of the Defense appropriation act; and 10 USC 2676, Acquisition Limitation, which precludes military department leases without specific lease authority. As a result, any obligations and expenses under this contract may have violated the *Anti-Deficiency Act*. Interior is working with the OIG and OMB to resolve these matters.

Recommendations
We recommend that in fiscal year 2007, Interior continue working with the OIG and OMB to:
1. Investigate and resolve the potential noncompliance with the *Anti-Deficiency Act*, procurement regulations, and leasing laws and regulations.
2. Improve its contracting processes and controls to ensure compliance with the *Anti-Deficiency Act*, acquisition regulations, and leasing laws and regulations.

Management Response
Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our recommendations; however, management did not agree with the finding conclusions, including that a potential *Anti-Deficiency Act* violation may have occurred.

Auditors' Response to Management's Response
As summarized above, we recommend that Interior continue working with the OIG and OMB to resolve these matters.

* * * * *

The results of our tests of compliance with certain provisions of other laws and regulations, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 06-03.

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The results of our tests of FFMIA disclosed instances, described below, where Interior's financial management systems did not substantially comply with applicable Federal accounting standards. The results of our tests of FFMIA disclosed no instances in which Interior's financial management systems did not substantially comply with the Federal financial management systems requirements or the United States Standard General Ledger at the transaction level.

L. ***Federal Financial Management Improvement Act of 1996***

Interior is required to prepare its financial statements in accordance with Federal accounting standards. As discussed in the Internal Control over Financial Reporting section of this report, we identified one material weakness related to controls over Indian Trust Funds that affected Interior's ability to prepare its financial statements and related disclosures in accordance with Federal accounting standards. Also as discussed in the Internal Control Over Required Supplementary Information section of this report, Interior needs to complete and revise its condition of museum collections disclosures to comply with Federal accounting standards. As a result of these conditions, Interior's financial management systems do not substantially comply with applicable Federal accounting standards.

Recommendation

We recommend that in fiscal year 2007, Interior improve procedures and internal controls to ensure that the financial statements and related disclosures are prepared in accordance with the Federal accounting standards.

Management Response

Management has prepared an official response presented as a separate attachment to this report. In summary, management disagreed with our findings because management believes that it does not have a material weakness and because management believes that its museum collection disclosures are in accordance with the standards.

Auditors' Response to Management's Response

We continue to believe that Interior has a material weakness in internal controls because Interior had not resolved significant financial reporting differences from prior periods and weaknesses in BIA trust-related systems and processes continue to exist at September 30, 2006. In addition, we believe that Interior needs to disclose the condition of the museum collection in accordance with the accounting standards. Therefore, we continue to recommend that Interior improve procedures and internal controls to ensure that the financial statements and related disclosures are prepared in accordance with the Federal accounting standards.

* * * * *

RESPONSIBILITIES

Management's Responsibilities. The United States Code, Title 31, Sections 3515 and 9106 require agencies to report annually to Congress on their financial status and any other information needed to fairly present their financial position and results of operations. To meet these reporting requirements, Interior prepares and submits financial statements in accordance with OMB Circular No. A-136.

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Management is responsible for the financial statements, including:

- Preparing the financial statements in conformity with U.S. generally accepted accounting principles;
- Preparing the Management's Discussion and Analysis (including the performance measures), Required Supplementary Information, and Required Supplementary Stewardship Information;
- Establishing and maintaining effective internal controls; and
- Complying with laws, regulations, contracts, and grant agreements applicable to Interior, including FFMIA.

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

Auditors' Responsibilities. Our responsibility is to express an opinion on the fiscal year 2006 and 2005 financial statements of Interior based on our audits. 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*, issued by the Comptroller General of the United States; and OMB Bulletin No. 06-03. Those standards and OMB Bulletin No. 06-03 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Interior's internal control over financial reporting. Accordingly, we express no such opinion.

An audit also 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 2006 audit, we considered Interior's internal control over financial reporting by obtaining an understanding of Interior's 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 *Government Auditing Standards* and OMB Bulletin No. 06-03. 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 an opinion on Interior's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

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As required by OMB Bulletin No. 06-03, in our fiscal year 2006 audit, we considered Interior's internal control over the Required Supplementary Stewardship Information by obtaining an understanding of Interior's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. We limited our testing to those controls necessary to test and report on the internal control over Required Supplementary Stewardship Information in accordance with OMB Bulletin No. 06-03. However, our procedures were not designed to provide an opinion on internal control over the Required Supplementary Stewardship Information and, accordingly, we do not provide an opinion thereon.

As further required by OMB Bulletin No. 06-03, in our fiscal year 2006 audit, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis section, we obtained an understanding of the design of internal controls relating to the existence and completeness assertions and determined whether these internal controls had been placed in operation. We limited our testing to those controls necessary to test and report on the internal control over key performance measures in accordance with OMB Bulletin No. 06-03. However, our procedures were not designed to provide an opinion on internal control over reported performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether Interior's fiscal year 2006 financial statements are free of material misstatement, we performed tests of Interior's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of the financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 06-03, 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, regulations, contracts, and grant agreements applicable to Interior. However, providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 06-03 and FFMIA, we are required to report whether Interior's 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.

RESTRICTED USE

This report is intended solely for the information and use of Interior's management, Interior's Office of Inspector General, OMB, the U.S. Government Accountability Office, 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

November 15, 2006

Exhibit I

U.S. DEPARTMENT OF THE INTERIOR

Status of Prior Year Findings

September 30, 2006

Ref	Condition	Status
A	Controls over implementing new accounting policies and procedure	This has been corrected.
B	Controls over the Indian Trust funds	This has not been corrected and is repeated at finding A.
C	Reconciliation of intragovernmental transactions and balances	This has been corrected.
D	Application and general controls over financial management systems	This has been partially corrected and is repeated at finding B.
E	Controls over property, plant, and equipment	This has not been corrected and is repeated at finding C.
F	Controls over accruals	This has been corrected.
G	Controls over environmental contingencies	This has been corrected.
H	Financial management at the Bureau of Indian Affairs	This has been corrected.
I	Controls over revenue	This has been corrected.
J	Controls over grants	This has been corrected.
K	Segregation of responsibilities over purchases and entries	This has been corrected.
L	Controls over charge cards	This has not been corrected and is repeated at finding F.
M	Controls over obligations	This has been corrected.
N	Controls over the U.S. Park Police Pension Plan	This has not been corrected and is repeated at finding E.
O	Stewardship Reporting	This has been partially corrected and is repeated at finding I.
P	Deferred maintenance estimates	This has been corrected.
Q	*Single Audit Act Amendments of 1996*	This has not been corrected and is repeated at finding J.

U.S. DEPARTMENT OF THE INTERIOR

Status of Prior Year Findings, Continued

September 30, 2006

Ref	Condition	Status
R	*Debt Collection Improvement Act of 1996*	This has been corrected.
S	OMB Circular No. A-25, *User Charges*	This has been corrected.
T	*Federal Financial Management Improvement Act of 1996*	This has not been corrected and is repeated at finding L.