

INDEPENDENT AUDITORS' REPORT







UNITED STATES DEPARTMENT OF COMMERCE
The Inspector General
 Washington, D.C. 20230

November 9, 2004

MEMORANDUM FOR: Donald L. Evans
 Secretary of Commerce

FROM: Johnnie E. Frazier *Johnnie Frazier*

SUBJECT: *Department of Commerce's FY 2004 Consolidated Financial Statements, Audit Report No. FSD-16696-5-0001*

I am pleased to provide you with the attached audit report, which presents an unqualified opinion on the Department of Commerce's FY2004 consolidated financial statements. The audit results indicate that the Department has established an internal control structure that facilitates the preparation of reliable financial and performance information. We commend the Department for the noteworthy accomplishment of once again attaining an unqualified opinion—the sixth consecutive year, and for meeting the fiscal year 2004 accelerated reporting deadline.

My office contracted with the independent public accounting firm of KPMG LLP (KPMG) to perform the audit of the Department's financial statements as of and for the year ended September 30, 2004. The contract required that the audit be done in accordance with U.S. generally accepted government auditing standards and OMB Bulletin 01-02, *Audit Requirements for Federal Financial Statements*.

In its audit of the Department, KPMG found that:

- the financial statements were fairly presented, in all material respects, and in conformity with U.S. generally accepted accounting principles;
- there was one reportable condition related to the Department's financial management systems (but not considered a material weakness in internal control as defined on page 3 of the audit report) due to weaknesses in general information technology controls;
- there were no instances in which the Department's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA); and
- there was one instance in which the Department did not comply with other laws and regulations tested—OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*.

We are pleased that the Department made significant progress in 2004 toward correcting internal control weaknesses. The auditor's report discusses the Department's success in fully implementing the Commerce Administrative Management System (CAMS) in October 2003, as well as some improvements made in general information technology controls. In addition, for the first time, during fiscal year 2004 ITA was deemed acceptably in compliance with OMB Circular A-25, *User Charges*, based on a plan submitted to OMB that outlines its full-cost

recovery initiatives. Thus, the finding of noncompliance with laws and regulations was removed in that area. These successes are surely the result of Commerce senior officials' commitment to sound financial management and reliable financial/performance information, as well as the important role and substantial efforts of the Department's financial managers and staff to improve internal controls and eliminate specific deficiencies identified by KPMG and our office in prior audits.

My office defined the audit's scope and oversaw its performance and delivery. We reviewed KPMG's report and related documentation, and made inquiries of its representatives. Our review disclosed no instances where KPMG did not comply, in all material respects, with U.S. generally accepted government auditing standards. However, our review, as differentiated from an audit in accordance with U.S. generally accepted government auditing standards, was not intended to enable us to express, and we do not express, an opinion on the Department's consolidated financial statements, conclusions about the effectiveness of internal control, or conclusions on compliance with laws and regulations. KPMG is responsible for the attached audit report dated November 9, 2004, and the conclusions expressed in the report.

In accordance with Department Administrative Order (DAO) 213-5, we ask that the Department's Chief Financial Officer and Assistant Secretary for Administration provide for our review and concurrence an audit action plan that addresses all of the recommendations contained in this report within 60 days of the date of this memorandum.

If you wish to discuss the contents of this report, please call me on (202) 482-4661, or Edward Blansitt, Deputy Inspector General, on (202) 482-3516. We appreciate the cooperation and courtesies the Department extended to KPMG and my staff during the audit.

Attachment

cc: Otto J. Wolff
Chief Financial Officer and Assistant Secretary for Administration

Tom Pyke
Chief Information Officer



KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

Office of Inspector General, U.S. Department of Commerce and
Secretary, U.S. Department of Commerce:

We have audited the accompanying consolidated balance sheets of the U. S. Department of Commerce (Department) as of September 30, 2004 and 2003, and the related consolidated statements of net cost, changes in net position, and financing, and the combined statements of budgetary resources (hereinafter referred to as consolidated financial statements), for the years then ended. The objective of our audits was to express an opinion on the fair presentation of these consolidated financial statements. In connection with our audits, we also considered the Department's internal control over financial reporting and tested the Department's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on its consolidated financial statements.

SUMMARY

As stated in our opinion on the consolidated financial statements, we concluded that the Department's consolidated financial statements as of and for the years ended September 30, 2004 and 2003, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our consideration of internal control over financial reporting resulted in the identification of one reportable condition, related to weaknesses in the Department's general information technology controls. However, we do not consider this reportable condition to be a material weakness.

The results of our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements disclosed one instance of noncompliance or other matters, relating to OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*, that is required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

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



OPINION ON THE CONSOLIDATED FINANCIAL STATEMENTS

We have audited the accompanying consolidated balance sheets of the U.S. Department of Commerce as of September 30, 2004 and 2003, and the related consolidated statements of net cost, changes in net position, and financing, and the related combined statements of budgetary resources, for the years then ended.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Department as of September 30, 2004 and 2003, and its net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The information in the Management Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information sections is not a required part of the consolidated 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 September 30, 2004 consolidating balance sheet is presented for purposes of additional analysis of the related consolidated balance sheet, rather than to present the financial position of the Department's bureaus individually. The September 30, 2004 consolidating balance sheet has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, based on our audits, is fairly stated in all material respects in relation to the September 30, 2004 consolidated balance sheet, taken as a whole. The information in the fiscal year 2004 Performance Report section is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. This information has not been subjected to the same 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 the Department's ability to record, process, summarize, and report financial data consistent with the assertions by management in the consolidated 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 consolidated 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.

In our fiscal year 2004 audit, we noted certain matters relating to the Department's financial management systems, summarized below and in more detail in Exhibit I, that we consider to be a reportable condition. However, this reportable condition is not believed to be a material weakness.

General information technology controls. We found that although the Department has taken corrective actions to address certain information technology (IT) control weaknesses, general IT weaknesses still exist. Despite the positive efforts made by the Department, the Department needs to make continued improvement in its IT general control environment to fully ensure that financial data being processed on the Department's systems has integrity, is confidentially maintained, and is available when needed.

* * * * *

A summary of the status of prior year reportable conditions is included as Exhibit II.

We also noted other matters involving internal control over financial reporting and its operation that we have reported to the management of the Department in two separate letters addressing information technology and other matters, respectively.

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* (FFMIA), disclosed one instance of noncompliance or other matters that is required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, and is described below.

- **OMB Circular A-11, *Preparation, Submission, and Execution of the Budget*. (Repeat Condition Since 1997)** As reported in prior years, we identified 11 capital leases that were not fully funded at NOAA, as required by OMB Circular A-11. In fiscal year 2004, NOAA took corrective action to fully fund all of these leases. NOAA also conducted an extensive follow-on analysis of its real and personal property lease portfolio and identified 65 additional leases that meet the criteria of capital leases under A-11 guidelines and that require full funding. The estimated budgetary authority required to fully fund these additional budgetary capital leases is approximately \$8 million, but will likely be reduced to approximately \$3.1 million with planned lease modifications and fiscal year 2005 payments. NOAA and the Department agreed with this finding and conducted the research to determine the scope of the issue. NOAA has indicated that it plans to submit a reprogramming request, early in fiscal year 2005, to fully fund these additional capital leases. We believe that the planned corrective actions are responsive to resolving this matter.

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. 01-02.

FFMIA. The results of our tests of FFMIA disclosed no instances in which the Department's financial management systems did not substantially comply with the three requirements discussed in the Responsibilities section of this report.

Additional Concern. We were informed by NOAA that during fiscal year 2004, it identified two reimbursable agreements, one signed in fiscal year 2000 and the other in fiscal year 2001, between NOAA and nonprofit entities that contained indemnification clauses. These clauses raise Anti-Deficiency Act concerns. The two agreements were amended in June and July 2004, eliminating future Anti-Deficiency Act concerns. The Office of General Counsel is reviewing this matter to determine whether an Anti-Deficiency Act violation occurred. However, although the outcome of this matter, and any resulting ramifications, is not presently known, NOAA has confirmed that no claims have been made against NOAA or the Department based on these agreement provisions.

RESPONSIBILITIES

Management's Responsibilities. The *Government Management Reform Act of 1994* (GMRA) requires each Chief Financial Officer (CFO) Act 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 meet the GMRA reporting requirements, the Department prepares annual consolidated financial statements.

Management is responsible for the consolidated financial statements, including:

- Preparing the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal controls over financial reporting, and preparing the Management Discussion and Analysis (including the performance measures), Required Supplementary Information, and Required Supplementary Stewardship Information, and
- Complying with laws, regulations, contracts, and grant agreements, 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. Because of inherent limitations in internal control, misstatements, due to error or fraud, may nevertheless occur and not be detected.

Auditors' Responsibilities. Our responsibility is to express an opinion on the fiscal year 2004 and 2003 consolidated financial statements of the Department 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*, 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 consolidated financial statements are free of material misstatement.



An audit includes:

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

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

In planning and performing our fiscal year 2004 audit, we considered the Department's internal control over financial reporting by obtaining an understanding of the Department'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 consolidated 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. 01-02. 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 Department's internal control over Required Supplementary Stewardship Information by obtaining an understanding of the Department's 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 Discussion and Analysis section, 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 Department's fiscal year 2004 consolidated financial statements are free of material misstatement, we performed tests of the Department'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 consolidated 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, regulations, contracts, and grant agreements applicable to the Department. 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. 01-02 and FFMIA, we are required to report whether the Department'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.

DISTRIBUTION

This report is intended for the information and use of Department's management, Department's Office of the Inspector General, OMB, the 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 9, 2004

U.S. Department of Commerce
 Independent Auditors' Report
 Exhibit I – Reportable Condition

Financial Management Systems Need Improvement (*Repeat Condition Since 1998*)

For many years, the U.S. Department of Commerce (Department) Office of Inspector General (OIG), U.S. Government Accountability Office (GAO), and departmental self-assessments have identified weaknesses in the Department's information technology (IT) and financial systems controls. Our fiscal year 2004 assessment of the Department's general IT and financial systems controls, performed in support of the fiscal year 2004 consolidated financial statement audit, found that although the Department needs to make further progress with its general IT control environment, progress has been made in addressing many prior weaknesses. For example, at the beginning of fiscal year 2004, the Department successfully implemented the Commerce Administrative Management System, the Department's core financial system, at the National Institute of Standards and Technology (NIST), eliminating a large legacy system, and providing for the implementation of automated budgetary controls at that bureau.

During fiscal year 2004, the Department also made progress in addressing certain prior IT general control weaknesses. In particular, the Department provided increased focus on improving its information security program. The Department's efforts were commended by GAO¹, which noted that the Department was the only agency in their review that had an agency-wide process to routinely ensure quality of information security certification and accreditation (C&A) efforts. GAO also commended the Department OIG, noting that the OIG was only one of two OIGs in the GAO review that specifically addressed security C&A efforts as part of their required *Federal Information Security Management Act* (FISMA) reporting efforts².

Despite these improvements, we continued to identify weaknesses in general IT controls that we consider to be a reportable condition as defined by the American Institute of Certified Public Accountants. As part of the Department's fiscal year 2004 FISMA evaluation, the Department determined (and the OIG also confirmed) that a FISMA-related significant deficiency, related to IT information security, continues to exist. The Department had also classified IT security as a material weakness under the Federal Managers' Financial Integrity Act.

Effective general IT controls add assurance that data used to prepare and report financial information and statements is complete, reliable, and has integrity. Our fiscal year 2004 IT assessment was focused on the general IT controls over the Department's major financial management systems and supporting network infrastructure, using GAO's *Federal Information System Controls Audit Manual* (FISCAM) as a guide. The six FISCAM general IT control review elements, and our related findings, are as follows:

- **Entity-wide security program.** An entity-wide security program for security planning and management is the foundation of an organization's information security

¹ General Accounting Office - June 2004 report titled *Agencies Need to Implement Consistent Processes in Authorizing Systems for Operation*

² Ibid

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Exhibit I – Reportable Condition, Continued

control structure. The program should provide a framework and continuing cycle of activity for managing risk, developing security policies, assigning responsibilities, and monitoring the adequacy of computer-related security controls.

Although the Department has made improvements in this area, as noted earlier in this report, our fiscal year 2004 audit indicated that the Department should continue to improve. Specifically, we noted that (1) several bureaus should ensure that contractors sign non-disclosure agreements, (2) procedures for reporting security incidents to the U.S. Computer Emergency Readiness Team (US-CERT) should be better documented, and (3) system security plans should be improved. We also noted that one bureau needs to perform a system and data center risk assessment.

The Office of Management and Budget (OMB) Circular A-130, *Management of Federal Information Resources* provides key guidelines for establishing and maintaining an entity-wide information security program. Collectively, the identified entity-wide security planning and management issues, coupled with the access control issues described below, reduce the overall effectiveness of the entity-wide security programs for the individual bureaus and operating units, and the overall Department. The *Department of Commerce IT Security Program Policy and Minimum Implementation Standards*, reiterates OMB Circular A-130 guidance, and implements key elements of such guidance as Department-wide policy.

- **Security access controls.** In close concert with an organization's entity-wide information security program, access controls for general support systems and financial systems 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, loss, or impairment. Access controls are facilitated by an organization's entity-wide security program. Such controls include physical controls and logical controls.

The objectives of limiting access are to ensure that users have only the access needed to perform their duties; that access to very sensitive resources, such as security software programs, is limited to very few individuals; and that employees are restricted from performing incompatible functions or functions beyond their responsibility. This is reiterated by Federal guidelines. For example, OMB Circular A-130 and supporting NIST publications provide guidance related to the maintenance of technical access controls. In addition, the *Department of Commerce IT Security Program Policy and Minimum Implementation Standards* contain many requirements for operating Department IT devices in a secure manner.

During fiscal year 2004, we noted that access controls need improvement at certain bureaus, primarily in the areas of user account management and technical device security. We recognize that the Department and its bureaus have compensating controls in place to help reduce the risk that some of the access control vulnerabilities

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Exhibit I – Reportable Condition, Continued

identified could be exploited, and we have considered such compensating controls as part of our overall consolidated financial statement audit.

- **Application software development and change control.** The primary focus of application software development and change control is on controlling the changes that are made to software systems in operation. Establishing controls over the modification of application software programs ensures that only authorized programs and authorized modifications are implemented. This is accomplished by instituting policies, procedures, and techniques to determine that all programs and program modifications are properly authorized, tested, and approved, and that access to and distribution of programs is carefully controlled. Without proper controls, there is a risk that security features could be inadvertently or deliberately omitted or turned off, or that processing irregularities or malicious code could be introduced into the IT environment.

During fiscal year 2004, we noted that application software development and change controls should be improved at certain Department bureaus, primarily in the areas of better (1) monitoring for unauthorized personal and public software, and (2) documenting application software change control policies and procedures.

- **System software.** System software is a set of programs designed to operate and control the processing activities of computer equipment. System software helps control the input, processing, output, and data storage associated with all of the applications that run on a system. Controls over access to and modification of system software are essential in providing reasonable assurance that operating system-based security controls are not compromised and that the system will not be impaired.

During fiscal year 2004, we noted that system software controls should be improved at one bureau, in the areas of usage and monitoring of system software controls.

- **Segregation of duties.** Work responsibilities should be segregated so that an individual does not control more than one critical function within a process. Inadequately segregated duties increase the risk that erroneous or fraudulent transactions could be processed, improper program changes could be implemented, and computer resources could be damaged or destroyed. Key areas of concern for segregation of duties involves duties among major operating and programming activities, including duties performed by users, application programmers, and data center staff. Policies outlining individual responsibilities should be documented, communicated, and enforced. The prevention and/or detection of unauthorized or erroneous actions by personnel require effective supervision and review by management, as well as formal operating procedures.

During fiscal year 2004, we noted that controls over segregation of duties should be improved at one bureau, primarily related to segregating key functions and better documenting IT-related position descriptions.

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Exhibit I – Reportable Condition, Continued

- **Service continuity.** Losing the capability to process, retrieve, and protect information maintained electronically can significantly affect an agency's ability to accomplish its mission. For this reason, an agency should have: (1) procedures in place to protect information resources and minimize the risk of unplanned interruptions, and (2) a plan to recover critical operations should interruptions occur.

During fiscal year 2004, we noted that service continuity controls should be improved at certain Department bureaus, primarily in the areas of implementing additional service continuity related controls and testing service continuity plans.

Recommendations

Specific recommendations are included in a separate limited distribution IT general controls report, issued as part of the fiscal year 2004 consolidated financial statement audit. The Department should monitor bureau actions to ensure effective implementation of our recommendations.

Management's Response

Management agreed with our findings, conclusions, and recommendations related to improving the Department's financial management systems controls. The Department is in the process of finalizing corrective action plans to address the recommendations presented in the separate limited distribution IT general controls report. We believe the Department's planned corrective actions are responsive to our recommendations.

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 Independent Auditors' Report
 Exhibit II – Status of Prior Year Findings

| Reported Issue | Prior Year Recommendation | Fiscal Year 2004 Status |
|--|--|--|
| <i>Reportable Condition - Financial Management Systems Need Improvement</i> | | |
| <p>a. <i>General information technology controls.</i> Weaknesses in general controls were identified in all six FISCAM review areas.</p> | <p>The Department should monitor bureau actions to ensure effective implementation of our recommendations.</p> | <p>Reportable Condition (see comments in Exhibit I).</p> |
| <p>b. <i>Integrated financial management systems.</i> The Department has not fully complied with OMB Circular A-127, <i>Financial Management Systems</i>. The Circular requires each agency to establish and maintain a single, integrated financial management system.</p> | <p>The Department ensure that the implementation of CAMS for NIST, NTIA, and TA, effective October 1, 2003, is successful and in compliance with OMB Circular A-127. In addition, the Department should continue to replace legacy feeder systems with integrated systems.</p> | <p>Completed.</p> |
| <p>c. <i>Automated budgetary controls</i> NIST's accounting system does not contain automated procedures or system controls to prevent over-obligation of apportioned funds at the required level.</p> | <p>Effective October 1, 2003, NIST implement the CAMS funds control modules at the level required by OMB Circular A-11, at a minimum.</p> | <p>Completed.</p> |