Part 4. Independent Auditors' Report

United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20240

November 28, 2003

Memorandum

To: The Secretary

From: Earl E. Devaney
Inspector General

Earl E Devaney

Subject: Independent Auditors' Report on the U.S. Department of the Interior's Fiscal Year 2003 Annual Report on Performance and Accountability (Report No. X-IN-MOA-80-2003)

INTRODUCTION

This report presents the results of the audit of Department of the Interior's (DOI) financial statements as of September 30, 2003 and for the year then ended. We contracted with KPMG LLP (KPMG), an independent certified public accounting firm, to perform the audit. The contract required that KPMG perform its audit in accordance with the Comptroller General of the United States of America's *Government Auditing Standards,* the Office of Management and Budget's Bulletin 01-02 *Audit Requirements for Federal Financial Statements*, and the General Accounting Office/President's Council on Integrity and Efficiency's *Financial Audit Manual*. Also, we identify the top management challenges for DOI in this report.

FINDINGS

In its audit report dated November 28, 2003 (Attachment 1), KPMG issued an unqualified opinion on DOI's financial statements for fiscal years 2003 and 2002. The report identified 13 internal control weaknesses over financial reporting, 2 internal control weaknesses over required supplementary information and required supplementary stewardship information, and 4 instances of noncompliance with laws and regulations. Details follow:

✓ *INTERNAL CONTROLS OVER FINANCIAL REPORTING*

Deficiencies in internal controls are described as reportable conditions, with the most serious conditions identified as material weaknesses.

Material weaknesses are significant deficiencies in the design or operation of one or more components of internal controls which do not reduce to a relatively low level the risk that a material misstatement to the financial statements could occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. KPMG identified material internal control weakness in the following areas:

A. Recording, classifying, and accounting for property, plant, and equipment
B. Recording transactions promptly and properly in financial reports
C. Reconciling intra-governmental transactions
D. Recording promptly and properly Indian trust funds transactions

Reportable conditions are significant deficiencies in the design or operation of the internal control over financial reporting that could adversely affect an organization's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. KPMG identified reportable conditions in the following areas:

E. Safeguarding electronic information in the financial management systems
F. Calculating accruals
G. Recording and disclosing legal claims and assessments
H. Estimating environmental liabilities
I. Accounting for and classifying revenue transactions
J. Monitoring grants
K. Reconciling intra-departmental transactions
L. Recording promptly and properly budgetary transactions
M. Using charge cards

✓ *INTERNAL CONTROLS OVER REQUIRED SUPPLEMENTARY INFORMATION AND REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION*

KPMG identified significant deficiencies in internal control over required supplementary information and required supplementary stewardship information which it believes could adversely affect DOI's ability to collect, process, record, and summarize information in the following areas:

N. Reporting deferred maintenance
O. Maintaining and approving support for and performing annual inventories of stewardship assets

✓ *NONCOMPLIANCE WITH LAWS AND REGULATIONS*

KPMG identified noncompliance with the following laws and regulations:

P. *Single Audit Act Amendments of 1996*
Q. *Debt Collection Improvement Act of 1996*

R. *Prompt Pay Act*
S. *Federal Financial Management Improvement Act of 1996*

✓ *DOI CORRECTIVE ACTIONS*

Although DOI has made progress in correcting financial management weaknesses, significant changes are still needed in its financial management infrastructure. These changes include: (1) acquiring and implementing a new financial management system, (2) developing DOI-wide financial policies that all finance and program offices are required to implement and follow, (3) ensuring that DOI's policy-setting representatives have the authority to enforce financial policies and that sufficient resources are available to monitor compliance with the policies, and (4) enhancing the depth and breadth of its financial management personnel. In its response, which has been incorporated into the report, DOI indicated general concurrence with the findings and recommendations.

KPMG is responsible for the auditors' report and for the conclusions expressed in the report. We do not express opinions on the DOI's financial statements; conclusions on the effectiveness of internal control; conclusions on whether DOI's financial management systems substantially complied with FFMIA; or conclusions on compliance with laws and regulations.

MANAGEMENT CHALLENGES

We identified, in accordance with Public Law 106-531*, Reports Consolidation Act of 2000*, the most serious management challenges facing the DOI. The challenges, which are discussed in detail in "Management Challenges" (Attachment 2), are in the following areas:

- Financial Management
- Information Technology
- Health, Safety and Emergency Management
- Maintenance of Facilities
- Responsibility to Indians and Insular Areas
- Resource Protection and Restoration
- Revenue Collections
- Procurement, Contracts, and Grants

The legislation, as amended, creating the Office of Inspector General, (5 U.S.C.A. App. 3) requires semiannual reporting to Congress on all audit reports issued, actions taken to implement audit recommendations, and recommendations that have not been implemented. Therefore, this report will be included in our next semiannual report**.**

We appreciate the cooperation and assistance of DOI personnel during the audit. If you have any questions, please contact me at (202) 208-5745.

Attachments (2)

KPMG

2001 M Street NW
Washington, DC 20036

Independent Auditors' Report

Secretary 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, 2003 and 2002, and the related consolidated statements of net cost, changes in net position, and financing, combined statements of budgetary resources, and statements of custodial activity for the years then ended (hereinafter referred to as 'financial statements'). The objective of our audits was to express an opinion on the fair presentation of these financial statements. In connection with our audits, we also considered Interior's internal control over financial reporting and tested Interior's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements.

SUMMARY

As stated in our opinion on the financial statements, we concluded that Interior's financial statements as of and for the years ended September 30, 2003 and 2002 are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 21 to the financial statements, Interior restated its fiscal year 2002 consolidated balance sheet, the related consolidated statements of net cost, changes in net position, and financing, and the related combined statement of budgetary resources. In addition, as discussed in Note 21 to the financial statements, in fiscal year 2003, Interior changed its method of accounting for the U.S. Geological Survey working capital fund as of October 1, 2002, and in fiscal year 2002, Interior changed its method of accounting for allocation transfers as of October 1, 2001.

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

<u>Reportable Conditions that are Considered to be Material Weaknesses</u>

A. Controls over property, plant, and equipment

B. Financial reporting controls

C. Intra-governmental reconciliation

D. Indian trust fund controls

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Other Reportable Conditions

E. Application and general controls over financial management systems

F. Controls over accruals

G. Controls for recording and disclosing legal contingencies

H. Controls over environmental liabilities

I. Controls over revenue process

J. Controls over grants

K. Intra-departmental reconciliation

L. Controls over budgetary transactions

M. Controls over charge cards

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

N. Deferred maintenance reporting

O. Stewardship assets and investments

The results of our tests of compliance with certain provisions of laws and regulations disclosed instances of noncompliance with the following laws and regulations that are 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*.

P. *Single Audit Act Amendments of 1996*

Q. *Debt Collection Improvement Act of 1996*

R. *Prompt Payment Act*

S. *Federal Financial Management Improvement Act of 1996*

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

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OPINION ON THE FINANCIAL STATEMENTS

We have audited the accompanying consolidated balance sheets of the Department of the Interior as of September 30, 2003 and 2002, and the related consolidated statements of net cost, changes in net position, and financing, combined statements of budgetary resources, and statements of 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 Interior as of September 30, 2003 and 2002, and its net costs, changes in net position, reconciliation of net costs to budgetary obligations, budgetary resources, and custodial activity for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 21 to the financial statements, Interior restated its fiscal year 2002 consolidated balance sheet, the related consolidated statements of net cost, changes in net position, and financing, and the related combined statement of budgetary resources. In addition, as discussed in Note 21 to the financial statements, in fiscal year 2003, Interior changed its method of accounting for the U.S. Geological Survey working capital fund as of October 1, 2002, and in fiscal year 2002, Interior changed its method of accounting for allocation transfers as of October 1, 2001.

The information in the Management's Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information sections is not a required part of the financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it. As a result of such limited procedures, we believe that the Required Supplementary Information for deferred maintenance is not presented in conformity with accounting principles generally accepted in the United States of America because Interior does not have adequate procedures and controls for identifying, recording, and updating its deferred maintenance information, timely. In addition, we determined that Interior did not reconcile the non-fiduciary accounts with its trading partners, as specified by OMB requirements because Interior's trading partners did not provide information by Interior component or Treasury fund symbol.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information in the Other Supplementary Information section is presented for purposes of additional analysis of the consolidated balance sheet and consolidated statement of changes in net position, 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 other accompanying information included in the Performance Section and the Appendices is presented for purposes of additional analysis and is not a required part of the financial statements. We did not audit this information and, accordingly, we express no opinion on it.

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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, 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.

In our fiscal year 2003 audit, we noted certain matters involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that reportable conditions A through D are material weaknesses.

A. Controls over Property, Plant, and Equipment

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

1. *Acquisitions and Disposals* – Interior did not consistently record property, plant, and equipment transactions properly or timely. Specifically, Interior capitalized assets purchased and assets transferred in from other Federal agencies at incorrect amounts, capitalized assets below Interior's capitalization threshold, capitalized assets in the current year that Interior had inadvertently expensed in prior years, and expensed assets that should have been capitalized. In addition, Interior recorded the net book value of found property rather than the gross cost and accumulated depreciation. Furthermore, Interior did not record disposals in a timely manner.

2. *Land and Land Rights* – Interior does not have a complete and accurate inventory system for land and land rights. Interior is in the process of completing an inventory of land and land rights and expects to complete this project in fiscal year 2005. In addition, during fiscal year 2003, Interior did not have controls to ensure land transactions are properly recorded because Interior improperly expensed certain land acquisitions and did not record a land disposal.

3. *Construction in Progress* – Interior needs to improve controls to monitor and reconcile the construction in progress account. Interior recorded advances for future construction as construction in progress, rather than as advances to others. Interior did not transfer completed construction projects at the time the asset was placed in service or consistently record the proper transfer amounts. In addition, Interior recorded depreciation on certain projects that were still under construction. Furthermore, Interior did not consistently reconcile additions to supporting vendor invoices or have a fully developed process for capturing internal payroll and purchased materials related to the construction of property.

4. *Leased Property* – Interior did not consistently review leases to determine if they were capital or operating leases, and had difficulty providing documentation supporting certain lease reviews. In addition, Interior was not able to efficiently prepare lease information for disclosure in the financial report. This is because Interior has several different lease databases and did not consistently maintain them throughout the year.

5. *Inventory and Certification Processes* – Interior completes annual inventory or certification processes to confirm the accuracy, existence, and completeness of property, plant, and equipment. However, the inventory and certification processes are not always effective, because Interior did not consistently identify acquisitions and disposals that need to be reflected in the financial statements.

6. *Depreciation* – Interior has not established and implemented controls to ensure depreciation is properly calculated and recorded. Specifically, Interior did not review and test certain depreciation calculations; as a result, depreciation expense was misstated during the year. In addition, Interior had assets with abnormal balances in the accumulated depreciation account, assets that Interior placed in service but did not start depreciating, and assets with placed in-service dates that did not match the receiving report dates.

7. *Reconciliation* – Interior is not able to accurately and efficiently reconcile certain subsidiary and general ledgers for property, plant, and equipment. This is because Interior does not promptly resolve reconciling items and does not maintain and reconcile certain subsidiary ledgers throughout the fiscal year, and instead reconciles the ledgers at the end of the year.

As a result of our observations, Interior expended a significant amount of time and resources analyzing, counting, reconciling, and adjusting property, plant, and equipment balances.

Recommendations

We recommend that Interior perform the following to improve controls over its property, plant, and equipment:

1. *Acquisitions and Disposals* – We recommend that Interior implement internal controls to ensure that property, plant, and equipment transactions are recorded in the subsidiary ledger and general ledger at the proper amount and at the time the financial event occurs. This should include analyzing capitalized amounts to ensure that they are above the capitalization threshold and properly coding disbursements to ensure that they are appropriately capitalized or expensed.

2. *Land and Land Rights* – We recommend that Interior complete the five-year action plan to establish a complete and accurate inventory of land and land rights and to reconcile the inventory records (i.e., subsidiary ledger) to the general ledger. We also recommend that Interior establish controls to ensure land acquisitions and disposals are properly recorded in the general ledger.

3. *Construction in Pro*gress – We recommend that Interior implement controls to record and monitor advances for future construction projects. In addition, we recommend that Interior review the construction in progress accounts to identify completed projects that should be transferred to the appropriate property account and reconcile the construction in progress account to the supporting vendor invoices. Interior should complete these procedures and controls on a monthly basis. We also recommend that Interior implement controls to ensure Interior properly records internal payroll and purchased material for property that Interior constructs.

4. *Leased Property* – We recommend that Interior expand its policies on determining whether leases should be classified as capital or operating leases and communicate these policies through training programs. We also recommend that Interior document the capital versus operating lease determinations and include supporting documentation for present value calculations and fair market value assessments. Furthermore, we recommend that Interior consider consolidating several of its lease databases and maintain these databases throughout the year to enable Interior to properly report this information in its financial statements.

5. *Inventory and Certification Processes* – We recommend that Interior improve its inventory and certification policies and train individuals on how to perform inventory observations and certifications.

6. *Depreciation* –We recommend that Interior develop and implement formal month-end financial reporting processes to test depreciation calculations, start depreciation for assets placed in service, as well as identify and resolve assets with abnormal balances in the accumulated depreciation account. This should include having a second team member review and approve the processes to ensure depreciation is properly calculated and recorded.

7. *Reconciliation* – We recommend that Interior reconcile its subsidiary and general ledgers on a monthly basis, in accordance with its policies. This should include promptly resolving any reconciling items.

Management Response

Management concurs. Interior issued significant policies and procedures for the financial management of property, plant and equipment in fiscal year 2003. Interior will expand and refine these to address the policy and procedural issues identified. Interior is developing training on these policies and procedures for roll-out to users in fiscal year 2004. Implementation of the Financial and Business Management System will help ensure that standard processes and property systems are used throughout Interior.

B. Financial Reporting Controls

Interior needs to improve financial reporting controls in the following areas to ensure transactions are promptly and properly recorded for timely and reliable financial reports:

1. *Financial Resources* – During fiscal year 2003, Interior invested additional resources in financial management, and program representatives increased their focus on financial management. This helped improve Interior's financial accounting and reporting processes; however, Interior continues to experience turnover and vacancies in certain key financial positions. In addition, Interior financial management policies are not fully integrated into daily responsibilities, and financial responsibilities are not consistently segregated to prevent or detect financial misstatements.

2. *Financial Analysis* – During fiscal year 2003, Interior implemented financial analysis checklists and templates to improve consistency of financial reporting. However, certain Interior components did not effectively complete the procedures and templates. We identified adjustments needed to the financial statements, footnotes, and Required Supplementary Information. In addition, Interior needs to continue to enhance its cost allocation methodologies. As a result of our findings, Interior adjusted the balances and information in the final reports.

3. *Transaction Entry* – Interior did not consistently ensure that journal vouchers are properly recorded. Specifically, Interior did not include the proper general ledger accounts or proper amounts for certain journal vouchers and supervisors did not consistently review and approve the journal vouchers. In addition, Interior did not ensure that all transactions are recorded in a timely manner. Interior recorded over 180 adjustments subsequent to issuing the final year-end trial balance report on October 8, 2003. As a result, Interior expended a significant amount of time and resources analyzing manual entries and recording adjustments after the end of the year.

4. *Reconciliation* – Interior does not consistently reconcile subsidiary ledgers to general ledgers, reconcile Treasury records to the general ledger, and resolve balances in suspense accounts, timely.

Recommendations

We recommend that Interior perform the following, to improve the recording and reporting of financial transactions:

1. *Financial Resources* – We recommend that Interior continue to enhance its financial resources and implement succession planning for financial positions to minimize the impact of turnover. We also recommend that Interior fully integrate its financial management responsibilities into the daily responsibilities of finance and program representatives, and fully segregate financial responsibilities to prevent or detect financial misstatements.

2. *Financial Analysis* – We recommend that Interior analyze its financial information throughout the year and invest additional time and resources in analyzing financial reports to ensure that Interior identifies all necessary adjustments and disclosures. We also recommend that Interior improve its costing methodologies.

3. *Transaction Entry* – We recommend that Interior record transactions during the year at the time the transactions are incurred, and utilize automated posting models throughout the year, as well as during the year-end reporting process. This should minimize the number of journal vouchers. For any journal vouchers, we recommend that Interior have a second individual review the entries to ensure that they are accurate and complete, prior to entering the transactions into the general ledger.

5. *Reconciliation* – We recommend that Interior develop and implement formal month-end financial reporting processes to reconcile subsidiary ledgers to general ledgers, reconcile Treasury's records to the general ledger, and resolve balances in suspense account items. This should include having a supervisor review and approve the reconciliations.

Management Response

Management concurs. During fiscal year 2003, Interior established a Finance Transformation Project to address these and other financial management issues in Interior. Interior believes it made substantial progress during fiscal year 2003 by establishing a financial workforce initiative to address shortages in finance resources, accelerating the schedule for preparing the Performance and Accountability Report from January to November, and establishing an elimination team that resulted in improvements to the intra-Department elimination process. In addition, Interior decreased adjustments into the Consolidated Financial Statement System from over 700 adjustments in fiscal year 2002 to less than 200 adjustments in fiscal year 2003, representing improvement in the accuracy of Interior's transaction processing. However, Interior recognizes much still has to be done and is committed to continuing the Finance Transformation Project.

C. **Intra-governmental Reconciliation**

Interior is required to reconcile transactions and balances with other Federal entities in accordance with OMB Bulletin No. 01–09, *Form and Content of Agency Financial Statements,* and U.S. Department of the Treasury's *Federal Intra-governmental Transactions Accounting and Policies Guide.* Interior reconciles its fiduciary intra-governmental transactions and balances; however, Interior has not reconciled its non-fiduciary intra-governmental transactions and balances because its trading partners did not consistently provide information by Interior component or Treasury fund symbol. In addition, Interior did not designate the appropriate trading partner codes for certain transactions. As a result, Interior's transactions and balances with other Federal entities may not properly eliminate on the government-wide financial statements.

Recommendation

We recommend that Interior establish quarterly procedures to reconcile non-fiduciary transactions and balances with other Federal entities and consistently code transactions to the appropriate trading partners. These procedures should include confirming amounts at the bureau level and meeting with trading partners to resolve any differences identified.

Management Response

Management concurs. The Federal government is implementing a new system to track intra-governmental transactions. Interior is committed to using the new system and expects that the new system will assist Interior in future years to reconcile non-fiduciary transactions and balances on a quarterly basis with other agencies. In addition, Interior will continue to improve trading partner coding of transactions within Interior's accounting systems.

D. **Indian Trust Fund Controls**

The United States Congress has designated the Secretary of the Interior as the primary fiduciary with responsibility for the monetary and non-monetary resources held in trust on behalf of American Indian Tribes, individual Indians, and other trust funds (hereafter collectively referred to as the Indian Trust Funds). The Secretary carries out this fiduciary responsibility through the Office of the Special Trustee for American Indians (OST), the Bureau of Indian Affairs (BIA), and other Interior bureaus.

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

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

1. *Trust Fund Balances* – Interior is unable to provide accounting records to properly support the Indian Trust Funds' balances. For example, the aggregate sum of all positive balances of Individual Indian Monies (IIM) trust fund balances in the subsidiary ledger exceed the balance in the control account by approximately $6 million as of September 30, 2003. In addition, as of September 30, 2003, the Individual Indian Monies subsidiary ledger contains negative trust fund balances of approximately $44 million (of which approximately $233 thousand is attributed to individual Indian accounts as of September 30, 2003). In addition, Interior was unable to provide documentation supporting the authorization of certain 2003 automated disbursements. OST also is in the process of investigating and resolving an undistributed interest account of approximately $1.7 million. Furthermore, certain account holders do not agree with the trust fund balances and have filed claims against the U.S. Government and Interior, which remain unresolved.

2. *Special Deposit Accounts* – In accordance with Title 25 of the Code of Federal Regulations and as directed by BIA, OST records receipts into a special deposit account within the IIM subsidiary ledger when the recipient trust fund account is unknown at time of receipt. When BIA identifies the trust fund account, OST transfers the amount from the special deposit account to the designated trust fund account or disburses as appropriate, in accordance with BIA instructions. During fiscal years 2002 and 2001, management of OST, together with the BIA and a contractor, developed and put into place a formal plan to address special deposit accounts. Beginning in fiscal year 2003, Interior's Office of Historical Trust Accounting began working with OST and BIA to distribute funds in special deposit accounts that were opened on or before December 31, 2002. BIA will address special deposit account activity after December 31, 2002, by providing instructions for distributions to OST. Interior needs to resolve approximately $59 million and $62 million of special deposit accounts included in the IIM subsidiary ledger as of September 30, 2003 and 2002, respectively. At September 30, 2003 a significant number of special deposit accounts continue to require resolution, and management anticipates that these accounts will be reconciled by the beginning of fiscal year 2007.

3. *Trust Fund Information Systems* – Interior needs to improve security and general controls over the Trust Fund information systems. Specifically, Interior needs to improve segregation of duties, accredit and certify its general and application systems, and strengthen controls to prevent unauthorized access.

4. *Appraisal Compacts* – One of the key elements in performing realty trust transactions is the requirement to obtain appraisals for realty transactions. Current laws allow the appraisal function to be compacted to tribes, who are often the named parties involved in realty transactions. BIA is responsible for assisting trust beneficiaries in the negotiation and execution of realty transactions. Office of Appraisal Services (OAS) is responsible for conducting reviews of appraisals that are completed for the benefit of tribes or individual trust beneficiaries. Controls are not in place to ensure that all appraisals, completed for the benefit of tribes or individual trust beneficiaries, are provided to OAS.

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 the following weaknesses related to the internal controls performed by regional and agency offices:

   a. *Segregation of Duties* – The responsibilities for trust fund processing are not properly segregated to prevent or detect errors. Specifically, in some locations an individual employee has the ability to initiate lease agreements; generate annual billings for property leases; collect payment for leases; send instructions to OST to create IIM accounts; and distribute funds.

   b. *Probate Backlog* – The probate orders for land title are not entered into the trust management systems timely. Although BIA has made progress in reducing the backlog, BIA still has probate orders that have not been recorded. This increases the potential for inaccurate and untimely distributions of income to the Indian Trust Fund account holders.

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

Recommendation

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

Management Response

Management concurs. A variety of actions are underway within Interior to correct these deficiencies.

E. Application and General Controls over Financial Management Systems

During fiscal year 2003, Interior improved the security and controls over information systems. However, Interior needs to continue to improve the areas described below in order to meet the requirements of OMB Circular A-130, *Management of Federal Information Resources.* These conditions could affect Interior's ability to prevent and detect unauthorized changes to financial information, control electronic access to sensitive information, and protect its information resources.

1. *Entity-wide Information Technology (IT) Security Program* – An entity-wide IT security program, including security policies and a related implementation plan, is the foundation of an entity's security control structure and a reflection of senior management's commitment to addressing security risks. As outlined in OMB Circular A-130, an effective security program includes a risk assessment process, certification process, and effective incident response and monitoring capabilities. Interior needs to improve assignment of security responsibilities, finalize certain security policies and procedures, enhance monitoring of the security program, and consistently performing background investigations. In addition, Interior has not fully completed the certification and accreditation process for all major application and general support systems. Without a clear security program, Interior's systems are vulnerable to unauthorized access, use, or loss of sensitive information.

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

3. *Segregation of Duties* – Proper segregation of duties should be ensured through the establishment of policies, procedures, and organizational structure such that one individual cannot control key aspects of financial transactions, and thereby conduct unauthorized actions or gain unauthorized access to assets or records. Interior has not fully segregated responsibilities as certain programmers may also move software changes into production, security managers perform primary and secondary security functions; and technology staff perform change management responsibilities and network monitoring. In addition, Interior needs to further segregate payroll and procurement system responsibilities.

4. *System Software Controls* – Controls over the modification of system software change controls should provide reasonable assurance that operating system controls are not compromised. Without proper system software controls, unauthorized individuals using the system software could circumvent controls to read, modify, or delete critical or sensitive information or programs. Interior has not fully limited access to its system software or updated its guidelines identifying standards for system software, desktop applications, file transfers, utilities and e-mail.

5. *Software Development and Change Controls* – Establishing controls over the modification of application software programs helps ensure that only authorized programs and modifications are implemented. Without proper change controls, there is an increased risk that either intentional or unintended changes are made to the system's processing functionality, the wrong version of a program could be implemented, a virus could be inserted, or built-in security features could be disabled. Interior has not fully developed procedures for controlling changes over software that would prevent unauthorized programs or modifications to an existing program from being implemented. In addition, Interior has not fully developed procedures to ensure that tests of system software changes are performed and documented, system software changes are reviewed, and approval of changes is documented prior to implementation.

6. *Service Continuity* – Losing the capability to process, retrieve, and protect information maintained electronically could significantly affect Interior's ability to accomplish its mission. Consequently, procedures should be in place to protect information resources, minimize the risk of unplanned interruptions, and recover critical operations should interruptions occur. However, Interior has not formalized an incident response capability to mitigate the risk of service interruptions.

Recommendation

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

Management Response

Management concurs. Interior believes that substantial work was performed in fiscal year 2003 to improve computer security and these efforts will continue in future years.

F. Controls over Accruals

During fiscal year 2003, Interior revised its processes and controls to calculate accruals for inclusion in the financial reports. However, certain Interior components did not implement the revised processes until the end of the year. We determined that Interior's accrual calculations were not consistently complete and accurate and that Interior's accrual calculations did not always match the general ledger. As a result of our findings, Interior expended a significant amount of time and resources revising its accrual calculations, reconciling the calculations to the ledger, and adjusting the accrual balances.

Recommendations

We recommend that Interior refine its accrual calculations, reconcile the accrual calculations to the general ledger, and enhance its accrual policies and controls to ensure that the accruals are complete and accurate. This should include having a supervisor review and approve the accrual calculation and reconciliation. We also recommend that Interior implement and test the accrual calculations for its interim financial statements to reduce the year-end accrual effort. This testing should include comparing estimated and actual results.

Management Response

Management concurs. During fiscal year 2003, Interior devoted substantial effort to developing accrual calculations and testing these calculations and, while in many cases the calculations worked as planned, in other cases testing indicated additional work was necessary. Interior will continue its efforts to improve the accrual calculations in future years.

G. Controls for Recording and Disclosing Legal Contingencies

During fiscal year 2003, Interior implemented an automated system to capture and monitor legal contingencies. Interior uses the contingency information from this automated system to record liabilities and prepare disclosures in accordance with Federal accounting standards. However, the information in the automated system is not always sufficient to determine the accounting treatment for each claim or assessment. In addition, the financial management offices do not consistently review the information provided by the solicitors or meet with the solicitors to discuss the accounting treatment of contingencies. As a result, Interior spent a significant amount of time revising the year-end contingency information and determining the contingencies that should be accrued or disclosed.

Recommendations

We recommend that Interior improve internal controls to ensure that contingencies are properly accrued or disclosed in the financial report as follows:

1. *Training* – We recommend that Interior provide training to the solicitors on entering sufficient information in the system to enable the financial management offices to determine the appropriate accounting treatment of each claim or assessment.

2. *Analysis and Communication* – We recommend that the solicitor's office provide a quarterly or more frequent analysis of contingencies to the financial management offices. The financial management offices should review this analysis, meet periodically with the solicitor's office to discuss the status of and changes in the more significant contingencies, and consider the results of the analysis and discussions in preparing the financial statements and related disclosures.

Management Response

Management concurs. During fiscal year 2003, Interior implemented a new system to track legal contingencies. Interior distributed detailed instructions on the proper use of the new system, and is prepared to provide additional training as necessary. Interior believes that the system and the process represents an improvement over prior year and will continue to enhance the process.

H. Controls over Environmental Liabilities

Interior has developed and communicated policies for estimating environmental liabilities. However, certain locations did not consistently interpret and apply these policies. In addition, Interior did not consistently evaluate and record government-acknowledged sites in accordance with Federal accounting standards. Furthermore, Interior did not consistently research and document the basis for changes in environmental liabilities or record the appropriate increases/decreases in expected clean-up costs. As a result of our observations, Interior analyzed and adjusted its environmental liabilities.

Recommendations

We recommend that Interior improve its controls over environmental liabilities, as follows:

1. *Training* – We recommend that Interior provide periodic training to scientists, financial management staff, and others to ensure that they understand Interior policies and the Federal accounting standards on environmental liabilities.

2. *Adjusting the Liability* – We recommend that Interior establish controls to ensure that changes in the environmental liabilities are properly researched, supported, and recorded. This should include having a supervisor approve the adjustments and compare the adjustments to the general ledger to ensure that balances are properly recorded.

Management Response

Management concurs and is committed to providing additional training and improving controls.

I. Controls over Revenue Process

Interior's revenue controls did not ensure that Interior consistently accounted for and classified revenue transactions as follows:

1. *Recording Activity* - Interior did not review revenue transactions to ensure that they are properly presented in accordance with Federal accounting standards. Specifically, Interior did not consistently:

   a. Recognize revenue for services provided in a timely manner, leaving deferred revenue on the balance sheet several months after the service or products had been provided;

   b. Recognize non-exchange revenue and accounts receivable for settlement funds that Interior had a legal enforceable claim to, were considered collectible, and were reasonably estimable; and

c. Classify non-exchange revenue and transfers on the statement of changes in net position.

2. *Issuing Bills and Matching Payments* – Interior did not consistently issue bills timely in accordance with prudent business practices. We noted Interior had old unbilled receivables. In addition, Interior's royalty system does not enable Interior to efficiently match receivables with the payments received, hindering Interior's ability to monitor outstanding accounts receivable.

3. *Monitoring Accounts* – Interior does not effectively analyze accounts receivable and advances from others, as we noted these accounts contained the following:

   a. Customer agreements with both an accounts receivable and an advances from others balance;

   b. Accounts receivable and advances from others with abnormal and old balances; and

   c. Accounts receivable and advances from others balances not associated with a customer agreement.

As a result of our comments, Interior performed a detailed analysis of revenue transactions and adjusted the balances.

Recommendations

We recommend that Interior improve controls over the revenue process as follows:

1. *Recording Activity* – We recommend that Interior establish controls to ensure that transactions are recorded in the proper account, at the proper amount, and in the proper period. These controls should also include periodic inspections by a second individual to ensure transactions are properly recorded.

2. *Issuing Bills and Matching Payments* – We recommend that Interior standardize customer agreements and implement billing policies that enable Interior to issue bills when the associated costs are incurred. We also recommend that Interior improve the configuration of the royalty system to minimize unmatched receivables and payments as well as to provide Interior with a monthly report of any unmatched items. Interior should investigate and resolve these unmatched items on a monthly basis.

3. *Monitoring Accounts* – We recommend that Interior implement formal month-end financial reporting processes to identify and resolve customer agreements with both an accounts receivable and advance balance, resolve accounts with abnormal balances, review and collect older accounts receivable balances, and associate balances with a customer agreement. We also recommend that Interior configure its accounting systems to prevent customer accounts from having both an accounts receivable and an advances from others balance, as well as transactions not associated with an agreement.

Management Response

Management concurs. This finding relates to billing, receivable, and deferred revenue transactions in several bureaus. Interior intends to work with these bureaus to improve Interior's billing and collections process with non-Federal entities. In addition, part of the problem deals with inconsistent processing of agreements between Federal entities. Interior established a team during fiscal year 2003 to prepare a Department-wide handbook that provides a basis for much greater consistency among the components of Interior. Moreover, establishment of the government-wide Business Partners Network (BPN) will further assist Interior in this endeavor. It is anticipated that this handbook with be issued in fiscal year 2004 and the bureaus will immediately begin to implement its provisions.

J. Controls over Grants

In accordance with *Single Audit Act Amendments of 1996,* Interior should monitor grantees to ensure grantees expend awards in accordance with the grant requirements and Federal regulations. Interior has not fully developed controls to monitor its grantees to detect and prevent misuse of Federal awards. Specifically, Interior did not consistently perform the following:

1. *Reports* – Ensure that grantees complete single audits and submit reports within nine months of the grantees' year-end.

2. *Findings* – Issue management decisions on audit findings within six months after receipt of audit reports and ensure that grantees take appropriate and timely corrective action.

Recommendations

We recommend that Interior improve its monitoring efforts of grantees as follows:

1. *Reports* – We recommend that Interior establish a monitoring process to verify that Interior receives single audits reports within nine months of the grantees' year-end. Interior should monitor the Federal Clearinghouse website periodically to determine when an audit report has been submitted. If reports are not received, Interior should inquire of grantees and consider the need to limit future grant awards until reports are submitted.

2. *Findings* – We recommend that Interior issue management decisions on audit findings within six months after receipt of single audit reports and verify that grantees take appropriate and timely corrective action. If findings are not resolved, Interior should consider the need to limit future grant awards until grantees resolve the findings.

Management Response

Management concurs. Currently, grant program managers have the authority to limit future grant awards if required financial reports have not been received. In July 2003, Interior issued new grant policies regarding grantee financial reporting. Interior will develop additional guidance on financial monitoring of Federal assistance recipients, to establish a consistent process for documenting receipt of Single Audit Act audits and completion of actions to address audit findings.

K. Intra-departmental Reconciliation

Interior components should reconcile intra-departmental transactions and balances in accordance with Interior policies. However, Interior components did not reconcile intra-departmental transactions and balances in a timely manner, as the components did not start the reconciliation process until the third quarter of the fiscal year. In addition, Interior's reconciliation process is manual, causing Interior to expend a significant amount of time reconciling and adjusting balances.

Recommendation

We understand that Interior is developing an automated process to facilitate the reconciliation of intra-departmental transactions and balances. We recommend that Interior complete and implement this automated process. Until the automated process is implemented, we recommend that Interior improve the manual process to identify and reconcile the intra-departmental transactions and balances. The reconciliation process should be completed at least quarterly, and include procedures to resolve any differences identified in a timely manner.

Management Response

Management concurs. Interior implemented procedures during fiscal year 2003, to reconcile intra-departmental transactions and balances during the year. Interior believes that this resulted in substantial improvement in the intra-departmental reconciliation process. Interior has additional efforts underway to improve the intra-departmental reconciliation process, and an automated process may be part of the Finance and Business solution currently being procured.

L. Controls over Budgetary Transactions

Interior needs to improve controls in the following areas to ensure that budgetary transactions are promptly and properly recorded:

1. *Obligations Incurred* – In some instances, Interior recorded obligations in the general ledger before incurring a legal obligation, recorded obligations at the improper amount, and recorded obligations that had not been reviewed and approved. In addition, Interior did not consistently code obligations to the appropriate budget object classification.

2. *Undelivered Orders* – Interior performed periodic reviews and certifications for undelivered orders; however, the reviews and certifications were not always effective. Our test work, performed subsequent to the review and certification process, identified several obligations that should have been de-obligated as part of the review and certification process. These exceptions occurred because Interior did not complete the reviews and certifications in a timely manner, inadvertently concluded that outstanding obligations were valid, or did not record de-obligations identified in the review and certification process.

3. *Unfilled Customer Orders* – Interior did not effectively reconcile customer orders from the subsidiary ledger to the general ledger. In addition, Interior did not consistently record modifications to customer orders.

As a result of our observations, Interior analyzed and adjusted the budgetary balances.

Recommendations

We recommend that Interior perform the following to improve controls over budgetary transactions:

1. *Obligations Incurred* – We recommend that Interior establish controls to record obligations at the proper amount, at the time the transaction occurs, and using the proper budget object classification. This should include having a supervisor review and approve obligation documents and having a second individual compare approved obligation documents to the general ledger to ensure transactions are properly classified and recorded.

2. *Undelivered Orders* – We recommend that Interior complete the reviews and certifications within the established deadlines, properly document the results of the certifications, and record the appropriate de-obligations promptly. We also recommend that Interior require managers to review and approve certifications focusing on undelivered orders without any activity during the previous three months.

3. *Unfilled Customer Orders* – We recommend that Interior reconcile the customer orders from the subsidiary ledger to the general ledger on a monthly basis. In addition, we recommend that Interior require supervisors to review and approve customer orders sent from the subsidiary ledger to the general ledger suspense records before posting the customer orders to the general ledger.

Management Response

Management concurs. Interior believes that it has made improvements in recording obligations and is committed to improving controls over budgetary transactions.

M. 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. In conjunction with the issuance of these cards, Interior published guidance and instructions on the card's utilization through its *Integrated Charge Card Program Guide*. This policy 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, Interior does not consistently follow these internal control procedures. Specifically, cardholders did not always sign and date the charge card statements or describe each charge on the statement. In addition, Interior was unable to locate certain charge card statements. Furthermore, approving officials did not consistently review and approve the charge card statements in a timely manner (e.g., within one month of statement date).

Recommendation

We recommend that Interior provide users and approving officials additional training on Interior's charge card policies. In addition, approving officials should be more diligent in monitoring and enforcing compliance with Interior's charge card policies. This will help prevent and detect unauthorized use of charge cards.

Management Response

Management concurs. Interior believes it has a strong charge card program, although compliance issues were identified at three Interior bureaus. Interior formally appointed approving officials beginning in the middle of fiscal year 2002. Since then, Interior has appointed over 10,000 individual supervisors, who have successfully completed the required training. The initial roll-out of training was completed in the first quarter of fiscal year 2003. Interior maintains the appointment and training process through quarterly reviews of the personnel/payroll system to identify newly appointed supervisors who will have approving official responsibilities. New training for cardholders, including those with the travel business line, is under development and scheduled for implementation beginning early in the second quarter of fiscal year 2004. Efforts will continue to improve this program.

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

We have identified controls over property, plant, and equipment, financial reporting controls, and intra-governmental reconciliations as material weaknesses that were not reported in Interior's *Federal Managers' Financial Integrity Act* report.

INTERNAL CONTROLS OVER REQUIRED SUPPLEMENTARY INFORMATION AND REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION

We noted certain significant deficiencies in internal control over Required Supplementary Information and Required Supplementary Stewardship Information discussed in the following paragraphs that, in our judgment, could adversely affect Interior's ability to collect, process, record, and summarize this information.

N. Deferred Maintenance Reporting

Interior has not fully established controls to identify and report deferred maintenance in accordance with the Federal accounting standards. Specifically, the deferred maintenance estimates disclosed in the Required Supplementary Information section include amounts that do not meet the definition of deferred maintenance and amounts that should be excluded as Interior already completed the deferred maintenance or does not intend to complete it. In addition, Interior does not consistently maintain supporting documentation for the condition assessments and deferred maintenance estimates. Furthermore, Interior has not completed condition assessments for all of its assets and has stopped maintaining one of its deferred maintenance reporting systems. As a result, the Required Supplementary Information disclosure on condition assessments and deferred maintenance is not complete or accurate.

Recommendations

We recommend that Interior develop and implement internal controls over identifying and reporting deferred maintenance to:

1. Verify that condition assessments and the related deferred maintenance estimates meet the definition of deferred maintenance, are properly supported, and exclude items that Interior has maintained or does not intend to maintain.

2. Complete condition assessments and the related deferred maintenance estimates for all stewardship assets as well as general property, plant, and equipment.

Management Response

Interior has taken extensive steps in the past few years to improve deferred maintenance reporting. Interior has identified "Department-wide Maintenance Management Capability" as a mission critical FMFIA material weakness. The corrective action plan for this FMFIA material weakness includes steps to improve deferred maintenance reporting. Interior believes that it is making substantial progress and the Department plans to continue these efforts to improve deferred maintenance reporting.

O. Stewardship Assets and Investments

Interior does not consistently follow its established procedures and controls over recording Required Supplementary Stewardship Information. Specifically, Interior does not consistently maintain and approve source documents to support additions and deletions to stewardship assets and does not consistently perform annual inventories and verifications for stewardship assets. In addition, Interior does not consistently track investments in non-federal physical property or research and development.

Recommendations

We recommend that Interior strengthen internal controls over reporting Required Supplementary Stewardship Information to:

1. *Stewardship Assets* – Record and report stewardship asset transactions at the time the event occurs, require supervisors to review and approve these transactions, maintain source documentation for these transactions, and perform periodic inventories of stewardship assets.

2. *Stewardship Investments* – Accumulate and report investments in non-federal physical property as well as research and development.

Management Response

Interior agrees that continued improvements are needed to support the data provided in the Required Supplementary Stewardship Information section. Interior reports extensive stewardship information from a variety of sources, including non-financial systems. Interior will establish the minimum required internal control framework for these non-financial systems and work with its bureaus to ensure that they meet the minimum requirements.

COMPLIANCE WITH LAWS AND REGULATIONS

Our tests of compliance with certain provisions of laws and regulations, as described in the Responsibilities section of this report, exclusive of those referred to in the *Federal Financial Management Improvement Act* (FFMIA), disclosed instances of noncompliance with the following laws and regulations that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, and are described below.

P. *Single Audit Act Amendments of 1996*

As discussed in the Internal Control over Financial Reporting section of this report, Interior does not perform adequate monitoring of grantees in accordance with the *Single Audit Act Amendments of 1996*. Interior needs to ensure that grantees complete single audits and submit single audit reports to Interior in a timely manner. In addition, Interior needs to issue management decisions on audit findings in a timely manner.

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Recommendation

We recommend that in fiscal year 2004, Interior improve its grantee monitoring process to ensure grantee compliance with the reporting requirements of the *Single Audit Act Amendments of 1996*.

Management Response

Management concurs and will work with financial assistance programs and the Office of Inspector General to ensure compliance with the *Single Audit Act Amendments of 1996*.

Q. *Debt Collection Improvement Act of 1996*

In accordance with the *Debt Collection Improvement Act of 1996*, Interior is required to refer eligible receivables that are delinquent to the U.S. Department of the Treasury for collection or offset. Eligible receivables include those that are not the subject of litigation, related to foreclosure proceedings, or from organizations in bankruptcy. Interior did not consistently refer Bureau of Indian Affairs receivables that are over 180 days delinquent to the U.S. Department of the Treasury.

Recommendation

We recommend that the Interior establish a process, in fiscal year 2004 to ensure eligible receivables are referred to the U.S. Department of the Treasury in a timely manner.

Management Response

Management concurs. During fiscal year 2003, the Office of Financial Management worked closely with the Bureau of Indian Affairs (BIA) to address its unique debt management issues. Specifically these issues relate to loan and power programs of BIA and have esoteric legal implications under the *Indian Self Determination and Education Assistance Act*. Interior's Office of the Solicitor is in the process of assessing to what extent certain receivables are truly eligible to be referred to Treasury for debt cross-servicing as is required for most delinquent receivables under the *Debt Collection Improvement Act of 1996*. Interior believes that progress has been made in its debt management program; however, to attain the desired level of performance Interior requires additional time. Debt management improvements will again be a primary focus during the next phase of Interior's comprehensive Finance Transformation Project.

R. *Prompt Payment Act*

In accordance with the *Prompt Payment Act,* Interior is required to pay interest penalties when payments are late. The Bureau of Indian Affairs, a component of Interior, did not consistently record the proper acceptance dates into the accounting system. As a result, Interior did not consistently pay interest penalties when payments were late.

Recommendation

We recommend that the Interior establish a process, in fiscal year 2004 to record the proper acceptance dates into the accounting system and pay interest penalties when payments are late.

Management Response

Management concurs. Interior monitors on-time payments for all of its bureaus. Most bureaus are able to achieve a 97% or better on-time payment performance. However, the Bureau of Indian Affairs has struggled with payment processing and has only been able to achieve an 88% on-time payment rate. Interior will focus on improving Bureau of Indian Affairs' payment processing during fiscal year 2004.

The results of our tests of compliance with other laws and regulations, exclusive of FFMIA, disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02.

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

The results of our tests of FFMIA disclosed instances, described below, where Interior's financial management systems did not substantially comply with Federal financial management systems requirements, the Federal accounting standards, or the United States Standard General Ledger at the transaction level.

1. *Federal Financial Management Systems Requirements* – As discussed in the Internal Control over Financial Reporting section of this report, Interior has several weaknesses in its information technology general control environment that contribute to noncompliance with OMB Circular A-130. Interior needs to improve security policies monitor the security program, strengthen access controls, segregate information technology duties, fully develop and implement procedures for controlling changes to software, and formalize its incident response processes. As a result, Interior does not substantially comply with the Federal financial management system requirements.

2. *Federal Accounting Standards* – 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 weaknesses that affected Interior's ability to prepare its financial statements and related disclosures in accordance with Federal accounting standards. Specifically, we determined that Interior needs to improve controls over property plant and equipment, financial reporting, intra-governmental reconciliation, and Indian trust funds. Also as discussed in the Internal Control over Required Supplementary Information and Required Supplementary Stewardship Information section of this report, Interior needs to improve its policies and procedures for determining and reporting deferred maintenance information to comply with Federal accounting standards. As a result, Interior does not substantially comply with the accounting standard indicators of FFMIA.

3. *United States Standard General Ledger at the Transaction Level* – In accordance with OMB Circular A-127, *Financial Management Systems*, Interior is required to record financial events consistent with the applicable account descriptions and attributes reflected in the United States Standard General Ledger (SGL) at the transaction level. Interior utilizes certain posting models for royalty transactions that are not consistent with Treasury's guidance and do not allow Interior to track transactions at the trading partner level. Therefore, Interior must manually adjust these balances for financial reporting purposes. In addition, Interior records certain Bureau of Indian Affairs receivables as a total in its subsidiary ledgers rather than recording the individual transactions. As a result, Interior does not substantially comply with the SGL requirements.

Recommendations

We recommend that Interior perform the following, during fiscal year 2004:

1. *Federal Financial Management Systems Requirements* – Improve the security and general controls over its financial management systems to meet the requirements set forth in OMB Circular A-130.

2. *Federal Accounting Standards* – Improve procedures and internal controls to ensure that the financial statements and related disclosures are prepared in accordance with the Federal accounting standards.

3. *United States Standard General Ledger at the Transaction Level* – Modify the posting models in the royalty accounting system and revise the process for recording receivables to ensure that Interior records activity consistent with the SGL at the transaction level.

Management Response

Management concurs. Interior recognizes that improved controls can improve the efficiency of reporting and is moving to enhance the efficiency of Interior's reporting. This includes moving to monthly financial statement reporting, implementing performance metrics, and requiring periodic reviews of financial performance with senior bureaus personnel.

RESPONSIBILITIES

Management's Responsibilities

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

Management is responsible for the financial statements, including:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;

- Establishing and maintaining internal controls over financial reporting, and preparing the Management's Discussion and Analysis (including the performance measures), Required Supplementary Information, and Required Supplementary Stewardship Information, and

- Complying with laws and regulations, including FFMIA.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies. 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 2003 and 2002 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*, and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements;

- Assessing the accounting principles used and significant estimates made by management, and

- Evaluating the overall financial statement presentation.

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

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In planning and performing our fiscal year 2003 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 OMB Bulletin No. 01-02 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin No. 01-02, we considered Interior's internal control over 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. Our procedures were not designed to provide assurance on internal control over Required Supplementary Stewardship Information and, accordingly, we do not provide an opinion thereon.

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

As part of obtaining reasonable assurance about whether Interior's fiscal year 2003 financial statements are free of material misstatement, we performed tests of Interior's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws and regulations applicable to Interior. Providing an opinion on compliance with laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin No 01-02 and FFMIA, we are required to report whether 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.

DISTRIBUTION

This report is intended for the information and use of Interior's management, Interior's Office of the Inspector General, OMB, GAO, 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 28, 2003

Exhibit I

U.S. DEPARTMENT OF THE INTERIOR

Summary of the Status of Prior Year Findings

September 30, 2003

Ref	Fiscal Year 2002 Condition	Fiscal Year 2003 Status
A	Security and general controls over financial management systems	This condition has not been fully corrected and is repeated at finding E.
B	Controls over property, plant, and equipment	This condition has not been corrected and is repeated at finding A.
C	Controls over financial reporting	This condition has not been corrected and is repeated at finding B.
D	Controls to reconcile intra-governmental transactions and balances	This condition has not been fully corrected and is repeated at findings C and K.
E	Indian Trust Fund controls	This condition has not been fully corrected and is repeated at finding D.
F	Financial processes at U.S. Geological Survey	This condition has been corrected.
G	Controls over undelivered orders and accruals	This condition has not been corrected and is repeated at findings F and L.
H	Controls for recording and disclosing claims and assessments	This condition has not been corrected and is repeated at finding G.
I	Controls over environmental liabilities	This condition has not been corrected and is repeated at finding H.
J	Controls over revenue process	This condition has not been corrected and is repeated at finding I.
K	Controls over Interior Franchise Fund	This condition has been corrected.
L	Deferred maintenance reporting	This condition has not been corrected and is repeated at finding N.
M	Debt Collection Improvement Act of 1996	This condition has not been corrected and is repeated at finding Q.
N	Section 113 of Public Law 104-208 – Advances for Interior Franchise Fund	This condition has been corrected.
O	Federal Financial Management Improvement Act of 1996	This condition has not been corrected and is repeated at finding S.

Attachment 2

United States Department of the Interior

OFFICE OF INSPECTOR GENERAL
Washington, D.C. 20240

Office of Inspector General Update for 2003 of the Top Management Challenges for the Department of the Interior

1. Financial Management

The Department of the Interior's (DOI or the Department) financial management systems do not produce timely, accurate and reliable information throughout the course of the year. As a result, the Department undertakes a massive effort every year to compile, analyze, and correct its financial data in order to prepare accurate financial statements within a reasonable timeframe after the close of the fiscal year.

Good financial management information, especially cost information, is key to good management decision-making and is necessary to address other challenges facing the Department. Hindering DOI progress are longstanding significant control weaknesses over activities such as property, plant, and equipment; financial reporting; Indian trust funds; and transactions between bureaus and offices. Also, Department-wide initiatives to introduce activity based costing across the Department and to better integrate performance, budget, and accounting information place increased burdens on an already over-taxed financial management staff.

DOI has made some progress in correcting financial management weaknesses. For example, significant improvements have been made in addressing weaknesses at the U.S. Geological Survey (GS) which last year prevented GS from producing accurate and timely financial statements. However, DOI must enhance both the depth and breadth of its financial management personnel, and must continue its endeavor to secure funding for an updated, integrated Department-wide financial management system.

2. Information Technology

Shortcomings in policies, procedures, and controls need to be addressed before Information Technology (IT) systems and data at DOI are adequately protected. According to a September 2003 Office of Inspector General (OIG) report (No. 2003-I-0066) DOI's overall security program does not demonstrate that all information systems supporting its operations and assets are adequately protected.

During the past 2 years, DOI has made progress in strengthening IT security in its financial accounting systems, and has established security processes and documentation for its Indian Trust systems that places the trust systems in a better information-security posture than the majority of other DOI information systems. If DOI continues its current

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rate of improvement, it should meet its target date for having all information systems certified and accredited by December 2005. However, until bureaus and offices fully implement security policies and procedures, effectively assess risks, and fully integrate corrective action plans with the capital planning and investment control process, DOI should continue to report to the Congress the lack of an adequate information security program as a material weakness.

3. Health, Safety and Emergency Management

DOI must protect millions of visitors, hundreds of thousands of employees and volunteers, thousands of facilities, and millions of acres of property from both internal and external threats. Risk assessments conducted by the OIG and other entities concluded that:

- Water and power facilities and national icon parks remain vulnerable to outside threats.
- Visitor safety and security remains inadequate at many DOI parks and other facilities.
- Employee safety and security remains inadequate at many DOI facilities.
- The physical isolation of some DOI lands and facilities increases their vulnerability to threats and inhibits DOI's response time.

DOI continues to be slow to change its mission and priorities to reflect its new security responsibilities and commitment. OIG's August 2003 homeland security assessment (No. 2003-I-0063) concentrated on the security management, security staffing, and use of funds designated for security at national icon parks. These icons were chosen because they enjoy prominent historical attention, large numbers of visitors and frequent media attention. We found they continue to be in jeopardy.

While some security measures have been adopted, most security improvements have been delayed, postponed or wholly disregarded, employees continue to remain unconvinced of the necessity for new security measures, and there is little to or no accountability for non-compliance.

Also, the Department reported that wireless telecommunications was inadequate. The current wireless telecommunications program in some bureaus does not effectively support bureau and public safety operations, does not comply with Department management directives, and is not funded to achieve timely compliance. The Department will implement a plan to meet employee and public safety objectives, and restore the program to efficiency by reviewing bureau narrowband capital investment and implementation plans; revise plans to maximize radio system sharing, minimize supporting infrastructure requirements; and ensure maximum use of alternative wireless services by fiscal year 2005.

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4. Maintenance of Facilities

DOI owns, builds, purchases, and contracts services for assets such as visitor centers, schools, office buildings, roads, bridges, dams, irrigation systems, and reservoirs. These assets include some deteriorating facilities for which repair and maintenance have not been adequately funded. According to a GAO report (No. GAO-03-104) issued January 2003, entitled, "Major Management Challenges and Program Risks, Department of the Interior," DOI needs to more aggressively address the deferred maintenance backlog. The report stated that the repair and maintenance on these assets have been postponed for years due to budgetary constraints and that the deterioration of facilities can adversely impact public health and safety, reduce employees' morale and productivity, and increase the need for costly major repairs or early replacement of structures and equipment. In February 2002, the DOI estimated that the deferred maintenance backlog was between \$8.1 billion and \$11.4 billion. The maintenance needs for the National Park Service (NPS) and the Bureau of Indian Affairs (BIA) facilities alone account for over 85 percent of the DOI-wide deferred maintenance backlog.

In a December 2001 report (No. 2002-I-0008), OIG outlined a comprehensive approach to maintenance management within DOI. The report stated that DOI needs to implement a comprehensive maintenance management system to effectively plan, prioritize, conduct, and track the condition and maintenance of facilities within all bureaus, especially the NPS. Also, DOI needs to provide long-term leadership to keep money available to address the long-standing issues of deferred maintenance.

In fiscal year 2003, DOI reported that it lacked consistent, reliable, and complete information to plan for, budget, and account for resources dedicated to maintenance activities. The DOI planned to identify and implement a comprehensive maintenance management system with an appropriate linkage to the accounting system; conduct comprehensive condition assessments; make determinations to repair, replace, or relocate facilities; develop a five-year Deferred Maintenance Plan and Capital improvement Plan; repair, replace, and relocate facilities to "good condition," and reduce deferred maintenance to established goals by fiscal year 2005.

DOI has adopted a computer-based facilities maintenance management system, which it tested at multiple locations during fiscal year 2002, and has been assessing the condition of facilities, developing a 5-year maintenance plan, and establishing goals to reduce the deferred maintenance backlog. Also, DOI has established a Facilities Management Systems Partnership (FMSP) that provides a forum for the Department and its facilities-managing bureaus to coordinate the development and use of facilities management systems. While the FMSP has made demonstrable strides in developing a framework within which to address facilities management issues, maintenance in the Department remains a material weakness and an enormous challenge to be managed.

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5. Responsibility to Indians and Insular Areas

According to GAO report (No. GAO-03-104) issued January 2003, entitled, "Major Management Challenges and Program Risks, Department of the Interior" DOI needs to address persistent management problems in programs for Indians and island communities. DOI is responsible for administering the Federal government's trust responsibilities to Indian tribes and individual Indians, and provides more than $750 million annually for basic tribal services, such as social services, tribal courts, and natural resource management. Over the years, the GAO and OIG have reported on DOI's poor management of Indian trust funds and programs. Despite DOI's efforts, inadequate accounting and information systems and internal controls, as well as other weaknesses prevent DOI from ensuring that the funds are properly managed. In addition, DOI has various responsibilities to seven island communities - four U.S. territories and three sovereign island nations. The Insular Area governments have serious long-standing financial and program management deficiencies.

Indian Affairs

In fiscal 2003, the independent certified public accounting firm of KPMG LLP, under contract with the Office of Special Trustee for American Indians (OST), rendered qualified opinions on OST's fiscal year 2001 financial statements for Tribal and Other Trust Funds and Individual Indian Monies Trust Funds. KPMG qualified its opinions because cash balances in the financial statements were materially greater than balances reported by the U.S. Treasury. In addition, inadequacies in certain DOI accounting systems made it impractical to extend auditing procedures to satisfy auditors regarding the fairness of Trust Fund balances. Finally, certain parties for whom the Office of Trust Funds Management (OTFM) holds monetary assets in trust do not agree with the balances recorded by the OTFM and have filed or are expected to file claims against the U.S. Government.

DOI reported for fiscal year 2003, that OST's conversion to a commercial trust fund accounting system and the implementation of enhanced OST management controls will help ensure that all collected trust funds are properly accounted for. Major efforts remaining to be accomplished include: (1) completing an historical accounting of individual Indian money accounts; and (2) ensuring that BIA ownership and distribution information is correct. Also, DOI reported in fiscal year 2003 that long standing deficiencies in the records management program have made it difficult to ensure the maintenance and preservation of Indian Trust records. An updated work plan with strategies, tasks, timelines and resource requirements has been developed by the Office of Trust Records. According to DOI, the implementation of this work plan will resolve many of the identified deficiencies and establish an active and comprehensive records management program for BIA and OST.

The majority of funds provided for tribal services are administered by Indian tribes under Indian Self-Determination Act contracts, grants, and compacts from BIA. According to the Act, the principal reporting requirement for tribes and the major monitoring tool for

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BIA is the single audit report. The single audits present information on tribes' compliance with funding agreements and controls over Federal funds. OIG quality control reviews of single audit reports revealed that about 70 tribes were delinquent in submitting their reports for fiscal year 2001.

Insular Affairs

Insular Area governments generally lack the standard business practices essential to financial accountability. Most of our audits have identified serious administrative and accounting deficiencies, including property management practices that were not sufficient to satisfactorily account for and safeguard equipment purchased with grant funds; improper procurement practices that allowed purchases without competition; poor records management; inadequate accounting practices that resulted in questioned costs, incorrect grant balances, and unreconciled records; and poor reporting practices to OIA that unnecessarily delayed projects. A February OIG audit (No. 2003-I-0011) on the status of prior audit findings and recommendations pertaining to Insular Areas underscores a fundamental dilemma faced by DOI in correcting serious deficiencies. While the OIG is authorized to audit all revenues and expenditures of Insular Area governments, the DOI does not have authority to enforce audit findings and recommendations for funds provided by other Federal departments or for funds provided by the DOI that have Federally imposed entitlement conditions. While, the Office of Insular Affairs (OIA) has taken steps to strengthen controls over its grants, OIG's follow-up audit highlighted the necessity of continuing to urge other Federal agencies providing funds to the Insular Areas to become more involved in monitoring these funds and ensuring their proper use.

As with Indian programs, one of the major tools available for monitoring the use of Federal funding by Insular Areas is the single audit report. OIG has noted, however, that many Insular areas are delinquent in submitting reports and the reports which have been submitted disclosed serious financial management deficiencies. For example, the single audit report on the U.S. Virgin Islands for fiscal year 2001, the most recent completed report, documented 61 reportable conditions pertaining to Federal programs of which 39 were classified as material weaknesses.

On the positive side, OIG's Insular Area field liaison for the Pacific, appointed in July 2002, reported progress in several areas: (1) building the capacity of local Offices of Public Auditor in Pacific areas to audit local funds, (2) working with OIA to look at the adequacy of Insular Area government systems and controls that account for grant monies, and (3) closing out unresolved audit recommendations. We hope that this concerted effort will help remedy the general lack of meaningful action by Pacific Insular Area governments to address past audit recommendations.

6. Resource Protection and Restoration

DOI resource managers face the challenge of balancing the competing interests for use of the nation's natural resources. Major contributors to the challenge of effective resource

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management include increased population, environmental issues, shortages of resources such as water, oil and gas, and demands for more recreational areas. DOI faces challenges in implementing policy goals for repairing and maintaining ecosystems within budget limitations. Of special concern are wildfires, water allocations, a changing land and recreation base, and invasive (non-native) species. Federal lands account for 30 to 35 percent of energy produced in the United States. The primary challenge is developing energy resources while protecting natural resources, including endangered plant and animal species.

A GAO report (No. GAO-03-104) issued January 2003, entitled, "Major Management Challenges and Program Risks, Department of the Interior," stated that over the years, the OIG and GAO have determined that the land exchanges completed by the Bureau of Land Management (BLM) to date have not ensured that the lands being exchanged were appropriately valued or protected the public interest. In exchanging lands, Federal agencies are required under the Federal Land Policy and Management Act of 1976 to determine that the exchange serves the public interest. In addition, the law requires that the lands exchanged be of equal value, or equalized by a payment of money

To address long-standing concerns about the valuation of exchanged lands and the management of appraisal functions, as documented for several decades in reports issued by OIG, GAO and, most recently, by the Appraisal Foundation, the Secretary announced that the appraisal function performed by BLM, the Fish and Wildlife Service (FWS), NPS, and the Bureau of Reclamation will be consolidated within a newly-formed Departmental office. DOI's new appraisal organization is intended to ensure greater appraiser independence, thereby enabling DOI to provide unbiased valuation services that meet recognized professional standards.

According to a GAO report (No. GAO-03-104) issued in January 2003, entitled, "Major Management Challenges and Program Risks, Department of the Interior," DOI needs to Improve Management of Ecosystem Restoration Efforts. To achieve its Departmentwide mandate for protecting and preserving the natural resources under its management, DOI has developed long-term goals of restoring the health of public lands and maintaining ecosystems. To accomplish these goals, the Department will need to restore significant national ecosystems to health by addressing the growing wildland fire threat to communities and resources caused by the excessive buildup of fuels in forested ecosystems, such as those located in the interior Western states; restoring the South Florida ecosystem, which includes the Everglades; and controlling and eradicating invasive nonnative species.

7. Revenue Collections

DOI is a large, decentralized agency with over 70,000 employees and 200,000 volunteers located at approximately 2,400 operating locations across the United States, Puerto Rico, U.S. territories, and freely associated states. DOI raises more than $8.3 billion in revenues collected from oil and gas and mineral leasing, grazing, timber sales, recreation fees, land sales, and mining fees.

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The highest revenue collector in DOI is by far the Minerals Management Service (MMS) which annually collects more than $6 billion in mineral revenues from more than 84,260 onshore and offshore Federal leases. Since 1982, the MMS' Minerals Revenue Management Program (MRMP) has collected and distributed approximately $127 billion to Federal, state and Indian accounts.

The MMS also conducts a comprehensive compliance effort to ensure that royalty payments from lessees are on time and accurate. Historically, both OIG and MMS have identified significant mineral revenue underpayments from lessees. Between 1982 and 2002, MMS compliance activities have resulted in $2.5 billion of additional collections. During fiscal year 2002, MRMP continued the implementation and refinement of a new system infrastructure to support its comprehensive reengineered business process to meet the challenge of accomplishing its responsibilities and to maintain a high level of efficiency.

A March 2003 OIG report (No. 2003-I-0023) concluded that MMS' systems and safeguards over its audit procedures are insufficient, and that some of its audit work did not meet Government Auditing Standards. MMS audits represent a significant portion of its efforts to detect and deter royalty underpayments. Also, investigations conducted by OIG with MMS assistance continue to uncover multi-million dollar royalty underpayments. One investigation resulted in a $49 million settlement agreement in 2003 with a major oil company for failure to pay royalties on natural gas production from offshore leases. Another investigation uncovered a scheme in which a lessee conspired with another company to underpay royalties on natural gas produced from Federal leases. In this case, the lessee accepted substantially less than it was entitled to for gas sales resulting in underpayments to MMS of about $7 million. Because of the amount of collections and the significant potential for underpayments, OIG believes that revenue collections should continue as a management challenge for the Department.

8. Procurement, Contracts and Grants

DOI spends substantial resources each year in contracting for goods and services and in providing Federal assistance to states and Indian organizations. Procurement has historically been an area subject to fraud and waste government-wide, and managing procurement activities is an unending challenge requiring constant attention. DOI has reported on the material inadequacy of BIA's acquisition management organization, policies, procedures, and guidelines since fiscal year 1991. OIG has also reported (No. 2002-I-0011) on a lack of management supervision by the bureaus and offices of the Department over purchases made with credit cards. More recently, OIG reported (No. 2003-I-0009) on poor business decisions by the former park superintendent and contracting officer in the administration of a contract for construction at the Bryce Canyon Visitor Center led to excessive costs, as follows: (1) NPS selected a fixed unit-price contract that did not provide incentive to the contractor for cost control or labor efficiency; (2) NPS did not sufficiently monitor the contract (3) NPS used rough estimates of quantities and materials to prepare the bid schedule. As a result, contract specifications were inaccurate, and, after contract award, NPS had to increase 60 line items and add 45 new line items for changes and additions to the project. Consequently, project costs increased almost a million dollars, from $3.9 to $4.8 million (24 percent). The excessive contract costs contributed to deficit balances in the park's recreation fee demonstration account in fiscal years 2000 and 2001.

Furthermore, OIG reviews of FWS Sportfish and Wildlife Restoration program grants, totaling about $504 million for 14 states and two territories, identified questioned costs and other significant issues, as follows: (1) ten states and the two territories claimed $4.9 million that was ineligible for reimbursement, (2) five states did not offset grant costs of $823,000 with revenues earned from commercial activities on lands purchased or managed with grant funds, (3) five states did not return a total of $2.6 million of interest earned on hunting and fishing license revenues to their fish and wildlife programs, (4) five states diverted over $5 million of revenue from the sale of state hunting and fishing licenses for purposes other than administering their fish and wildlife programs. Based on our reports, FWS is working with the states and territories to resolve these matters.