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Independent Auditors' Report

Commissioner of the U.S. Bureau of Reclamation and Inspector General of the U.S. Department of the Interior:

We have audited the accompanying consolidated balance sheets of the U.S. Bureau of Reclamation (Reclamation) as of September 30, 2004 and 2003, and the related consolidated statements of net cost, consolidated statements of changes in net position, combined statements of budgetary resources, and consolidated statements of financing for the years then ended (hereinafter referred to as the 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 Reclamation's internal control over financial reporting and tested Reclamation's compliance with certain provisions of applicable laws, regulations, and contracts 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 the U.S. Bureau of Reclamation's financial statements as of and for the years ended September 30, 2004 and 2003, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1B to the financial statements, Reclamations' fiscal year 2004 consolidated statement of net cost is not comparable to the fiscal year 2003 consolidated statement of net cost because, in fiscal year 2004, Reclamation revised the presentation of costs and revenues to match the Government Performance and Results Act strategic plan applicable to fiscal year 2004, which is different than the plan applicable to fiscal year 2003.

Our consideration of internal control over financial reporting identified the following reportable conditions:

Reportable Condition that is Considered to be a Material Weakness

- A. Controls over land inventory

Other Reportable Conditions

- B. Controls over revenue recognition

The results of our tests of compliance with certain provisions of laws, regulations, and contracts exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards*, issued by the Comptroller General of the United States, or Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

The results of our tests of FFMIA disclosed an instance where Reclamation's financial management systems did not substantially comply with Federal accounting standards.

C. Federal Financial Management Improvement Act of 1996 (FFMIA)

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

Opinion on the Financial Statements

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

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

As discussed in Note 1B to the financial statements, Reclamations' fiscal year 2004 consolidated statement of net cost is not comparable to the fiscal year 2003 consolidated statement of net cost because, in fiscal year 2004, Reclamation revised the presentation of costs and revenues to match the Government Performance and Results Act strategic plan applicable to fiscal year 2004, which is different than the plan applicable to fiscal year 2003.

The information in the Management's Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information sections (Supplemental Section) 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 information. However, we did not audit this information and, accordingly, we express no opinion on it.

Internal Control Over Financial Reporting

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect Reclamation'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 2004 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 condition A is a material weakness.

A. *Controls Over Land Inventory*

Reclamation did not have a complete and accurate inventory system to support the \$1.9 billion of land and land rights reported in the financial statements as a component of general property, plant, and equipment. The weakness occurred because Reclamation had not established adequate procedures for maintaining an accurate inventory of land and land rights and for reconciling its subsidiary records with its financial accounting system. Reclamation's financial accounting system for land and land rights costs is detailed in a cost summary report that had not been fully reconciled with subsidiary records, including individual project plat book maps, which contain data from individual land purchase contracts.

In response to the fiscal year 2000 consolidated financial statement audit finding, Reclamation recognized the need for supporting records and initiated a five-year action plan to develop a complete and accurate land inventory that supported the financial accounting system, issued guidelines and procedures for reconciling land records, and developed a schedule for completing the reconciliation within the five-year plan period. During fiscal year 2003 and 2004, Reclamation performed oversight reviews at each of the regional offices on the progress of the reconciliation project. As of September 30, 2004, Reclamation believes that it will complete the plan within the five-year plan period. Despite these efforts, we noted several land disposals that had been completed, but not recorded timely in Reclamation's accounting system.

Recommendations

We recommend that the Commissioner, U.S. Bureau of Reclamation:

1. Continue to complete the reconciliation of the financial accounting system support for land and land rights costs with the subsidiary records, including individual project plat book maps, which contain data from individual land purchase contracts.
2. Continue to include a material land inventory system internal control weakness in Reclamation's Federal Managers' Financial Integrity Act (FMFIA) report to the U.S. Department of the Interior until resolved.
3. Properly implement existing policies and procedures to ensure land deletions are recorded properly in Reclamation's financial accounting system. This includes improved coordination between Reclamation's realty office and finance.

Management Response

Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with the recommendations to continue the reconciliation of the financial accounting system support for land and agreed to properly implement existing policies and procedures to ensure land deletions are recorded properly in Reclamation's financial accounting system. Management did not agree with our recommendation to continue to include a material land inventory system internal control weakness in Reclamation's FMFIA report to the U.S. Department of the Interior. Management indicated it has reconciled 93% of projects and 98% of land costs in the Foundation Information for Real Property Management System (FIRM) to the Federal Financial System (FFS) and the remaining outstanding balance does not meet the definition of a material weakness.

Auditors' Response to Management's Response

FMFIA requires management to provide timely and accurate financial statements. The portion of land and land rights costs not reconciled is significant and this situation does not provide an adequate control environment for management to provide timely and accurate financial statements.

B. Controls Over Revenue Recognition

Reclamation did not have sufficient internal controls to ensure that the general ledger account for revenue was complete and accurate. During our audit, we noted that Reclamation made entries in fiscal year 2004 for \$24.2 million of revenue related to cost share, construction reimbursement, land sales, and revenue transfers that should have been made for fiscal year 2003. These errors are a result of insufficient regional quality control reviews and management oversight.

Also, during our audit, we noted that Reclamation did not have sufficient internal controls to ensure that transfers of facilities to state and local authorities were properly classified. We noted that Reclamation made entries in fiscal year 2004 for \$31.5 million of losses on disposition of assets. Reclamation incorrectly recorded the entire amount of proceeds received as either gain or revenue and the entire net book value as a loss rather than offsetting the loss by the proceeds received as required by Federal accounting standards. However, since gains and losses were netted in Reclamation's Statement of Net Cost and reported under expenses there was no impact on the Statement of Net Cost. In addition, we believe that Reclamation should have reported the net loss on the transfers as an investment in non-Federal physical property.

Recommendations

We recommend that the Commissioner, U.S. Bureau of Reclamation:

1. Establish and implement sufficient internal controls, including regional quality control reviews and management oversight, to ensure that the revenue recognition entries are complete and accurate.
2. Establish and implement controls, including policies and procedures, to ensure transfers of facilities are properly accounted for in accordance with accounting principles generally accepted in the United States of America.

Management Response

Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with the recommendation to establish and implement controls, including regional quality control reviews and management oversight to ensure that revenue recognition entries are complete and accurate. Management did not agree with our recommendation to establish and implement controls to ensure transfers of facilities are properly accounted for in accordance with generally accepted accounting principles. Management indicated its procedures for transferring facilities are in accordance with Statement of Federal Financial Accounting Standards (SFFAS) No. 6 and SFFAS No. 8, and therefore, are in accordance with generally accepted accounting principles.

Auditors' Response to Management's Response

The key focus of this finding is management's process for recording the gain or loss on facility transfers. SFFAS No. 6 stipulates the gain or loss to be recorded on the sale or disposal of general property, plant, and equipment should equal the proceeds received less the associated net book value. Reclamation's process records a loss for the net book value amount and a gain for the proceeds received, rather than netting the gain and loss. As a result, the transactions are not properly reflected in the gain and loss standard general ledger account balances.

Secondary to our primary recommendation, the finding addresses Reclamation's overall accounting policy for facility transfers. SFFAS No. 8, paragraph 12, states, "Stewardship investments' are substantial investments made by the Federal Government for the benefit of the nation. When incurred, they are treated as expenses in determining the net cost of operations. However, these items

merit special treatment so that readers of Government financial reports know the extent of these investments that are made for long-term benefit.” This literature suggests that the appropriate accounting treatment for facility transfers to state and local governments may be to record the associated gain or loss as an investment in non-Federal physical property. Our recommendation specific to this matter is that management should seek additional authoritative guidance regarding facility transfers in relation to non-Federal physical property.

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 Reclamation in a separate letter dated November 12, 2004.

Compliance and Other Matters

The results of our tests of compliance with certain provisions of laws, regulations, and contracts as described in the Responsibilities section of this report, exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996 (FFMIA)*, disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02.

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

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

Federal Accounting Standards

Reclamation is required to prepare its consolidated financial statements in accordance with Federal accounting standards. As discussed in reportable condition A above, we identified a material weakness that affected Reclamation’s ability to prepare its consolidated financial statements and related disclosures in accordance with federal accounting standards. Specifically, we determined that Reclamation needs improved controls over its land inventory.

Recommendation

Our recommendations are addressed in the reportable condition A, controls over land inventory, discussed in the Internal Control Over Financial Reporting section of our report.

Management Response

Management has prepared an official response presented as a separate attachment to this report. In summary, management did not agree with the determination to include a finding of non-compliance with FFMIA in relation to the material weakness on controls over land inventory. Management indicated that the land inventory material weakness has not significantly affected its ability to prepare financial statements and related disclosures that are consistent with Federal accounting standards.

Auditors’ Response to Management’s Response

FFMIA requires management to provide timely and accurate consolidated financial statements. The portion of land and land rights costs not reconciled is significant and this situation does not provide an adequate control environment for management to provide timely and accurate consolidated financial statements.

Responsibilities

Management's Responsibilities

The *Government Management Reform Act of 1994* (GMRA) requires each Chief Financial Officer (CFO) Act agency to report annually to Congress on its financial status and any other information needed to fairly present its financial position and results of operations. To assist the Department of the Interior in meeting the GMRA reporting requirements, Reclamation 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;
- Complying with laws, regulations, and contracts including FFMIA.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements, due to error or fraud may nevertheless occur and not be detected.

Auditors' Responsibilities

Our responsibility is to express an opinion on the fiscal year 2004 and 2003 financial statements of Reclamation 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;
- Evaluating the overall financial statement presentation.

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

In planning and performing our fiscal year 2004 audit, we considered Reclamation's internal control over financial reporting by obtaining an understanding of Reclamation's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards* and OMB Bulletin No. 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and may not be detected. Also projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate. In addition, our internal control testing may not be sufficient for other purposes. 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 Reclamation's internal control over Required Supplementary Stewardship Information by obtaining an understanding of Reclamation'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 section, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal control over performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether Reclamation's fiscal year 2004 financial statements are free of material misstatement, we performed tests of Reclamation's compliance with certain provisions of laws, regulations, and contracts 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, regulations, and contracts applicable to Reclamation. Accordingly, noncompliance may occur and not be detected by these tests and such testing may not be sufficient for other purposes. Providing an opinion on compliance with laws, regulations, and contracts 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 Reclamation'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 Reclamation's and the U.S. Department of the Interior's management, the U.S. Department of the Interior's Office of Inspector General, the Government Accountability Office, OMB, and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 12, 2004

BUREAU OF RECLAMATION

Summary of the Status of Prior Reportable Conditions

September 30, 2004

Ref	Condition	Status
A	Controls over land inventory.	This condition has not been corrected and is repeated in fiscal year 2004. See finding A.
B	Application and general controls over financial management systems.	This condition has been downgraded from a reportable condition to a management letter comment. Management letter comments are reported in a separate letter to management dated November 12, 2004.
C	Controls over construction-in-progress and structures and facilities accounts.	This condition has been downgraded from a reportable condition to a management letter comment. Management letter comments are reported in a separate letter to management dated November 12, 2004.
D	Controls over accrued liabilities.	This condition has been corrected.
E	Controls over revenue recognition on prepayment of repayment contracts.	This condition has been corrected. However, a separate revenue recognition condition was noted in FY 2004. See finding B.
F	Controls over accounting for intradepartmental transactions.	This condition has been corrected.
G	Federal Financial Management Improvement Act of 1996 (FFMIA).	This condition has not been corrected and is repeated in fiscal year 2004. See finding A.