



United States Department of the Interior

Office of Inspector General
Washington, D.C. 20240

April 10, 2002

Memorandum

To: Assistant Secretary for Policy, Management and Budget

From: Roger La Rouche
Assistant Inspector General for Audits

Subject: Independent Auditors' Report on the Interior Franchise Fund's Financial Statements for Fiscal Years 2001 and 2000 (No. 2002-I-0030)

KPMG LLP, an independent certified public accounting firm, audited the Interior Franchise Fund's (IFF) financial statements as of September 30, 2001 and for the year then ended. The contract required that KPMG conduct its audit in accordance with the *Government Auditing Standards* issued by the Comptroller General of the United States of America, Office of Management and Budget Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, and the General Accounting Office/President's Council on Integrity and Efficiency *Financial Audit Manual*.

In connection with the contract, we monitored the progress of the audit at key points and reviewed KPMG's report and related working papers and inquired of their representatives. Our review, as differentiated from an audit in accordance with *Government Auditing Standards*, was not intended to enable us to express, and we do not express, opinions on the IFF financial statements or on conclusions about the effectiveness of internal controls or on conclusions about compliance with laws and regulations. KPMG is responsible for the auditors' report (Attached) and for the conclusions expressed in the report. However, our review disclosed no instances where KPMG did not comply in all material respects with *Government Auditing Standards*.

In its audit report dated February 5, 2002, KPMG issued an unqualified opinion on the IFF's financial statements for fiscal year 2001. The balance sheet of IFF as of September 30, 2000, was audited by other auditors whose report dated January 19, 2001, expressed an unqualified opinion on the balance sheet, before the restatement described in Note 9 to the 2001 financial statements. KPMG audited the adjustments described in Note 9 that were applied to restate the September 30, 2000, balance sheet and the beginning balance on the statement of budgetary resources. In KPMG's opinion, such adjustments were appropriate and had been properly applied. The statement of net cost for the year ended September 30, 2000, was not audited.

KPMG found eight internal control weaknesses related to financial reporting five of which are considered material weaknesses. With regard to compliance with laws and regulations, KPMG found IFF to be noncompliant with portions of the *Federal Financial Management Improvement Act*. Specifically, IFF's financial management systems did not meet Federal financial management systems requirements and the IFF did not comply with federal accounting standards. In addition, KPMG found that the IFF was not in compliance with Section 113 of Public Law 104-208 concerning advances.

IFF concurred with all 11 recommendations and indicated corrective action would be taken. Based on IFF's response, we consider all 11 recommendations resolved but not implemented. The recommendations will be referred to the Assistant Secretary for Policy, Management and Budget for resolution and tracking of implementation.

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

The Independent Auditor's Report is intended for the information of the management of IFF, the Office of Management and Budget, and the U.S. Congress. The report, however, is a matter of public record, and its distribution is not limited.

Attachment



2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

Executive Board of the Interior Franchise
Fund and Inspector General
U.S. Department of the Interior

We have audited the accompanying balance sheet of the Interior Franchise Fund (IFF) as of September 30, 2001, and the related statement of net cost, statement of changes in net position, statement of budgetary resources and statement of financing, (herein after referred to as the financial statements) for the year then ended. The objective of our audit was to express an opinion on the fair presentation of these financial statements. In connection with our audit, we also considered IFF's internal control over financial reporting and tested IFF's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its financial statements.

The balance sheet of IFF as of September 30, 2000, was audited by other auditors whose report dated January 19, 2001, expressed an unqualified opinion on the balance sheet, before the restatement described in Note 9 to the financial statements. The statement of net cost for the year ended September 30, 2000 has not been audited.

Summary

As stated in our opinion on the financial statements, we concluded that IFF's financial statements as of and for the year ended September 30, 2001, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our consideration of internal control over financial reporting resulted in identifying the following reportable conditions:

Reportable Conditions That Are Considered to be Material Weaknesses

- A. Establish Procedures and Controls to Record Obligations
- B. Re-Design the Process for Recording Minerals Management Service (MMS) Activity
- C. Improve Controls over Accruals
- D. Improve Timeliness of Transaction Entry and Reconciliation
- E. Improve Organizational Structure

Other Reportable Conditions

- F. Improve Application and General Controls over Financial Management Systems
- G. Document Policies and Procedures for Certain Areas
- H. Review and Investigate Old and Negative Account Balances

The results of our tests of compliance with certain provisions of laws and regulations, exclusive of those referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996, disclosed an instance of noncompliance with the following laws and regulations that is required to be reported under *Government Auditing Standards* issued by the Comptroller General of the United States and OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*:

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

In addition, our tests of compliance with FFMIA section 803(a) requirements disclosed instances where IFF's financial management systems did not substantially comply with federal financial management systems requirements and the federal accounting standards.

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

Opinion on the Financial Statements

We have audited the accompanying balance sheet of IFF as of September 30, 2001, and the related statement of net cost, statement of changes in net position, statement of budgetary resources and statement of financing, for the year then ended. The balance sheet of IFF as of September 30, 2000, was audited by other auditors whose report dated January 19, 2001, expressed an unqualified opinion on the balance sheet, before the restatement described in Note 9 to the financial statements. The statement of net cost for the year ended September 30, 2000 has not been audited.

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of IFF as of September 30, 2001, and its net cost of operations, changes in net position, budgetary resources, and reconciliation of net cost of operations to budgetary obligations for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

We also audited the adjustments described in Note 9 that were applied to restate the September 30, 2000 balance sheet and the September 30, 2000 balances on the fiscal year 2001 statement of budgetary resources. In our opinion, such adjustments are appropriate and have been properly applied.

The information in the Management Discussion's and Analysis and Required Supplementary Information sections are not a required part of the financial statements, but is supplementary information required by the Federal Accounting Standards Advisory Board or Office of Management and Budget Bulletin No. 97-01, *Form and Content of Agency Financial Statements*, as amended. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The Other Supplementary Information section is presented for purposes of additional analysis of the financial statements and is not a required part of the financial statements. Such additional information has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on it.

IFF prepared the accompanying financial statements assuming that IFF will continue as a going concern. As discussed in Note 6 to the financial statements, the expiration of IFF's authorizing legislation on October 1, 2002 creates an uncertainty about IFF's ability to continue as a going concern. Management plans regarding this matter are also described in Note 6. The financial statements do not include any adjustments that might be necessary if IFF does not continue as a going concern.

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 IFF'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. Because of inherent limitations in internal control, misstatements, due to error or fraud may nevertheless occur and not be detected.

We noted certain matters involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that reportable conditions A through E are material weaknesses:

A. Establish Procedures and Controls to Record Obligations

IFF has not fully implemented internal controls and procedures to ensure that IFF records obligations when they are incurred. IFF's current process is to record obligations when payments are made to the service providers. As we determined that obligations are incurred prior to when IFF pays the service providers, IFF completed an analysis of obligations that resulted in restating prior years undelivered order balance by approximately \$60 million and adjusting the current year undelivered order balances by approximately \$150 million.

Recommendation

We recommend that IFF establish procedures and controls to record obligations when they are incurred instead of when they are paid. As part of this process, IFF should establish formal interagency agreements with each service provider that should serve as the basis for recording obligations.

Management Response

IFF concurs. IFF and its service providers will work together to establish workable and cost effective procedures and controls to record obligations on the IFF books. The KPMG recommended approach, i.e. establish formal interagency agreements with the Service Providers, is already in place between the IFF and the National Business Center (NBC) and thus will be used as the basis for recording obligations to NBC. The same approach will be considered, among other options, as the basis for implementing the recording of obligations between IFF and MMS.

B. Re-Design the Process for Recording MMS Activity

The process for recording activity related to MMS is a manual process that needs to be improved. The process begins with MMS recording transactions into their accounting system (i.e., ABACIS) at the purchase order level. MMS manually extracts information from ABACIS into a billing spreadsheet that MMS sends to IFF. IFF uses the billing spreadsheet to record activity into their accounting system (i.e., Federal Financial System).

In addition, the process for recording activity related to MMS does not enable IFF to efficiently reconcile the individual agreement balances. MMS records activity at the purchase order level in ABACIS, reports the purchase order level information on the billing spreadsheet, and adds the related agreement numbers to the billing spreadsheet. IFF records the activity at the agreement level in its accounting system.

As the billing spreadsheet contains historical activity and has numerous lines, both MMS and IFF expend a significant amount of time reviewing and reconciling the spreadsheet to their accounting systems.

Recommendation

IFF has started a process to redesign the procedures for recording the MMS activity. For example, IFF is in the process of evaluating the cost/benefit of an automated interface between the ABACIS and FFS accounting systems. We recommend that IFF complete its process to redesign the procedures and controls for recording the MMS activity. This revised process should include controls to ensure that transactions are properly extracted from ABACIS and entered into FFS.

Management Response

IFF concurs that procedures and controls for recording transactions initiated by Minerals Management Service need improvement. IFF will work with MMS to make needed improvements to ensure all expense transactions are recorded accurately by reimbursable agreement in the IFF accounting system.

C. Improve Controls over Accruals

IFF has not fully implemented internal controls and procedures to ensure that liabilities are accrued for goods and services received prior to the end of the reporting period. Specifically we identified several instances where the accrued liability balance was understated. As a result, IFF worked with its service providers to analyze the accrued liability balances and adjust the balances, appropriately.

Recommendation

We recommend that IFF work with its service providers to establish procedures and controls to ensure that accruals are recorded for services and products received prior to the end of the reporting period. These procedures and internal controls should be completed each quarter, as the Department of the Interior will be required to prepare and submit semi-annual financial statements in fiscal year 2002 and quarterly financial statements in fiscal year 2003.

Management Response

IFF concurs. IFF will work with its service providers to establish procedures and controls to ensure that revenue and expense accruals are recorded on both IFF's and the service provider's books prior to the end of each quarter and more frequently if necessary. Additional attention will be directed towards procedures for synchronizing the accruals and timely reconciliation of differences.

D. Improve Timeliness of Transaction Entry and Reconciliation

IFF does not consistently record financial transactions and reconcile the financial accounts in a timely manner. For example, we noted that IFF did not record June transactions until the second week in July and that IFF recorded numerous transactions after the end of the fiscal year. We also noted that IFF did not reconcile its balances and related activity with its service providers (i.e. Minerals Management Service and National Business Center) periodically during the fiscal year. Instead, after the end of the fiscal year, IFF began the process to reconcile their balances and activity with the balances and activity reported by the service providers. At the end of December, IFF and the service providers were unable to fully reconcile these balances. After incurring a significant amount of time and resources, the balances and activity were ultimately reconciled to within an insignificant amount.

Recommendation

We recommend that IFF record the financial transactions on a daily basis and reconcile all financial accounts on a monthly basis. We also recommend that IFF reconcile its balances and activities with the service providers' balances and activity on at least a quarterly basis. The reconciliation process should include resolving any differences identified in a timely manner.

Management Response

IFF management concurs with the recommendation and will develop procedures for recording transactions on a daily basis during the month and reconciling all accounts on a monthly basis, including prompt follow-up on any differences identified. See responses to B. and C. above.

E. Improve Organizational Structure

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

Recommendation

We understand that the IFF Executive Board and Department of the Interior management are in the process of evaluating the IFF organizational structure. We recommend that the IFF executive board and Department of the Interior management complete this evaluation process and adjust the organizational structure as appropriate.

Management Response

IFF concurs. As part of the effort to obtain permanent franchising authority within the Department of the Interior, the IFF Executive Board and Departmental management have jointly begun, but have not yet completed, a process of reviewing the organizational structure of the IFF to make it more efficient and effective, including reviewing authorities and responsibilities related to oversight and compliance.

We noted the following reportable conditions, which are not considered to be material weaknesses:

F. Improve Application and General Controls over Financial Management Systems

The Interior National Business Center (NBC) administers the IFF financial management systems including the Federal Financial System and Hyperion. Although NBC has recently improved the security and controls over these information systems, NBC needs to continue improvements in the areas of entity-wide security planning; configuration of the operating systems; system software controls; software development and change controls; and service continuity. Weaknesses in these control areas could affect IFF's ability to prevent and detect unauthorized changes to its financial information and increases the need for less efficient manual controls to monitor financial information.

Recommendation

We recommend that IFF annually obtain assurance similar to a SAS 70 type II report from NBC that adequate security and controls are in place over the financial management systems.

Management Response

IFF concurs. Beginning with FY 2003, IFF will annually request written assurance from the NBC that adequate security and controls are in place over the financial management systems. If such assurances are not forthcoming, IFF will explore alternative methods for preventing and detecting unauthorized changes in its financial information.

G. Document Policies and Procedures for Certain Areas

Documentation of the procedures and internal controls to record transactions is an integral component of an effective internal control system. The IFF has not fully documented procedures and internal controls for recording and monitoring accounting transactions and preparing financial statements. As a result, IFF may not record financial transactions consistently and may not perform the related internal controls and procedures effectively. In addition, IFF may not record transactions efficiently, especially if there is a change in personnel performing the procedures and internal controls.

Recommendation

We recommend that IFF develop and implement procedures and internal controls for recording financial transactions and preparing financial statements as indicated in the OMB Circular A-123, section II, *Establishing Management Controls* and GAO's publication GAO/AIMD-00-21.3.1, *Standards for Internal Control in the Federal Government*. We also recommend that IFF communicate these procedures and internal controls through training.

Management Response

IFF concurs. IFF can benefit from additional policies and procedures for recording and monitoring revenues, expenses, fund balance with Treasury, accounts receivable, advances from others, and accounts payable. Such policies and procedures are necessary to increase consistency in accounting operations treatment, improve data quality and controls, and provide the basis for on-going employee training. IFF will consider OMB Circular A-123, section II, *Establishing Management Controls* and GAO's publication GAO/AIMD-00-21.3.1 *Standards for Internal Control in the Federal Government* during this development process.

H. Review and Investigate Old and Negative Account Balances

IFF does not consistently review and resolve older accounts receivable and payable balances. Specifically we identified several older accounts receivable and payable balances and several negative account balances. As a result, IFF investigated the older and negative accounts receivable and payable balances and adjusted the balances, appropriately.

Recommendation

We recommend that IFF design formal system generated accounts receivable and payable aging reports and review these reports on a monthly basis. IFF should investigate and resolve any accounts receivable and payable balances that are negative or over 6 months old.

Management Response

IFF concurs. IFF will develop monthly accounts receivable and accounts payable aging reports and establish procedures (see G. above) for reviewing and following up on accounts that are negative or over 6 months old.

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 IFF in a separate letter dated February 5, 2002.

Compliance with Laws and Regulations

The results of our tests of compliance with certain provisions of laws and regulations, as described in the Responsibilities section of this report, exclusive of the FFMIA of 1996, disclosed an instance of noncompliance with the following laws and regulations that is required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*:

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

In accordance with section 113 of Public Law 104-208, IFF is required to obtain advances from customers before costs are incurred to provide goods or services to the customer. We determined that IFF does not consistently obtain advances from customers as IFF reported accounts receivable of approximately \$15.8 million as of September 30, 2001.

Recommendation

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

Management Response

Department of the Interior developed appropriation language supporting the Interior Franchise Fund under the Government Management Reform Act establishing the franchise fund pilot program following the Office of Management and Budget guidelines. The intent of the pilot program was to allow these pilot programs to provide quality service at reduced costs to federal agencies through competition. IFF does not believe that the recommended appropriation language was intended to require advances for all services but was intended to allow the pilot program to receive advances so that the organizations could operate in a more business like manner. However, IFF can see how the existing language could be interpreted as described above. Interior will work with the Office of Management and Budget and Congress to adjust the appropriation to support the intent of the stated Government Management Reform Act objectives.

The results of our tests of compliance with other laws and regulations, exclusive of FFMIA, disclosed no other 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 section 803(a) requirements disclosed instances, described below, where IFF financial management systems did not substantially comply with the federal financial management systems requirements and the federal accounting standards.

J. Provide Adequate Application and General Controls over Financial Management Systems

As discussed in the section of our report entitled “Internal Control over Financial Reporting,” IFF needs to work with NBC to improve the EDP security and general control environment. As a result, IFF does not substantially comply with the security and general EDP control requirements of OMB Circular A-130, *Management of Federal Information Resources*.

Recommendation

We recommend that IFF take the necessary actions to improve the security and general controls over its financial management systems in accordance with requirements set forth in OMB Circular A-130 in fiscal year 2002.

Management Response

IFF concurs. See response to F. above.

K. Federal Accounting Standards

IFF is required to prepare its financial statements in accordance with Federal accounting standards. As discussed in the section of our report entitled “Internal Control over Financial Reporting,” we identified material weaknesses that affected IFF’s ability to prepare its financial statements and related disclosures in accordance with federal accounting standards. Specifically, we determined that IFF needs to re-design its process for recording MMS activity, improve controls over obligations and accruals, and improve timeliness of transaction entry and reconciliation.

Recommendation

We recommend that during fiscal year 2002, IFF strengthen its procedures and internal controls that ensure the financial statements and related disclosures are prepared in accordance with the Federal accounting standards.

Management Response

IFF concurs. See response to B. above.

The results of our tests of FFMIA section 803(a) requirements disclosed no instances in which the IFF management did not substantially comply with the United States Government Standard General Ledger at the transaction level requirement.

Responsibilities

Management's Responsibilities

The Government Management Reform Act (GMRA) of 1994 requires a 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, the IFF prepares annual financial statements.

Management is responsible for:

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

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

Auditors' Responsibilities

Our responsibility is to express an opinion on the fiscal year 2001 financial statements of the IFF based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and OMB Bulletin No. 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 audit provides a reasonable basis for our opinion.

In planning and performing our fiscal year 2001 audit, we considered IFF's internal control over financial reporting by obtaining an understanding of IFF'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 controls over financial reporting. Consequently, we do not provide an opinion on internal control over financial reporting.

As 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 on such controls.

As part of obtaining reasonable assurance about whether IFF's fiscal year 2001 financial statements are free of material misstatement, we performed tests of IFF'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 IFF. Providing an opinion on compliance with laws and regulations was not an objective of our audit, and, accordingly, we do not express such an opinion.

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

Distribution

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

KPMG LLP

February 5, 2002

**Interior Franchise Fund
Summary of the Status of Prior Year Reportable Conditions
September 30, 2001**

REF	Condition Area	Status
1.	Improve financial reporting and related controls:	
	a. Improve monitoring of service provider relationships.	This condition has not been fully corrected and is repeated in conditions B and D above.
	b. Improve controls over payments to service providers.	This condition has not been fully corrected and is repeated in conditions B and D above.
	c. Document policies and procedures for closing the accounts for a reporting period.	This condition has not been corrected and is repeated in condition G above.
	d. Inadequate pricing knowledge.	Although this comment has not been fully corrected, we do not believe that this comment meets the definition of reportable condition. As a result, we have included this as a comment in a separate letter to management.
	e. Improve controls over deposits.	This condition has been corrected.
	f. Improve controls over accounts receivable.	This condition has not been corrected and is repeated in condition H above.
2.	Improve information technology controls.	This condition has not been fully corrected and is repeated in condition F above.