



United States Department of the Interior

Office of Inspector General
Washington, D.C. 20240

February 21, 2003

Memorandum

To: Commissioner, Bureau of Reclamation

From: Roger La Rouche 
Assistant Inspector General for AuditsSubject: Independent Auditors' Report on the Bureau of Reclamation's Financial
Statements for Fiscal Years 2002 and 2001 (No. 2003-I-0020)

We contracted with KPMG LLP, an independent certified public accounting firm, to audit the Bureau of Reclamation's (BOR) financial statements as of September 30, 2002 and for the year then ended. The contract required that KPMG conduct 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*.

In its report (Attachment 1), KPMG issued an unqualified opinion on BOR's financial statements. KPMG identified seven reportable conditions related to the following internal control areas and financial operations: (1) land inventory, (2) security and internal controls over information technology systems, (3) construction-in-progress and structures and facilities accounts, (4) accrued liabilities, (5) revenue cut-off, (6) quality control program, and (7) accounting for intra-Departmental transactions. KPMG considers the reportable condition related to land inventory to be a material weakness. With regard to compliance with laws and regulations, KPMG found BOR noncompliant with portions of the Federal Financial Management Improvement Act (FFMIA). Specifically, BOR's financial management systems did not substantially comply with Federal financial management systems requirements and the Federal accounting standards.

In connection with the contract, we monitored the progress of the audit at key points, reviewed KPMG's report and selected related working papers, and inquired of its representatives. Our review, as differentiated from an audit in accordance with the *Government Audit Standards*, was not intended to enable us to express, and we do not express, an opinion on the BOR's financial statements, conclusions about the effectiveness of internal controls, conclusions on whether BOR's financial management

systems substantially complied with the three requirements of FFMIA, or conclusions on compliance with laws and regulations. KPMG is responsible for the auditors' report and for the conclusions expressed in the report. Our review disclosed no instances where KPMG did not comply in all material respects with the *Government Auditing Standards*.

In the January 15, 2003 response to the draft report from the Commissioner, BOR, (Attachment 2) BOR concurred with Recommendations A through G. BOR did not concur that it was in noncompliance with the Federal Financial Management Improvement Act of 1996, specifically with the Federal accounting standards. However, BOR has implemented a plan to correct the deficiencies noted. Based on the response, all seven recommendations are considered resolved but not implemented. The seven recommendations will be referred to the Assistant Secretary for Policy, Management and Budget for tracking of implementation.

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

Attachments



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Independent Auditors' Report

Commissioner of the United States Bureau of Reclamation and Inspector General
United States Department of the Interior:

We have audited the accompanying consolidated balance sheets of the U.S. Department of the Interior, Bureau of Reclamation (Reclamation) as of September 30, 2002 and 2001, the related consolidated statements of net costs for the years then ended, and the related consolidated statement of changes in net position, combined statement of budgetary resources, and consolidated statement of financing for the year ended September 30, 2002 (hereinafter referred to as the consolidated financial statements). The objective of our audits was to express an opinion on the fair presentation of these consolidated financial statements. In connection with our audits, we also considered Reclamation's internal control over financial reporting and tested Reclamation's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its consolidated financial statements.

Summary

As stated in our opinion on the consolidated financial statements, we concluded that Reclamation's consolidated financial statements are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 14 to the consolidated financial statements, the September 30, 2001 consolidated balance sheet, consolidated statement of net cost, and consolidated statement of changes in net position have been restated. Also, as discussed in Note 16 to the consolidated financial statements, Reclamation implemented a change in accounting principle related to accounting for budgetary activity for allocation transfers from other federal entities.

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

- A. Reclamation needs improved controls over its land inventory;
- B. Reclamation needs improved security and internal control over its information technology systems;
- C. Reclamation needs improved controls over its construction-in-progress and structures and facilities accounts;
- D. Reclamation needs improved controls over its accrued liabilities;
- E. Reclamation needs improved controls over its revenue cut-off;
- F. Reclamation needs an improved quality control program; and
- G. Reclamation needs improved controls over its accounting for intradepartmental transactions.

We consider reportable condition A, above, to be a material weakness.

The results of our tests of compliance with certain provisions of laws and regulations, exclusive of the *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed no instances of noncompliance with laws and regulations 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 compliance with FFMIA disclosed instances where Reclamation's financial management systems did not substantially comply with federal financial systems requirements and the federal accounting standards.

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

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Reclamation as of September 30, 2002 and 2001, the related consolidated statements of net costs for the years then ended, and the related consolidated statement of changes in net position, combined statement of budgetary resources, and consolidated statement of financing for the year ended September 30, 2002.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Reclamation as of September 30, 2002 and 2001, its net costs for the years then ended, and its changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the year ended September 30, 2002, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 14 to the consolidated financial statements, the September 30, 2001 consolidated balance sheet, consolidated statement of net cost, and consolidated statement of changes in net position have been restated. Also, as discussed in Note 16 to the consolidated financial statements, Reclamation implemented a change in accounting principle related to accounting for budgetary activity for allocation transfers from other federal entities.

The information in the Management Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information sections is not a required part of the consolidated financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information, and accordingly, we express no opinion on it.

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 consolidated financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the consolidated financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

In our fiscal year 2002 audit, we noted the matters below involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that the reportable condition A is a material weakness.

A. Reclamation needs improved controls over its land inventory

Condition

Reclamation's fiscal year 2000 consolidated financial statement audit identified a weakness wherein Reclamation did not have a complete and accurate inventory system to support its \$1.9 billion of land and land rights reported in the consolidated 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 support for land and land rights costs is detailed in a cost summary report that did not reconcile 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 issued a five-year action plan to develop a complete and accurate land inventory that supported the financial accounting system, issued interim guidelines and procedures for reconciling land records, and developed a schedule for completing the reconciliation within the five-year plan period. During fiscal year 2002, Reclamation issued a Reclamation Manual Supplement to provide policies and procedures for the valuation of land and land rights. Also during fiscal year 2002, Reclamation completed and issued the Land Verification and Reconciliation Process Handbook, which provides procedures for verifying and reconciling land and land right balances, and has performed oversight reviews at each of the regional offices on the progress of the reconciliation project. As of September 30, 2002, Reclamation believes that it will complete the plan within the five-year plan period.

Recommendation

We recommend that the Commissioner, Bureau of Reclamation:

1. Complete the reconciliation of the financial accounting system support for lands and land rights costs with the subsidiary records, including individual project plat book maps, which contain data from individual land purchase contracts.
2. Include a material land inventory system internal control weakness in Reclamation's Federal Managers' Financial Integrity Act (FMFIA) report to the Department of the Interior until resolved.

Management Response

- A.1. Concur. Reclamation will continue the reconciliation of the financial accounting system support for lands and land rights costs with subsidiary records, including individual project plat book maps in accordance with the 5-year corrective action plan. As of September 30, 2002, approximately 40 percent of the projects were reconciled.

The responsible official is the Director, Operations. The target date for completing the reconciliation is September 30, 2005.

- A.2. Concur. Reclamation included the land inventory material weakness in Reclamation's Annual Assurance Statements on Management Controls for fiscal years 2000 through 2002, and will continue to report this weakness until all corrective actions are implemented.

The responsible official is the Director, Management Services. This material weakness will be reported each year until it is resolved.

B. Reclamation needs improved security and internal control over its information technology systems

Condition

Reclamation has made significant progress during the year by implementing and enhancing controls in several areas of information technology (IT) security and governance, including security programs, service continuity, application development, and logical access controls. However, certain IT security and controls over Reclamation's financial management systems have not been fully implemented, and controls need to be improved in the areas described below, as required by OMB Circular A-130, *Management of Federal Information Resources*. These conditions could affect Reclamation's ability to prevent and detect unauthorized changes to financial information, control electronic access to sensitive information, and protect its information resources.

Segregation of Duties

Proper segregation of duties should be governed by policies, procedures, and organizational structure to ensure that one individual cannot control key aspects of computer-related operations, and thereby conduct unauthorized actions or gain unauthorized access to assets or records. Reclamation has not fully addressed or maintained appropriate segregation of duties in certain aspects of computer-related operations.

Access Controls

Access controls should provide reasonable assurance that computer resources (data files, application programs, and computer-related facilities and equipment) are protected against unauthorized modification, disclosure, loss, or impairment. The objectives of limiting access are to ensure that (1) users have only the access needed to perform their duties; (2) access to very sensitive resources, such as security software programs, is limited to very few individuals; (3) application security configuration settings are sufficient to provide reasonable assurance that access to applications through user log-on cannot be easily compromised; and (4) network security configurations are optimized to provide reasonable assurance that computer resources (data files, application programs, and computer-related facilities and equipment) are protected against unauthorized modification, disclosure, loss, or impairment. Technical and procedural access controls over Reclamation's network and certain financial applications have not been fully developed and implemented to minimize the risks of unauthorized access to network and systems.

Recommendation

We recommend that the Commissioner, Bureau of Reclamation:

1. Continue implementation of its formal action plan to improve the security and general controls over the financial management systems. This plan should address each of the areas discussed above.

Management Response

- B.1. Concur. Reclamation will continue to implement its formal action plan to improve the security and general controls over financial management systems. Information technology security and internal control items identified in this audit will be added to and tracked in this action plan.

The responsible manager is the Chief Information Officer. September 30, 2003 is the target date for addressing the financial system segregation of duties and access control issues identified in this audit.

C. Reclamation needs improved controls over its construction-in-progress and structures and facilities accounts

Condition

Reclamation did not sufficiently implement internal controls to ensure that the general ledger control account for construction-in-progress (CIP) was accurate. During our audit, we noted that the CIP account included costs that should have been expensed as incurred, and excluded other costs that should have been capitalized, which resulted in an understatement of CIP. These errors also impacted the structures and facilities accounts, which are also reported in the consolidated financial statements as part of general property, plant, and equipment, since CIP costs are transferred to structures and facilities upon completion of a project.

In Reclamation's fiscal year 2000 audit, the Office of Inspector General (OIG) reported a material weakness and a reportable condition related to Reclamation's CIP account. Despite new policies and procedures established in response to the OIG finding, a reportable condition was reported in Reclamation's fiscal year 2001 audit report as Reclamation continued to include in the CIP account \$21.2 million in assets that should have been expensed as incurred.

During fiscal year 2002, Reclamation continued the implementation of its policies and procedures to identify substantially complete CIP projects for timely transfer to the structures and facilities accounts. However, we found that of Reclamation's five regions, one region continued to include \$56.4 million in the CIP and structures and facilities account that should have been expensed, a portion of which should have been transferred to another federal entity, and improperly tracked contributions from other entities as an offset to CIP, resulting in a \$10.8 million understatement. Another region improperly netted \$29.8 million in costs against the CIP and structures and facilities accounts, thereby, reducing the balance, and another region did not record CIP of \$19.1 million. We also noted that the regions did not consistently utilize the forms for transfer from CIP to structures and facilities, as required by Reclamation policy. Reclamation reviewed the account balances and transactions and made the necessary adjustments.

Recommendation

We recommend that the Commissioner, Bureau of Reclamation:

1. Implement and follow existing Reclamation policies and procedures, including regional quality control procedures, to ensure that the CIP and structures and facilities accounts only include costs for items meeting the definition of capitalizable general property, plant, and equipment, and that costs which should be expensed are reported as such in the proper accounting periods.

Management Response

- C.1. Concur. Reclamation will implement and emphasize the need to adhere to Reclamation policies and procedures, including improving regional quality controls over the construction-in-progress processes, to ensure that the construction-in-progress account only includes costs meeting the definition of capitalizable general property, plant, and equipment, and that costs that should be expenses are reported in the proper accounting period in accordance with the guidance provided in the Reclamation Manual Supplement.

The responsible official is the Director, Operations. The target date for implementing this recommendation is June 30, 2003.

D. Reclamation needs improved controls over its accrued liabilities

Condition

Reclamation did not sufficiently implement internal controls to ensure that the general ledger control accounts for accrued liabilities were complete and accurate. In response to the prior year reportable condition on controls over accrued liabilities, Reclamation has taken many steps to improve the process to ensure complete and accurate accrued liabilities. Reclamation has conducted regional training on the nature of accruals and the accounting requirements necessary to account for them. Reclamation has also created a standard form to facilitate the reporting of the accruals by the regional offices. The form, if properly completed, facilitates documentation of the necessary information and support. Finally, Reclamation developed procedures and provided them to the regional offices for reporting accruals.

Although these steps are appropriate, they are not sufficient to ensure that the accruals are complete and accurate. During Reclamation's fiscal year 2002 consolidated financial statement audit, we noted exceptions related to improper or incomplete accruals at each regional office. Issues that were identified included: (1) necessary accruals not made in the current fiscal year; (2) necessary accruals not made in prior fiscal years; and (3) improper accruals made for balances relating to subsequent fiscal years. These issues resulted in misstatements of \$16.6 million. Improved coordination with the program organization is considered essential, as the program personnel are the most knowledgeable on the status of the current contracts.

We also noted through our testing that supporting documentation for the accrual could be improved. We noted inconsistencies between regional offices in estimating accruals as some were calling vendors and others did trend analysis. While both methods provide acceptable estimates, consistency is important when estimating accrued liabilities.

Additionally, during our testing of employee benefit accruals, we noted the accrued annual leave was understated by approximately \$9 million in fiscal year 2002. The understatement related to inadequate accrual calculations for annual leave associated with the working capital fund. Reclamation reviewed the account balances and transactions and made the necessary adjustments.

Recommendation

We recommend that the Commissioner, Bureau of Reclamation:

1. Implement additional controls to ensure that accruals are complete, exist, are accurately recorded, and are adequately supported by documentation.
2. Implement oversight procedures to ensure compliance with current Reclamation policies and procedures to improve coordination within Reclamation's finance and program organizations.
3. Improve Reclamation's policies and procedures for accruals to specify additional procedures necessary to ensure complete and accurate accruals.

Management Response

- D.1. Concur. Reclamation will implement additional quality controls to ensure the completeness, existence, and accuracy of accruals. To improve the complete and accurate reporting of accrued liabilities, Reclamation has formed a multi-disciplinary "Accrual Team" to identify and define the essential steps that need to be taken to improve the accrual process.

The responsible official is the Director, Operations. The target date for developing additional quality controls is April 30, 2003. The target date for implementing the additional quality controls is September 30, 2003.

- D.2. Concur. Reclamation will implement oversight procedures to ensure compliance with current Reclamation policies and procedures. Reclamation will analyze and modify, as necessary, its current post-closing automated program to test disbursements made subsequent to year-end, for which a liability had not been recorded.

The responsible official is the Director, Management Services. The target date for developing additional oversight procedures is April 30, 2003. The target date for implementing oversight procedures is September 30, 2003.

- D.3. Concur. Reclamation will improve its policies and procedures for accruals to specify additional procedures, as necessary, to ensure complete and accurate accruals.

The responsible official is the Director, Management Services. The target date for implementing additional procedures is September 30, 2003.

E. Reclamation needs improved controls over its revenue cut-off

Condition

Reclamation did not have sufficient internal controls to ensure that the general ledger control account for revenue was complete. During our audit, we noted that Reclamation made entries in fiscal year 2003 for \$9.7 million of revenue that should have been made for fiscal year 2002. These errors are a result of insufficient regional quality control reviews and management oversight. Reclamation reviewed the account balances and transactions and made the necessary adjustments.

Recommendation

We recommend that the Commissioner, Bureau of Reclamation:

1. Establish and implement sufficient internal controls, including regional quality control reviews and management oversight, to ensure that the revenue cut-off entries are complete.

Management Response

E.1. Concur. Reclamation will implement sufficient internal controls, including regional quality control reviews and management oversight, to ensure the revenue cut-off entries are complete.

The responsible official is the Director, Operations and the Director, Management Services. The target date for developing additional revenue control procedures is April 30, 2003. The target date for implementing these procedures is September 30, 2003.

F. Reclamation needs an improved quality control program

Condition

Reclamation's fiscal year 2001 consolidated financial statement audit identified a control weakness wherein Reclamation did not have a sufficient quality control program to ensure that Reclamation Manual Supplements were completely and consistently implemented by the regional offices. Reclamation Manual Supplements establish accounting policies and procedures based on authoritative criteria, and are created by the Finance and Accounting Division, of the Management Services Office of Reclamation. However, the Finance and Accounting Division did not have procedures to ensure that the Reclamation Manual Supplements were fully and consistently implemented.

During fiscal year 2002, in response to the fiscal year 2001 consolidated financial statement audit finding, the Finance and Accounting Division started making compliance reviews of the regional office's progress on the land inventory reconciliation discussed in reportable condition A. Additionally, Reclamation has developed a plan for implementation of additional reviews and other procedures to be completed by the Finance and Accounting Division to address this weakness during fiscal year 2003.

Recommendation

We recommend that the Commissioner, Bureau of Reclamation:

1. Continue to implement a practice whereby Reclamation's policymaking body has authority to ensure compliance with the Reclamation Manual Supplements among the regions.
2. Continue to establish procedures to address the completeness, accuracy, and consistency of implementation of Reclamation Manual Supplements among the various regional offices.

Management Response

- F.1. Complied. Reclamation's Finance and Accounting Division was authorized and delegated responsibility for the financial oversight function in fiscal year 2002. Reclamation developed a Financial Management Plan that provides a process for continuously improving the accountability, efficiency, and effectiveness of Reclamation's financial processes and has among its objectives ensuring financial policy is developed, implemented, and applied consistently.
- F.2. Concur. A draft Financial Oversight Plan was developed in fiscal year 2002 and will be finalized in fiscal year 2003. The Financial Oversight Plan establishes a process to evaluate the effectiveness of internal controls for financial management, the reliability and validity of Reclamation's financial information, and implementation of Reclamation Manual Supplements. Fiscal year 2002 improvements included a review of the land inventory reconciliation process, quarterly variance analyses of general ledger accounts, and reviews of construction-in-progress, investigations and development, accruals, undelivered orders, and allowance for doubtful accounts.

The responsible official is the Director, Management Services. The target date for finalizing the Financial Oversight Plan is April 30, 2003. The target date for implementing the Financial Oversight Plan is September 30, 2003.

G. Reclamation needs improved controls over its accounting for intradepartmental transactions

Condition

As part of its reporting process, Reclamation is required to reconcile intradepartmental transactions between other Department of the Interior bureaus (referred to as "trading partners"). As of November 5, 2002, Reclamation had differences with other Department of the Interior bureaus totaling \$81.4 million. Reclamation made correcting entries to its consolidated financial statements for \$30.7 million subsequent to November 5, 2002 to reconcile with other bureaus. Differences within Reclamation accounts and with trading partners indicate misstatements in financial reporting at both the bureau and department levels.

Differences within Reclamation accounts and between trading partners are currently identified through a manual process, which includes entering transaction data into the Department of the Interior's financial reporting system (Hyperion). This information is accessible by all Department of the Interior bureaus. Although the information is entered into Hyperion throughout the year, differences are not reconciled and resolved in a timely manner, with the majority of reconciliations occurring at year-end and requiring a significant amount of accounting staff resources. As timelines for financial reporting continue to be expedited, manual processes and lack of accurate and timely trading partner data may impact Reclamation's ability to prepare reliable consolidated financial statements in a timely manner.

During the year, Reclamation has devoted additional resources to identify and correct out of balance intragovernment differences, and it has improved its processes to standardize the data provided to other bureaus, provide detail more frequently, and request more information as needed from other bureaus. However, the process continues to be informal, manual, and dependent on the cooperation of other agencies.

Recommendation

We recommend that the Commissioner, Bureau of Reclamation:

1. In conjunction with the Department and other Department of the Interior bureaus, should automate the process to reconcile and correct differences in intrabureau and trading partner transactions. The process should be governed by formal policies and procedures.
2. Until formal and automated processes are implemented, Reclamation should continue to improve its manual process to reconcile and resolve differences. The reconciliation process should be completed quarterly and include procedures to resolve and record differences in a timely manner.

Management Response

- G.1. Concur. Subject to the Department's guidance and direction. Reclamation will participate in the Department's efforts to automate the process for accounting for intradepartmental transactions and to develop formal policies and procedures for reconciling and correcting intrabureau and trading partner variances.

The responsible official is the Director, Management Services. The target date is subject to the Department's timeframes for developing and implementing an automated process and formal policies and procedures for accounting for intradepartmental transactions.

- G.2. Concur. Reclamation will continue to improve the process for reconciling and resolving intradepartmental differences.

The responsible official is the Director, Management Services. The target date for implementing an improved process is April 30, 2003.

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 December 6, 2002.

Compliance with Laws and Regulations

Our tests of compliance with certain laws and regulations, as described in the Responsibilities section of this report, exclusive of the FFMIA, disclosed no instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02.

The results of our tests of the FFMIA disclosed instances in which Reclamation's financial management systems did not substantially comply with the federal financial management systems requirements and with the federal accounting standards, and are described below.

Condition

Reclamation is not in compliance with OMB Circular A-130, *Management of Federal Information Resources*. As discussed in reportable condition B above, we noted weaknesses in Reclamation's computer security controls, including segregation of duties, access controls, and network security.

Recommendation

Our recommendations are addressed in the reportable condition discussed in the Internal Control over Financial Reporting section of our report.

Condition

Reclamation is required to prepare its consolidated financial statements in accordance with federal accounting standards. As discussed in reportable condition A above, we identified material weaknesses 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 discussed in the Internal Control over Financial Reporting section of our report.

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 level.

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 assist the Department of the Interior in meeting the GMRA reporting requirements, Reclamation prepares annual consolidated financial statements.

Management is responsible for:

- Preparing the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal controls over financial reporting, and preparation of 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 consolidated 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 consolidated financial statements are free of material misstatement.

An audit includes:

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

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

In planning and performing our fiscal year 2002 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 consolidated 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 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 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 Reclamation's fiscal year 2002 consolidated financial statements are free of material misstatement, we performed tests of Reclamation'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 Reclamation. 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 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 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

January 11, 2003

U.S. Department of the Interior – Bureau of Reclamation
Summary of the Status of Fiscal Year 2001 Findings and Recommendations
As of September 30, 2002

Ref	Condition Area	Status
A	Reclamation needs improved security and internal control over its information technology systems.	Reclamation has made significant progress in addressing this condition and as a result, although the condition is repeated in FY 2002, it is no longer considered a material weakness.
B	Reclamation needs improved controls over its land inventory.	Reclamation is in the second year of implementing a five-year corrective action plan, which is scheduled for completion in FY 2005. As a result, this condition has not been corrected and is considered a repeat condition in FY 2002.
C	Reclamation needs improved controls over its construction-in-progress.	This condition has not been corrected and is repeated in FY 2002.
D	Reclamation needs improved controls over accounting for investigations and development costs.	This condition has been corrected.
E	Reclamation needs an improved financial reporting process related to its allowance for doubtful loans receivable account.	This condition has been corrected.
F	Reclamation needs improved controls over its allowance for doubtful accounts receivable account.	This condition has been corrected.
G	Reclamation needs improved controls over its accrued liabilities.	This condition has not been corrected and is repeated in FY 2002.

Ref	Condition Area	Status
H	Reclamation needs improved controls over trust revenue recognition.	This condition has been corrected.
I	Reclamation needs an improved quality control program.	In response to the FY 2001 finding, Reclamation set a target date of September 30, 2003 for implementation of its oversight program. As a result, this condition has not been corrected and is repeated in FY 2002.
J	Reclamation needs improved controls over its accounting for undelivered orders.	This condition has been corrected.



United States Department of the Interior

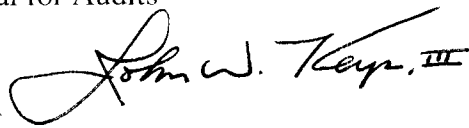
BUREAU OF RECLAMATION
PO Box 25007
Denver, Colorado 80225-0007

IN REPLY REFER TO:

D-5600
ADM-1.00

MEMORANDUM

To: Office of the Inspector General
Attention: Assistant Inspector General for Audits

From: John W. Keys, III
Commissioner, Bureau of Reclamation 

Subject: Response to Draft Independent Auditors' Report on the Bureau of
Reclamation's Financial Statements for Fiscal Years 2002 and 2001

We appreciate the opportunity to review and comment on the draft report titled Independent Auditors' Report on the Bureau of Reclamation's Financial Statements for Fiscal Years 2002 and 2001. Enclosed for your consideration is Reclamation's response to the recommendations as stated in the report.

Overall, we concur with the findings and recommendations and have provided information on planned corrective actions. However, Reclamation disagrees with KPMG's finding that Reclamation did not substantially comply with Federal accounting standards as required by the Federal Financial Management Improvement Act (FFMIA). Reclamation believes that it is in substantial compliance with accounting standards as required by FFMIA and in accordance with guidance provided in the Office of Management and Budget (OMB) Memorandum, Revised Implementation Guidance for the Federal Financial Management Improvement Act, dated January 4, 2001. Specifically, Reclamation prepares its financial statements in compliance with OMB's Form and Content Bulletin (OMB 01-09) and the financial information used for internal management is accurate and consistent with Federal accounting standards.

If you have any questions or require additional information, please contact Reclamation's Audit Liaison Officer, Sandie Simons, at (303) 445-2902.

Attachment

cc: Assistant Secretary - Water and Science
Attention: Olivia Ferriter
w/attachment

Bureau of Reclamation
KPMG, LLP Draft Audit Report
Response to Audit Report Recommendations
January 2003

Recommendation A.1

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.

Response

Concur. Reclamation will continue the reconciliation of the financial accounting system support for lands and land rights costs with subsidiary records, including individual project plat book maps in accordance with the 5-year corrective action plan. As of September 30, 2002, approximately 40 percent of the projects were reconciled.

The responsible official is the Director, Operations. The target date for completing the reconciliation is September 30, 2005.

Recommendation A.2

Include a material land inventory system internal control weakness in Reclamation's Federal Managers' Financial Integrity Act (FMFIA) report to the Department of the Interior until resolved.

Response

Concur. Reclamation included the land inventory material weakness in Reclamation's Annual Assurance Statements on Management Controls for fiscal years 2000 through 2002, and will continue to report this weakness until all corrective actions are implemented.

The responsible official is the Director, Management Services. This material weakness will be reported each year until it is resolved.

Recommendation B.1

Continue implementation of its formal action plan to improve the security and general controls over the financial management systems. This plan should address each of the areas discussed above.

Response

Concur. Reclamation will continue to implement its formal action plan to improve the security and general controls over financial management systems. Information technology security and internal control items identified in this audit will be added to and tracked in this action plan.

The responsible manager is the Chief Information Officer. September 30, 2003, is the target date for addressing the financial system segregation of duties and access control issues identified in this audit.

Recommendation C.1

Implement and follow existing Reclamation policies and procedures, including regional quality control procedures, to ensure that the CIP and structures and facilities accounts only include costs for items meeting the definition of capitalizable general property, plant, and equipment, and that costs which should be expensed are reported as such in the proper accounting periods.

Response

Concur. Reclamation will implement and emphasize the need to adhere to Reclamation policies and procedures, including improving regional quality controls over the construction-in-progress processes, to ensure that the construction-in-progress account only includes costs meeting the definition of capitalizable general property, plant, and equipment, and that costs that should be expensed are reported in the proper accounting period in accordance with the guidance provided in the Reclamation Manual Supplement.

The responsible official is the Director, Operations. The target date for implementing this recommendation is June 30, 2003.

Recommendation D.1

Implement additional controls to ensure that accruals are complete, exist, are accurately recorded, and are adequately supported by documentation.

Response

Concur. Reclamation will implement additional quality controls to ensure the completeness, existence, and accuracy of accruals. To improve the complete and accurate reporting of accrued liabilities, Reclamation has formed a multi-disciplinary "Accrual Team" to identify and define the essential steps that need to be taken to improve the accrual process.

The responsible official is the Director, Operations. The target date for developing additional quality controls is April 30, 2003. The target date for implementing the additional quality controls is September 30, 2003.

Recommendation D.2

Implement oversight procedures to ensure compliance with current Reclamation policies and procedures to improve coordination within Reclamation's finance and program organizations.

Response

Concur. Reclamation will implement oversight procedures to ensure compliance with current Reclamation policies and procedures. Reclamation will analyze and modify, as necessary, its current post-closing automated program to test disbursements made subsequent to year-end, for which a liability had not been recorded.

The responsible official is the Director, Management Services. The target date for developing additional oversight procedures is April 30, 2003. The target date for implementing oversight procedures is September 30, 2003.

Recommendation D.3

Improve Reclamation's policy and procedures for accruals to specify additional procedures necessary to ensure complete and accurate accruals.

Response

Concur. Reclamation will improve its policies and procedures for accruals to specify additional procedures, as necessary, to ensure complete and accurate accruals.

The responsible official is the Director, Management Services. The target date for implementing additional procedures is September 30, 2003.

Recommendation E.1

Establish and implement sufficient internal controls, including regional quality control reviews and management oversight, to ensure that the revenue cut-off entries are complete.

Response

Concur. Reclamation will implement sufficient internal controls, including regional quality control reviews and management oversight, to ensure the revenue cut-off entries are complete.

The responsible officials are the Director, Operations and the Director, Management Services. The target date for developing additional revenue control procedures is April 30, 2003. The target date for implementing these procedures is September 30, 2003.

Recommendation F.1

Continue to implement a practice whereby Reclamation's policymaking body has authority to ensure compliance with the Reclamation Manual Supplements among the regions.

Response

Complied. Reclamation's Finance and Accounting Division was authorized and delegated responsibility for the financial oversight function in fiscal year 2002. Reclamation developed a Financial Management Plan that provides a process for continuously improving the accountability, efficiency, and effectiveness of Reclamation's financial processes and has among its objectives ensuring financial policy is developed, implemented, and applied consistently.

Recommendation F.2

Continue to establish procedures to address the completeness, accuracy, and consistency of implementation of Reclamation Manual Supplements among the various regional offices.

Response

Concur. A draft Financial Oversight Plan was developed in fiscal year 2002 and will be finalized in fiscal year 2003. The Financial Oversight Plan establishes a process to evaluate the effectiveness of internal controls for financial management, the reliability and validity of Reclamation's financial information, and implementation of Reclamation Manual Supplements. Fiscal year 2002 improvements included a review of the land inventory reconciliation process, quarterly variance analyses of general ledger accounts, and reviews of construction-in-progress, investigations and development, accruals, undelivered orders, and allowance for doubtful accounts.

The responsible official is the Director, Management Services. The target date for finalizing the Financial Oversight Plan is April 30, 2003. The target date for implementing the Financial Oversight Plan is September 30, 2003.

Recommendation G.1

In conjunction with the Department and other Department of the Interior bureaus, should automate the process to reconcile and correct differences in intrabureau and trading partner transactions. The process should be governed by formal policies and procedures.

Response

Concur, subject to the Department's guidance and direction. Reclamation will participate in the Department's efforts to automate the process for accounting for intra-departmental transactions and to develop formal policies and procedures for reconciling and correcting intra-bureau and trading partner variances.

The responsible official is the Director, Management Services. The target date is subject to the Department's timeframes for developing and implementing an automated process and formal policies and procedures for accounting for intra-departmental transactions.

Recommendation G.2

Until formal and automated processes are implemented, Reclamation should continue to improve its manual process to reconcile and resolve differences. The reconciliation process should be completed quarterly and include procedures to resolve and record differences in a timely manner.

Response

Concur. Reclamation will continue to improve the process for reconciling and resolving intra-departmental differences.

The responsible official is the Director, Management Services. The target date for implementing an improved process is April 30, 2003.

Compliance with Laws and Regulations

Reclamation does not concur that its financial management systems do not substantially comply with Federal accounting standards as required by the Federal Financial Management Improvement Act (FFMIA). Reclamation asserts that its financial management systems are substantially in compliance with accounting standards as required by FFMIA. Specifically, Reclamation meets the FFMIA compliance requirements as provided in the Office of Management and Budget (OMB) Memorandum, "Revised Implementation Guidance for the Federal Financial Management Improvement Act," dated January 4, 2001. For example, Reclamation prepares financial statements in compliance with Form and Content of Agency Financial Statements, OMB Bulletin No. 01-09, and Reclamation's financial information produced for internal management is accurate and consistent with Federal accounting standards.

The OMB FFMIA Implementation Guidance recognizes three indicators of compliance with accounting standards, (1) receiving an unqualified opinion, which Reclamation has received, (2) producing managerial cost information consistent with Financial Accounting Standards Advisory Board Standard No. 4, which Reclamation has achieved, and (3) receiving an internal control audit report that disclosed no material weaknesses in internal controls that affect the agency's ability to prepare financial statements and related disclosures that are consistent with Federal accounting standards, budget reports, or other financial information for management decision-making purposes. KPMG's finding focuses primarily on Reclamation's land and land rights material internal control weakness as their basis for determination of non-compliance with accounting standards. Reclamation does not dispute the land inventory internal control weakness and has taken corrective action in accordance with a 5-year corrective action plan. However, Reclamation does not agree that the land inventory material weakness has significantly affected the ability to prepare financial statements and related disclosures that are consistent with Federal accounting standards, budget reports, or other financial information for management decision-making purposes. Taken as a whole, Reclamation's financial management systems provide

financial information which is complete, accurate, reliable, and consistently in accordance with Federal accounting standards.