OFFICE OF
INSPECTOR GENERAL
U.S. DEPARTMENT OF THE INTERIOR

Independent Auditors' Report on the U.S. Department of the Interior Financial Statements for Fiscal Years 2016 and 2015

Assignment No.: 2016-FIN-025

November 2016

OFFICE OF
INSPECTOR GENERAL
U.S. DEPARTMENT OF THE INTERIOR

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Memorandum

To: Secretary Jewell

From: Mary L. Kendall
Deputy Inspector General

Subject: Independent Auditors' Report on the U.S. Department of the Interior Financial Statements for Fiscal Years 2016 and 2015
Report No. 2016-FIN-025

This memorandum transmits the KPMG LLP (KPMG) auditors' report of the U.S. Department of the Interior's (DOI) financial statements for fiscal years (FYs) 2016 and 2015. The Chief Financial Officers Act of 1990 (Public Law 101-576), as amended, requires the DOI Inspector General, or an independent external auditor as determined by the Inspector General, to audit DOI's financial statements.

Under a contract issued by DOI and monitored by the Office of Inspector General, KPMG, an independent public accounting firm, performed an audit of DOI's FYs 2016 and 2015 financial statements. The contract required the audit to be performed in accordance with the Generally Accepted Government Auditing Standards (GAGAS), issued by the Comptroller General of the United States, and Office of Management and Budget Bulletin No. 15-02, "Audit Requirements for Federal Financial Statements."

Results of Independent Audit

KPMG's audit report includes (1) an opinion on the consolidated financial statements of DOI, (2) a report on internal controls, and (3) a report on compliance with laws and regulations:

1. The consolidated financial statements were fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles.
2. KPMG identified no material weaknesses in internal controls, but it did identify three significant deficiencies[1]:
    - Lack of Sufficient Controls over General Property, Plant, and Equipment
    - Lack of Sufficient Controls over Accrued Liabilities
    - Lack of Sufficient General Information Technology Controls
3. KPMG identified no instances of noncompliance with laws or regulations.

[1] A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Evaluation of KPMG's Audit Performance

To fulfill our oversight responsibilities under the Chief Financial Officers Act of 1990 for ensuring that high quality audit work is performed, we reviewed KPMG's report and related documentation and questioned KPMG auditors regarding the audit. We performed several tasks, to include—

- Reviewing KPMG's approach and planning of the audit;
- Evaluating the qualifications and independence of the auditors;
- Monitoring the progress of the audit at key points;
- Attending periodic meetings with DOI management and KPMG auditors to discuss audit progress, findings, and recommendations; and
- Reviewing KPMG's audit report.

Our review, as differentiated from an audit in accordance with GAGAS, was not intended to enable us to express—and we do not express—an opinion on DOI's financial statements, internal controls, or compliance with laws and regulations. KPMG is responsible for the attached auditors' report and the conclusions expressed. Our review of the report, however, disclosed no instances where KPMG did not comply, in all material respects, with GAGAS.

Report Distribution

The legislation creating the Office of Inspector General requires that we report to Congress semiannually on all audit, inspection, and evaluation reports issued; actions taken to implement our recommendations; and recommendations that have not been implemented.

We appreciate the courtesies and cooperation extended to KPMG and our staff during this audit. If you have any questions regarding the report, please contact me at 202-208-5745.

Attachment

KPMG LLP
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Washington, DC 20006

Independent Auditors' Report

Secretary and Deputy Inspector General
U.S. Department of the Interior:

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of the U.S. Department of the Interior (the Department), which comprise the consolidated balance sheets as of September 30, 2016 and 2015, and the related consolidated statements of net cost, changes in net position, and custodial activity, and combined statements of budgetary resources for the years then ended, and the related notes to the consolidated financial statements (hereinafter referred to as "consolidated financial statements").

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, in accordance with the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and in accordance with Office of Management and Budget (OMB) Bulletin No. 15-02, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 15-02 require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion on the Financial Statements

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the U.S. Department of the Interior as of September 30, 2016 and 2015, and its net costs, changes in net position, budgetary resources, and custodial activity for the years then ended in accordance with U.S. generally accepted accounting principles.

Other Matters

Interactive Data

Management has elected to reference information on websites or other forms of interactive data outside the Agency Financial Report to provide additional information for the users of its financial statements. Such information is not a required part of the basic consolidated financial statements or supplementary information required by the Federal Accounting Standards Advisory Board (FASAB). The information on these websites or the other interactive data has not been subjected to any of our auditing procedures, and accordingly we do not express an opinion or provide any assurance on it.

Required Supplementary Information

U.S. generally accepted accounting principles require that the information in the Management's Discussion and Analysis, Required Supplementary Information, and Required Supplementary Stewardship Information sections be presented to supplement the basic consolidated financial statements. Such information, although not a part of the basic consolidated financial statements, is required by the Federal Accounting Standards Advisory Board who considers it to be an essential part of financial reporting for placing the basic consolidated financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic consolidated financial statements, and other knowledge we obtained during our audits of the basic consolidated financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audits were conducted for the purpose of forming an opinion on the basic consolidated financial statements as a whole. The information in the Introduction, Message from the Chief Financial Officer, and Other Information is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the basic consolidated financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Other Reporting Required by *Government Auditing Standards*

Internal Control Over Financial Reporting

In planning and performing our audit of the consolidated financial statements as of and for the year ended September 30, 2016, we considered the Department's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that have not been identified. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. We did identify certain deficiencies in internal control, described below under items A., B., and C., that we consider to be significant deficiencies.

A. Lack of Sufficient Controls over General Property, Plant, and Equipment (PP&E), net

Criteria

The standards and guidelines, issued by GAO, in the *Standards for Internal Control in the Federal Government* (Green Book), dated September 2014, states:

Control Activities Principle 10: *Design Control Activities*:

10.02 – *Response to Objectives and Risks:*

"Management designs control activities in response to the entity's objectives and risks to achieve an effective internal control system. Control activities are the policies, procedures, techniques, and mechanisms that enforce management's directives to achieve the entity's objectives and address related risks. As part of the control environment component, management defines responsibilities, assigns them to key roles, and delegates authority to achieve the entity's objectives. As part of the risk assessment component, management identifies the risks related to the entity and its objectives, including its service organizations; the entity's risk tolerance; and risk responses. Management designs control activities to fulfill defined responsibilities and address identified risk responses."

10.03 – *Accurate and timely recording of transactions:*

"Transactions are promptly recorded to maintain their relevance and value to management in controlling operations and making decisions. This applies to the entire process or life cycle of a transaction or event from its initiation and authorization through its final classification in summary records. In addition, management designs control activities so that all transactions are completely and accurately recorded."

Statement of Federal Financial Accounting Standards (SFFAS) No. 6, *Accounting for Property, Plant, and Equipment,* paragraphs 34 and 38 state that:

> 34. PP&E shall be recognized when title passes to the acquiring entity or when the PP&E is delivered to the entity or to an agent of the entity. In the case of constructed PP&E, the PP&E shall be recorded as construction work in process until it is placed in service, at which time the balance shall be transferred to general PP&E.
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> 38. In the period of disposal, retirement, or removal from service, general PP&E shall be removed from the asset accounts along with associated accumulated depreciation/amortization. Any difference between the book value of the PP&E and amounts realized shall be recognized as a gain or a loss in the period that the general PP&E is disposed of, retired, or removed from service.

Condition

During our FY2016 testing of general property, plant, and equipment, net, we noted the following:

- Additions and deletions of general property, plant, and equipment, net were not recorded accurately and timely.
- Due to the previous policies, procedures, and controls being inconsistently applied and the newly implemented policies not being in effect for the full fiscal year, assets under construction were not adequately monitored to allow management to determine the validity of the project's classification and to ensure associated transactions were recorded accurately and timely. Specifically, eight assets, totaling $319 million, were placed in service in prior years but were not transferred out of the assets under construction account until FY2016.

Cause

The Department's internal controls are not properly designed, implemented, and operating effectively to ensure general property, plant, and equipment, net transactions are accurately and timely recorded to allow management to validate the classification of general property, plant, and equipment, net is complete, accurate, and valid. In addition, newly implemented policies, procedures, and controls for monitoring assets under construction was not in effect for the full fiscal year and previous policy was not consistently applied.

Effect

As a result of the errors noted above, the Department reclassified $319 million of general property, plant, and equipment, net during the fiscal year. In addition, the Department's general property, plant and equipment, net, as of September 30, 2016, may be overstated by an estimated $36 million. Furthermore, the lack of adequate policies, procedures, and controls over the classification of general property, plant, and equipment, net increases the risk that errors may occur and not be detected in the general property, plant, and equipment, net footnote disclosure.

Recommendations

We recommend that the Department and Bureaus maintain effective internal controls over general property, plant, and equipment, net to prevent a misstatement as follows:

- Reinforce existing policies, procedures, and controls over the additions, deletions, and transfers of general property, plant, and equipment, net to ensure transactions are recorded accurately and timely; and,
- Reinforce newly implemented and existing policies, procedures, and controls over assets under construction to ensure projects are monitored timely and that transactions are recorded accurately and timely.

KPMG

B. Lack of Sufficient Controls over Accrued Liabilities

Criteria

The Green Book, dated September 2014, states:

Control Activities Principle 10: *Design Control Activities*:

10.02 – *Response to Objectives and Risks:*

"Management designs control activities in response to the entity's objectives and risks to achieve an effective internal control system. Control activities are the policies, procedures, techniques, and mechanisms that enforce management's directives to achieve the entity's objectives and address related risks. As part of the control environment component, management defines responsibilities, assigns them to key roles, and delegates authority to achieve the entity's objectives. As part of the risk assessment component, management identifies the risks related to the entity and its objectives, including its service organizations; the entity's risk tolerance; and risk responses. Management designs control activities to fulfill defined responsibilities and address identified risk responses."

It further states:

10.03 – Design *of Appropriate Types of Control Activities:*

"Management clearly documents internal control and all transactions and other significant events in a manner that allows the documentation to be readily available for examination. The documentation may appear in management directives, administrative policies, or operating manuals, in either paper or electronic form. Documentation and records are properly managed and maintained."

Additionally, the Green Book, states:

Monitoring Principle 16: *Perform Monitoring Activities*:

16.09 – *Evaluation of Results*:

"Management evaluates and documents the results of ongoing monitoring and separate evaluations to identify internal control issues. Management uses this evaluation to determine the effectiveness of the internal control system. Differences between the results of monitoring activities and the previously established baseline may indicate internal control issues, including undocumented changes in the internal control system or potential internal control deficiencies."

FASAB SFFAS 5 *Accounting for Liabilities of the Federal Government,* paragraphs 19 and 25 state that:

> 19. A liability for federal accounting purposes is a probable future outflow or other sacrifice of resources as a result of past transactions or events. General purpose federal financial reports should recognize probable and measurable future outflows or other sacrifices of resources arising from (1) past exchange transactions, (2) government-related events, (3) government-acknowledged events, or (4) nonexchange transactions that, according to current law and applicable policy, are unpaid amounts due as of the reporting date.
>
> 25. Many grant and certain entitlement programs are nonexchange transactions. When the federal government creates an entitlement program or gives a grant to state or local governments, the provision of the payments is determined by federal law rather than through an exchange transaction.

Further, FASAB Technical Release 12: *Accrual Estimate for Grant Programs* paragraphs 14, 16, and 26 state that:

> 14. Agencies must accumulate sufficient relevant and reliable data on which to base accrual estimates. Each agency should prepare grant accrual estimates based upon the best available data at the time the estimates are made.
>
> 16. In the absence of sufficient relevant and reliable historical data on which to base accrual estimates, agencies should prepare estimates based upon the best available data at the time the estimates are made.
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> 26. As part of the agencies' internal control procedures to ensure that grant accrual estimates for the basic financial statements were reasonable, agencies should validate grant accrual estimates by comparing the estimates with subsequent grantee reporting.

DOI Financial Management Memorandum 2010-008 Vol. II.B, *Estimation Methodology and Validation for Certain Accruals* states:

> Bureaus must develop an accrual (estimation) methodology that provides valid, timely financial estimates. Estimation methodologies must be determined for all types of accruals. Documentation must be developed and tests should be conducted over the accrual methodologies, the results of which should be provided to Office of Financial Management for review.

Condition

During our FY2016 testing of Department's accrued liabilities, we noted the following:

- Bureaus performed a retrospective review of the September 30, 2015 accrued liabilities and drew inaccurate conclusions about the reasonableness of the estimation methodologies.
- The Department performed a consolidated review of the Bureaus' analysis of the retrospective review of the September 30, 2015 accrued liabilities in total showing a net impact, but did not take appropriate action for large variances at the financial statement line item level, resulting in an inaccurate conclusion about the completeness and accuracy of the accrued liabilities recorded in the Department's financial statements.

Cause

Controls are not properly designed, implemented, and operating effectively to ensure that the results of the Bureau's retrospective reviews are validating the reasonableness of the accrued liabilities estimation methodology and, if warranted, adjustments are made to the methodology and calculations in subsequent periods.

Effect

The Department's accrued liabilities and gross costs, as of September 30, 2016 and for the year then ended, may be overstated by an estimated $131 million and $74 million, respectively.

Recommendations

We recommend that the Department and Bureaus improve controls over the monitoring and accounting of accrued liabilities as follows:

- Redefine policies and procedures to establish an appropriate precision threshold to be used in the operation of the Department's control and document the monitoring procedures performed and the conclusions reached at the Department level.
- Perform the Department's accrued liability analysis at the financial statement line item level.
- Ensure that inputs into the Bureau estimation methodology are complete and accurate.
- Consider the results of the retrospective review analysis when determining whether modifications to the estimation methodology are warranted.

C. Lack of Sufficient General Information Technology Controls

Criteria

The Green Book provides the overall framework for establishing and maintaining an effective internal control system. In addition, OMB Circular No. A-123 provides specific requirements for assessing and reporting on controls in the federal government.

The standards and guidelines issued by the National Institute of Standards and Technology (NIST), *Special Publication 800-53, Revision 4*, define IT security and related business process application control objectives supporting the structure, policies, and procedures that apply to the use, operability, interface, edit, and monitoring controls of a financial IT application.

The Department of Interior, Security Control Standards, specifies organization-defined parameters that are deemed necessary or appropriate to achieve a consistent security posture across the Department of the Interior.

In addition, the Department of Interior, Departmental Manual, provides the standards, guidelines, and implementation plans necessary to effectively establish the information security program of the Department.

Condition

During our FY2016 testing of the significant financial IT systems of the Department, we identified several control deficiencies that we have classified into the following categories:

Provisioning of Access and Segregation of Duties:

Preventive controls, such as provisioning of IT access, are controls designed to reduce the risk of unauthorized and/or inappropriate access to the relevant financial IT systems. When IT personnel or users are given, or can gain, access privileges beyond those necessary to perform their assigned duties, a breakdown in segregation of duties can occur. This unauthorized access could result in inappropriate and/or unauthorized transactions or changes to programs or data that affect the consolidated financial statements. Deficiencies were identified in the annual recertification of user access rights, the granting of privileged access to several individuals through a shared privileged account, and the timely removal of user access rights due to changes in assigned duties or separations.

Security and Vulnerability Management:

Detective controls, such as credentialed vulnerability scanning and safeguards, are controls designed to detect and protect systems that are exposed to risks related to misconfiguration, out-of-date patches or internal/external threats. Deficiencies were identified in the Department's untimely remediation of identified vulnerabilities and documented risk assessment/acceptance. In addition, the Department has failed to fully implement the relevant security control standards and guidelines of NIST *Special Publication 800-53, Revision 4*.

System Audit Log Reviews and Change Management:

Detective controls, such as system audit logs and change management, are controls designed to determine that changes to financial IT systems are authorized, tested, approved, properly implemented, and documented. Deficiencies were identified in the Department's ability to track all system-generated configuration changes and in the Department's failure to review system patches in a test environment before moving to a production environment.

Cause

The Department does not have sufficient procedures and controls in place to ensure compliance with Green Book and the Department's Security Control Standards and Manuals. In addition, the Department has not fully implemented the requirements of NIST, Special Publication 800-53, Revision 4, into the procedures and controls reference above.

Effect

The aforementioned IT control deficiencies pose a risk to the completeness, accuracy, and integrity of the Department's financial information, which could ultimately affect the Department's ability to produce accurate and timely consolidated financial statements. The Department is at risk that unauthorized, unanticipated, and/or inappropriate activities or changes, made to the relevant financial IT systems, may go undetected by management. The related systems are at risk of data leakage, denial-of-service, or unauthorized modification of data held within the financial IT systems that are necessary for the complete and accurate presentation of the consolidated financial statements.

Recommendations

We recommend that the Department develop and maintain effective general information technology controls to reduce the risks posed to the completeness, accuracy, and integrity of the Department's financial information. Specifically, the Chief Information Officer should:

1. Develop policies, procedures and controls to address the provisioning of access, security and vulnerability management, system audit log review, and change management control deficiencies identified in the Department's financial IT systems;

2. Continue to formalize and disseminate security control standards and guidelines to the bureaus and formally establish security control implementation and testing policies and procedures; and,

3. Monitor progress to ensure that procedures and controls are appropriately designed, implemented, and maintained.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Department's consolidated financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests of compliance disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 15-02.

We also performed tests of its compliance with certain provisions referred to in Section 803(a) of the *Federal Financial Management Improvement Act of 1996* (FFMIA). Providing an opinion on compliance with FFMIA was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests of

FFMIA disclosed no instances in which the Department’s financial management systems did not substantially comply with the (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level.

Department’s Responses to Findings

The Department’s responses to the findings, identified in our audit, are described and presented as a separate attachment to this report and were not subjected to the auditing procedures, applied in the audit of the consolidated financial statements and, accordingly, we express no opinion on the responses.

Purpose of the Other Reporting Required by Government Auditing Standards

The purpose of the communication described in the Other Reporting Required by *Government Auditing Standards* section is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the Department’s internal control or compliance. Accordingly, this communication is not suitable for any other purpose.

KPMG LLP

Washington, D.C.
November 15, 2016

Report Fraud, Waste, and Mismanagement

Fraud, waste, and mismanagement in Government concern everyone: Office of Inspector General staff, departmental employees, and the general public. We actively solicit allegations of any inefficient and wasteful practices, fraud, and mismanagement related to departmental or Insular Area programs and operations. You can report allegations to us in several ways.

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