

**Department of Energy**

Washington, DC 20585

December 5, 2003

MEMORANDUM FOR THE SECRETARY

FROM:


Gregory H. Friedman
Inspector General

SUBJECT:

INFORMATION: Report on the Department of Energy's
Consolidated Financial Statements

This is to inform you that the Department's consolidated financial statements for Fiscal Year (FY) 2003 have received an unqualified audit opinion. The audit of the Department's statements was conducted pursuant to the Government Management and Reform Act of 1994. The objective of the Act is to improve financial practices in the Federal Government by issuing audited financial statements for each agency. The Department is responsible for the preparation of the statements and the Office of Inspector General (OIG) is responsible for the audit.

As in previous years, the OIG contracted with the accounting firm of KPMG LLP to conduct the audit. KPMG is responsible for expressing an opinion on the Department's consolidated financial statements and reporting on applicable internal controls, and compliance with laws and regulations. In connection with the contract, the OIG monitored audit progress and reviewed the audit report and related documentation. Our review disclosed no instances where KPMG did not comply, in all material respects, with generally accepted Government auditing standards. The OIG, however, did not express an independent opinion on the Department's financial statements.

Based on its audit, KPMG concluded that the consolidated financial statements present fairly, in all material respects, the Department's financial position as of September 30, 2003, and its net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activities for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As described in KPMG's opinion, the firm did not audit the FY 2003 financial statements of the Bonneville Power Administration or Western Area Power Administration. Those statements were audited by other public accounting firms whose reports were considered by KPMG in forming their overall opinion on the Department's consolidated financial statements.



As part of KPMG's determination, the auditors considered internal controls over financial reporting and tested the Department's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on the consolidated financial statements. The examination revealed two reportable conditions in the Department's system of internal controls:

- The Department has certain network vulnerabilities and general access control weaknesses that could impact its unclassified information systems. In certain instances, the integrity of financial system data is at risk because of ineffective access and computer security controls. The Department has made numerous improvements; however, additional effort is required to ensure that Federal information standards are met and that information systems are adequately protected against unauthorized access.
- While the Department made significant progress in improving performance measurement reporting, more remains to be done to satisfy the Office of Management and Budget's requirements. Specifically, the Department needs to strengthen internal controls to ensure the accuracy of reported performance data and the maintenance of related supporting documentation.

Management officials generally concurred with the audit findings and initiated or agreed to initiate specific corrective actions. It should be noted that these conditions represent findings that were previously reported in last year's audit report.

I would like to thank all elements of the Department for their courtesy and cooperation during the conduct of the audit.

Attachment

cc: Deputy Secretary
Under Secretary for Energy, Science and Environment
Administrator, National Nuclear Security Administration
Director, Office of Management, Budget and Evaluation/Chief Financial Officer

Audit Report: DOE/OAS-FS-04-02



2001 M Street, NW
Washington, DC 20036

INDEPENDENT AUDITORS' REPORT

The Inspector General, U.S. Department of Energy:

We have audited the accompanying consolidated balance sheets of the U.S. Department of Energy (Department) as of September 30, 2003 and 2002, and the related consolidated statements of net cost, changes in net position, financing, and custodial activities, and the related combined statements of budgetary resources (hereinafter referred to as "consolidated financial statements"), for the years then ended. 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 the Department's internal control over financial and performance reporting and tested the Department's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its consolidated financial statements.

As described in our opinion, we did not audit the fiscal year 2003 financial statements of Bonneville Power Administration or Western Area Power Administration, whose Department-related financial data as of and for the year ended September 30, 2003 is included in the accompanying consolidated financial statements. Those statements were audited by other auditors whose reports have been furnished to us and were considered in forming our overall opinion on the Department's consolidated financial statements.

Summary

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

Our opinion emphasizes that the cost estimates supporting the Department's environmental remediation liabilities are based upon assumptions regarding future actions and decisions, many of which are beyond the Department's control, and that the Department's environmental liabilities may increase significantly if it is not allowed to reclassify a portion of its radioactive waste.

Our consideration of internal control over financial and performance reporting identified two reportable conditions with respect to unclassified network and information systems security and performance measurement reporting. However, these reportable conditions are not believed to be material weaknesses.



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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.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The information in the Consolidating Schedules section is presented for purposes of additional analysis of the consolidated financial statements, rather than to present the financial position, net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activities of the Department's components individually. The information in the Consolidating Schedules section has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, based upon our audits and the reports of other auditors, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole. The information in the Performance Results section of the Department's *Fiscal Year 2003 Performance and Accountability Report* is presented for purposes of additional analysis and is not a required part of the financial statements. This information has not been subjected to the auditing procedures, except for the testing of controls over selected performance measures, as described in the Responsibilities section of this report, 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 the Department'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 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.

We noted the following matter, described in more detail in Exhibit I, involving internal control over financial reporting and its operation that we consider to be a reportable condition. However, this reportable condition is not believed to be a material weakness.

Unclassified Network and Information Systems Security – We noted network vulnerabilities and weaknesses in access and other security controls in the Department's unclassified computer information systems. The identified weaknesses and vulnerabilities increase the risk that malicious destruction or alteration of data or unauthorized processing

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The results of our tests of compliance with certain provisions of laws and regulations disclosed no instances of noncompliance 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 following sections discuss our opinion on the Department's consolidated financial statements, our consideration of the Department's internal control over financial and performance reporting, our tests of the Department's compliance with certain provisions of applicable laws and regulations, management's responsibilities, and our responsibilities.

Opinion on Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of the U.S. Department of Energy as of September 30, 2003 and 2002, and the related consolidated statements of net cost, changes in net position, financing, and custodial activities, and the related combined statements of budgetary resources, for the years then ended.

We did not audit the fiscal year 2003 financial statements of Bonneville Power Administration or Western Area Power Administration, whose Department-related financial data as of and for the year ended September 30, 2003 is included in the accompanying consolidated financial statements, and which, combined and compared to the Department's consolidated financial statements, represent 17 percent of total assets; 58 percent of total earned revenues; and 15 percent of total program costs. Those statements were audited by other auditors whose reports have been furnished to us, and our opinion, insofar as it relates to the fiscal year 2003 amounts included for Bonneville Power Administration and Western Area Power Administration, is based solely upon the reports of the other auditors.

In our opinion, based upon our audits and the reports of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the U.S. Department of Energy as of September 30, 2003 and 2002, and its net costs, changes in net position, budgetary resources, reconciliation of net costs to budgetary obligations, and custodial activities for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 15 to the consolidated financial statements, the cost estimates supporting the Department's environmental remediation liabilities of \$183 billion and \$210 billion as of September 30, 2003 and 2002, respectively, are based upon assumptions regarding future actions and decisions, many of which are beyond the Department's control. The Department reduced its environmental remediation liabilities during the years ended September 30, 2003 and 2002, by implementing an accelerated cleanup approach. Also, as discussed in Note 17 to the consolidated financial statements, the Department's environmental liabilities may increase by more than \$100 billion if it is not allowed to reclassify a portion of its radioactive waste in accordance with its accelerated cleanup approach.

The information in the Management's Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information sections of the Department's *Fiscal Year 2003 Performance and Accountability Report* is not a required part of the consolidated

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could occur, and may threaten the integrity of essential financial management system data. The Department should continue to improve its network and information systems security.

We also noted other matters involving internal control over financial management systems and its operation that we have reported to Departmental management in a separate letter dated September 26, 2003. In addition, we will report other matters involving internal control over financial reporting and its operation to Departmental management in a separate letter.

Internal Control over Performance Reporting

With respect to the design of internal controls relating to existence and completeness assertions over performance measures determined by management to be key and reported in Management's Discussion and Analysis, we noted certain deficiencies, described below and in more detail in Exhibit I, in internal control over reported performance measures that, in our judgment, could adversely affect the Department's ability to collect, process, record, and summarize performance information and report performance measures in accordance with management's criteria. However, this reportable condition is not believed to be a material weakness.

Performance Measurement Reporting – The Department's performance reporting for fiscal year 2003 contains certain deficiencies, some of which were noted in previous audits, that limit the reader's ability to properly assess the Department's performance. The Department should strengthen internal controls to ensure the accuracy of reported performance data and the availability of related supporting documentation, and to continue improving the development of performance measures.

A summary of the status of the prior year reportable conditions is included as Exhibit II.

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 those referred to in the *Federal Financial Management Improvement Act of 1996 (FFMIA)*, disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards* and OMB Bulletin No. 01-02.

The results of our tests of FFMIA disclosed no instances in which the Department's financial management systems did not substantially comply with the three requirements discussed in the Responsibilities section of this report.

Responsibilities

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

Management is responsible for the consolidated financial statements, including:

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- Preparing the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal control over financial reporting, and preparing Management's Discussion and Analysis (including the performance measures), Required Supplementary Stewardship Information, and Required Supplementary Information; and
- Complying with laws and regulations, including FFMIA.

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

Auditors' Responsibilities. Our responsibility is to express an opinion on the fiscal year 2003 and 2002 consolidated financial statements of the Department based upon our audits and the reports of other auditors. 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 consolidated financial statement presentation.

We believe that our audits and the reports of other auditors provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2003 audit, we considered the Department's internal control over financial reporting by obtaining an understanding of the Department's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls 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 *Government Auditing Standards* and OMB Bulletin No. 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide assurance on internal control over financial reporting and, accordingly, we do not provide an opinion thereon.

As required by OMB Bulletin No. 01-02, we considered the Department's internal control over the Required Supplementary Stewardship Information by obtaining an understanding of the Department's internal control, determining whether controls had been placed in operation, assessing control risk, and performing tests of controls. Our procedures were not designed to provide

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assurance on internal control over the 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 Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal control over performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether the Department's fiscal year 2003 financial statements are free of material misstatement, we performed tests of the Department's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of consolidated 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 the Department. 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 Department'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 the Department's management, the Department's Office of Inspector General, OMB, GAO, and the U.S. Congress, and is not intended to be used and should not be used by anyone other than these specified parties.

KPMG LLP

November 26, 2003

Unclassified Network and Information Systems Security

We noted network vulnerabilities and weaknesses in access and other security controls in unclassified information systems.

Finding 1: Network Security

The Department maintains a series of interconnected unclassified networks and information systems. Federal and Departmental directives require the establishment and maintenance of security over unclassified information systems, including financial management systems. Past audits identified significant weaknesses in selected systems and devices attached to the computer networks at some Department sites. The Department has implemented corrective actions to improve network security at the sites we reviewed in prior years. However, we, and the Department's Office of Independent Oversight and Performance Assurance, continued to identify network security weaknesses at sites reviewed in fiscal year 2003, although the frequency and severity of those weaknesses were less than in prior years. Improvements are still needed in the areas of password management, configuration management, and restriction of services.

The identified weaknesses and vulnerabilities increase the risk that malicious destruction or alteration of data or unauthorized processing could occur. Because of our concerns, we performed supplemental procedures and identified compensating controls that mitigate their potential effect on the integrity of the Department's financial systems.

Recommendation:

We recommend that the Department's Chief Information Officer take actions to improve network security throughout the Department. Detailed recommendations to address the issues discussed above have been separately reported to the Office of the Chief Information Officer.

Finding 2: Information Systems Access and Other Security Controls

The Department has mandated compliance with several Federal information security directives and public laws in DOE Order 205.1, *Cyber Security Management Program*, dated March 21, 2003. The Order also establishes policies for the protection of unclassified information and information systems. Within this security framework, the Department operates the financial management systems that provide the information needed to prepare its consolidated financial statements.

Our fiscal year 2003 audit disclosed weaknesses in access and other security controls at several sites, similar to our prior year findings. Specifically, we noted weaknesses in the review of physical access controls, monitoring of networks for questionable activity, password security, restriction and review of user privileges, segregation of incompatible privileges, and contingency and disaster recovery planning. In addition, we identified weaknesses in security planning, including insufficient identification of critical and sensitive systems and applications, and

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Exhibit I – Reportable Conditions, Continued

outdated or nonexistent risk assessments and security certifications for support systems and major applications. Further, the Department's Office of Inspector General also reported deficiencies in the Department's network and information system risk management, contingency planning, configuration management, and access controls in its evaluation report on *The Department's Unclassified Cyber Security Program*, dated September 2003.

The Department has acknowledged the need to improve its information systems security and other information technology controls. In fiscal year 2003, the Department's Chief Information Officer initiated an aggressive approach to identify the root causes of the control weaknesses and to develop new policies and procedures to strengthen controls and reduce network vulnerabilities. Once implemented, these new policies and procedures should strengthen the Department's overall cyber security program. While significant progress has been achieved, continued focus is needed to resolve the access and security control weaknesses noted above.

The identified weaknesses in access and computer security controls may threaten the integrity of essential financial management system data. Because of our concerns, we performed supplementary audit procedures and identified compensating controls that mitigate the potential effect of these security weaknesses on the integrity of the Department's financial systems. However, we did not address the potential effect of the security weaknesses on the integrity of the Department's non-financial systems.

Recommendation:

As recommended in the prior year, the Department's Chief Information Officer should monitor and enforce the implementation of its Cyber Security Program throughout the Department to ensure that the Federal information security standards are met and that its networks and information systems are adequately protected against unauthorized access. Detailed recommendations to address the issues discussed above have been separately reported to the Office of the Chief Information Officer.

Performance Measurement Reporting

Statement of Federal Financial Accounting Standards (SFFAS) No. 15, *Management's Discussion and Analysis*, requires Federal agencies to include, in documents presenting their financial statements, discussion and analysis of the financial statements and related information, including performance measures.

The Department presents performance measurement data and other information required by SFFAS No. 15 for each of its principal programs in the Management's Discussion and Analysis section of its *Fiscal Year 2003 Performance and Accountability Report*. This performance measurement data is based primarily upon information from the Department's *Strategic Plan* and the revised final goals for fiscal year 2003 published in the *Revised Final Annual Performance Plan for Fiscal Year 2003*, prepared under the requirements of the *Government Performance and Results Act of 1993*.

Prior audits have reported that many of the Department's performance measures (1) were not stated in objective or quantifiable terms; (2) were not clearly written to be understandable; and (3) did not provide related cost information. During fiscal year 2003, the Department made significant progress in resolving performance reporting issues, but more remains to be done.

Finding 3: Performance Measurement Reporting

The OMB indicates that performance measures should be output or outcome oriented, meaningful and relevant, objective and quantifiable, and consistent with the measures developed in the strategic planning process. Performance measures should also be described in terms understandable to a non-technical audience. Finally, underlying records should support the reported information, and controls should be in place to ensure the accuracy of the reported results.

In fiscal year 2003, the Department implemented a new performance management system to track and report quarterly on its performance measures. The Department also made progress in improving the quality and measurability of its performance measures and in linking costs to performance at the general goal level. In fiscal year 2003, we selected a statistical sample of 32 performance measures, called annual performance targets, and found that:

- Two targets were initially reported incorrectly as being met, even though the supporting data clearly stated that the efforts were terminated or reduced.
- One target was reported incorrectly as being met, based on insufficient data.
- Four targets were not written in specific or easily understandable terms.
- One target was not easily quantifiable.

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Exhibit I – Reportable Conditions, Continued

These deficiencies limit the reader's ability to properly assess the Department's performance.

Management has indicated that its planned fiscal year 2004 changes to the performance measurement process will be responsive to our recommendations.

Recommendation:

We recommend that the Department's Chief Financial Officer strengthen internal controls to ensure the accuracy of reported performance data and the availability of related supporting documentation, and continue to improve the development of performance measures consistent with the *Government Performance and Results Act*, applicable OMB guidance, and Federal accounting standards. Making these improvements will require cooperation from all elements within the Department.

Independent Auditors' Report
Exhibit II – Status of Prior Year Audit Findings

Reportable Conditions from Fiscal Year 2002
(with parenthetical disclosure
of year first reported)

Status at September 30, 2003

- | | |
|---|--|
| 1. Unclassified Information Systems Security (1999) | Still reported in Exhibit I as a reportable condition. |
| 2. Performance Measurement Reporting (1997) | Still reported in Exhibit I as a reportable condition. |