U.S. DEPARTMENT OF ENERGY

OFFICE OF INSPECTOR GENERAL

OFFICE OF AUDIT SERVICES

AUDIT OF
THE U.S. DEPARTMENT OF ENERGY'S
CONSOLIDATED STATEMENT OF FINANCIAL POSITION

(As of September 30, 1995)

REPORT NUMBER: IG-FS-96-01
FEBRUARY 29, 1996

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United States Government
Department of Energy
memorandum

DATE: February 29, 1996

REPLY TO
ATTN OF: IG-1

SUBJECT: INFORMATION: Report on "Audit of the Department of Energy's Consolidated Statement of Financial Position as of September 30, 1995"

TO: The Secretary

BACKGROUND:

The subject report is provided to inform you of the results of our audit.

DISCUSSION:

The Office of Inspector General was unable to express an opinion on the reasonableness of the Department's Statement of Financial Position as of September 30, 1995. Increased management involvement in identifying unfunded liabilities, and strengthened controls over property and equipment are needed in order for the Department to prepare future financial statements that present fairly, in all material respects, its financial position. The Office of Chief Financial Officer agreed with our findings and recommendations, and has initiated actions to respond to them. These initiatives will require top management support throughout the Department to ensure their success.

CHALLENGES TO THE DEPARTMENT:

Although the Office of Inspector General was unable to express an opinion on the Statement, the preparation and audit of the Fiscal Year (FY) 1995 Statement of Financial Position was noteworthy because it was a first-time effort by the Department. As such, the Department did not have the benefit of past plans and experience to draw on in organizing, planning, coordinating, and executing the preparation and audit of the statement. Additionally, the Department was faced with the unique challenges posed by its changing mission environment which had a dramatic impact on the Department's FY 1995 Statement of Financial Position. Key challenges posed by the uniqueness of the effort included organizing and coordinating Departmental resources to prepare the statement for audit. Especially challenging was organizing program managersm involvement in the process to obtain their representations about the accuracy and completeness of their information in the financial statement. Another major challenge was coordinating multiple sources of information to provide the timely submission of consolidated financial information for audit purposes. Although progress was made in responding to these challenges during FY 1995, increased efforts need to be made during the preparation of the FY 1996 financial statements to obtain greater management involvement in the process, as well as to provide timely information for audit.

Recognizing the financial impact of the Department's changing mission also posed major challenges to the preparation of the statement. Major international developments have lessened the need for many of the Department's national security mission related assets. Accordingly, the Department initiated a major effort in FY 1995 to identify and revalue facilities and inventories that were surplus to its mission needs. During FY 1995, the Department also recognized unfunded environmental liabilities of almost $200 billion related to the cleanup of environmental contamination caused by past activities of the Department and its predecessor agencies. While we found the estimate to be based on some assumptions that are uncertain, the estimate is historic because of its magnitude and is likely to be one of the major unfunded liabilities of the entire Federal Government. Recognition of these unfunded environmental liabilities resulted in the Department reporting that it had a negative net position of approximately $127 billion as of September 30, 1995.

MANAGEMENT RESPONSE:

The Office of the Chief Financial Officer concurred with the results of the audit and initiated recommended corrective actions. In responding to our report, the Office of the Chief Financial Officer stated that the Departmentms accounting system was auditable and was not a factor in the

Inspector General's inability to render an opinion on the Statement of Financial Position. The Office also believed that the Department had not experienced many of the financial system problems surfaced during many first-time financial statement audits of other Federal agencies.

MEETING THE CHALLENGE:

The Department's experience in responding to the challenges described above provides valuable lessons for the preparation and audit of the FY 1996 financial statements. Greater management involvement in the financial statement process, as well as more timely availability of financial information for audit, will be needed during FY 1996.

(Signed)

John C. Layton
Inspector General

Attachment

cc: Deputy Secretary
Acting Under Secretary
Chief Financial Officer

U.S. DEPARTMENT OF ENERGY
OFFICE OF INSPECTOR GENERAL

AUDIT OF

THE U.S. DEPARTMENT OF ENERGY'S

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

(As of September 30, 1995)

Report Number: IG-FS-96-01
Capital Regional Audit Office
Germantown, MD 20874
Date of Issue: February 29, 1996

AUDIT OF THE U.S. DEPARTMENT OF ENERGY'S
CONSOLIDATED STATEMENT OF FINANCIAL POSITION

(As of September 30, 1995)

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U.S. Department of Energy
Office of Inspector General
Office of Audit Services

SUMMARY

Report Number: IG-FS-96-01

In preparation for fulfilling our responsibilities under the Government Management Reform Act of 1994, we planned to conduct an audit of the Department of Energy's FY 1995 Consolidated Statement of Financial Position. As discussed in the accompanying reports, the Office of Inspector General (OIG) could not express an opinion on the reasonableness of the value of assets and liabilities of the Department because of matters outside the control of the auditors that restricted the scope of their work. Although the OIG could not express an opinion, the audit disclosed reportable conditions in the Department's internal control structure that adversely affected its ability to manage and account for its assets and liabilities. Corrective management actions on these reportable conditions should help the Department in preparing its Fiscal Year (FY) 1996 Statement of Financial Position.

BACKGROUND

The Department of Energy is responsible for a wide variety of missions and programs focusing on national defense, environmental cleanup, research and development, and energy resources. To carry out these missions and programs, the Department manages over $90 billion in assets through a staff of over 20,000 Federal employees and more than 120,000 contractor employees. These employees are located nationwide at over 40 major Departmental field locations. The Department's financial management system operates through a decentralized system composed of integrated contractors, field offices, and Headquarters offices.

SCOPE AND METHODOLOGY

The Government Management Reform Act of 1994 requires Federal agencies, including the Department of Energy, to issue audited financial statements by March 1, 1997. Because the Department did not have audited consolidated financial statements prior to FY 1995, the OIG determined that it would be more practical to accomplish the audit objectives of the Act through a multi-phase strategy. The audit of the FY 1995 Statement of Financial Position was the first phase of the strategy. It was intended to provide audited opening balances for the FY 1996 audit of the Statement of Financial Position and facilitate the audit of the Statement of Operations for FY 1996.

The OIG determined the account balances that were material to the Departmentms Statement of Financial Position. As a result, the OIG selected 15 major accounts that represented over 95 percent of the Departmentms assets, liabilities, and equity accounts. Audit procedures on these accounts were conducted nationwide at 29 of the 62 entities reporting financial information. These audit procedures included tests of internal controls, compliance with applicable laws and regulations, and substantive tests of account balances.

The OIG audit effort was augmented through agreed upon procedures applied by an independent public accounting firm, as well as audit procedures applied by internal audit staffs of six of the Department's integrated managing and operating contractors. The OIG provided quality assurance procedures throughout the audit to ensure accuracy, completeness, and consistency for all work performed. Responsibility for the reports on the Department's Statement of Financial Position rests solely with the OIG.

RESULTS IN BRIEF

The OIG was not able to satisfy itself as to the reasonableness of the value of assets and liabilities of the Department as of September 30, 1995. The scope of audit, as described in the accompanying audit reports, was not sufficient to express an opinion, and the OIG did not express an opinion, on the Statement of Financial Position.

As part of the audit, the OIG identified reportable internal control weaknesses that could adversely affect the Department's preparation of complete and accurate financial statements. The OIG determined that the Department did not have a system to ensure that program managers were sufficiently involved in the process to identify all unfunded liabilities confronting the Department. Additionally, the OIG determined that the Department did not have adequate controls over its property and equipment to ensure proper accountability for these assets. The Department's automated financial management system was not capable of producing adjusted consolidated financial statements, and required an "off-line," personal computer-based system to record adjusting, eliminating, and consolidating entries.

A review of Departmental compliance with laws and regulations that could have a direct and material impact on the financial statements did not disclose any additional areas beyond those disclosed by the Department in its statements.

Actions to correct matters discussed in the accompanying reports will improve the Department's management and accounting controls over its financial management system. Such improvements are a prerequisite to the preparation of financial statements that reasonably represent the Department's financial position and results of operations.

U. S. Department of Energy
Office of Inspector General
Office of Audit Services

REPORT OF THE OFFICE OF INSPECTOR GENERAL

The Secretary
U.S. Department of Energy

In preparation for fulfilling our responsibilities under the Government Management Reform Act of 1994, we planned to conduct an audit of the Department of Energy's FY 1995 Consolidated Statement of Financial Position. This statement is the responsibility of the Departmentms management.

The Department's Consolidated Statement of Financial Position (Statement) was prepared in conformity with the hierarchy of accounting principles and standards approved by the principals of the Federal Accounting Standards Advisory Board, as described in Note 1 to the Statement. This hierarchy is a comprehensive basis of accounting other than generally accepted accounting principles.

In conducting the examination, several conditions impacted our ability to audit the Consolidated Statement of Financial Position of the Department as of September 30, 1995. For the reasons described below, it was not practicable to extend our auditing procedures to determine the extent to which the Statement may have been affected by these conditions.

The Department's Unfunded Environmental Liabilities of $196.9 billion did not include an estimate of the costs to remediate contamination associated with currently active facilities, as discussed in Note 12 to the Statement. The costs to remediate active facilities such as the Y-12 Plant, Pantex, Oak Ridge National Laboratory, Lawrence Livermore National Laboratory, and Sandia National Laboratories were not included in the Consolidated Statement of Financial Position as of September 30, 1995. We, therefore, were not able to apply our auditing procedures to the unfunded environmental liabilities applicable to these and other active facilities.

Also, we were not able to verify the Department's Property and Equipment, Net balance of $23.9 billion. Past practices and current weaknesses in the Department's accountability system made it impractical to rely on $1.3

billion in property and equipment at the Idaho National Engineering Laboratory and the Rocky Flats Environmental Technology Site. Other material weaknesses further impacted the reliance that could be placed on the Department's system of accounting for property and equipment. For example, the Department had not reduced to their net realizable value some surplus, excess, and obsolete facilities and equipment in the Property and Equipment, Net balance.

In addition, we were not able to verify the reasonableness of the write-down of about $3 billion to the Property and Equipment, Net balance for facilities related to the treatment, storage, or disposal of legacy waste. Such facilities are required to be written down consistent with Issue No. 90-8 of the Financial Accounting Standards Board Emerging Issues Task Force. Although the Department initiated actions to write-down these assets, estimates of the balances to be recorded were not received until after yearend closing, and there was not sufficient time to extend our audit procedures to validate the adjustments.

Further, we were not able to audit the Pension and Other Actuarial Liabilities balance because the Department did not have a systematic process in place to implement Statement of Financial Accounting Standards No. 87. This pronouncement specifies accounting requirements applicable to integrated contractor pension plans. Since a systematic process was not in place for recording contractor pension costs and only limited pension liability amounts were recorded in the Departmentms Consolidated Statement of Financial Position as of September 30, 1995, we were not able to audit this unfunded liability.

We also were not able to audit the Department's disclosure of over $1.9 billion in potential unfunded liabilities for activities that must be completed to comply with environment, safety, and health laws and regulations, as described in Note 16 to the Statement. Because data supporting this disclosure was not identified until after yearend, there was not sufficient time to extend our audit procedures to validate the disclosure.

Finally, we could not determine what portion of the Bonneville Power Administration's assets and liabilities were attributable to the Department of Energy. Bonneville's assets and liabilities are owned by multiple Government agencies and are audited separately under the provisions of the Chief Financial Officers Act. In performing the audit, we were not able to obtain adequate assurance that the balances attributable to Bonneville and included in the Departmentms Consolidated Statement of Financial Position were accurate and complete.

DISCLAIMER OF OPINION

Because the scope of our work was not sufficient to enable us to express an opinion as discussed in the above paragraphs, we cannot and do not express an opinion on the U.S. Department of Energy's Consolidated Statement of Financial Position as of September 30, 1995.

MATTERS OF EMPHASIS

In addition to the matters discussed above, several other matters of importance should be noted in understanding the Department's Consolidated Statement of Financial Position as of September 30, 1995. As described in Note 12 to the Statement, the Department's environmental remediation liability of $196.9 billion is based on cost estimates that are highly uncertain. The uncertainty is due to the length of time over which the remediation work is planned; the lack of knowledge as to what remedies will be considered acceptable to regulators and the public; the uncertainty as to whether Congressional appropriations will be received at the levels anticipated in the estimate; potential cost increases caused by future inflation; the uncertainty as to whether geological repositories will be available to receive wastes when planned; and the uncertainty inherent in the estimating process. In addition, the cost estimates assume that the Department's Environmental Management Program will increase its productivity by 20 percent over the period beginning with FY 1996 and ending with FY 2000 and by 1 percent in each year thereafter until the completion of the environmental management program. It is uncertain whether the Department will achieve the assumed level of productivity improvements.

Also, the Department has significant quantities of nuclear materials that are excess to national security needs, as discussed in Note 8 to the Statement. Departmental officials are presently determining whether alternative uses exist for these materials. For such materials determined to have no alternative use, the Department should recognize a liability for storage and disposition costs associated with the materials. Since a final decision on this material has not been made, the Department was unable to determine the amount of storage and disposition costs that will ultimately be recognized.

The Department also is a party to various administrative proceedings, legal actions, and tort claims that may ultimately result in settlements or decisions adverse to the Government, as discussed in Note 15 to the Statement. The Office of General Counsel, in responding to our inquires about these matters, was not able to form a conclusion as to the likely outcome or potential loss resulting from litigation, claims, and assessments against the Department. Readers of the Departmentms Consolidated Statement of Financial Position should, therefore, be aware that the Statement may be affected by uncertainties concerning the outcome of claims described in Note 15 which are not currently susceptible to reasonable estimation.

MATTERS REQUIRING CONSIDERATION WHICH DO NOT AFFECT THE OPINION

We planned to perform our audit for the purpose of forming an opinion on the Department's Consolidated Statement of Financial Position as of September 30, 1995, taken as a whole. An Overview of the Reporting Entity and Supplemental Financial and Management Information are not required parts of the Department's financial statements, but are supplementary information specified by Office of Management and Budget Bulletin No. 94-01, Form and Content of Agency Financial Statements. As of the completion of field work, management had not completed preparation of the Overview of the Reporting Entity and Supplemental Financial and Management Information. Because we were not provided this additional information and were not able to express an opinion on the Consolidated Statement of Financial Position as of September 30, 1995, we cannot and do not express an opinion on the Overview of the Reporting Entity and Supplemental Financial and Management Information to the Department's Fiscal Year 1995 financial statements.

REFERENCE TO OTHER REPORTS

In accordance with Government Auditing Standards, we have also issued a report dated December 29, 1995, on our consideration of the Departmentms internal control structure and a report dated December 29, 1995, on its compliance with laws and regulations.

_____(Signed)________
December 29, 1995

U.S. Department of Energy
Office of Inspector General
Office of Audit Services

REPORT OF THE OFFICE OF INSPECTOR GENERAL ON INTERNAL CONTROL STRUCTURE

The Secretary
U.S. Department of Energy

In preparation for fulfilling our responsibilities under the Government Management Reform Act of 1994, we planned to conduct an audit of the Department of Energy's FY 1995 Consolidated Statement of Financial Position, and have issued our report thereon dated December 29, 1995. Because of problems described in that report, we disclaimed an opinion on the Consolidated Statement of Financial Position.

The management of the Department is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that the following objectives are met:

> Transactions are executed in accordance with managementms authorization and are properly recorded and accounted for to permit the preparation of reliable financial reports in accordance with applicable accounting policies and to maintain accountability over the assets.
>
> Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.
>
> Transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements, and in compliance with any other laws and regulations that Office of Management and Budget (OMB), Departmental management, or the Inspector General have identified as being significant and for which compliance can be objectively measured and evaluated.
>
> Data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our testwork of the Department's Statement of Financial Position as of September 30, 1995, we considered its internal control structure in order to determine our audit procedures for the purpose of expressing an opinion on that financial statement. Our consideration included obtaining an understanding of the significant internal control structure policies and procedures, determining whether they had been placed in operation, assessing the level of control risk relevant to all significant account balances, and performing sufficient tests to assess whether internal controls are effective and working as designed. Our evaluation of the internal control structure was conducted to determine whether it met the objectives identified in the previous paragraph and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

We did not evaluate the internal control system related to the proper accumulation, validation, and presentation of performance information because the Department had not developed such a system. Performance information was not presented with the Department's FY 1995 Statement of Financial Position.

In evaluating the internal control structure, we considered matters reported by the Department in compliance with the Federal Managers' Financial Integrity Act, our prior and current audit reports, and other independent auditor reports on financial matters and internal accounting control policies and procedures. The Appendix to this report lists audit reports published by the Office of Inspector General during FY 1995 that were considered in our evaluation of the internal control structure.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants and OMB Bulletin No. 93-06, Audit Requirements for Federal Financial Statements. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the Department's ability to ensure that the objectives of the internal control structure, as previously defined, are being achieved. The conditions that we consider to be reportable conditions are discussed in Exhibits I and II to this report.

A reportable condition is classified as a material weakness when the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts material to the financial statement being audited, or material to performance measures or the aggregation of performance data, may occur and not be detected within a timely period in the normal course of business. We considered all conditions discussed in Exhibit I to this report to be material weaknesses. Management should consider these weaknesses when preparing its yearend assurance memorandum on management controls.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above.

During our review of the FY 1995 Federal Managers' Financial Integrity Act compliance activities, we also noted certain matters that may affect the Department's internal control structure in future periods. The Department underwent a number of significant changes in its internal control structure during FY 1995. These changes included a realignment of Departmental missions and functions, significant reductions in Federal and contractor staffing levels, severe budget restrictions imposed by the Congress, changes in how management and operating contractors are managed, and the adoption of performance-based contracting approaches. Because of the magnitude of these changes, we were not able to fully evaluate whether these changes would significantly impact the future operations of the Department. While these matters did not impact our testwork in our examination of the FY 1995 Statement of Financial Position, they may significantly impact the Department's internal control structure in subsequent periods.

We also noted other matters involving the internal control structure and its operation that we have reported to the Department in a separate management report.

This report is intended for the information of the management of the U.S. Department of Energy. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

______(Signed)______
December 29, 1995

Liabilities Not Covered by Budgetary Resources

Background: The Department, based on past events and its continuing mission, is subject to a number of liabilities that cannot be calculated with certainty. These liabilities, particularly those related to environmental management activities and contractor employee pension plans, involve resource outflows that will not occur until well into the future and, as such, are not covered by budgetary resources. Exact amounts for these liabilities cannot be determined because of uncertainties such as the amount and timing of Congressional appropriations, the amount and extent of environmental contamination at uncharacterized facilities, and pension plan unknowns such as the actual return on plan investments and participant lifespans. While exact dollar amounts cannot be determined, Departmental management is responsible for developing estimates of such liabilities that are complete and independently verifiable.

Finding 1: Estimating Liabilities of a Contingent Nature

OMB Bulletin No. 94-01, Form and Content of Agency Financial Statements, and generally accepted accounting principles require the Department to identify and report all liabilities not covered by budgetary resources in its Statement of Financial Position. The Department's method of identifying and validating estimated liabilities, however, is not completely effective. We found the following problems:

* The Department relied primarily on the FY 1995 Baseline Environmental Management Report (BEMR) as the basis for recording its unfunded environmental liability and did not estimate or record a liability for the cost of remediating environmental damage associated with currently active facilities;

* The BEMR cost estimate omitted certain items and contained other errors that amounted to a net overstatement of about $800 million;

* The Department did not require all contractors with defined benefit pension plans to implement Statement of Financial Accounting Standards No. 87 (SFAS 87), Employers' Accounting for Pensions, and is therefore unable to estimate the effect of pension costs on its liabilities; and

* The Office of Chief Financial Officer was unaware of an estimate developed by management that purported to represent a $1.9 billion liability related to noncompliance with Environment, Safety and Health (ES&H) laws and regulations.

These problems occurred because the Department's management had not developed and implemented a system or systems to ensure that:

* Cognizant program elements identify issues that may result in contingent liabilities and, when required, develop estimates to support accruals for such liabilities;

* All aspects or components of an issue are addressed or considered when developing such estimates; and

* Completed estimates are evaluated for reasonableness and conform to applicable accounting guidance.

The conditions identified above result in a misstatement of the Department's Statement of Financial Position with respect to the balance reported for liabilities not covered by budgetary resources. Although the total dollar effect cannot be determined because current estimates of remediation costs for active facilities were not prepared and because actuarial reports required for SFAS 87 valuations were not obtained, we believe that the misstatement is most likely material.

Recommendation: Management officials, in coordination with the Office of Chief Financial Officer, should develop a system or systems to ensure that amounts recorded by the Department for liabilities not covered by budgetary resources are complete and that estimates prepared to support the accrual are evaluated for reasonableness and conform to applicable accounting guidance.

More detailed recommendations regarding unfunded environmental liabilities and implementation of SFAS 87 are included in the detailed findings and recommendations that follow. A detailed finding related to the purported $1.9 billion liability for noncompliance with ES&H related laws and regulations has not been included because the Department provided disclosure and is working to validate and refine the estimate.

Management Reaction: Management concurred with the finding and recommendation and stated that the Office of Chief Financial Officer has and will continue to reach out to field and program officials. Such efforts will help support preparation of the financial statements, including the discovery and reporting of unfunded liabilities. As in the past, the Office of the Chief Financial Officer will rely on cognizant program offices for validation of estimates.

Auditor Response. Management's proposed actions are generally responsive to our recommendation. We agree that outreach efforts should form an integral part of our recommended approach. Such efforts must also include increased coordination and interaction between the Office of Chief Financial Officer and field and program management officials. To be successful, outreach efforts must inform program officials of the character and nature of items that may require financial statement recognition. Program officials must also understand the extent and type of evidence necessary to support the financial statement disclosure or accrual of contingent liabilities.

Unfunded Environmental Liabilities

Background: The Department relied on the FY 1995 BEMR as the primary basis for recording its unfunded environmental liabilities. This study, required by the National Defense Authorization Act of 1994, estimated that the cost of remediating environmental damage related to the Environmental Management Program would range from $200 billion to $350 billion, with a mid-range estimate of $230 billion. This estimate included $24 billion for costs related to the treatment, storage, and disposal of future waste streams generated by ongoing operations.

The Chief Financial Officer appropriately concluded that costs related to future waste streams generated by ongoing operations did not presently constitute a liability. Based on that conclusion, the Department recorded unfunded environmental liabilities of $206 billion, the mid-range BEMR cost estimate ($230 billion) less the portion of the estimate attributable to ongoing operations ($24 billion). Funding received during FY 1995 and other adjustments further reduced total unfunded environmental liabilities to $196.9 billion as of September 30, 1995. The amount recorded does not, however, include remediation costs associated with currently active facilities.

Finding 2: Determining Remediation Costs for Currently Active Facilities

Generally accepted accounting principles require that a liability be recorded, with a corresponding charge to expense, for all discrete environmental remediation projects associated with past activities that can be identified and for which costs can be estimated. The Department did not include an estimate of environmental remediation costs associated with currently active facilities in its unfunded environmental liabilities balance as of September 30, 1995. Examples of costs excluded are those required to remediate most contaminated facilities at the Y-12 Plant located in Oak Ridge, Tennessee; the Pantex Plant located near Amarillo, Texas; and those located at some of the Departmentms multi-program research laboratories. Estimates of remediation costs for these facilities were not developed during preparation of the FY 1995 BEMR because the Department considered such costs to be outside the scope of its Environmental Management Program. The exclusion of active facilities' remediation costs understates the Department's unfunded environmental liabilities. It is not possible to estimate the total impact of these omissions because current cost estimates were not prepared; however, the omission most likely resulted in a material misstatement of the Department's unfunded environmental liabilities.

Recommendation: The Department should develop an estimate of the remediation costs for active facilities using a methodology consistent with that of the BEMR and should adjust its unfunded environmental liabilities accordingly.

Management Reaction: Management generally concurred with the finding and agreed that remediation costs associated with active facilities are probable and reasonably estimable. However, management believes that the cost to complete studies normally used to estimate eventual remediation costs (remedial investigations and feasibility studies) consistent with the BEMR methodology would outweigh any benefit derived. Therefore, management is evaluating other methods of estimating remediation costs for active facilities to meet accounting requirements.

Auditor Comments: Management's planned actions are generally responsive to our recommendation. Should management choose an estimating methodology other than that used to develop the BEMR estimate, such methodology must produce an estimate that is complete, reasonably consistent, and readily verifiable.

Finding 3: Preparation of the BEMR Cost Estimate

As a component of its overall internal control structure, the Department is responsible for establishing a system of controls to provide reasonable assurance that estimates supporting accruals of unfunded environmental liabilities are complete and readily verifiable. The Department's control system was not totally effective in preventing or detecting errors and omissions in the data used to develop the BEMR. Our review disclosed examples of the following problems:

* Supporting documentation for certain project cost estimates could not be produced;

* Project cost estimates could not be traced to support;

* Certain project costs were omitted from estimates; and

* Estimates contained mathematical and modeling errors.

Such problems occurred because the BEMR estimate was not initially intended to support a financial statement accrual and because the estimate was produced in an extremely short time frame. The monetary impact of errors ranged from $221 million to $3.4 billion, with a net overstatement of about $800 million.

Recommendation: The Department should establish internal controls to provide reasonable assurance that estimates used to support accruals of environmental liabilities are reasonable and that significant errors or omissions in such estimates are prevented or detected.

Management Reaction: Management generally concurred with our finding and recommendation and has completed or initiated corrective actions. The Office of Environmental Management commented, however, that the items identified did not materially affect the BEMR cost estimate.

Auditor Comments: Managementms proposed actions are generally responsive to our recommendation.

Contractor Pension Plans

Background: The majority of contractors performing work for the Department sponsor defined benefit pension plans for their employees. Although pension costs for these plans are related to private sector employees, the Department approves and is ultimately liable for the payment of such costs. Because Federal accounting standards are silent on costs related to private sector employees, the Department should account for liabilities associated with such costs based on requirements established for private sector pension costs.

The Department's current policy is to authorize contributions to these plans and to recognize pension costs only to the extent required by the Employee Retirement Income Security Act (PL 93-406). Such practice is contrary to SFAS 87, which recognizes that pension costs are a component of compensation expense and requires that they be recognized in the period during which employees render services.

Finding 4: Implementation of SFAS 87, Employers' Accounting for Pensions

OMB Bulletin No. 94-01 establishes a hierarchy of accounting standards for Federal agencies. Because Federal accounting standards are silent on accounting for contractor pension plans, the Department is required to follow generally accepted accounting principles prescribed for private sector entities. The Department did not, however, require that all contractors with defined benefit pension plans adopt SFAS 87. The accounting standard was not adopted because the Department did not make a firm decision or issue guidance to its integrated contractors requiring implementation during FY 1995. The dollar value effect of not implementing SFAS 87 could not be determined because the Department did not obtain required actuarial valuation reports. Not implementing SFAS 87 constitutes a material departure from generally accepted accounting principles.

Recommendation: The Department should adopt SFAS 87 during FY 1996. In so doing, the Department should develop specific guidance to field activities illustrating how SFAS 87 pension costs and position are to be calculated, recorded, and disclosed. Actuarial valuations obtained for FY 1996 should also provide the basis for adjusting the Financial Statements to reflect a FY 1995 implementation date.

Management Reaction: Management concurred with the finding and recommendation and will require contractor pension liabilities to be accrued in accordance with SFAS 87 in FY 1996.

Auditor Comments: Management's planned actions are responsive to our recommendation.

Property, Plant and Equipment

Background: The Department is charged with the responsibility of protecting and maintaining accountability over about $23.9 billion of Government property. Management of the vast majority of such property is delegated to the contractors that operate the Department's facilities across the country. These contractors are responsible for implementing financial and physical property accounting controls that are consistent with guidance promulgated by the Department and other cognizant Government bodies. As detailed in the following findings, the Department needs to strengthen its internal control system for property, plant and equipment in a number of areas.

Finding 5: Property Accountability Systems for Completed Property, Plant and Equipment (CPP&E)

Generally accepted accounting principles require the maintenance of property accounting records sufficient to support management's assertion that account balances are accurate. However, the Department cannot support the assertion that CPP&E account balances for the Rocky Flats Environmental Technology Site and the Idaho National Engineering Laboratory (INEL) are accurate. During FY 1995, one contractor replaced five separate contractors at INEL, while the management and operating contractor at Rocky Flats was replaced by a single integrating contractor. These successor contractors did not accept responsibility for CPP&E balances at contract inception because of past practices and current weaknesses in the Department's property accountability system at their respective sites. Therefore, the Department has no assurance that the combined net CPP&E balance of about $1.3 billion for these sites is reliable and free of material misstatement.

The Department has initiated action to remedy these problems by requiring that successor contractors complete wall-to-wall inventories at each of the sites.

Recommendation: The Department should monitor the contractorsm actions to ensure that the inventories are completed in a timely manner and that all required account adjustments are accomplished prior to the end of FY 1996.

Management Reaction: Management concurred with our finding and recommendation and stated that the required corrective action would be taken.

Auditor Comments: Management's proposed actions are responsive to our recommendation.

Finding 6: Application of Accounting Policies, Principles, and Procedures Related to Property, Plant and Equipment

Departmental accounting directives specify property, plant and equipment accounting policies, principles, and procedures that are applicable to all Departmental elements. These directives and other policy guidance delineate the appropriate accounting treatment for a broad spectrum of events and transactions. Despite this detailed guidance, the Departmentms internal control system to prevent or detect the inconsistent or misapplication of accounting policies, principles, and procedures was not entirely effective. The following general problem areas illustrate the deficiencies observed and summarize separate audit findings issued to various Departmental field activities:

* Some surplus, excess, or inactive facilities and equipment remained on the accounting records at cost rather than being reduced to their net realizable value;

* Certain general and administrative costs were inappropriately included in the cost of capitalized purchased assets;

* Standard service lives specified by accounting guidance were not always used for capitalized assets;

* Subsidiary ledgers were not reconciled to control accounts; and

* Physical property accounting systems contained major omissions and errors as to the status, location, and type of property.

These problems occurred because contractors misinterpreted certain requirements and Heads of Field Elements did not ensure that contractors consistently applied applicable accounting criteria. Because of these problems, the Department cannot provide adequate assurance that its CPP&E account balance is correct and not materially misstated.

Recommendation: The Department should strengthen its internal control system over property, plant and equipment accounting by reasserting that Heads of Field Elements are responsible for ensuring that contractors implement the provisions of Departmental accounting instructions. No further recommendations are made with regard to separately issued audit findings because those findings will be addressed in management reports issued at the field element level.

Management Reaction: Management generally concurred with our finding and recommendation and indicated that the required corrective action would be taken.

Auditor Comments: Management's proposed action is responsive to our recommendation.

Finding 7: Transfer of Costs Accumulated in the Construction Work in Progress (CWIP) Account

Departmental accounting guidance requires that the cost of constructed assets be removed from the CWIP account and transferred to other accounts when construction and costing are complete, when beneficial occupancy occurs, or when the project is canceled or abandoned. However, the Department's internal control system for ensuring that costs accumulated in its CWIP account are closed in a timely manner is ineffective. We observed problems related to the untimely closure of projects at each of the reporting entities covered by our audit of this account. The Department's contractors retained projects in the CWIP account long after beneficial occupancy occurred or after the project had been abandoned. We specifically identified about $525 million of costs that should have been closed to CPP&E accounts or written off. These costs were not transferred as required because contractors did not remove costs for beneficially occupied projects until all subprojects were fully costed and the Department did not provide timely authorization for the write-off of canceled projects. Retention of these costs in the CWIP account resulted in the misstatement of the yearend Accumulated Depreciation and CPP&E account balances.

The Department completed an initiative during FY 1995 that succeeded in reducing the CWIP account balance by about $2.8 billion. That initiative also identified a number of projects, in addition to those identified by our audit, with accumulated costs of $439 million as candidates for closure. We specifically considered the initiative when developing our recommendation.

Recommendation:. The Department should strengthen or improve its internal control system and augment or expand its management initiative as necessary to ensure that project costs accumulated in the CWIP account are removed in a timely manner.

Management Reaction: Management generally concurred with our finding and recommendation. As resources permit, the Office of Chief Financial Officer will require field activities to monitor the CWIP account on a monthly basis. The Office will also monitor related accounting information on a monthly basis and will use a risk-based approach to ensure that completed or abandoned projects are removed from the CWIP account in a timely manner.

Auditor Comments: Management's proposed actions are responsive to our recommendation.

Financial Management System

Background: The Department's financial management system operates through a decentralized system composed of integrated contractors, field offices, and Headquarters offices. This system was developed and implemented a number of years before the Department became subject to the requirement to produce consolidated financial statements. The Department is now involved in a multi-phased effort to develop and implement a major enhancement to its financial management system. This enhancement, known as the Management Analysis Reporting System, was designed to update the system and to increase its usefulness. As indicated by the following finding, the Department's financial management system, in its present state of development, does not provide sufficient functionality to permit the entry of financial statement-level adjusting, eliminating and consolidating entries necessary to produce adjusted consolidated financial statements.

Finding 8: Production of Adjusted Consolidated Financial Statements

Sound financial management practices require that financial management systems be capable of recording financial statement-level adjusting, eliminating and consolidating entries necessary to produce yearend financial statements. However, the Department's financial management system is not directly capable of making such entries. To compensate for this problem, Departmental officials rely on an "off-line" system, maintained on a personal computer, to record adjustments, eliminations, and consolidating entries and to produce the adjusted consolidated financial statements. Adjusting entries accumulated in the "off-line" system are not posted until the subsequent fiscal year, and information attributable to the power marketing administrations (PMA) is not recorded in the financial management system. This situation occurs because the Department's financial management system does not include features that permit financial statement-level adjustments. As a result, the Department's financial management system does not accurately reflect its consolidated position and results of operations.

Recommendation: The Department should modify its financial management system to:

* Eliminate the need for ancillary loff-linen information systems;

* Incorporate appropriate management and systems level controls; and

* Permit the entry of statement-level adjusting, eliminating and consolidating entries necessary to accurately reflect the Departmentms consolidated position and results of operations.

Management Response: Management generally concurred with our finding and recommendation. The Office of Chief Financial Officer recognized the need to improve controls over off-line adjustments and will endeavor to limit the use of such adjustments when preparing the Departmentms FY 1996 financial statements. Adequate review and approval processes are to be implemented for Headquarters level adjustments and options for recording such entries directly into the financial management system will be examined. In addition, efforts to conform PMA financial data to U.S. Government Standard General Ledger format will continue with the ultimate goal of directly including such data in the Department's financial management system.

Auditor Comments: Management's planned actions are generally responsive to our recommendations.