OFFICE OF INSPECTOR GENERAL

U.S. Department of Energy

AUDIT REPORT

OAI-FS-17-02 November 2016

THE DEPARTMENT OF ENERGY'S FISCAL YEAR 2016 CONSOLIDATED FINANCIAL STATEMENTS

Department of Energy
Washington, DC 20585

November 15, 2016

MEMORANDUM FOR THE SECRETARY

FROM: Rickey R. Hass
Acting Inspector General

SUBJECT: INFORMATION: Audit Report on "The Department of Energy's Fiscal Year 2016 Consolidated Financial Statements"

Pursuant to requirements established by the *Government Management Reform Act of 1994*, the Office of Inspector General engaged the independent public accounting firm of KPMG LLP (KPMG) to perform the audit of the Department of Energy's Fiscal Year 2016 Consolidated Financial Statements.

KPMG audited the consolidated financial statements of the Department as of September 30, 2016 and 2015, and the related consolidated statements of net cost, changes in net position, custodial activity, and combined statement of budgetary resources for the years then ended. KPMG concluded that these consolidated financial statements are presented fairly, in all material respects, in conformity with United States generally accepted accounting principles and has issued an unmodified opinion based on its audits and the reports of other auditors for the years ended September 30, 2016 and 2015.

As part of this audit, auditors also considered the Department's internal controls over financial reporting and tested for compliance with certain provisions of laws, regulations, contracts, and grant agreements that could have a direct and material effect on the consolidated financial statements. The audit revealed a certain deficiency in internal control related to the reconciliation of environmental liabilities. The following significant deficiency in the Department's system of internal control is not considered a material weakness.

> **Reconciliation of Environmental Liabilities**: Office of Management and Budget Circular No. A-123, *Management's Responsibility for Internal Control,* indicates that management should have control activities in place to help ensure that agency objectives are met. The Department had not implemented effective controls to properly reconcile and record adjustments in the environmental liability estimate. Due to turnover late in fiscal year 2016 and the lack of a complete set of procedures for new staff to follow, the Department did not identify and correct accounting entries of $3.05 billion which would have resulted in a net $1.90 billion understatement of the environmental liability. Upon further review during the process of vetting the finding, with additional information presented by the National Nuclear Security Administration, the Department determined that the largest entry of $2.45 billion was not required. The amounts were corrected prior to the issuance of the Agency Financial Report.

The Office of Inspector General issued numerous notices of findings and recommendations to management during the course of the audit. In nearly all instances, management concurred with the findings and recommendations. However, a response to one information technology-related finding indicated a partial concurrence. In addition, one response to a finding pertaining to the reconciliation of the Department's environmental liability indicated a non-concurrence. All findings will be detailed in forthcoming management letters and a management decision will be requested, as appropriate.

The results of the auditors' review of the Department's compliance with provisions of laws and regulations disclosed no instances of noncompliance or other matters 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 Bulletin Number 15-02, *Audit Requirements for Federal Financial Statements*.

KPMG is responsible for the attached auditors' report and the opinions and conclusions expressed therein. The Office of Inspector General is responsible for technical and administrative oversight regarding KPMG's performance under the terms of the contract. Our review was not intended to enable us to express, and accordingly we do not express, an opinion on the Department's financial statements, management's assertions about the effectiveness of its internal control over financial reporting, or the Department's compliance with laws and regulations. Our monitoring review disclosed no instances where KPMG did not comply with applicable auditing standards.

I would like to thank each of the Department elements for their courtesy and cooperation during the review.

Attachment

cc: Deputy Secretary
Administrator for the National Nuclear Security Administration
Under Secretary for Science and Energy
Deputy Under Secretary for Management and Performance
Chief of Staff
Chief Financial Officer

Department financial reports are available for download on the Office of the Chief Financial Officer Web site: http://www.energy.gov//cfo/reports/agency-financial-reports

INDEPENDENT AUDITORS' REPORT

KPMG LLP
Suite 12000
1801 K Street, NW
Washington, DC 20006

Attachment

Independent Auditors' Report

The Acting Inspector General, United States Department of Energy and
The Secretary, United States Department of Energy:

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of the United States Department of Energy (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.

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 United States Department of Energy 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.

Emphasis of Matters

As discussed in Note 7 to the consolidated financial statements, the Department has total direct loans and loan guarantees, net, of $17 billion and $17 billion as of September 30, 2016 and 2015, respectively, which are issued under the *Federal Credit Reform Act of 1990*. Subsidy costs of the direct loans and loan guarantees are intended to estimate the long-term cost to the U.S. Government of its loan program and include interest rate differentials, delinquencies, defaults, fees, and other cash flow items. A subsidy re-estimate is performed annually at September 30. Any adjustment resulting from the re-estimate is recognized as subsidy expense. Our opinion is not modified with respect to this matter.

As discussed in Note 15 to the consolidated financial statements, the cost estimates supporting the Department's environmental cleanup and disposal liabilities of $372 billion and $340 billion as of September 30, 2016 and 2015, respectively, are based upon assumptions regarding funding and other future actions and decisions, many of which are beyond the Department's control. Our opinion is not modified with respect to this matter.

As discussed in Note 18 to the consolidated financial statements, the Department is involved as a defendant in several matters of litigation relating to its inability to accept commercial spent nuclear fuel by January 31, 1998, the date specified in the Nuclear Waste Policy Act of 1982, as amended. The Department has recorded liabilities for likely damages of $25 billion and $24 billion as of September 30, 2016 and 2015, respectively. Our opinion is not modified with respect to this matter.

Other Matters

Interactive Data

Management has elected to reference to 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. 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.

Supplementary and Other Information

Our audits were conducted for the purpose of forming an opinion on the basic consolidated financial statements as a whole. The consolidating information in the Consolidating Schedules section, the Message from the

Secretary, the Message from the Chief Financial Officer, and Other Information section of the Department's Fiscal Year 2016 *Agency Financial Report* are presented for purposes of additional analysis and are not a required part of the basic consolidated financial statements.

The consolidating information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic consolidated financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic consolidated financial statements or to the basic consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the consolidating information is fairly stated in all material respects in relation to the basic consolidated financial statements as a whole.

The information in the Message from the Secretary, the Message from the Chief Financial Officer, and Other Information section of the Department's Fiscal Year 2016 Agency Financial Report 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 a deficiency in internal control, described below and in more detail in Exhibit I, that we consider to be a significant deficiency.

- **Reconciliation of Environmental Liabilities.** The Department had not implemented effective controls to properly reconcile and record adjustments to the environmental liability.

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.

The Department's Response to Findings

The Department's response to the findings identified in our audit is described in Exhibit I. The Department's response was not subjected to the auditing procedures applied in the audit of the consolidated financial statements and, accordingly, we express no opinion on the response.

***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

November 14, 2016

Exhibit I – Significant Deficiency

Reconciliation of Environmental Liabilities

Office of Management and Budget Circular No. A-123, *Management's Responsibility for Internal Control*, indicates that management should have control activities in place to help ensure that agency objectives are met. The Department had not implemented effective controls to properly reconcile and record adjustments in the environmental liability estimate. Due to turnover late in FY 2016 and the lack of a complete set of procedures for new staff to follow, the Department did not identify and correct accounting entries of $3.05 billion which would have resulted in a net $1.90 billion understatement of the environmental liability. Upon further review during the process of vetting the finding, with additional information provided by the National Nuclear Security Administration (NNSA), the Department determined that the largest entry of $2.45 billion was not required. The amounts were corrected prior to the issuance of the Agency Financial Report (AFR).

Recommendation

We recommend that the Department implement improved controls over the environmental liability reconciliation process to verify that entries related to the environmental liability estimates are recorded appropriately in the general ledger and reconcile to supporting documentation.

Management's Response

The US Army Corps of Engineers (USACE) provided a revised estimate of the Mixed Oxide Fuel Fabrication Facility (MOX) in mid-August 2016, which extended the timeline for an additional 19 years. This revised estimate did not include costs for additional items such as storage for the additional time period. An Environmental Management (EM) staff member provided a rough (everyone agrees that this was a "back of the envelope") estimate of $2.454 billion for this storage. On October 20, 2016, the Office of the Chief Financial Officer (OCFO) suggested for the $2.454 billion to be disclosed as a footnote due the uncertainty of the cost alignment, but KPMG proposed that OCFO book this $2.454 billion. The requirement to align costs and to book the contingency was originally identified by KPMG during discussions between EM, NNSA and OCFO regarding the timing and scope of a new estimate provided by NNSA and prepared by USACE for MOX. As of October 28, 2016 the OCFO did not record the additional estimated contingent liability.

Subsequent to October 28, 2016 OCFO recorded the $2.454 billion estimated contingent liabilities. The estimated contingent liability was recorded with EM's confirmation it was only to be posted as a contingent liability and not a life cycle cost liability. The rough estimate submitted by EM had yet to go through the full review process by NNSA and EM offices.

However, during the exit conference on November 10, 2016, it was confirmed by the NNSA MOX Program Executive that the $2.454 billion is an uncertain cost to the program and should not have been included as part of the MOX cost alignment. This is also noted [in the finding above]. As a result of the exit conference discussion, the OCFO reversed the $2.454 billion and footnoted the uncertainty of the cost alignment as originally had planned prior to the conversation with KPMG LLP.

OCFO disagrees with KPMG's determination that this issue is a significant deficiency for the following reasons:

- **Procedures and internal controls are and were in place. OCFO has a process in place to review the statements and AFR before it is finalized and published.** OCFO has provided the procedures and evidence of the review activity for FY 2015 and FY 2016 to KPMG. OCFO originally wanted this $2.454 billion cost to be disclosed in the footnote. This approach was subsequently confirmed by the NNSA MOX Program Executive that this cost involved too much uncertainty and it shouldn't be included as a liability on our Balance Sheet. Therefore, there is no breakdown in the process controls over the preparation of the financial statements. The measurability and the probability of this cost does not meet the conditions within Statement of Federal Financial Accounting Standards (SFFAS) 5 on contingencies.

- **The amount is not information that management will rely on and will not form a basis for decision-making**. The Government Accountability Office (GAO) Financial Audit Manual (FAM) 540.02 states that consideration should be given to whether the information that was misstated was something that someone would have used for management decision-making purposes. Due to the uncertainty of the program direction/ approach and the associated cost alignment, the entry should not be included in the liability on the Balance Sheet because the MOX approach of the surplus plutonium disposition is facing potential termination of its project. By disclosing the cost alignment information in the footnote, this will ensure that information is presented as accurately reasonable for management decision-making.

- **Even if the adjustment was needed to align with the USACE MOX, it is immaterial** because it was only 0.66% of the total Environmental Cleanup and Disposal Liabilities and makes up 0.48% of the Department's $510.721 billion total liability.

- **Even if the adjustments noted in the Conditions section of the Notification of Findings and Recommendations (NFR) were needed, the amounts are significantly below materiality of total liabilities**. American Institute of Certified Public Accountants (AICPA) AU-C 265.A06 provides the factors that identify the magnitude of a misstatement that might result from a deficiency in internal controls as follows:

  - The financial statement amounts or total of transactions exposed to the deficiency - The DOE error was 4 transactions for an absolute value of $3.05 billion, which is significantly below materiality of the total liabilities of $510.721 billion.

- **The amount in contention is not material to result in a finding of a significant deficiency**. The Gross Costs on the FY 2016 Statement of Net Cost is $79 billion. The errors from the Headquarters (HQ) reconciliation of Note 3 was a net adjustment of $1.90 billion or 2.4% of Gross Costs (GC).

- **The finding on the HQ Note 3 reconciliation process does not rise to the materiality factors in AU-C312.04.**

  - The auditor's consideration of materiality is influenced by the auditor's perception of the needs of users of financial statements. The perceived needs of users are recognized in the discussion of materiality in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information, which defines materiality as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement".

The 4 noted transactions under the Condition section of the NFR occur once a year and 3 of the 4 transactions were placeholders or contingent liabilities. Given that the Environmental Cleanup and Disposal Liabilities includes subjective judgments on estimates, uncertainty on the future path of the approach currently undertaken, uncertainty of reliability of some of the details of the estimates in calculating certain contingencies related to environmental liabilities as a whole based on current knowledge, experience and technology regarding clean-up activities in consideration of future events, the qualitative characteristics involved does not meet a supportable judgment process of this materiality test.

Procedures and internal controls are and were in place. DOE has an established process in place to review the statements and AFR before it is finalized and published. It is management's judgment that Conditions noted in this NFR would have been identified by DOE before the final statements were delivered. In addition it is also management's judgment that [the situation related to MOX] should have been disclosed in the footnote and was confirmed by NNSA from a programmatic perspective. Thus, there was no omission in reporting liabilities that would mislead the reader of the financial statements nor would lead to incorrect management decision-making.

For the above reasons, and on the basis of reasonableness and management professional judgment, we do not concur that the finding rises to a significant deficiency.

Auditor Comments

Management did not agree that improved controls were needed to address the four identified errors. While management asserted that it would have identified the errors prior to the issuance of the financial statements, our review of the documentation provided in response to the finding did not find that the management review referred to in their response operated at a level of precision to identify the errors in a timely manner. A majority of the documentation evidenced reviews that were contemporaneous with the errors and as such did not demonstrate a compensating review. The documentation that evidenced a final review did not demonstrate a level of precision to compensate for the errors we noted. We maintain our recommendation that the Department implement improved controls over the environmental liability reconciliation process.

GAO's Financial Audit Manual identifies a significant deficiency to include a misstatement of the entity's financial statement that is more than inconsequential. We maintain our position that errors aggregating to $3.05 billion, representing 4.8 percent of the Department's net costs, although not material is more than inconsequential.

FEEDBACK

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Office of Inspector General (IG-12)
Department of Energy
Washington, DC 20585

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