Independent Auditors' Report


DEPARTMENT OF COMMERCE
UNITED STATES OF AMERICA

UNITED STATES DEPARTMENT OF COMMERCE
The Inspector General
Washington, D.C. 20230

November 9, 2007

MEMORANDUM FOR: Carlos M. Gutierrez
Secretary of Commerce

Elizabeth T. Barlow

FROM: Elizabeth T. Barlow
Acting Inspector General

SUBJECT: *Department of Commerce's FY 2007 Consolidated Financial Statements*, Audit Report No. FSD-18530-8-0002

I am pleased to provide you with the attached audit report required by the Chief Financial Officers Act of 1990, as amended, which presents an unqualified opinion on the Department of Commerce's FY 2007 consolidated financial statements. The audit results indicate that the Department has established an internal control structure that facilitates the preparation of reliable financial and performance information. We commend the Department for the noteworthy accomplishment of once again attaining an unqualified opinion—the ninth consecutive year.

The independent public accounting firm of KPMG LLP performed the audit of the Department's financial statements for the year ended September 30, 2007. The contract required that the audit be done in accordance with U.S. generally accepted government auditing standards and Office of Management and Budget Bulletin 07-04, *Audit Requirements for Federal Financial Statements.*

In its audit of the Department, KPMG found that

- the financial statements were fairly presented, in all material respects and in conformity with U.S. generally accepted accounting principles;
- there was one significant deficiency related to weaknesses in controls over the Department's financial management systems (but not considered a material weakness in internal control as defined in the independent auditors' report);
- there were no instances in which the Department's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act of 1996;
- there was one instance in which the Department did not comply with other laws and regulations (Anti-Deficiency Act violation at the National Oceanic and Atmospheric Administration); and
- there was one additional concern in which the Department's Office of General Counsel is reviewing whether the United States Patent and Trademark Office violated the Anti-Deficiency Act and the Patent and Trademark Fee Fairness Act of 1999 during fiscal year 2005. However, a conclusion has not yet been reached.

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The Department implemented corrective actions during FY 2007 to resolve many of the previously identified information technology control weaknesses and agreements in violation of the Anti-Deficiency Act. These actions and management's expression of its intent to resolve the remaining and newly identified weaknesses are evidence of the Department's continued commitment to sound financial management, effective internal controls, and reliable financial/performance information.

My office oversaw the audit performance and delivery. We reviewed KPMG's report and related documentation and made inquiries of its representatives. Our review disclosed no instances where KPMG did not comply, in all material respects, with U.S. generally accepted government auditing standards. However, our review cannot be construed as an audit in accordance with U.S. generally accepted government auditing standards. It was not intended to enable us to express, and we do not express, any opinion on the Department's consolidated financial statements, conclusions about the effectiveness of internal controls, or conclusions on compliance with laws, regulations, contracts, and grant agreements. KPMG is solely responsible for the attached audit report dated November 9, 2007, and the conclusions expressed in the report.

An audit action plan is not required to address the significant deficiency reported by KPMG. However, we ask that you provide a plan addressing the related specific recommendations included in the separate, limited-distribution information technology general controls report (FSD-18530-8-0001) in accordance with Department Administrative Order 213-5.

If you wish to discuss the contents of this report, please call me on (202) 482-4661, or John Seeba, Assistant Inspector General for Auditing, on (202) 482-5910. We appreciate the cooperation and courtesies the Department extended to both KPMG and my staff during the audit.

Attachment

cc: Otto J. Wolff
Chief Financial Officer and Assistant Secretary for Administration

Barry C. West
Chief Information Officer

Jon W. Dudas
Under Secretary of Commerce for Intellectual Property and
Director of the United States Patent and Trademark Office

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INDEPENDENT AUDITORS' REPORT

Acting Inspector General, U.S. Department of Commerce and
Secretary, U.S. Department of Commerce:

We have audited the accompanying consolidated balance sheets of the U.S. Department of Commerce (Department) as of September 30, 2007 and 2006, and the related consolidated statements of net cost and changes in net position, and the 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 fiscal year 2007 audit, we also considered the Department's internal controls over financial reporting and performance measures and tested the Department's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on these consolidated financial statements.

Summary

As stated in our opinion on the consolidated financial statements, we concluded that the Department's consolidated financial statements as of and for the years ended September 30, 2007 and 2006, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.

As discussed in our opinion, the Department changed its method of reporting the reconciliation of budgetary resources obligated to the net cost of operations in fiscal year 2007.

Our consideration of internal controls over financial reporting resulted in the identification of one significant deficiency related to the weaknesses in the Department's general information technology controls. However, we do not consider this significant deficiency to be a material weakness.

We noted no deficiencies involving the design of the internal control over the existence and completeness assertions related to key performance measures.

The results of our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements disclosed instances of noncompliance with the *Anti-Deficiency Act* that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and

Budget (OMB) Bulletin No. 07-04, *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 controls over financial reporting and performance measures; our tests of the Department's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements; and management's and our responsibilities.

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of the U.S. Department of Commerce as of September 30, 2007 and 2006, and the related consolidated statements of net cost and changes in net position, and the combined statements of budgetary resources for the years then ended.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Department as of September 30, 2007 and 2006, and its net costs, changes in net position, and budgetary resources for the years then ended, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 21 to the consolidated financial statements, the Department changed its method of reporting the reconciliation of budgetary resources obligated to the net cost of operations in fiscal year 2007, based on new reporting requirements under OMB Circular No. A-136.

The information in the Management Discussion and Analysis, Required Supplementary Stewardship Information, and Required Supplementary Information sections is not a required part of the consolidated financial statements, but is supplementary information required by U.S. generally accepted accounting principles and OMB Circular No. A-136, *Financial Reporting Requirements*. 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 September 30, 2007 consolidating balance sheet on page 253 is presented for purposes of additional analysis of the consolidated balance sheet rather than to present the financial positions of the Department's bureaus individually. The September 30, 2007 consolidating balance sheet has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the September 30, 2007 consolidated balance sheet taken as a whole. The information in the FY 2007 Performance Section, Appendices, and the information on pages IV through VIII are presented for purposes of additional analysis and are not required as part of the

consolidated financial statements. This information has not been subjected to auditing procedures and, accordingly, we express no opinion on it.

Internal Control over Financial Reporting

Our consideration of the internal control over financial reporting was for the limited purpose described in the Responsibilities section of this report and would not necessarily identify all deficiencies in the internal control over financial reporting that might be significant deficiencies or material weaknesses.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Department's ability to initiate, authorize, record, process, or report financial data reliably in accordance with U.S. generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Department's consolidated financial statements that is more than inconsequential will not be prevented or detected by the Department's internal control over financial reporting. A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Department's internal control.

In our fiscal year 2007 audit, we noted one matter relating to the Department's financial management systems, summarized below, and in more detail in Exhibit I, that we consider to be a significant deficiency. However, this significant deficiency is not believed to be a material weakness.

> **General information technology controls**. We found that although the Department has taken corrective actions to address certain information technology (IT) control weaknesses, general IT weaknesses still exist. Despite the positive efforts made by the Department, the Department needs to make continued improvement in its IT general control environment to fully ensure that financial data being processed on the Department's systems has integrity, is confidentially maintained, and is available when needed.

A summary of the status of the Department's prior year reportable condition is included as Exhibit II.

We also noted certain additional matters that we reported to the management of the Department in two separate documents addressing information technology and other matters, respectively.

Internal Controls over Performance Measures

Our tests of internal control over performance measures, as described in the Responsibilities section of this report, disclosed no deficiencies involving the design of the internal control over the existence and completeness assertions related to key performance measures.

Compliance and Other Matters

Our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, 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 instances of noncompliance with the Anti-Deficiency Act (ADA) that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 07-04, and are described below.

> **Anti-Deficiency Act.** As reported in the prior year, we were informed by the National Oceanic and Atmospheric Administration (NOAA) that during fiscal year 2005, 82 real property agreements, with the earliest signed in 1923, included indemnification clauses or provisions involving an indeterminate liability, or both. The Office of General Counsel (OGC) determined that these clauses or provisions were *prima facie* violations of the ADA, because those clauses constituted open-ended obligations of the U.S. Government, even though no liability claims were filed against the agreements. As of November 8, 2007, the date of our fiscal year 2007 Independent Auditors' Report, 79 agreements have been amended, terminated or expired, thereby eliminating future ADA concerns, and corrective actions are underway on the remaining 3 agreements, which are being renegotiated to remove the clauses. Plans are also being made to relocate the equipment covered by one of the remaining leases to another site in fiscal year 2008, because the lessor did not agree to make the necessary amendment.
>
> **Additional Concern.** In fiscal year 2007, The United States Patent and Trademark Office informed us that in fiscal year 2005, obligations related to the processing of patent applications temporarily exceeded fees collected related to these applications. As a result, fees intended for use in processing trademark registrations were used temporarily to fund patent obligations. The OGC is reviewing this matter to determine whether a violation of the ADA and the *Patent and Trademark Fee Fairness Act of 1999* occurred, but a conclusion has not yet been reached. Since OGC's review is not complete, the outcome of this matter, and any resulting ramifications, is not presently known.

The results of our tests of compliance as described in the Responsibilities section of this report, exclusive of those referred to in FFMIA, disclosed no other instances of

noncompliance or other matters that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 07-04.

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 United States Code, Title 31, Sections 3515 and 9106 require agencies to report annually to Congress on their financial status and any other information needed to fairly present their financial position and results of operations. To meet these reporting requirements, the Department prepares and submits financial statements in accordance with OMB Circular No. A-136.

Management is responsible for the consolidated financial statements, including:

- Preparing the consolidated financial statements in conformity with U.S. generally accepted accounting principles;

- Preparing the Management Discussion and Analysis (including the performance measures), Required Supplementary Stewardship Information, and Required Supplementary Information;

- Establishing and maintaining effective internal control; and

- Complying with laws, regulations, contracts, and grant agreements applicable to the Department, including FFMIA.

In fulfilling this responsibility, management is required to make estimates and judgments to assess the expected benefits and related costs of internal control policies.

Auditors' Responsibilities. Our responsibility is to express an opinion on the fiscal year 2007 and 2006 consolidated financial statements of the Department based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 07-04. Those standards and OMB Bulletin No. 07-04 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we express no such opinion.

KPMG

An audit also 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 provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2007 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 as a basis for designing 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. 07-04. 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 express an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting.

As required by OMB Bulletin No. 07-04 in our fiscal year 2007 audit, with respect to internal control related to performance measures determined by management to be key and reported in the Management Discussion and Analysis and Performance sections, we obtained an understanding of the design of internal controls relating to the existence and completeness assertions and determined whether these internal controls had been placed in operation. We limited our testing to those controls necessary to report deficiencies in the design of internal control over key performance measures in accordance with OMB Bulletin 07-04. However, our procedures were not designed to provide an opinion on internal control over reported performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether the Department's fiscal year 2007 consolidated financial statements are free of material misstatement, we performed tests of the Department's 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 the consolidated financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 07-04, 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, regulations, contracts, and grant agreements applicable to the Department. However, providing an opinion on compliance with laws, regulations, contracts, and

grant agreements was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 07-04 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.

The Department's response to the significant deficiency identified in our audit is presented in Exhibit I. We did not audit the Department's response and, accordingly, we express no opinion on it.

This report is intended solely for the information and use of the Department's management, the Department's Office of Inspector General, OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 9, 2007

U.S. Department of Commerce
Independent Auditors' Report
Exhibit I – Significant Deficiency

Financial Management Systems Need Improvement ***(Repeat Condition Since 1998)***

For many years, the U.S. Department of Commerce (the Department) Office of Inspector General (OIG), U.S. Government Accountability Office (GAO), and departmental self-assessments have identified weaknesses in the Department's information technology (IT) and financial systems controls. As at many federal entities, information security is recognized as a top management challenge for the Department. During our fiscal year (FY) 2007 assessment of the Department's general IT and financial systems controls, performed in support of the FY 2007 consolidated financial statement audit, we found that there is continued emphasis on the need for a strong certification and accreditation (C&A) program. We also noted that the bureaus and the Department took positive steps to implement management, operational, and technical controls to help establish sound information security practices and address known weaknesses, including an IT security material weakness reported under the *Federal Managers' Financial Integrity Act* (FMFIA) in the prior year.

Despite continued progress, during our FY 2007 audit we identified weaknesses in general IT controls that we consider to be a significant deficiency as defined by the American Institute of Certified Public Accountants. As part of the Department's FY 2007 FMFIA evaluation, the Department determined (and the OIG also confirmed) that a weakness, related to IT information security, still exists.

Effective general IT controls add assurance that data used to prepare and report financial information and statements is complete, reliable, and has integrity. Our FY 2007 IT assessment was focused on the general IT controls over the Department's major financial management systems and supporting network infrastructure, using GAO's *Federal Information System Controls Audit Manual* (FISCAM) as a guide. The six FISCAM general IT control review elements, and our related findings, are as follows:

- **Entity-wide security program.** An entity-wide security program for security planning and management is the foundation of an organization's information security control structure. The program should provide a framework and continuing cycle of activity for managing risk, developing security policies, assigning responsibilities, and monitoring the adequacy of computer-related security controls.

  Although the Department has made improvements in this area, during our FY 2007 audit we identified that entity-wide security can still be improved at all bureaus, primarily in the areas of: (1) updating risk assessments, (2) finalizing C&As, (3) updating system security plans to comply with current Federal guidance, (4) improving incidence response procedures and training, (5) ensuring completion of initial security awareness and specialized training, (6) establishing a memorandum of understanding for shared financial data, and (7) obtaining executed non-disclosure agreements from contracted personnel.

Office of Management and Budget (OMB) Circular A-130, *Management of Federal Information Resources*, provides key guidance for establishing and maintaining an entity-wide information security program. Collectively, the identified entity-wide security planning and management issues, coupled with the access control issues described below, reduce the overall effectiveness of the entity-wide security programs for the individual bureaus and operating units, and the overall Department. The *Department of Commerce IT Security Program Policy and Minimum Implementation Standards*, reiterates OMB Circular A-130 guidance, and implements key elements of such guidance as Department-wide policy.

- **Security access controls.** In close concert with an organization's entity-wide information security program, access controls for general support systems and financial systems should provide reasonable assurance that computer resources such as data files, application programs, and computer-related facilities and equipment are protected against unauthorized modification, disclosure, loss, or impairment. Access controls are facilitated by an organization's entity-wide security program. Such controls include physical controls and logical controls.

  The objectives of limiting access are to ensure that users have only the access needed to perform their duties; that access to very sensitive resources, such as security software programs, is limited to very few individuals; and that employees are restricted from performing incompatible functions or functions beyond their responsibility. This is reiterated by Federal guidelines. For example, OMB Circular A-130 and supporting National Institute of Standards and Technology (NIST) security publications provide guidance related to the maintenance of technical access controls. In addition, the *Department of Commerce IT Security Program and Minimum Implementation Standards* contain many requirements for operating Department IT devices in a secure manner.

  During fiscal year 2007, we noted that access controls should be improved at all bureaus and at the Department level, primarily in the areas of: (1) managing user accounts, (2) logical controls over financial system and network access, (3) strengthening password controls, (4) improving data center access, (5) configuring settings of system devices, (6) monitoring user actions through the use of audit trails, and (7) consistent application of patch management practices to protect system devices against vulnerabilities associated with malicious threats and attacks. We recognize that the Department and its bureaus have some compensating controls in place to help reduce the risk of the identified vulnerabilities, and we have considered such compensating controls as part of our overall consolidated financial statement audit.

- **Application software development and change control**. The primary focus of application software development and change control is on controlling the changes that are made to software systems in operation. Establishing controls over the modification of application software programs ensures that only authorized programs and authorized modifications are implemented. This is accomplished by instituting policies, procedures, and techniques to determine that all programs and program modifications are properly authorized, tested, and approved, and that access to and distribution of programs is carefully controlled. Without proper controls, there is a risk that security features could be inadvertently or deliberately omitted or turned off, or that processing irregularities or malicious code could be introduced into the IT environment.

During fiscal year 2007, we did not identify any weaknesses related to application software development and change controls at the bureaus within the scope of our audit.

- **System software.** System software is a set of programs designed to operate and control the processing activities of computer equipment. System software helps control the input, processing, output, and data storage associated with all of the applications that run on a system. Controls over access to and modification of system software are essential in providing reasonable assurance that operating system-based security controls are not compromised and that the system will not be impaired.

  During fiscal year 2007, we noted that system software controls should be improved at one bureau by improving patch management documentation processes.

- **Segregation of duties.** Work responsibilities should be segregated so that an individual does not control more than one critical function within a process. Inadequately segregated duties increase the risk that erroneous or fraudulent transactions could be processed, improper program changes could be implemented, and computer resources could be damaged or destroyed. Key areas of concern for segregation of duties involves duties among major operating and programming activities, including duties performed by users, application programmers, and data center staff. Policies outlining individual responsibilities should be documented, communicated, and enforced. The prevention and/or detection of unauthorized or erroneous actions by personnel require effective supervision and review by management, as well as formal operating procedures.

  During fiscal year 2007, we noted a weakness related to segregation of duties that affected the implementation of system software modifications at one bureau.

- **Service continuity**. Losing the capability to process, retrieve, and protect information maintained electronically can significantly affect an agency's ability to accomplish its mission. For this reason, an agency should have: (1) procedures in place to protect information resources and minimize the risk of unplanned interruptions, and (2) a plan to recover critical operations should interruptions occur.

  During fiscal year 2007, we noted that service continuity controls should be improved at five bureaus and at the Department level, primarily in the areas of: (1) updating

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Exhibit I – Significant Deficiency, Continued

contingency plans to include appropriate controls and reflect current processing environments, (2) testing disaster recovery and continuity plans, (3) procuring alternate processing sites, (4) establishing off-site storage locations that are geographically removed from primary processing sites, (5) developing a detailed policy and procedure for backing up key financial systems, and (6) improving data center physical and environmental controls.

Recommendations

Specific recommendations are included in a separate limited distribution IT general controls report, issued as part of the fiscal year 2007 consolidated financial statement audit. The Department should monitor bureau actions to ensure effective implementation of our recommendations.

Management's Response

Management agreed with our findings, conclusions, and recommendations related to improving the Department's financial management systems controls. The Department is in the process of developing corrective action plans to address the recommendations presented in the separate limited distribution IT general controls report.

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Exhibit II – Status of Prior Year Reportable Condition

Reported Issue	Prior Year Recommendation	Fiscal Year 2007 Status
Financial Management Systems Need Improvement		
Weaknesses in general controls were identified in all six FISCAM review areas.	The Department should monitor bureau actions to ensure effective implementation of our recommendations.	Significant Deficiency (see comments in Exhibit I).