United States General Accounting Office

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Report to the Chairman, Subcommittee on Interior and Related Agencies, Committee on Appropriations, House of Representatives

MINERAL REVENUES

Options to Accelerate Royalty Payment Audits Need Further Consideration

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Resources, Community, and
Economic Development Division

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June 5, 1989

The Honorable Sidney R. Yates
Chairman, Subcommittee on Interior
and Related Agencies
Committee on Appropriations
House of Representatives

Dear Mr. Chairman:

This report responds to your March 1, 1989, request for information about the Department of the Interior's funding proposal for fiscal year 1990 to hire contractor auditors. This proposal is part of a 3-year effort to accelerate royalty payment audits of Interior's Minerals Management Service (MMS) and to make them more current. Specifically, you asked us to determine

- the status of MMS' audit program,
- the effect of the 3-year effort on the current audit program,
- the completeness of MMS' benefit-cost analysis that led to the decision to use contractor auditors, and
- the possibility of conflict of interest in hiring contractor auditors and the sufficiency with which MMS has addressed this issue.

Background

MMS is responsible for collecting, accounting for, and distributing royalties from mineral leases on federal and Indian lands and the federal Outer Continental Shelf. Royalty payors (generally oil and gas companies) make royalty payments to MMS in accordance with the terms of the leases and federal regulations. The Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA) requires the Secretary of the Interior to audit all current and past lease accounts and collect any unpaid or underpaid royalties. MMS' Royalty Compliance Division is responsible for auditing royalty payments. The act also requires payors to retain records associated with royalty payments for 6 years and longer if the Secretary notifies them that Interior has initiated an audit.

Between its creation in January 1982 and April 1988, MMS did not have an overall strategy for auditing royalty payments. Most of its audit efforts during this period were directed toward responding to referrals from other bureaus within Interior, resolving findings from previous audits conducted by Interior's Office of Inspector General, and reviewing payors' royalty refund requests.

In April 1988 MMS issued a strategy for auditing royalty payments of the 232 companies that paid about 98 percent of all royalties in fiscal year 1986—12 residency companies that paid about 68 percent and 220 major companies that paid about 30 percent.[1] This strategy called for auditing 6 years of royalty payments at the residency companies by the end of fiscal year 1992. That is, payments for fiscal years 1981-86 would be audited in fiscal years 1987-92. For the major companies, 6 years of royalty payments would be audited during the year following the 6-year period selected for audit—for example, payments for fiscal years 1983-88 would be audited in fiscal year 1989.

After issuance of the audit strategy, Interior became concerned that the period for performing the audits was unnecessarily long because companies would be required to maintain accounting records for up to 12 years. According to Interior's fiscal year 1990 budget justification, a 12-year period is inconsistent with the intent of FOGRMA's record retention requirement. Consequently, effective August 31, 1988, Interior revised its strategy to make its audits more current by the end of 1992 and thus reduce the records retention period for companies. The revised strategy calls for MMS to close the gap between when royalties are paid and when the payments are audited.

MMS identified two options to carry out its strategy—hiring contractor auditors or hiring permanent federal employees—and developed cost estimates for both. MMS selected the contractor auditor option, and Interior, in its fiscal year 1990 budget submission, requested $5 million to implement the first year of a 3-year effort to hire contractor auditors. MMS expects the need for the contractor auditors to end by the beginning of fiscal year 1993.

Results in Brief

We found the following regarding each of the questions that you asked:

- As of May 24, 1989, MMS had audits ongoing at the 12 residency companies. In addition, it had completed audits at 16 major companies and had audits ongoing at 47 other major companies.

[1] MMS maintains a resident audit staff at the 12 largest companies; thus, the name "residency" companies. The next largest 220 companies are called "major" companies. Although the strategy referred to 13 residency companies, 1 of these companies, El Paso Natural Gas, was later eliminated.

- MMS' revised audit strategy, which includes a 3-year effort to accelerate royalty payment audits, will make its audit program more current—by 1993 MMS will audit payments on a 6-year cycle for the 12 largest payors, rather than a 12-year cycle. That is, starting in 1993, 3 years of royalty payments will be audited during the following 3 years. At the next 220 largest payors, 5 years of payments will be audited in the year following the 5-year period selected for audit.
- MMS did not prepare a benefit-cost analysis supporting its decision to request funds to hire contractor auditors for the one-time effort to make audits more current and did not consider hiring federal employees under term appointments who could be terminated after the audits had been made more current.
- Because MMS has not finalized its request for proposal, we cannot determine, at this time, whether it has taken sufficient steps to eliminate the possibility of conflict of interest. However, if MMS proceeds with the option of hiring contractor auditors, it plans to include language in its request for proposal intended to ensure that there are no conflicts of interest.

Based on our analysis, we do not believe that Interior's proposal to hire contract auditors has been adequately justified. MMS' proposal to accelerate the auditing of royalty payors will have the same benefits whether contract auditors or federal employees are used, but the cost would be significantly higher if contractor auditors are hired.

Status of MMS' Audit Program

MMS' August 1988 revised audit strategy calls for completing audits of residency companies' fiscal years 1981 through 1983 royalty payments by the end of fiscal year 1989. As of May 24, 1989, MMS had audits ongoing at all of the residency companies and expected to complete these audits by September 30, 1989.

MMS' April 1988 strategy called for auditing 99 major companies in fiscal years 1988 and 1989. At this time, MMS had 38 audits ongoing and planned to initiate 28 and 33 audits in fiscal years 1988 and 1989, respectively. The August 1988 revised audit strategy did not specify the years in which audits would be initiated or completed for the major companies. Table 1 presents the status of the 99 audits of the major companies that MMS had ongoing or planned to start in fiscal years 1988 and 1989. Twenty-four of the planned audits for major companies were deferred to later fiscal years because MMS shifted some of its resources from audits of the major companies to audits of the residency companies.

Table 1: Status of Audits for the Major Companies (As of March 31, 1989)

Status	Number of audits
Completed	15
Ongoing	48
Starting later in fiscal year 1989	5
Deferred	24
Canceled	3
Status not provided	4
Total	**99**

Effect of 3-Year Effort on Current Audit Program

MMS' August 1988 revised audit strategy will accelerate the audits of royalty payments. It requires MMS to complete audits of the 12 residency companies' fiscal years 1981 through 1983 royalty payments by the end of fiscal year 1989, and for fiscal years 1984 through 1989 payments by the end of fiscal year 1992. Beginning in fiscal year 1993, MMS would be on a 6-year cycle whereby 3 years of the residency companies' royalty payments would be audited during the following 3 years. The revised strategy also calls for auditing 5 years of royalty payments at the 220 major companies. Royalty payments would be audited in the fiscal year following the last year's payments to be audited (i.e., an audit initiated in fiscal year 1993 would encompass royalties paid in fiscal years 1988 through 1992).

Benefit-Cost Analysis Was Not Prepared

MMS identified two options to carry out its strategy of accelerating its audits—hiring contractor auditors or hiring permanent federal employees—and developed cost estimates for both. MMS officials told us that they do not expect any difference in the amount of unpaid royalties to be collected whether MMS or contract auditors are used. MMS selected the contractor auditor option, and Interior, in its fiscal year 1990 budget submission, requested $5 million to implement the first of a 3-year effort to hire contractor auditors. However, MMS did not prepare a benefit-cost analysis supporting its decision to request funds to hire contractor auditors.

In response to a February 1989 request from your Committee, Interior developed a paper presenting its two options. MMS identified the same benefits under both options, but different costs. MMS estimated that for fiscal years 1990 through 1992, it would cost between $22.8 million and $33.8 million to hire contractor auditors and between $10.6 million and $12.7 million to hire federal employees.

MMS provided two reasons for proposing to use contractor auditors: (1) to test the relative efficiency and effectiveness of private and public auditors and (2) to avoid excess staffing cost between the time when this effort is completed and increased staffing for this one-time effort is reduced through attrition.

The two options that MMS presented did not consider hiring federal employees under term appointments. Federal personnel regulations allow agencies to use term appointments to hire staff for up to 4 years to work on one-time efforts. Such an option would alleviate MMS' concern about the costs associated with reducing the number of federal employees after this one-time effort is completed at the end of fiscal year 1992. These employees can be terminated at the expiration of their appointments with no additional costs. We did not, however, evaluate the relative ease or difficulty that MMS might encounter in hiring or retaining employees for a limited term.

Benefits

MMS expected the following benefits under both options: (1) faster identification and resolution of royalty payment problems, (2) more timely assurance of proper royalty payments to recipients, (3) better compliance with FOGRMA record retention provisions, and (4) more certainty for all parties in completing royalty reporting transactions and periods.

Costs

MMS compared the cost of hiring contractor auditors for fiscal years 1990 through 1992 with the cost of hiring permanent federal employees during the same period. Table 2 provides MMS' comparison.

Table 2: MMS' Comparison of Hiring Contractor Auditors vs. Permanent Federal Employees for Fiscal Years 1990-92

	Contractor auditors	Federal employees
Number of staff-years		
Auditing	212	212
Cost per staff-year		
Auditing	\$100,000–\$150,000	\$50,000–\$60,000
Monitoring[a]	\$50,000–\$60,000	0
Total (Dollars in millions)	**\$22.8–\$33.8**	**\$10.6–\$12.7**

[a]According to MMS, 16 federal employees will be required in the second and third years to monitor the contractor's work.

Under both options, MMS estimated that it would take 212 staff-years to perform the audit work. On the basis of past experience, MMS estimated that it takes 3 staff-years to audit 1 year of royalty payments at a residency company and 1.6 staff-years to audit 5 years of royalty payments at a major company. Further, MMS estimated the need to hire 16 federal employees to monitor the work of the contractor auditors during the second and third year of the contract.

MMS estimated that it would cost between $100,000 and $150,000 per staff-year to hire contractor auditors. The $100,000 figure represents the actual cost, updated for inflation to 1989, incurred by Interior's Office of Inspector General when it hired contractor auditors in the past. The $150,000 figure is the 1988 cost per staff-year under an ongoing contract that MMS has with a public accounting firm.

Under both options, MMS also expects a need for an additional 22 federal employees (at an annual cost of between $1.1 million and $1.3 million) in fiscal years 1993 and beyond to keep the audit cycle current. MMS estimated that it would cost between $2.5 million and $3.1 million, and possibly higher, to reduce staffing to needed levels through attrition after fiscal year 1992 if it hired permanent federal employees. Conversely, the contractor auditors can be terminated when their services are no longer needed.

Conflict of Interest

The issue of conflict of interest was addressed by Interior's Office of Inspector General in fiscal years 1981 through 1985 when it contracted with public accounting firms for audits of some of the largest royalty payors. Interior's request for proposal contained provisions intended to ensure that there are no conflicts of interest. For example, payors to be audited should not be clients of the public accounting firms hired to perform the audits, nor should the accounting firm have any stock or ownership in the payor company. MMS is using the Office of Inspector General request for proposal as a foundation when preparing its own request for proposal. This will be reviewed and approved by Interior's Regional Solicitor's Office prior to its issuance. Because MMS has not finalized its request for proposal, we cannot determine, at this time, whether it has taken sufficient steps to eliminate the possibility of conflict of interest. MMS could not provide an estimated issuance date. As of May 24, 1989, MMS was awaiting Interior's approval to proceed with the issuance.

Conclusion

We do not believe that Interior's current proposal to hire contractor auditors to accelerate the audits of royalty payors has been adequately justified. MMS' proposal to accelerate the auditing of royalty payors will have the same benefits whether contractor auditors or federal employees are used. However, it will cost significantly more if contractor auditors are hired—about $100,000 to $150,000 per year per contractor auditor as opposed to $50,000 to $60,000 per year for each federal employee. One of the justifications cited for proposing to hire contractor auditors is to test the relative efficiency and effectiveness of private and public auditors. However, Interior's Office of Inspector General used contractor auditors during fiscal years 1981 through 1985 to audit royalty payors and, therefore, should already have a basis to make such a comparison. In addition, we question the potential for meaningful efficiencies or effectiveness because MMS officials told us that they do not expect any difference in the amount of unpaid royalties to be collected whether MMS or contractors perform the audits. Interior also is seeking to avoid excess staffing cost between the time when this one-time effort requiring additional staff is completed and when staffing is reduced through attrition. However, this cost, which MMS estimates to range between $2.5 million and $3.1 million, is small when compared with the higher cost of hiring contract auditors.

Moreover, Interior did not consider hiring federal employees for only the term of this one-time effort through the use of available federal hiring authority. Term employees can be terminated, with no additional cost, at the completion of this 3-year effort.

Recommendation to the Congress

Because MMS has not adequately considered all the options available to accelerate its audits of royalty payors, we recommend that the Congress not approve the funds Interior has requested for hiring contractor auditors in fiscal year 1990 until Interior considers all options and adequately justifies whatever option it selects.

In conducting this review, we interviewed MMS program, budget, and procurement officials at the MMS Royalty Management Program offices in Lakewood, Colorado. We also met with Interior's Acting Assistant Secretary for Land and Minerals Management in Washington, D.C. We obtained data on the status of audits that were ongoing when the April 1988 audit strategy was issued as well as the status of audits that MMS planned to start in fiscal years 1988 and 1989 from the three MMS Royalty Compliance Division area compliance offices in Lakewood, Colorado, and Dallas and Houston, Texas. The three offices provided data as of March 31, 1989. We conducted our review between March 13, 1989, and May 4, 1989.

We discussed the facts presented in this report with officials in MMS headquarters and incorporated their comments where appropriate. However, as requested, we did not obtain written agency comments on a draft of this report.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to interested parties and make copies available to others upon request.

This work was performed under the direction of James Duffus III, Director, Natural Resources Management Issues. Major contributors to this report are listed in appendix I.

Sincerely yours,

J. Dexter Peach
Assistant Comptroller General

Appendix I

Major Contributors to This Report

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