

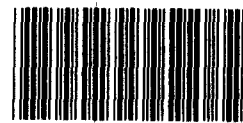
GAO

Report to the Chairman, Committee on
Interior and Insular Affairs, House of
Representatives

October 1992

ROYALTY
COMPLIANCE

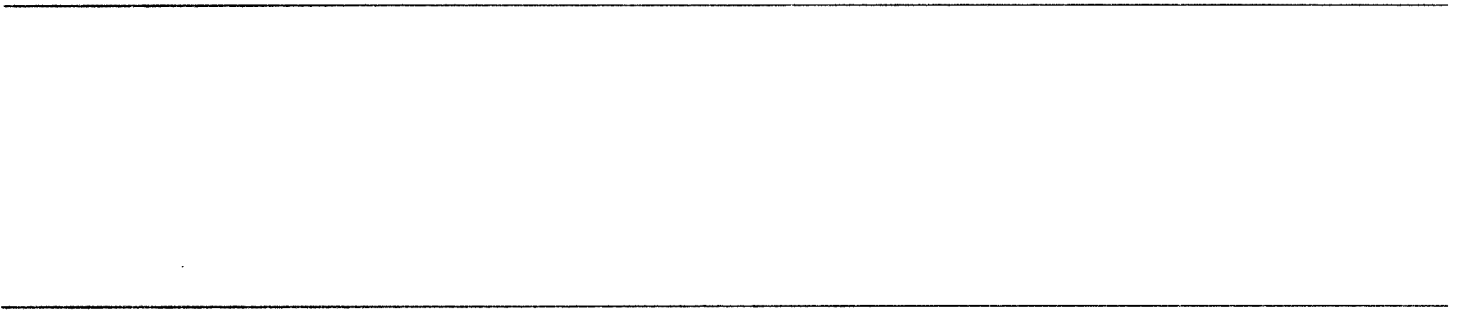
Improvements Made in
Interior's Audit
Strategy, but More Are
Needed



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**Resources, Community, and
Economic Development Division**

B-248526

October 29, 1992

The Honorable George Miller
Chairman, Committee on Interior
and Insular Affairs
House of Representatives

Dear Mr. Chairman:

Over the past few years, the Department of the Interior's Minerals Management Service (MMS) has collected about \$4 billion annually in royalty revenues from royalty payors such as oil and gas companies that hold mineral leases on federal and/or Indian land. Concerned about whether MMS is adequately ensuring proper royalty collection, you asked us to evaluate MMS' strategy for auditing royalty payors.

MMS undertakes these audits to reasonably ensure that mineral revenue reports and payments submitted by payor companies are in accordance with the requirements of leasing statutes, regulations, and policies. Under the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), the Secretary of the Interior, acting through MMS, is to audit and reconcile, to the extent practicable, all current and past accounts for leases of oil or gas and is to collect or refund additional payments as warranted.

You also asked us to obtain information on MMS' (1) communication and coordination with state and Indian tribal auditors to whom MMS delegates audit authority under cooperative agreements, (2) funding allocations to state and Indian tribal auditors, (3) plans to contract out to private firms for audits of individual Indian leases, and (4) internal controls over MMS audits in general. This information is presented in appendix I.

Results in Brief

In 1988, MMS developed a strategy for auditing royalty payors that would systematically target for audit over 90 percent of all federal and Indian royalties and that would make the audit cycle more current. MMS achieved its September 30, 1992, target date for completing the cycle. While this strategy is a substantial improvement over the nonsystematic auditing activities that preceded it, it still does not reasonably ensure, for the following reasons, that payments by royalty payors will comply with applicable laws, rules, and regulations:

- The amount of royalties actually audited or verified is very small, increasing the probability that instances of noncompliance will go undetected.
- The judgmental samples are not representative of all payors and leases; consequently, MMS cannot determine with any degree of confidence such things as the level of compliance by payors or the magnitude of underpayment—that is, the royalties at risk.

MMS can, however, require payors to perform the additional work necessary to correct the systemic problems found by audits and to compute any additional royalties due.

MMS established a task force in August 1990 to, among other things, study methods that would increase the effectiveness of its compliance activities. In its June 1991 report,¹ the task force recommended major changes to improve MMS' strategy for auditing royalty payors, including the use of statistical sampling. Such sampling of payors and leases would allow MMS to estimate things like the level of compliance and the magnitude of underpayments. It would also allow MMS to bill payors on the basis of the samples, as the Internal Revenue Service does, without requiring the payors to recompute any additional royalties due. MMS is currently examining whether and to what extent statistical sampling can be used in verifying royalty payments.

Background

The collection, accounting, and distribution of royalty revenues for minerals produced on federal and Indian land is important to the federal government and the states, Indian tribes, and Indian allottees (individuals for whom the federal government holds land in trust) who are beneficiaries of these royalty revenues. In fiscal year 1991, \$4.4 billion in royalty revenues were collected by Interior's Royalty Management Program.

MMS operates according to an honor system similar to the Internal Revenue Service's, in which the producing companies report their production and sales and then compute and pay the royalties they owe. MMS' role is primarily one of oversight—taking the actions necessary to reasonably ensure that mineral reports and payments by royalty payors comply with the various applicable laws, rules, and regulations. In fiscal years 1990 and

¹Report of the Task Force on Royalty Compliance, Department of the Interior, Office of the Assistant Secretary—Land and Minerals Management, MMS (Washington D.C., June 1991).

1991, MMS' compliance efforts resulted in additional revenues of \$54 million and \$88 million, respectively.

Ideally, a strategy for auditing royalty payors consists of systematic and field-based activities that monitor and correct the major components of the royalty equation: the volume of minerals produced, multiplied by the sales value, multiplied by the royalty rate, equals the amount of royalties owed for the minerals produced. Since its inception in 1982, MMS has developed the following three strategies/methods for ensuring that payors report and pay correctly: (1) the Auditing and Financial System (AFS), (2) the Production Accounting and Audit System (PAAS), and (3) the royalty compliance audits. AFS is designed to account for mineral revenues reported, collected, and disbursed, and to provide royalty data, such as sales volumes, to PAAS for comparison purposes. PAAS is designed to compare production information reported by lease operators with the corresponding royalty data that the lease operators report to AFS. The comparison is intended to allow MMS personnel to identify (1) potential underpayment of royalties for producing leases and (2) incorrect reporting by industry. Discrepancies between the reported production volume and royalties, identified through the AFS/PAAS comparison, are subject to further review.

However, according to a February 1992 report by your Committee,² neither AFS nor PAAS has ensured correct reporting. While MMS is working to resolve the problems with these systems, it will continue to rely almost exclusively on royalty compliance audits of royalty payors to ensure the appropriateness and accuracy of royalty payments.

Chronology of MMS' Audit Strategy for Royalty Compliance

MMS became responsible for Interior's Royalty Management Program in January 1982. However, MMS did not begin to develop a systematic, comprehensive audit strategy until 1988. Instead, MMS directed most of its audit resources toward nondiscretionary work activities that had to be completed within a specific time frame. These activities included (1) responding to referrals of potential problems or of irregularities on leases from land management agencies within Interior, (2) resolving audit issues initiated by Interior's Office of the Inspector General, (3) reviewing requests for refunds by royalty payors, and (4) reconciling royalty accounts.

²An Analysis of Problem Areas Related to the Department of the Interior's Minerals Management Service With Recommended Solutions, Committee on Interior and Insular Affairs, House of Representatives (Feb. 19, 1992).

By fiscal year 1987, MMS had substantially completed its nondiscretionary work load, and it decided to intensify and expand its audit coverage. In support of this effort, the Congress authorized MMS to increase its number of auditors. The audit staff increased by 78 percent—from 147 to 261 staff members—between fiscal years 1987 and 1992, and funding for audit activities increased by 72 percent—from \$10.9 million to \$18.8 million—during the same period.

In fiscal year 1988, MMS developed its first audit strategy for royalty payors. This strategy was designed to systematically target over 90 percent of all federal and Indian royalties. Another objective was to accelerate the completion of audits from previous years to make the audit cycle more current. Currency is important because payors are generally required, under FOGRMA, to retain records for only 6 years. The strategy set and achieved a September 1992 target for completion.

MMS originally envisioned that 60 percent of its audit resources would be allocated toward auditing the 233 major payors that, in aggregate, paid over 98 percent of the total royalties in fiscal year 1986. The remaining 40 percent would be allocated toward auditing the approximately 1,800 remaining “intermediate or small” royalty payors³ and toward conducting other audit activities such as nondiscretionary work. To deter noncompliance, MMS was to develop a sampling plan for all intermediate and small payors. However, the plan was never developed.

For each payor selected for audit, MMS was to first review the payor’s financial and reporting systems to determine if they complied with applicable laws, rules, and regulations. The audit would then proceed with a sample of leases and monthly reports that show the production and amount of royalties paid and that are designed to provide comprehensive coverage of all areas of the payor’s activity. The selected leases would represent a diversity of conditions and geographic locations; at least 2 months of production were to be examined for each year of every lease audited.

If problems with royalty payments were found in either the systems review or the lease sample, and the problems were deemed to be systemic, MMS could direct a payor to correct the problem through “restructured accounting.” Under this procedure, the payors, rather than MMS, are

³Intermediate or small” companies are those that pay annual royalties of less than an established threshold, which varies depending on the lease type. For federal offshore oil and gas leases, the threshold is \$1 million in annual royalties; for federal onshore oil and gas leases, it is \$500,000; for Indian oil and gas leases, \$100,000; and for other mineral leases, \$500,000.

required to correct the systemic problems and to compute additional royalties due that result from systemic error for all of the affected leases—not only the sample leases reviewed by MMS but also other leases with similar characteristics. MMS auditors then review the corrections and computations for adequacy. As a result of MMS' initial review and the payor's subsequent review, the process of restructured accounting can sometimes expand the number of leases and royalty payments reviewed.

MMS' Audit Strategy Does Not Reasonably Ensure Compliance

MMS' strategy for auditing royalty payors does not reasonably ensure that payments from royalty payors comply with the various laws, rules, and regulations governing those payments. First, the amount of actual royalties audited or verified is significantly smaller than the over 90 percent of all federal and Indian royalties that the strategy was designed to target. The smaller the amount of royalties audited, the more probable that instances of noncompliance will go undetected. Second, although the strategy is systematic in its approach, problems identified in the judgmental samples cannot be used to estimate such things as the level of compliance or the magnitude of underpayment for the lease universe because the samples are not representative of all payors and leases. However, the use of restructured accounting does increase the scope of MMS' audit coverage for a subset of the lease universe because MMS reviews a particular payor's leases that display similar characteristics to those of the sample leases reviewed.

The Amount of Royalties Audited Is Small

Under MMS' strategy for auditing royalty payors, the leases audited represent a small percentage of the total number of payors' leases. We reviewed the 12 completed audit reports for the largest payors covering fiscal years 1981 through 1983. These reports, issued in either draft or final version between March 1990 and February 1992, show that the number of leases MMS selected for audit ranged from 2.3 to 7.2 percent of the total number of leases. For example, for one major payor who paid \$209 million in annual royalties on 676 leases, MMS audited 28 leases, or 4 percent of that payor's total. For each of these 28 leases, MMS audited 2 months of production to determine the amount of royalties that should have been paid. For another major payor who paid more than \$233 million in annual royalties on 903 leases, MMS audited 25 leases, or less than 3 percent of the total. For 24 of these 25 leases, MMS audited only 1 month of each fiscal year, rather than the minimum of 2 months stipulated in MMS' audit strategy.

MMS reduced the scope of its audit coverage because it underestimated the amount of resources required to carry out its 1988 audit strategy. MMS fell behind schedule soon after implementing the strategy, despite an increased emphasis on auditing major payors and an increase in audit resources. To compensate for the schedule slippage, MMS took most of the resources it had planned to spend on audits of intermediate and small payors and reallocated them toward audits of major payors. According to a Royalty Compliance Division (RCD) official, the division reallocated those resources because it believed that the major payors would provide more revenue in correcting royalty underpayment, as these major payors contribute over 98 percent of total royalty payments. While MMS did complete its audit strategy by the September 30, 1992, target date, it indicated that it had reduced the scope of some audits to do so. This reduction in the scope of MMS' audit coverage increases the probability that instances of royalty noncompliance will go undetected.

Level of Compliance and Magnitude of Underpayment Cannot Be Estimated

MMS' audit strategy is systematic in that (1) the payors are stratified by the amount of royalties paid and (2) the agency tries to select leases that are diverse in their conditions and their geographic locations. But the judgmental samples are not representative of all payors and leases. Since all payors and leases do not stand the same chance of being selected for audit, problems identified in the lease samples cannot be used to estimate either the level of compliance or the magnitude of underpayment for all leases.

MMS' use of restructured accounting increases the scope of MMS' audit coverage of leases that display similar characteristics to those reviewed by MMS. However, payors are challenging MMS' restructured accounting requirement through MMS' and Interior's administrative appeals process and the courts. Of the nearly 500 restructured accounting directives MMS issued to payors between fiscal years 1987 and 1991, over 45 percent have been challenged by payors. Four payors have challenged MMS' restructured accounting requirement in court,⁴ and as of October 1, 1992, the issue had not been completely decided. According to MMS, if the courts find in favor of the payors, the scope and effectiveness of MMS' strategy for auditing royalty payors may be greatly reduced, as MMS may lose its primary procedure to ensure royalty collection.

⁴Four payors have filed law suits: Atlantic Richfield Company, one; Chevron U.S.A. Incorporated, one; Phillips Petroleum Company, three; and Public Service Company of Oklahoma, one.

However, a related case (a May 1992 decision by the U.S. Court of Appeals, Tenth Circuit),⁵ supports the position that MMS has the authority to require payors to correct repeated royalty underpayments caused by systemic deficiencies. Although restructured accounting was not the primary issue in this decision, the decision may have an impact on upcoming court decisions in which restructured accounting is a major issue. Of the six suits filed by the four companies, three are under the jurisdiction of the U.S. Court of Appeals for the Tenth Circuit. According to Interior, MMS is confident that its authority to require restructured accounting will be upheld by the courts.

MMS Is Revising Its Royalty Compliance Strategy

MMS established a task force on royalty compliance in August 1990 to study methods that would increase the effectiveness of its compliance activities and make MMS less vulnerable to legal challenges. In its June 1991 report, the task force recommended major changes to improve MMS' strategy for auditing royalty payors, including the use of statistical sampling. Since statistical sampling would ensure that all payors and leases stand the same chance of being selected for audit, the samples would be representative and could be used to estimate, for all leases, such things as the level of compliance and the magnitude of underpayment.

Task force members included Interior's Deputy Assistant Secretary, Land and Minerals Management; MMS' Deputy Director; and MMS' Chief, Royalty Management Analysis Division. The task force convened four work groups of MMS personnel to evaluate and develop objectives and recommendations in the areas of valuation, audit, enforcement, and systems. A fifth group of senior managers from the Royalty Management Program evaluated the recommendations of the work groups.

According to the task force's findings, a royalty compliance strategy based on statistical samples would assign compliance audits in the broadest and most equitable fashion. All royalty payors—not just the major ones—would recognize that any transaction could be selected for audit. The report recommended that statistical sampling be used in selecting both payors and leases for audit.

The report noted that the Internal Revenue Service uses sampling to select the transactions it will audit and that the agency is able to successfully bill on the basis of those samples without requiring restructured accounting

⁵Appeal from U.S. District Court for the Northern District of Oklahoma, *Phillips Petroleum Company v. Lujan* (No. 91-5071), consolidated with *Atlantic Richfield Company v. Lujan* (No. 91-5072), decided May 13, 1992.

by the taxpayers. According to the report, a similar method could be used for royalty compliance.

In November 1991, MMS issued an action plan to implement the recommendations of the task force.⁶ A principal goal of royalty compliance audits, as envisioned by the task force, is to achieve a high level of royalty compliance by encouraging payors to report correctly and promptly. To accomplish this goal, the action plan calls for a balanced and integrated combination of field compliance and automated system-based compliance audits to achieve several objectives. The plan also calls for MMS to use statistical sampling methods to the extent feasible to (1) assign compliance audits in a broad and equitable fashion, (2) ensure that all royalty payors are subject to review, and (3) ensure correct lease payments. According to Interior, MMS is currently examining whether and to what extent statistical sampling can be used in royalty verification. All of the task force's recommendations are expected to be implemented by November 1994.

Conclusions

MMS' 1988 strategy for auditing royalty payors was a substantial improvement over the nonsystematic activities that preceded it. For the first time, specific resources have been allocated for auditing, and an attempt has been made to provide broad audit coverage of federal and Indian royalties. As a result, more payors are being targeted for audit, and additional royalties are being collected.

However, the strategy's judgmental sampling method precludes determining, with any degree of confidence, the level of compliance or the magnitude of underpayment—that is, the royalties at risk. This weakness, coupled with the potential loss of the restructured accounting requirement, limits the strategy's effectiveness.

We agree with the MMS task force's conclusion that statistical sampling of both payors and leases for audit would assign compliance audits in the broadest and most equitable fashion. We also agree that, to be effective, such sampling must be representative of all payors and leases so that problems identified in the samples can be used to estimate the level of compliance and the magnitude of the royalties at risk with a high degree of confidence for all leases. Finally, we agree that representative sampling should permit MMS to bill on the basis of the samples, as the Internal

⁶Action Plan for Royalty Compliance, Department of the Interior, MMS, Royalty Management Program (Nov. 1991).

Revenue Service does now, without requiring restructured accounting by the payor companies.

Agency Comments

We requested and received written comments on a draft of this report from the Department of the Interior. Interior expressed appreciation for our recognition of the substantial improvements made to MMS' strategy for auditing royalty payors and the gains to be realized through implementation of the recommendations of the task force on royalty compliance. Interior expressed concern, however, with several issues in the draft report and asked that we provide additional discussion to avoid any possible confusion.

On the basis of Interior's comments, we have revised this report to make clear that (1) MMS' audit strategy was to target, rather than to audit or verify, over 90 percent of all federal and Indian royalties; (2) MMS is currently examining whether and to what extent statistical sampling can be used in royalty verification; (3) MMS achieved its 1988 audit strategy by the September 30, 1992, target date; and (4) MMS is confident that its authority to require restructured accounting will be upheld by the courts. We continue to believe, however, that statistical sampling of both payors and leases for audit would allow MMS to estimate the level of compliance as well as the magnitude of underpayment and would provide an alternative to restructured accounting. Interior's comments and our evaluation of them are included in appendix II.

Scope and Methodology

We conducted our work primarily at the office of MMS' Royalty Management Program in Lakewood, Colorado, where we reviewed MMS' audit policies and procedures. To obtain additional information on MMS' audit coverage and strategy, we interviewed MMS officials in all three MMS area compliance offices (Lakewood, Colorado, and Dallas and Houston, Texas). In Oklahoma City, Oklahoma, we interviewed the MMS official with primary responsibility for planning and monitoring MMS' efforts to conduct royalty compliance audits. We also reviewed reports issued by MMS, Interior's Office of the Inspector General, and your Committee.

To obtain the additional information you requested (see app. I), we reviewed budget and contracting documents, correspondence between MMS and state and tribal audit offices, and reports issued by MMS and Interior's Office of the Inspector General. We also interviewed MMS officials and auditors of states and Indian tribes that participated in audits

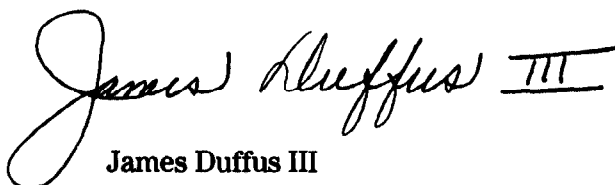
under cooperative agreements with MMS. Additionally, we attended several meetings of MMS officials and state and tribal auditors.

We conducted our review between October 1991 and May 1992 in accordance with generally accepted government auditing standards.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after the date of this letter. At that time, we will send copies to the Secretary of the Interior; the Director, MMS; and the Director, Office of Management and Budget. We will also make copies available to others on request.

Please contact me on (202) 275-7756 if you or your staff have any questions. Other major contributors to this report are listed in appendix III.

Sincerely yours,

A handwritten signature in black ink that reads "James Duffus III". The signature is written in a cursive style with a large initial "J" and a horizontal line under the "III".

James Duffus III
Director, Natural Resources
Management Issues

Contents

Letter		1
Appendix I		14
Information on Other Matters	Communication and Coordination Between MMS and State and Indian Tribal Auditors	14
	Funding Allocations to State and Indian Tribal Audit Offices	15
	MMS' Use of Contract Audits	17
	Internal Controls Over Audit Results	17
Appendix II		19
Comments From the Department of the Interior	GAO Comments	22
Appendix III		24
Major Contributors to This Report		
Table	Table I.1: Funded Expenses and Obligations to State and Tribal Audit Offices, Fiscal Years 1985 Through 1992	16

Abbreviations

AFS	Auditing and Financial System
FOGRMA	Federal Oil and Gas Royalty Management Act of 1982
GAO	General Accounting Office
MMS	Minerals Management Service
OSTPS	Office of State and Tribal Program Support
PAAS	Production Accounting and Audit System
RCD	Royalty Compliance Division

Information on Other Matters

As requested by the Chairman, House Committee on Interior and Insular Affairs, we obtained information on other matters pertaining to Interior's Minerals Management Service (MMS), including MMS'

- communication and coordination with state and Indian tribal auditors,
- funding allocations to state and Indian tribal auditors,
- plans to contract out for audits of individual Indian leases, and
- internal controls over MMS audit results.

In brief, we found the following:

- MMS has taken actions to improve communication and coordination with state and Indian tribal auditors. Although state and Indian tribal auditors and MMS officials agree that some problems continue, they also agree that relations have improved over the past few years.
- Funding allocations to state and tribal audit offices have increased overall during the past 6 fiscal years, but funding for individual states and Indian tribes has fluctuated from year to year, making planning difficult for them. According to state and Indian tribal auditors, the allocation process is outdated and unduly complex, and allocation amounts may be insufficient for planned audit work.
- MMS has contracted with a certified public accounting firm to conduct royalty audits of Indian leases, but at the time of our review MMS officials had not decided whether to expand the use of contract auditing.
- MMS relies primarily on review and independent verification of the factual data in reports to ensure the accuracy of audit results.

Communication and Coordination Between MMS and State and Indian Tribal Auditors

The state and Indian tribal program is an integral part of the overall royalty compliance program. Under the provisions of the Federal Oil and Gas Royalty Management Act (FOGRMA), MMS is authorized to enter into cooperative audit agreements with states and Indian tribes. Under such agreements, which MMS has used since 1983, MMS delegates to participating states and Indian tribes the authority to conduct audits of federal oil and gas leases. Currently, nine states and three Indian tribes, which employ more than 69 auditors, participate in MMS' program to conduct royalty compliance audits.

In a 1985 memorandum by the Associate Director of Royalty Management, MMS stated its intention to concentrate its own audit efforts toward offshore leases and those Indian and federal onshore leases not covered under cooperative agreements. States and Indian tribes participating in

cooperative agreements assume full responsibility for the quality of the audit work performed and the ability of the audit work to stand the test of peer and appellate review which includes, in many cases, judicial review. MMS, in turn, is to exercise enforcement authority and facilitate and oversee the state and Indian tribal audits. Specifically, MMS' Office of State and Tribal Program Support (OSTPS) was created to work with states and Indian tribes in carrying out their audit activities.

Over the past several years, according to MMS officials, MMS has taken several actions to encourage effective communication and coordination with state and Indian tribal audit programs. For example, MMS (1) integrated the Royalty Compliance Division's (RCD) OSTPS, state, and Indian tribal audit offices into a team by developing the 1988 audit strategy; (2) established quarterly planning meetings with MMS, state, and Indian tribal auditors; and (3) developed an audit procedures manual through consultation with state and Indian tribal audit personnel.

State and Indian tribal auditors told us that, while problems have continued, communication and coordination with MMS has improved. The problems cited include MMS' untimely issuance of some demand letters (letters to payors demanding payment of additional royalties on the basis of audit findings), the reluctance of MMS to exert its legal authority to force company compliance with information requests, and MMS' ineffectiveness in coordinating audit activities. We did not determine the frequency with which these problems occurred.

The Chief of RCD is aware that these problems exist, but he told us that there will always be some communication and coordination problems when dealing with people. However, he reiterated that relations have improved a great deal since the state and Indian tribal auditors began participating in royalty compliance audits.

Funding Allocations to State and Indian Tribal Audit Offices

Several months before the start of the fiscal year, OSTPS notifies states and Indian tribes that it is time to submit budget requests for the upcoming year. The budget requests they submit list scheduled audits; staff assignment plans; and project expenses, such as those for travel, training, administrative support, equipment, technical expertise, and mailing. A team of OSTPS officials reviews each request and, on the basis of the funds available and the judgment of the officials on how reasonable the requests are, it adjusts the amount requested. OSTPS officials allocate funds by

**Appendix I
Information on Other Matters**

applying a funding formula to the budget to distribute funds among participating states and Indian tribes.

Overall, funding for audits by states and Indian tribes (conducted under cooperative agreements with MMS) has increased from about \$1.4 million in fiscal year 1985 to about \$4.0 million in fiscal year 1992. Another \$200,000 was held back by OSTPS in fiscal year 1992, in case additional states or Indian tribes apply and were accepted for program participation.

Funding for individual states and Indian tribes, however, has fluctuated from year to year, as shown in table I.1. Accordingly, state and Indian tribal officials find it difficult to plan and schedule their audits until they are advised of the funding level they will receive, which MMS does not know until its budget has been approved.

Table I.1: Funded Expenses and Obligations to State and Tribal Audit Offices, Fiscal Years 1985 Through 1992

Dollars in thousands

State/tribe	Funded expenses by fiscal year							
	1985	1986	1987	1988	1989	1990	1991	1992 ^a
Alaska	\$51	\$60	\$60	\$58	\$28	b	b	b
California	337	404	727	400	350	350	559	559
Colorado	187	388	437	368	391	686	625	612
Louisiana	b	b	b	b	35	35	86	124
Montana	98	114	132	129	149	155	141	159
North Dakota	95	171	186	206	216	244	218	207
Oklahoma	60	82	77	65	110	212	264	164
Texas	b	b	b	b	b	b	41	67
Utah	180	180	180	246	298	433	413	394
Wyoming	275	436	498	620	566	1,037	969	911
Navajo	90	149	149	301	274	293	260	473
Southern Ute	b	b	b	b	74	70	65	185
Ute	b	b	b	b	72	73	83	108
Total	\$1,373	\$1,984	\$2,446	\$2,393	\$2,563	\$3,588	\$3,724	\$3,963

^aPlanned obligations for fiscal year 1992.

^bYears that states and Indian tribes were not participating in MMS' funded agreements.

State and Indian tribal audit officials believe that the funding allocation process is inequitable and unnecessarily complex and that the current

formula is outdated. An OSTPS official echoed these sentiments, stating that the funding formula may have been equitable 5 years ago but is now outdated. The funding formula takes into account the state and Indian tribal work plan, collections, past performance, and a minimum funding base. This formula was adopted by the Royalty Management Audit Committee, now defunct, and approved by the Secretary of the Interior in 1985.

State and Indian tribal audit officials have proposed a change to the funding formula. The proposed change would establish a minimum funding base that would be adjusted to offset the effects of inflation or of increasing contract costs in order to maintain the current level of effort. The proposed change was submitted to RCD in October 1991, but RCD had not yet responded to this proposal at the time of our review.

Although funding levels have increased overall, state and Indian tribal audit officials observed that funding levels have not been sufficient for the planned audit work load. Some state and Indian tribal audit officials said that even when funding levels increased, the increases were not adequate to keep up with inflation, staff growth, and promotions. The Chief of RCD said that he would accommodate all budget requests that he could but that states and Indian tribal officials must realize that funds for the state and Indian tribal program are limited.

MMS' Use of Contract Audits

In response to individual Indian allottees' complaints that leases they owned were receiving insufficient audit coverage, MMS negotiated a contract with a small certified public accounting firm to assist with royalty audits of Indian leases. A 1-year contract for \$381,748 was awarded in September 1991 to a Houston, Texas, certified public accounting firm. The firm, working under the supervision of MMS auditors in Oklahoma City, will audit selected companies with substantial numbers of leases owned by individual Indian allottees.

Although the contract is renewable, MMS officials have not yet decided whether to make more extensive use of contract audits. They will base such a decision, in part, on the results of the ongoing contract work.

Internal Controls Over Audit Results

MMS, state, and Indian tribal audit offices have procedures in place to ensure that audits are properly conducted and that audit results are accurate. Reviewing audit activities is the primary control. MMS is reviewed

by Interior's Office of the Inspector General at least every other year, as required by law, and a report must be issued on the results of the review. According to the Inspector General's May 1991 report,¹ MMS is conducting its audit activities in compliance with generally accepted government auditing standards. The individual states and tribes either arrange to review each other's audits (peer review) or hire a certified public accounting firm to do the review. For another control, MMS, state, and Indian tribal audit offices rely on the referencing process, through which an independent auditor (i.e., one who did not conduct the audit being reviewed) compares the audit findings with the evidence documented in the workpapers.

¹Follow-up of Recommendations Concerning Selected Aspects of the Royalty Compliance Division, Minerals Management Service, U.S. Department of the Interior, Office of Inspector General (Report No. 91-I-779, May 1991).

Comments From the Department of the Interior

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

AUG 17 1992

Mr. James Duffus III
Director, Natural Resources
Management Issues
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Duffus:

I am responding to your Draft Audit Report "Royalty Management - Shortcomings in Interior's Audit Strategy for Royalty Compliance" (Report No. GAO/RCED 92-191).

We appreciate the opportunity to comment on the audit findings contained within this draft report. We welcome the General Accounting Office's recognition of the substantial improvements made in the Minerals Management Service's (MMS) royalty compliance strategy and the gains to be realized through implementation of the Department of the Interior's Compliance Task Force recommendations.

We are concerned, however, with several issues identified in the report and believe further discussion is needed to avoid confusion. Specific comments on these issues are provided in the enclosure.

Once again, I appreciate the opportunity to comment on this report. Should you have any further questions, kindly contact the MMS' Audit Liaison Officer, Mr. D.S. Braden at (202) 208-3034.

Sincerely,

A handwritten signature in cursive script that reads "David C. O'Neal".

FOR

David C. O'Neal
Assistant Secretary, Land and
Minerals Management

Enclosure

**MINERALS MANAGEMENT SERVICE (MMS) RESPONSE TO DRAFT AUDIT REPORT:
"ROYALTY MANAGEMENT-Shortcomings in Interior's
Audit Strategy for Royalty Compliance**

Audit Agency: U.S. General Accounting Office
Report Number: GAO/RCED 92-191

See comment 1.
Now on p. 8.

We appreciate GAO's recognition of the substantial improvements made in MMS' royalty compliance strategy and the gains to be realized through implementation of the Compliance Task Force recommendations. Because the draft report focused upon the many improvements MMS has made and plans to make, we suggest that a title reflecting your first conclusion on page 12, i.e., "Substantial Improvements in Interior's Audit Strategy for Royalty Compliance" would be more appropriate to the findings in the report.

There are a few other issues in the report that we believe need additional discussion to avoid any possible confusion. Our comments on these issues are offered below.

NUMBER OF SAMPLE LEASES

See comment 2.

Although the number of leases actually audited is small, coverage is greatly increased by stratification and orders to perform restructured accounting. The goal of the 1988 audit strategy was to target over 90 percent of all Federal and Indian royalties. Through our stratification of payors and leases coupled with orders to perform restructured accounting, we exceeded this goal. Audit selection is stratified to 1) maximize the coverage of royalty dollars, 2) ensure coverage by lease type and lease category, and 3) ensure coverage for all Indian owners. Orders to perform require payors to identify and correct the reporting and royalty for all their leases in cases where systematic problems are found. Such corrections are then reviewed by the auditors for adequacy. Therefore, systemic problems identified in our audit of one or a few leases would result in corrections by the company of similar problems on other leases. Although we plan to continue to review and refine our audit lease selection process we believe our sample lease selection is both sufficient and appropriate. We do, however, plan to implement additional compliance initiatives to further expand and broaden representation of specific lease categories and royalty recipients.

See comment 3.

STATISTICAL SAMPLING

The Compliance Task Force, in making the statistical sampling recommendation, was looking for a measurement of overall compliance, a means to broaden and expand the compliance program, and an alternative to orders to perform restructured accounting.

See comment 4.

It is true that neither the 1988 strategy nor amendments to the strategy included statistical samples and projections. Statistical sampling may be appropriate for helping to determine a "level of compliance," estimating the magnitude of underpayments, and selecting audit candidates. MMS is currently conducting an analysis to determine

See comment 4.

whether and to what extent statistical sampling can be used for royalty operations. Until the analysis is completed, it is premature to make any definitive conclusions regarding the ability to use statistical sampling in royalty verification.

AUDIT SCHEDULE

See comment 5.

It appears that GAO may have reached its conclusion that MMS remains behind schedule in completing its audit strategy based on misunderstandings of the statements attributed to the Chief, Royalty Compliance Division (RCD), and misinterpretations of documents reviewed. Although there have been many modifications to the original 1988 audit program, MMS is still on schedule to complete the audits as planned. In fact, RCD has been able to complete some work early and redirect resources to other audits which could benefit from additional staffing. We believe that the September 30, 1992, target date will indeed be met.

ORDERS TO PERFORM

See comment 6.

The MMS is confident that the use of orders to perform restructured accounting is an acceptable technique which is consistent with mineral leasing and royalty payment requirements. As GAO noted in the draft report, a May 1992 court decision supports MMS' position that it has the authority to require companies to make changes to correct repeated royalty underpayments caused by system deficiencies. We strongly believe other courts will have similar findings.

The following are GAO's comments to the Department of the Interior's letter dated August 17, 1992.

GAO Comments

1. The report title has been revised to recognize the improvements made in Interior's strategy for auditing royalty payors.

2. We have revised the report to make clear that (1) the amount of actual royalties audited or verified is significantly smaller than the royalties targeted for coverage and (2) although the strategy is systematic in its approach, the problems identified in the lease samples cannot be used to estimate such things as the level of compliance among payors or the magnitude of underpayment for the lease universe because the samples are not representative of all payors and leases.

3. As noted above, problems identified in the lease samples cannot be used to estimate the level of compliance or the magnitude of underpayment for the lease universe. Conversely, using statistical sampling to select representative samples of payors and leases for audit would allow MMS to extend coverage to the lease universe being audited.

4. We have revised the report to make it clear that while MMS is still studying the use of statistical sampling, we continue to agree with the MMS task force on royalty compliance that a royalty compliance strategy based on statistical samples would assign compliance audits in the broadest and most equitable fashion and that statistical sampling should be used in selecting both payors and leases for audit.

5. Our report has been revised to make it clear that MMS completed its 1988 audit strategy by September 30, 1992, but that to meet the target date it had to reduce the scope of some audits to do so. As we stated in our draft report, any reduction in the scope of MMS audit coverage increases the probability that instances of royalty noncompliance will go undetected.

6. Our report has been revised to recognize MMS' belief that restructured accounting will be upheld by the courts. However, with or without restructured accounting, MMS' current audit strategy cannot determine a level of compliance among payors, cannot estimate the magnitude of underpayment, and cannot select payors for audit. Thus, we continue to believe, as did MMS' task force on audit compliance, that statistical

**Appendix II
Comments From the Department of the
Interior**

sampling would be a valuable procedure to be used either in conjunction with or in lieu of restructured accounting.

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