



Audit Report



OIG-07-004

Audit of the Bureau of Engraving and Printing's Fiscal Years
2006 and 2005 Financial Statements

November 1, 2006

Office of
Inspector General

Department of the Treasury



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

OFFICE OF
INSPECTOR GENERAL

November 1, 2006

**MEMORANDUM FOR LARRY R. FELIX, DIRECTOR
BUREAU OF ENGRAVING AND PRINTING**

FROM: Michael Fitzgerald *Michael Fitzgerald*
Acting Deputy Assistant Inspector General
for Financial Management and Information
Technology Audits

SUBJECT: Audit of the Bureau of Engraving and Printing's
Fiscal Years 2006 and 2005 Financial Statements

I am pleased to transmit the attached audited Bureau of Engraving and Printing (BEP) financial statements for fiscal years 2006 and 2005. We contracted with the independent certified public accounting firm KPMG LLP, an Independent Public Accountant (IPA), to audit the financial statements of BEP as of September 30, 2006 and for the year then ended. The accompanying financial statements of BEP as of September 30, 2005, and for the year then ended were audited by Ernst & Young LLP, another IPA, whose report dated October 25, 2005, expressed an unqualified opinion. Both contracts required that the audits be performed in accordance with generally accepted government auditing standards; applicable provisions of Office of Management and Budget Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*; and the *GAO/PCIE Financial Audit Manual*.

The following reports, prepared by KPMG LLP, are incorporated in the attachment:

- Independent Auditors' Report;
- Independent Auditors' Report on Internal Control Over Financial Reporting; and
- Independent Auditors' Report on Compliance and Other Matters

In its audit, KPMG LLP found that the financial statements were fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. KPMG LLP also found that BEP management's assertion that it maintained effective internal control over financial reporting as of September 30, 2006 was fairly stated in all material respects. However, KPMG LLP's Report on Internal Control Over Financial Reporting contained one reportable condition related to controls over inventory held by others, which was not considered a material weakness. KPMG LLP found no instances of reportable noncompliance with laws and regulations tested.

KPMG LLP also issued a management letter dated October 27, 2006, discussing other matters involving internal control over financial reporting and its operation that were identified during the audit but were not required to be included in the auditors' reports.

In connection with the contract, we reviewed KPMG LLP's reports and related documentation and inquired of its representatives. Our review, as differentiated from an audit in accordance with generally accepted government auditing standards, was not intended to enable us to express, and we do not express, an opinion on the financial statements or BEP management's assertion on the effectiveness of internal control over financial reporting, or a conclusion on compliance with laws and regulations. KPMG LLP is responsible for the attached auditors' reports dated October 27, 2006 and the conclusions expressed in the reports. However, our review disclosed no instances where KPMG LLP did not comply, in all material respects, with generally accepted government auditing standards.

Should you have any questions, please contact me at (202) 927-5789.

Attachment

**THE DEPARTMENT OF THE TREASURY
BUREAU OF ENGRAVING AND PRINTING**

Financial Statements

Years ended September 30, 2006 and 2005

(With Independent Auditors' Reports Thereon)

**THE DEPARTMENT OF THE TREASURY
BUREAU OF ENGRAVING AND PRINTING
FINANCIAL STATEMENTS
FOR THE YEARS ENDED SEPTEMBER 30, 2006 AND 2005**

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KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report

The Inspector General, Department of the Treasury and
The Director of the Bureau of Engraving and Printing, Department of the Treasury:

We have audited the accompanying balance sheet of the Bureau of Engraving and Printing (Bureau) as of September 30, 2006, and the related statements of operations and cumulative results of operations and cash flows (hereinafter referred to as "financial statements") for the year then ended. These financial statements are the responsibility of the Bureau's management. Our responsibility is to express an opinion on these financial statements based on our audit. The accompanying financial statements of the Bureau as of and for the year ended September 30, 2005, were audited by other auditors whose report thereon, dated October 25, 2005, expressed an unqualified opinion on those financial statements.

We conducted our audit 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 Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 06-03 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2006 financial statements referred to above present fairly, in all material respects, the financial position of the Bureau of Engraving and Printing as of September 30, 2006, and the results of its operations and its cash flows for the year then ended in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the financial statements, effective October 1, 2005, the Bureau adopted Financial Accounting Standards Board Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*.

We have also examined management's assertion that the Bureau maintained effective internal control over financial reporting as of September 30, 2006, and have issued our report thereon dated October 27, 2006. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in assessing the results of our audit.



In accordance with *Government Auditing Standards*, we have also issued our report dated October 27, 2006, on our tests of the Bureau's compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of compliance and the results of that testing, and not to provide an opinion on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in assessing the results of our audit.

KPMG LLP

October 27, 2006

**THE DEPARTMENT OF THE TREASURY
BUREAU OF ENGRAVING AND PRINTING**

Balance Sheets

As of September 30, 2006 and 2005

	2006	2005
(In Thousands)		
ASSETS		
Current assets		
Cash (Note 3)	\$ 164,729	\$ 183,250
Accounts receivable (Note 10)	33,032	42,038
Inventories, net (Note 4)	83,516	75,246
Prepaid expenses	4,321	3,675
Total current assets	285,598	304,209
Property and equipment, net (Note 5)	250,364	249,403
Other assets, net (Note 6)	17,525	17,322
Total assets	\$ 553,487	\$ 570,934
LIABILITIES AND EQUITY		
Liabilities		
Current liabilities (Notes 7 and 8)		
Accounts payable	\$ 11,818	\$ 13,564
Accrued liabilities	29,765	27,815
Advances	899	3,881
Total current liabilities	42,482	45,260
Workers' compensation liability (Note 8)	59,007	65,097
Total liabilities	101,489	110,357
Commitments and contingencies (Note 12)		
Equity		
Invested capital	32,435	32,435
Cumulative results of operations	419,563	428,142
Total equity	451,998	460,577
Total liabilities and equity	\$ 553,487	\$ 570,934

See accompanying notes to the financial statements.

**THE DEPARTMENT OF THE TREASURY
BUREAU OF ENGRAVING AND PRINTING**

Statements of Operations and
Cumulative Results of Operations
For the Years Ended September 30, 2006 and 2005

	2006	2005
(In Thousands)		
Revenue from sales (Note 10)	\$ 477,297	\$ 512,064
Cost of goods sold	421,637	472,478
Gross margin	55,660	39,586
Operating costs:		
General and administrative expenses	53,489	50,465
Research and development	10,750	7,648
	64,239	58,113
Excess of expenses over revenues	(8,579)	(18,527)
Cumulative results of operations at beginning of year	428,142	446,669
Cumulative results of operations at end of year	\$ 419,563	\$ 428,142

See accompanying notes to the financial statements.

**THE DEPARTMENT OF THE TREASURY
BUREAU OF ENGRAVING AND PRINTING**

Statements of Cash Flows
For the Years Ended September 30, 2006 and 2005

	2006	2005
(In Thousands)		
Cash flows from operating activities		
Excess of expenses over revenues	\$ (8,579)	\$ (18,527)
Adjustments to reconcile excess of expenses over revenues to net cash provided by operating activities:		
Depreciation	32,484	34,618
Loss from disposal of property and equipment	104	993
Changes in assets and liabilities		
Decrease in accounts receivable	9,006	2,569
(Increase) decrease in inventories	(8,270)	28,145
Increase in prepaid expenses	(646)	(527)
Increase in other assets	(203)	(729)
Decrease in accounts payable	(1,746)	(5,703)
Increase (decrease) in accrued liabilities	1,950	(3,165)
(Decrease) increase in advances	(2,982)	3,420
Decrease in workers' compensation costs	(6,090)	(2,800)
Net cash provided by operating activities	15,028	38,294
Cash flows from investing activities		
Purchases of property and equipment	(33,549)	(23,972)
Net cash used in investing activities	(33,549)	(23,972)
Net (decrease) increase in cash	(18,521)	14,322
Cash at beginning of year	183,250	168,928
Cash at end of year	\$ 164,729	\$ 183,250

See accompanying notes to the financial statements.

**THE DEPARTMENT OF THE TREASURY
BUREAU OF ENGRAVING AND PRINTING**

Notes to the Financial Statements
September 30, 2006 and 2005

1. Reporting Entity

The Bureau of Engraving and Printing (Bureau), a component of the United States (U.S.) Department of the Treasury, is the U.S. Government's security printer. The Bureau designs and produces U.S. currency. The Bureau also advises and assists Federal agencies in the design and production of other U.S. Government documents requiring counterfeit deterrence or secure production.

The Bureau operates under basic authorities conferred by the Act of July 11, 1862, (12 Stat. 532; also, 31 U.S.C. 5114) and other laws and regulations. In accordance with the provisions of Public Law 81-656, effective August 4, 1950, the operations of the Bureau are financed by means of a revolving fund. This fund is reimbursed through billings to the Bureau's customers for products delivered. Public Law 95-81 authorized the Bureau to include in its product prices an amount to provide funding for the acquisition of capital equipment and future working capital. Invested capital represents the historical value of the initial contribution made by the Federal Government.

The financial statements represent the consolidation of two Federal revolving funds. The majority of all financial transactions (approximately 99%) are contained in the Bureau of Engraving and Printing Revolving Fund, which finances Bureau operations. The other revolving fund, the Mutilated Currency Revolving Fund, is used to redeem damaged paper currency received from the public. All significant balances and transactions between the funds have been eliminated in consolidation.

2. Summary of Significant Accounting Policies

Basis of Accounting

The Bureau has historically prepared its financial statements in conformity with U.S. generally accepted accounting principles, based on accounting standards issued by the Financial Accounting Standards Board (FASB), the private-sector standards-setting body. Under such standards, the Bureau prepares its financial statements using the full accrual basis of accounting under which revenues are recognized when earned and expenses are recognized as incurred, regardless of when cash is exchanged.

The Federal Accounting Standards Advisory Board (FASAB) has been designated by the American Institute of Certified Public Accountants as the standards-setting body for financial statements of federal government entities, with respect to the establishment of generally accepted accounting principles. FASAB has indicated, however, that financial statements prepared based upon accounting standards published by the FASB may also be regarded as in conformity with generally accepted accounting principles for those federal agencies, such as the Bureau, that have issued financial statements based upon FASB accounting standards in the past.

**THE DEPARTMENT OF THE TREASURY
BUREAU OF ENGRAVING AND PRINTING**

Notes to the Financial Statements
September 30, 2006 and 2005

Accordingly, consistent with historical reporting, the Bureau's financial statements are presented in accordance with accounting standards published by the FASB.

Cash

Cash represents the aggregate amount of the Bureau's funds held on deposit with the U.S. Treasury and are available to pay liabilities. The Bureau historically does not maintain significant cash balances in commercial bank accounts, and owns no cash equivalents.

Equipment and Spare Parts

In July 2005, the Bureau permanently ceased production of postage stamps for the U.S. Postal Service. Postage stamp related production equipment and spare parts were disposed of in accordance with applicable U.S. Government regulations.

Estimation Process

The preparation of financial statements in accordance with U.S. Generally Accepted Accounting Principles (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and related revenues and expenses. Those estimates most significant to the Bureau's financial statements are the actuarial estimates made by the Department of Labor (DOL) in arriving at the liabilities for workers' compensation, allowances for obsolescence, the useful lives of property and equipment, the likelihood of losses associated with contingent liabilities, and certain accrued expenses at the date of the financial statements. Such estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed herein.

Inventories

Inventories are stated at standard cost, except for finished goods inventories, which are stated at weighted average unit cost. Both methods approximate actual cost. Cost elements included in work-in-process and finished goods inventories are direct materials, direct labor, manufacturing overhead, and manufacturing support.

Property and Equipment

Property and equipment are recorded at cost. Major alterations and renovations are capitalized, while maintenance and repair costs are charged to expense as incurred. The capitalization threshold is \$50,000. The Bureau capitalizes all cost associated with new construction and building improvements.

The Bureau occupies and uses buildings and land owned by the Department of the Treasury. In accordance with the Act establishing the revolving fund, the Bureau is not charged for the use of the buildings or land, but is responsible for maintenance and repair of all buildings and land

**THE DEPARTMENT OF THE TREASURY
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Notes to the Financial Statements
September 30, 2006 and 2005

improvements. The land and building shell for the Bureau's Western Currency Facility were donated by the City of Fort Worth, Texas to the Department of the Treasury. See Note 5 for details.

Other Assets

Other assets consist principally of machine repair parts and tools, which are used in the production of the Bureau's products. Other assets are stated at actual cost, net of reserve for obsolescence.

Depreciation

Depreciation of property and equipment is calculated using the straight-line method over the following estimated useful lives:

Machinery and equipment	3 - 15 years
Building improvements	3 - 40 years
Information technology (IT) equipment and software	3 - 5 years
Office machines	5 - 10 years
Furniture and fixtures	5 - 10 years
Motor vehicles	3 - 9 years

Employee Retirement Plans

Bureau employees participate in the contributory Civil Service Retirement System (CSRS) or Federal Employees' Retirement System (FERS), to which the Bureau and employees make contributions according to plan requirements. Consistent with reporting under multi-employer pension plans, the Bureau does not report CSRS and FERS assets, accumulated plan benefits or future liabilities, if any, applicable to its employees. This data is reported for plan participants by the Office of Personnel Management (OPM).

Postretirement Benefits Other than Pensions

Postretirement benefits for former Bureau employees, specifically health care costs and life insurance, are administered and paid by OPM through appropriations received from the U.S. Government. The Bureau does not reimburse OPM for these payments. The Bureau's financial statements do not include the cost of employee postretirement benefits paid by OPM, or the actuarial liability for such benefits.

Workers' Compensation Costs

The Federal Employee Compensation Act (FECA) provides income and medical cost protection to covered Federal civilian employees injured on the job, employees who have incurred a work-related occupational disease and beneficiaries of employees whose death is attributable to a job-related injury or occupational disease. Claims incurred for benefits for the Bureau's employees under FECA are administered by DOL and are ultimately paid by the Bureau.

**THE DEPARTMENT OF THE TREASURY
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Notes to the Financial Statements
September 30, 2006 and 2005

The FECA liability consists of two components. The first component, the accrued FECA liability, is based on actual claims paid by DOL but not reimbursed by the Bureau. The Bureau reimburses DOL for the amount of actual claims normally within one to two years after payment is made by DOL. As a result, the Bureau recognizes a current and non-current liability for actual claims paid by DOL, to be reimbursed by the Bureau.

The second component, the actuarial FECA liability, is the estimated liability for future benefit payments. These future workers' compensation estimates were generated from an application of actuarial procedures developed to estimate the liability for future FECA benefits. The actuarial liability for future worker's compensation benefits includes the expected liability for death, disability, medical and miscellaneous costs for approved compensation cases, plus a component for incurred but not reported claims. The liability is determined using a method that utilizes historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period. These annual benefit payments have been discounted to present value using OMB's economic assumptions for 10-year Treasury notes and bonds, which resulted in a discount rate of 5.17% in year one and 5.31% thereafter. Based on information provided by DOL, the Department of the Treasury allocated the overall liability to Treasury components based on past claims paid.

Annual, Sick and Other Leave

Annual leave is accrued as a liability when earned and the accrual is reduced as leave is taken. The balance in this accrued liability account reflects current pay rates.

Sick leave and other types of non-vested leave are expensed as the leave is taken.

Revenue Recognition

Revenue from sales to the Federal Reserve System is recognized when finished goods satisfactorily pass all Bureau quality control standards and are delivered to the on-site Federal Reserve Depository vaults. Finished goods are released for shipment in accordance with customer requirements. Revenue from the sale of uncut currency to the public is recognized at the time the product is shipped. The Bureau does not record an allowance for returns because of a historically negligible return rate.

Research and Development Costs and Advertising Costs

Research and development costs and advertising costs are expensed as incurred. Advertising costs amounted to \$5.9 million and \$7.4 million in the years ended September 30, 2006 and 2005, respectively.

**THE DEPARTMENT OF THE TREASURY
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Notes to the Financial Statements
September 30, 2006 and 2005

Tax Status

The Bureau is a Federal entity, and therefore is not subject to Federal, state, or local income taxes. Accordingly, no provision for income taxes is required in the accompanying financial statements.

Commitments and Contingencies

Liabilities from loss contingencies, including environmental remediation costs not within the scope of FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, arising from claims, assessments, litigation, fines and penalties, and other sources, are recorded when it is probable that a liability has been incurred and the amount of the assessment and/or remediation can be reasonably estimated. Loss contingencies that do not meet these criteria, but are reasonably possible and estimable are not accrued, but are disclosed in Note 12.

Recently Adopted Accounting Standards

In March 2005, the FASB issued Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (FIN 47), which requires a liability to be accrued if the reporting entity has a legal obligation to perform asset retirement activities and a reasonable estimate of the fair market value of the obligation can be made at fiscal year-end. FIN 47 also provides guidance as to when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The Bureau adopted the provisions of FIN 47 effective October 1, 2005. However, because the Bureau has no conditional asset retirement obligations that meet the above criteria, the adoption of FIN 47 had no effect on the Bureau's financial statements.

3. Cash

The year-end cash balances by fund are as follows as of September 30, 2006 and 2005:

	2006	2005
	(In Thousands)	
Bureau of Engraving and Printing		
Revolving Fund	\$ 163,992	\$ 182,510
Mutilated Currency Revolving Fund	737	740
Total	\$ 164,729	\$ 183,250

The balance in the mutilated currency revolving fund, consisting of mutilated currency submitted by the public for redemption, is offset by a liability to the public.

**THE DEPARTMENT OF THE TREASURY
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Notes to the Financial Statements
September 30, 2006 and 2005

4. Inventories, net

Inventories consist of the following as of September 30, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
	(In Thousands)	
Raw material and supplies	\$ 33,019	\$ 32,815
Work-in-process	32,688	28,818
Finished goods - currency	2,403	—
Finished goods - uncut currency	15,406	13,613
Total	<u>\$ 83,516</u>	<u>\$ 75,246</u>

The allowance for inventory obsolescence was \$615 thousand and \$741 thousand, at September 30, 2006 and 2005, respectively.

5. Property and Equipment, net

Property and equipment consist of the following as of September 30, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
	(In Thousands)	
Machinery and equipment	\$ 416,782	\$ 393,518
Building and land improvements	215,851	206,575
IT equipment and software	17,224	14,592
Office machines	1,103	1,201
Furniture and fixtures	1,385	1,385
Donated assets - art work	125	125
Motor vehicle	212	212
	<u>652,682</u>	<u>617,608</u>
Less accumulated depreciation	411,486	385,623
	<u>241,196</u>	<u>231,985</u>
Construction-in-progress	9,168	17,418
Net property and equipment	<u>\$ 250,364</u>	<u>\$ 249,403</u>

Deprecation expense for the years ended September 30, 2006 and 2005, was \$32.5 million and \$34.6 million, respectively.

The Bureau occupies and uses buildings and land owned by the Department of the Treasury. The land and building shell for the Fort Worth, Texas facility were donated by the City of Fort Worth to the Department of the Treasury in 1987, which holds the title thereto. At the time of

**THE DEPARTMENT OF THE TREASURY
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Notes to the Financial Statements
September 30, 2006 and 2005

donation, the land had an appraised value of \$1.5 million and the building shell cost was \$5.6 million. In accordance with the provisions of Public Law 81-656, Bureau financial statements include only the costs to build out the facility.

6. Other Assets, net

Other assets consist principally of machine repair parts and tools. The allowance for obsolescence for these parts and tools for the years ended September 30, 2006 and 2005, was \$5.1 million and \$4.8 million, respectively.

7. Current Liabilities

All current liabilities are funded and consist of the following as of September 30, 2006 and 2005:

	2006	2005
	(In Thousands)	
Intragovernmental	\$ 5,269	\$ 7,222
Other	37,213	38,038
Total	\$ 42,482	\$ 45,260

Accrued current liabilities consist of the following as of September 30, 2006 and 2005:

	2006	2005
	(In Thousands)	
Payroll	\$ 13,924	\$ 12,709
Annual Leave	10,315	10,183
Workers' compensation	4,766	4,420
Other	760	503
Total	\$ 29,765	\$ 27,815

8. Workers' Compensation Liability

Claims incurred and paid by DOL as of September 30, 2006 and 2005, but not yet reimbursed to DOL by the Bureau, are approximately \$10.2 million and \$10.1 million, of which \$4.7 million and \$4.4 million represents a current liability, as of September 30, 2006 and 2005, respectively. The Bureau will reimburse DOL for these claims in the next two years. The Bureau's estimated non-current actuarially derived future workers' compensation liability was \$53.5 million and \$59.4 million as of September 30, 2006 and 2005, respectively.

**THE DEPARTMENT OF THE TREASURY
BUREAU OF ENGRAVING AND PRINTING**

Notes to the Financial Statements
September 30, 2006 and 2005

9. Employee Retirement Plans and Postretirement Benefits Other than Pensions

Employer contributions to the retirement plans for 2006 and 2005 are \$15.9 million and \$15.7 million, respectively. The CSRS employer contribution rate for fiscal years 2006 and 2005 was 7.0%. The FERS agency contribution rate for fiscal years 2006 and 2005 was 11.2%. The cost of providing the CSRS and FERS benefits is more than the amounts contributed by the Bureau and the employees to OPM. The additional cost of providing benefits, including the cost financed by OPM, which is not included in the Bureau's Statements of Operations, totaled \$23.7 million and \$23.6 million in 2006 and 2005, respectively.

OPM paid costs totaling \$10.9 million and \$10.5 million for the Federal Employees Health Benefits Program (FEHBP) and Federal Employees Group Life Insurance (FEGLI) programs in 2006 and 2005, respectively. These costs are not included in the Bureau's Statements of Operations.

10. Related Party Transactions and Concentration of Revenue

The Bureau's principal customers are other Federal and quasi-Federal governmental organizations. During 2006 and 2005, the Bureau's sales to these organizations as well as the outstanding amounts due from them as of September 30, 2006 and 2005, are reflected in the following table:

	Sales for the year ended September 30		Accounts Receivable as of September 30	
	2006	2005	2006	2005
Federal Reserve System:				
Currency Production	\$ 444,297	\$ 476,762	\$ 30,136	\$ 40,630
Mutilated Currency	3,760	3,506	931	857
United States Postal Service	2,648	17,335	1,331	3
Other Federal Agencies	3,268	3,742	634	548
Total	<u>453,973</u>	<u>501,345</u>	<u>33,032</u>	<u>42,038</u>
 Total with the Public	 23,324	 10,719	 —	 —
Total	<u>\$ 477,297</u>	<u>\$ 512,064</u>	<u>\$ 33,032</u>	<u>\$ 42,038</u>

In 2001, the Bureau and the U.S. Postal Service entered into an agreement that gradually phased out production of postage stamps at the Bureau over a five-year period ending in 2005, with only delivery and storage services continuing through 2006.

**THE DEPARTMENT OF THE TREASURY
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Notes to the Financial Statements
September 30, 2006 and 2005

Other Federal sales revenues are derived principally from the sale of security printing products to U.S. Government agencies and fees charged to the Federal Reserve for the redemption of mutilated currency.

11. Principal Suppliers

The Bureau is dependent upon sole suppliers for distinctive currency paper, certain advanced counterfeit deterrent inks and currency paper fibers.

12. Commitments and Contingencies

The Bureau is a party in various administrative proceedings, legal actions, and claims brought against the Federal Government by employees, contractors, and other parties. Contingencies for litigations involving the Bureau, where the risk of loss was reasonably possible, were approximately \$2.9 million and \$0 as of September 30, 2006 and 2005, respectively.

Since the risk of loss for these litigations was not probable, the Bureau did not record any liability. Management believes that the ultimate resolution of these litigations will not have a material impact on reported results of operations, financial position and cash flows.

Judgments resulting from litigation against the Bureau are paid by the Department of the Treasury Judgment Fund. The Bureau is required to reimburse the Judgment Fund for paid claims related to employee discrimination and contract disputes. There were no amounts due to the Judgment Fund in fiscal years 2006 and 2005.

In 2006, the Bureau contracted to purchase currency production equipment, incorporating automated inspection and packaging capabilities, costing approximately \$34 million that will be delivered in 2007.

The Bureau does not carry commercial insurance on its physical assets because by law the Federal Government is self-insured.

The Bureau has not entered into any long-term leasing arrangements.

13. Staffing

In 2005, in order to better match facility staffing and production requirements, the Bureau offered voluntary employee separation incentives. As a result, in 2005, approximately 100 employees accepted the incentives and the Bureau incurred and paid the related expenses of approximately \$2.6 million. No voluntary employee separation incentives were offered or paid in 2006.



DEPARTMENT OF THE TREASURY

BUREAU OF ENGRAVING AND PRINTING

WASHINGTON, D.C. 20228

Management's Report on Internal Control Over Financial Reporting

We as management of the Bureau of Engraving and Printing (Bureau) are responsible for establishing and maintaining adequate internal control over financial reporting and for our assertion on the effectiveness of internal control over financial reporting. The Bureau's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

The Bureau's internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect our transactions and dispositions of the assets of the Bureau;
- provide reasonable assurance that our transactions are recorded as necessary to permit preparation of our financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures of the Bureau are being made in accordance with authorizations of management of the Bureau; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Bureau's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that internal controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

We assessed the effectiveness of the Bureau's internal control over financial reporting as of September 30, 2006. In making this assessment, the Bureau used the criteria established in the *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Based on our assessment and those criteria, we conclude that the Bureau maintained effective internal control over financial reporting as of September 30, 2006.

KPMG LLP, an independent public accounting firm, has issued their reports, included herein, on (1) our financial statements; (2) our compliance with certain provisions of laws, regulations, and contracts and other matters; and (3) our assertion on the effectiveness of internal control over financial reporting.

Larry R. Felix

Director

Leonard R. Olijar

Chief Financial Officer

October 27, 2006

Washington, DC



KPMG LLP
2001 M Street, NW
Washington, DC 20036

Independent Auditors' Report on Internal Control Over Financial Reporting

To the Inspector General, Department of the Treasury, and
The Director of the Bureau of Engraving and Printing, Department of the Treasury:

We have examined management's assertion, included in the accompanying "Management's Report on Internal Control Over Financial Reporting," that the Bureau of Engraving and Printing (Bureau) maintained effective internal control over financial reporting as of September 30, 2006, based on the criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. The Bureau's management is responsible for maintaining effective internal control over financial reporting and for its assertion on the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and the standards applicable to attestation engagements contained in *Government Auditing Standards*, issued by the Comptroller General of the United States and, accordingly, included obtaining an understanding of internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that the Bureau maintained effective internal control over financial reporting as of September 30, 2006 is fairly stated, in all material respects, based on the criteria established in *Internal Control – Integrated Framework* issued by COSO.

In accordance with *Government Auditing Standards*, we are required to report findings of deficiencies in internal control, violations of certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of the Bureau's financial statement amounts, certain other matters and any fraud and illegal acts that are more than inconsequential that come to our attention during our examination. We are also required to obtain the views of management on those matters. We performed our examination to express an opinion on management's assertion, included in the accompanying "Management's Report on Internal Control Over Financial Reporting," that the Bureau maintained effective internal control over financial reporting as of September 30, 2006, based on the criteria established in *Internal Control – Integrated Framework* issued by COSO and not for



the purpose of expressing an opinion on compliance and other matters; accordingly, we express no such opinion. Our examination disclosed a condition that is required to be reported under *Government Auditing Standards* involving internal control over financial reporting and its operations that we consider to be a reportable condition. However, this reportable condition is not considered to be a material weakness. The condition, along with the view of management, is described in Exhibit I of this report.

Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Bureau's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

In accordance with *Government Auditing Standards*, we also noted certain additional matters that we have reported to management of the Bureau in a separate letter dated October 27, 2006.

KPMG LLP

October 27, 2006

Fiscal Year 2006 Reportable Condition

Controls over inventory held by others

The Bureau has a contract with a vendor that requires the vendor to ship a certain raw material directly to the Bureau's paper provider for further processing before it can be shipped to the Bureau. Since the Bureau does not track the vendor's use of this material in paper production, the Bureau assumes that all the purchases of these raw materials were used by its vendors in production instantly and therefore, the Bureau records the purchase price as cost of goods sold at the time the raw materials are shipped to the Bureau's paper providers. However, at the end of FY 2006, the Bureau determined that there were approximately 28,000 pounds of this raw material with historical cost of \$3.8 million that had not been used by the vendor in the paper production as of fiscal year end and as such, should have been reflected as inventory at fiscal year end in accordance with U.S. generally accepted accounting principles. Accordingly, the Bureau adjusted the inventory and cost of goods sold balances to properly report this amount in its financial statements. The Bureau had approximately \$2.3 million of such raw materials held by the vendor as of September 30, 2005.

Without effective controls surrounding the tracking of the purchase and usage of such materials, inventory and cost of goods sold reported in the Bureau's financial statements could be materially misstated.

Recommendations

We recommend that the Bureau:

- Implements controls to ensure that the purchase and usage of these type of materials are properly tracked and recorded in the Bureau's financial statements in accordance with GAAP.
- Conducts periodic visits to the vendor's facility and conduct an inventory count of the balance on hand specifically at fiscal year-end.

Management's Response

We concur with the finding and will implement controls necessary to ensure that the purchase and usage of these type of materials are properly tracked and recorded in the Bureau's financial statements, and will conduct periodic visits to vendors' facilities to conduct inventory counts of the balance on hand.



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Independent Auditors' Report on Compliance and Other Matters

The Inspector General, Department of the Treasury and
The Director of the Bureau of Engraving and Printing, Department of the Treasury:

We have audited the balance sheet of the Bureau of Engraving and Printing (Bureau) as of September 30, 2006, and the related statements of operations and cumulative results of operations and cash flows (hereinafter referred to as "financial statements") for the year then ended, and have issued our report thereon dated October 27, 2006. That report notes that the Bureau's 2005 financial statements were audited by other auditors and that the Bureau implemented a new accounting standard effective October 1, 2005.

We conducted our audit 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 Office of Management and Budget (OMB) Bulletin No. 06-03, Audit Requirements for Federal Financial Statements. Those standards and OMB Bulletin No. 06-03 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of the Bureau is responsible for complying with laws, regulations, and contracts applicable to the Bureau. As part of obtaining reasonable assurance about whether the Bureau's financial statements are free of material misstatement, we performed tests of the Bureau's compliance with certain provisions of laws, regulations, contracts, and other matters, noncompliance with which could have a direct and material effect on the determination of the Bureau financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 06-03. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, and contracts applicable to the Bureau. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion.

The results of our tests of compliance described in the preceding paragraph, disclosed no instances of noncompliance or other matters that are required to be reported herein under Government Auditing Standards or OMB Bulletin No. 06-03.

This report is intended solely for the information and use of the Bureau's management, the Department of the Treasury'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

October 27, 2006