WILLIAMS ADLEY

DEPARTMENT OF INTERIOR
OFFICE OF NATURAL RESOURCES REVENUE

NORTH DAKOTA STATE AUDITOR'S OFFICE
ROYALTY AUDIT SECTION

FOR THE PERIOD JANUARY 1, 2010 THROUGH DECEMBER 31, 2012

September 10, 2013

INDEPENDENT PEER REVIEW OF THE NORTH DAKOTA STATE AUDITOR'S OFFICE ROYALTY AUDIT SECTION FOR THE PERIOD JANUARY 1, 2010 THROUGH DECEMBER 31, 2012

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WILLIAMS ADLEY

INDEPENDENT PEER REVIEW OF THE NORTH DAKOTA STATE AUDITOR'S OFFICE ROYALTY AUDIT SECTION

Dennis Roller
Manager
North Dakota State Auditor's Office
Royalty Audit Section

We have reviewed the system of quality control for the audit organization of the North Dakota State Auditor's Office Royalty Audit Section (Royalty Audit Section) in effect for the selected audit work performed by the Royalty Audit Section during the period January 1, 2010 through December 31, 2012. A system of quality control encompasses the Royalty Audit Section's organizational structure and the policies adopted and procedures established to provide it with reasonable assurance of conforming to *Government Auditing Standards.* The elements of quality control are described in the *Government Auditing Standards*. The Royalty Audit Section is responsible for designing a system of quality control and complying with it to provide reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to express an opinion on the design of the system of quality control and the Royalty Audit Section's compliance therewith based on our review.

Our review was conducted in accordance with *Government Auditing Standards* and Council of Inspectors General on Integrity and Efficiency (CIGIE) standards and guidelines. During our review, we interviewed Royalty Audit Section personnel and obtained an understanding of the nature of the audit organization, and the design of the system of quality control sufficient to assess the risks implicit in its audit function. Based on our assessments, we selected engagements and administrative files to test for conformity with professional standards and compliance with the Royalty Audit Section system of quality control. The engagements selected represented a reasonable cross section of open and closed royalty audits for the Royalty Audit Section. The contract for the peer review only allows information to be given to a contractor to conduct a peer review of oil and gas leases. No corresponding statutory authority exists now for the Office of Natural Resources Revenue (ONRR) to give any type of confidential information to a contractor to conduct peer reviews of coal, solids, section 8(g), and geothermal resources. Therefore, these audits were not included in the population of

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engagements to be selected for review. Prior to concluding the review, we reassessed the adequacy of the scope of the peer review procedures and met with management to discuss the results of our review. We believe that the procedures we performed provide a reasonable basis for our opinion.

In performing our review, we obtained an understanding of the system of quality control for the Royalty Audit Section. In addition, we tested compliance with the quality control policies and procedures of the Royalty Audit Section to the extent we considered appropriate. These tests covered the application of the policies and procedures on selected engagements. Our review was based on selected tests; therefore, it would not necessarily detect all weaknesses in the system of quality control or all instances of noncompliance with it.

There are inherent limitations in the effectiveness of any system of quality control, and therefore noncompliance with the system of quality control may occur and not be detected. Projection of any evaluation of a system of quality control to future periods is subject to the risk that the system of quality control may become inadequate because of changes in conditions, or because the degree of compliance with the policies or procedures may deteriorate. Section B to this report identifies the engagements that we reviewed.

In our opinion, the system of quality control for the audit organization of the Royalty Audit Section in effect for the selected audit work performed during the period January 1, 2010 through December 31, 2012, has been suitably designed and complied with to provide the Royalty Audit Section with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. State and Tribal organizations can receive a rating of *pass*, *pass with deficiencies*, or *fail*. The Royalty Audit Section has received a peer review rating of *pass*.

Williams, Adley & Company-DC, LLP

September 10, 2013
Washington, D.C.

SECTION A – SUMMARY OF RESULTS

1. Background

The Office of Natural Resources Revenue (ONRR) has its roots within the U.S. Geological Survey (USGS). USGS Regulations of 1936 provided that the Secretary of the Department of Interior (DOI) had the discretion to determine value for royalty purposes. In January 1982, the Minerals Management Service (MMS), was created within DOI from the Conservation Division of the USGS to improve management of Federal leasing revenues. There were two operational programs within MMS: Offshore Energy and Minerals Management, and the Minerals Revenue Management (MRM) program.

The Interior Secretary issued Secretarial Order No. 3299 separating the MMS responsibilities into three distinct organizations, one of which was ONRR in May 2010. Secretarial Order No. 3302 formally eliminated the former MMS and created the Bureau of Ocean Energy Management Regulation and Enforcement (BOEMRE) in June 2010. The functions of MRM officially transferred to ONRR, reporting to the Assistant Secretary for Policy, Management and Budget effective October 1, 2010.

ONRR collected and distributed over $200 billion since 1982. The revenues ONRR accounts for are distributed to special-purpose accounts administered by other Federal agencies, the U.S. Department of the Treasury, States, and the American Indian Community. ONRR reviews, analyzes, and audits companies' royalty payments to assure they are in compliance with applicable laws, rules, and regulations. Audits are conducted in accordance with Generally Accepted Government Auditing Standards (GAGAS), the ONRR Audit Manual (AM), and applicable policies and procedures. The audit compliance function is headquartered in Lakewood, Colorado. ONRR has field offices near principal energy development areas in Texas, Oklahoma, and New Mexico. ONRR also has a headquarters office in Washington D.C.

ONRR's authority for compliance activities, including audits, is in Sections 101 and 107 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), the Federal Oil and Gas Royalty Simplification and Fairness Act (RSFA), the lease terms, and the Federal regulations at 30 Code of Federal Regulation (CFR) 1201.100 and 1217.50.

State and Tribal Audits

The FOGRMA authorized the DOI to enter into cooperative agreements with Indian tribes under section 202 and to delegate audit authority to states under section 205. Under a cooperative agreement, an Indian tribe or state is permitted to conduct inspections, audits, and investigations of activities on their respective Indian or Federal lands. ONRR has cooperative agreements to conduct compliance audits of Federal and Tribal leases with 10 states and 7 tribes.

Royalty Audit Section

In accordance with §202 of the Federal Oil and Gas Royalty Management Act of 1982 (P.L. 97-451) as amended, the Secretary of the Interior has authorized ONRR to enter into a Delegation of Authority Agreement No. 0205CA40481 with the North Dakota State Auditor's Office to conduct audits and investigations related to royalty payments made for oil and gas produced and sold from Federal leases located within the borders of the State.

The North Dakota State Auditor's Office signed a six (6) year (October 1, 2010 through September 30, 2016) Grant and Cooperative Agreement with ONRR. The North Dakota State Auditor's Office has had a contract with ONRR to offer oil & gas royalty auditing on the Federal oil and gas leases located within the borders of the State lands since 1985.

The North Dakota State Auditor's Office conducts the audits in accordance with the ONRR Audit Manual (AM) and the *Government Auditing Standards* (2007 Revision), also known as the Yellow Book. The standards require that each organization should have quality control standards implemented and they should also undergo an external quality control review every three years.

2. Objective

The objective of this engagement was to conduct an Independent Peer Review of the royalty audit operations of the Royalty Audit Section in accordance with GAGAS, 2007 Revision, and the Council of the Inspectors General on Integrity & Efficiency (CIGIE) standards and guidelines under the Inspector General Reform Act 2008. The peer review considers selected audit work performed by the Royalty Audit Section during the period January 1, 2010 through December 31, 2012.

3. Scope

The scope was to perform a peer review of selected audits conducted by the Royalty Audit Section during the period January 1, 2010 through December 31, 2012. Our review was sufficient in scope to provide us a reasonable basis in determining whether, for the period under review, the reviewed audit organization's system of quality control was suitably designed and whether the audit organization was complying with its

quality control system in order to provide the audit organization with reasonable assurance of conforming to applicable professional standards.

The contract for the peer reviews only allows information to be given to a contractor to conduct a peer review of oil and gas leases. No corresponding statutory authority exists now for ONRR to give any type of confidential information to a contractor to conduct peer reviews of coal, solids, section 8(g), and geothermal resources. Therefore, audits of these resources were excluded from the scope of audits subject to our review.

4. Methodology

Williams Adley reviewed the system of quality control for the audit function of the Royalty Audit Section in effect for reports selected from the period January 1, 2010 to December 31, 2012.

We selected our sample of engagements from the population of audits performed during the period January 1, 2010 through December 31, 2012. If any audits were selected for which information could not be provided as indicated in the scope section above, the audit was replaced.

Williams Adley conducted the peer review of three selected engagements in conformity with standards and guidelines established by CIGIE and GAGAS. We tested compliance with ONRR's system of quality control to the extent we considered appropriate.

Finally, Williams, Adley & Company, LLP – DC (Williams Adley) provided a written report detailing our findings, to the Contracting Officer's Representative (COR), the applicable ONRR management, and the Royalty Audit Section.

5. Peer Review Results

Based on our peer review procedures, the system of quality control for the audit function of the Royalty Audit Section, in effect during the period covered, was suitably designed to meet the requirements of the quality control standards established by CIGIE and complied with DOI ONRR standards to provide reasonable assurance of performing and reporting in accordance with applicable professional auditing standards in all material respects. Agencies can receive a rating of *pass*; *pass with deficiency* (deficiencies), or *fail*. The Royalty Audit Section has received a peer review rating of *pass*.

SECTION B – PEER REVIEW DETAILS

1. Peer Review Scope and Methodology

WA conducted the review from September 9, 2013 to September 10, 2013 of the selected reports for the period January 1, 2010 to December 31, 2012. We performed the peer review in accordance with GAGAS, CIGIE standards and guidelines, and the AM. We tested compliance with ONRR's system of quality control to the extent we considered appropriate. We selected two (2) audits performed during the period. Additionally, we made one (1) surprise selection for testing. We reviewed and examined supporting working papers to ensure that they were in compliance with CIGIE, GAGAS, and AICPA audit criteria applicable to ONRR policies and procedures.

In analyzing the Royalty Audit Section's quality control system, we evaluated audit policies and procedures and the following elements for the selected reports inspected. Those elements are: Independence; Professional Judgment; Competence; Audit Planning; Supervision; Evidence and Audit Documentation; Reports on Performance Audits; Non-audit Services; and the Quality Control Process.

2. Royalty Audit Section Reports Reviewed

We visited the North Dakota State Auditor's Office Royalty Audit Section in Bismarck, ND and reviewed the following reports:

Number	Type of Report	Report Date	Name
10-00354-001	Closed	March 1, 2012	Griffon & Associates
11-00289-001	Closed	March 26, 2013	Prospective Investment and Trading Company
10-00819-001	Compliance work in progress	Open	Chaparral Energy *

(*) – Surprise Selection

We wish to acknowledge the exceptional assistance and extensive cooperation provided by the Royalty Audit Section staff in our performance of the peer review. The work could not have been completed without their full participation and support.

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September 30, 2013

Ms. TaVonna Serious, Audit Supervisor
Williams, Adley & Company-DC, LLP
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Re: Peer review response

Dear TaVonna:

The North Dakota State Auditor's Office Royalty Audit Section is in agreement with your report. We would like to thank you for your time and effort in performing our peer review. It was a pleasure meeting and working with you.

Sincerely,

Dennis Roller

Dennis Roller, Royalty Audit Section Manager
North Dakota State Auditor's Office