# REPORT ON CONSOLIDATED FINANCIAL STATEMENTS FOR FY 2007 AND FY 2006

***Department of Transportation***

***Report Number: FI-2008-011***

***Date Issued: November 13, 2007***

U.S. Department of Transportation
Office of the Secretary of Transportation
Office of Inspector General

# Memorandum

Subject: ACTION: Report on Consolidated Financial Statements for Fiscal Years 2007 and 2006, DOT Report Number: FI-2008-011

Date: November 13, 2007

From: Calvin L. Scovel III
Inspector General
Calvin L. Scovel III

Reply to Attn. of: JA–20

To: The Secretary

I respectfully submit the Office of Inspector General report on the Department of Transportation (DOT) Consolidated Financial Statements for Fiscal Years (FY) 2007 and 2006 (see Attachment). This year, our audit concluded that DOT's consolidated financial statements are fairly presented, in all material respects, in conformity with generally accepted accounting principles. The clean (unqualified) opinion signals to the public that the Department has successfully overcome last year's qualified opinion on the Construction in Progress (CIP) balance, which is a subcomponent of the Property, Plant, and Equipment line item on the Department's balance sheet.

Last year, KPMG LLP, under contract to us and under our supervision, rendered a qualified opinion on the Federal Aviation Administration's (FAA) FY 2006 financial statements because deficiencies in FAA's accounting for CIP prevented FAA from providing adequate support to verify that reported CIP balances were reliable. Since FAA's property, including CIP, represents about 95 percent of the Property, Plant, and Equipment line item on the Department's consolidated balance sheet, the Department's consolidated financial statements were similarly qualified. During FY 2007, FAA made a concerted effort to revise the CIP account balance, resulting in a clean opinion this year.

The Department's ability to regain a clean opinion on its consolidated financial statements would not have occurred without your emphasis and personal commitment to improving financial management practices, along with that of your senior leadership team, including the Acting FAA Administrator and the departmental Chief Financial Officer. During the year, you made several inquiries about FAA's CIP and financial statement audit progress. Your consistent attention to this subject helped departmental officials stay focused on their correction efforts.

The Department has undergone annual financial statement audits since FY 1992 and received the best outcome yet in FY 2007–a clean audit opinion and only one material weakness (FAA's continued challenge in managing the property account). While the Department should be commended for this accomplishment, it must remain vigilant in sustaining good financial management operations because auditors continue to find significant deficiencies associated with financial transaction processing. These deficiencies, if not properly addressed, could turn into material weaknesses in the future. The following summarizes key challenges the Department continues to face.

**Institutionalizing New CIP Processes**

FAA must institutionalize the new policies and procedures it developed to process CIP transactions. FAA's process for accounting for CIP has been a longstanding concern. Auditors reported material weaknesses concerning FAA's Property, Plant, and Equipment account balances, including inaccurate and untimely CIP transaction processing, 13 times since FY 1992. Congress provides more than $2 billion to FAA to invest in modernizing air traffic control systems each year. Most modernization projects involve sophisticated technology that may take years to develop/construct from concept to deployment. CIP projects are often deployed to multiple locations at different times and require FAA to use complicated formulas to calculate incurred and projected costs. In addition, the rapid advancement of technology and changes in FAA programs sometimes cause FAA to abandon projects before deployment.

For years, FAA has relied on a labor-intensive process to adjust the CIP account balance for the annual financial statement reporting. For FY 2006, however, FAA was unable to support the $4.7 billion CIP account balance as of September 30, 2006. As a result, both FAA and the Department received a qualified audit opinion on the FY 2006 financial statements.

During FY 2007, FAA made an unprecedented effort and devoted extensive resources to cleaning up the CIP account by conducting a comprehensive project-by-project evaluation. As part of these correction efforts, FAA also revised the associated CIP business processes. These included standardizing the methodology to calculate unit costs and overhead (burdening) allocation and enhancing procedures to record transactions in the property subsidiary ledger to ensure accurate, complete, and timely recording throughout the year. However, implementing these new procedures is very challenging. As a result, these new policies and procedures were not fully used to process FY 2007 transactions.

Institutionalizing the new (To-Be) procedures throughout the Agency will help ensure that FAA properly accounts for capital investment projects and avoids devoting extensive resources to this process again in future years. This year, KPMG reported FAA's CIP-related process a continued material weakness and recommended that FAA implement proper internal controls around the new policies and procedures; continue training and strengthening communications among field, regional, and accounting offices; enhance automated system processes to reduce manual interventions; and assess its human capital needs to reduce reliance on contract staff for future implementation.

Regarding the Highway Trust Fund (HTF) financial statements, KPMG rendered an unqualified (clean) opinion this year, the ninth consecutive HTF clean opinion since FY 1999. More importantly, auditors did not identify any material weakness associated with HTF financial accounting operations and oversight, which had been a repeated material weakness since FY 2003. This signals to the public that the Department has finally developed a mature and reliable financial environment to account for HTF resources. This is especially important because, beginning in FY 2008, this stand-alone financial statement will cease to exist. HTF-related financial activities will be audited as part of the Department's consolidated financial statements.

The Department was required to prepare a stand-alone financial statement to increase the visibility of HTF financial management. The HTF finances operations in multiple DOT Operating Administrations: the Federal Highway Administration (FHWA), the Federal Transit Administration, the National Highway Traffic Safety Administration, the Federal Motor Carrier Safety Administration, the Federal Railroad Administration, and the Research and Innovative Technology Administration. In addition, 15 other agencies outside of DOT receive HTF appropriations through FHWA. Together, these agencies disbursed about $40 billion in Federal funds during FY 2007.

To account properly for resources of this magnitude and complexity, the Department implemented new policies and procedures for internal governance and coordination with outside entities. In consideration of the progress made, the Office of Management and Budget approved the Department's request and waived the requirement for stand-alone HTF financial statements in June 2007.

**Facing the Highway Trust Fund Funding Crisis**

While the Department made good strides in strengthening financial management oversight of HTF resource usage, it is now facing a new challenge. The HTF is the primary source for financing highway construction projects and has experienced declining revenue collection. This year, the Department of the

Treasury's mid-year evaluation increased its projection of the FY 2009 cash shortfall from $230 million to $3.8 billion for the trust fund's highway account—a 16-fold escalation. Unless addressed, this shortfall could lead to reductions in obligation limitations for Federal highway programs below the levels anticipated in the current authorization to prevent HTF insolvency.

Highway funding levels are largely determined by the amount of revenue collected from the Federal motor fuel excise tax. The Internal Revenue Service (IRS) collects between $30 billion and $40 billion annually in motor fuel tax revenues, which account for almost 90 percent of HTF receipts. To combat motor fuel excise tax evasion, Congress has appropriated tens of millions of dollars from the HTF to help IRS develop more sophisticated information systems and enhance tax examination and motor fuel excise tax evasion investigations. This tax evasion is estimated to cost the trust fund $1 billion per year.[1]

In October 2005, the Treasury Inspector General for Tax Administration reported that the IRS did not effectively implement congressional direction.[2] In response to our request, the Treasury Inspector General has agreed to perform a follow-up review of IRS' corrective actions in FY 2008 (see Exhibit A). Reducing tax evasion is critical, given the erosion of trust fund revenues and the rising need for investments in the Nation's highway infrastructure.[3] FHWA management needs to work closely with IRS to implement congressional direction and increase tax revenue collections for the HTF.

**Ensuring Continued Financial Management Improvement**

Generating timely, reliable, and useful financial information is no small task and requires continued senior management attention. DOT is a complex organization that is accountable for substantial resources. DOT's FY 2007 financial statements show total assets of $62 billion, liabilities of $14 billion, program costs of $63 billion, and available financial resources of more than $122 billion. In FY 2007, DOT received appropriations of $63 billion. More than $51 billion (about 82 percent) of DOT's revenue sources came from two trust funds, the HTF and the Airport and Airway Trust Fund.

Based on the amount of resources received (appropriations), the Department would rank among the top 20 corporations in America. To measure up to what is

---

[1] According to the IRS estimate, the Highway Trust Fund loses about $1 billion annually because fuel owners mix motor fuel with other products—a practice aimed at increasing the fuel volume to reduce the effective tax rate.

[2] "The Excise Files Information Retrieval System Has Not Been Effectively Implemented," Treasury Inspector General for Tax Administration, 2006-20-001.

[3] In January 2007, the Government Accountability Office identified financing the Nation's transportation system as a high-risk area. GAO High-Risk Series: An Update, January 2007 (GAO-07-310).

expected from large publicly-held corporations, the Department needs to sustain clean audit opinions with no material weaknesses, continue enhancing its financial management oversight, and improve the quality of its financial information throughout the year. During this audit, we identified incidents in which management postponed researching/resolving account variances by posting adjusting entries at the end of each quarter, which were reversed at the beginning of the next quarter. This practice not only results in lower quality financial information throughout the year, but also inappropriately increases the yearend workload. It must be corrected.

We provided a draft of this report to the DOT Assistant Secretary for Programs and Budget/Chief Financial Officer, who concurred with its findings and agreed to implement corrective actions. We appreciate the cooperation and assistance of DOT and KPMG representatives. If we can answer any questions, please call me at (202) 366-1959; David Dobbs, Principal Assistant Inspector General for Auditing and Evaluation, at (202) 366-1427; or Rebecca Leng, Assistant Inspector General for Financial and Information Technology Audits, at (202) 366-1488.

Attachment

**DEPARTMENT OF TRANSPORTATION**
**INSPECTOR GENERAL'S INDEPENDENT AUDIT REPORT**
**ON THE DEPARTMENT OF TRANSPORTATION**
**CONSOLIDATED FINANCIAL STATEMENTS**
**FOR FISCAL YEARS (FY) 2007 AND 2006**

To the Secretary:

The Department of Transportation (DOT) Office of Inspector General (OIG) audited the DOT Consolidated Financial Statements for the years ended September 30, 2007, and September 30, 2006. We found:

- Financial statements that are fairly presented, in all material respects, in conformity with generally accepted accounting principles.
- One material internal control weakness: timely processing of transactions and accounting for Federal Aviation Administration (FAA) property, plant, and equipment, including the Construction in Progress (CIP) account.
- Four significant deficiencies: (1) journal entries and analysis of account relationships for the Highway Trust Fund (HTF) agencies,[1] (2) controls over financial management systems, (3) DOT's information security program, and (4) reporting the FTA grant accrual.
- Four instances of noncompliance with laws and regulations: (1) the Federal Financial Management Improvement Act of 1996 (FFMIA); (2) the Anti-deficiency Act; (3) the Improper Payments Information Act of 2002; and (4) SFFAS#4, Managerial Cost Accounting Concepts and Standards.
- Financial information in the Management Discussion and Analysis materially consistent with the financial statements.
- Supplementary and stewardship information, and other accompanying information, materially consistent with management representations and the financial statements.

We performed our work in accordance with Generally Accepted Government Auditing Standards and Office of Management and Budget (OMB) Bulletin 07-04,

[1] Federal Highway Administration, National Highway Traffic Safety Administration, Federal Transit Administration, Federal Railroad Administration, Federal Motor Carrier Safety Administration, and Research and Innovative Technology Administration.

"Audit Requirements for Federal Financial Statements." The following sections discuss these conclusions. Our audit objectives, scope, and methodology are described in Exhibit B. We believe that our audit provides a reasonable basis for our opinion.

## A. UNQUALIFIED OPINION ON FINANCIAL STATEMENTS

In our report dated November 15, 2006, we expressed a qualified opinion on the FY 2006 DOT consolidated financial statements because the FAA CIP balance presented to KPMG in August 2006 contained material errors, and FAA was not able to develop a reliable and supportable CIP balance prior to the issuance of the DOT FY 2006 Performance and Accountability Report (PAR). As discussed in footnotes 9 and 25, FAA has completed its review of the CIP balance and related transactions (reduced the September 30, 2006, CIP balance from $4.7 billion to $2.1 billion) and, as a result, DOT restated the FY 2006 consolidated financial statements to correct the error in accounting for FAA CIP. The restatement relates to the material weakness in the processing of transactions and accounting for FAA property, plant, and equipment, including the CIP account. Accordingly, our opinion on the DOT consolidated financial statements, including the FY 2006 restated financial statements, is different from that expressed in our previous report.

In our opinion, the DOT consolidated financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with generally accepted accounting principles, the DOT assets, liabilities, and net position; net costs; changes in net position; and budgetary resources; as of September 30, 2007, and September 30, 2006, and for the years then ended.

Under contract with OIG and under its supervision, KPMG audited the financial statements of FAA as of and for the years ended September 30, 2007, and September 30, 2006, and rendered an unqualified opinion on the FAA financial statements. KPMG also audited the financial statements of the HTF as of and for the years ended September 30, 2007, and September 30, 2006, and rendered an unqualified opinion on the HTF financial statements. We performed quality control reviews of the work performed by KPMG and relied on their results in performing our work on the FY 2007 and FY 2006 DOT consolidated financial statements.

As discussed in financial statement footnotes 1 and 21, the accompanying financial statements reflect actual excise tax revenues deposited in the HTF and the Airport and Airway Trust Fund for the 9 months ended June 30, 2007, and excise tax receipts estimated by the Department of the Treasury Office of Tax Analysis for the quarter ended September 30, 2007. As discussed in footnote 1, DOT changed its method of accounting for parent/child allocation transfers in FY 2007, in accordance with OMB Circular A-136.

Also, as discussed in footnotes 1 and 24, DOT changed its method of reporting footnotes 1 and 24, DOT changed its method of reporting the reconciliation of budgetary resources obligated to the net cost of operations in FY 2007, in accordance with OMB Circular A-136.

As discussed in footnote 25, DOT has restated certain balances previously reported to correct errors in accounting for FAA CIP, estimating the FTA grant accrual, and reporting FTA earmarked funds.

## B. CONSIDERATION OF INTERNAL CONTROLS

In planning and performing our audit, we considered DOT's internal controls over financial reporting, compliance with laws and regulations, and reliability of performance reporting. We do not express an opinion on internal controls because the purpose of our work was to determine our procedures for auditing the financial statements and to comply with OMB Bulletin 07-04 audit guidance, not to express an opinion on internal controls.

For the controls we tested, we found one material weakness. A material weakness is a significant deficiency, or combination of significant deficiencies, that result in a more than remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

Our work identified four significant deficiencies in internal controls. A significant deficiency is a deficiency in internal control, or a combination of deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is a more than remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. Our internal control work would not necessarily disclose all material weaknesses or significant deficiencies.

## MATERIAL WEAKNESS

Timely Processing of Transactions and Accounting for FAA Property, Plant, and Equipment, including the CIP Account

In FY 2005, KPMG reported a material weakness related to deficiencies in FAA's ability to process transactions and reconcile account balances in a timely manner. The account most affected was the CIP component of the Property, Plant, and Equipment (PP&E) line item. In FY 2006, KPMG reported that the CIP balance presented by FAA in August 2006 contained unknown and potentially material errors, and FAA management was unable to represent to KPMG, before the issuance of the Department's Performance and Accountability Report, that the CIP balance, reported to be $4.7 billion as of September 30, 2006, was fairly stated. Accordingly, KPMG could not complete its audit of CIP balances and again identified CIP process deficiencies as a material weakness. KPMG noted that FAA lacked adequate policies, procedures, and controls to monitor its CIP activity and balances in a routine and timely fashion.

During FY 2007 FAA executed an extensive corrective action plan, including a complete review of the CIP balance reported as of September 30, 2006. FAA's review of CIP resulted in a significant restatement of the DOT FY 2006 financial statements, including a reclassification of $1.7 billion from CIP to in-use fixed assets and more than $900 million from CIP to expense. The restated CIP balance at September 30, 2006, was $2.1 billion.

In its FY 2007 audit report, KPMG again identified the processing of transactions and accounting for PP&E, including the CIP account, as a material weakness. KPMG noted that FAA had not fully complied with standardized policies and procedures on unit costs, overhead allocations, and entry of transactions in the fixed asset subsidiary ledger, to ensure CIP and related PP&E balances were accurate, complete, and recorded in a timely manner throughout the year. Substantial manual processes were necessary for FAA to account for and report CIP transactions occurring during FY 2007 and to determine the appropriate balances reported at year end. Specifically, KPMG noted:

- FAA was focused on the cleanup of FY 2006 and prior-year activity in the first two quarters of FY 2007; therefore, about 80 percent of FY 2007 capitalization activity (additions and adjustments from CIP to in-use fixed assets) were not recorded at the detailed transaction level until after March 31, 2007;

- Documentation (joint acceptance inspections, contractor acceptance inspections, delivery schedules, etc.) was not readily available from program offices and did not consistently support management's conclusions on CIP project status; in some cases, management needed to reevaluate its initial disposition of CIP projects and adjust the general ledger and draft financial statement amounts;

- A lack of formal communications and training for program managers, engineers, and operational accountants needed to accurately account for and present capitalized balances and related expenses;

- A lack of adherence to policies and procedures to ensure the timely removal of fixed assets from the accounting system upon retirement;

- FAA processes and controls allowed errors to occur in the CIP capitalization and valuation process, such as unit costing and overhead allocation; the methodology adopted by FAA requires a high level of manual involvement to accurately account for CIP; and

- FAA has weaknesses in entity-level controls pertaining to human resources to properly account for PP&E and CIP, and relied heavily on outside contractors to compute the restatement of the FY 2006 financial statements and record FY 2007 CIP and PP&E transactions.

Accounting for FAA CIP and PP&E is very complex with many variables and inputs that affect capitalized asset values including estimates, indirect costs, projection of future spending rates, and the timing and number of asset deployments. The conditions leading to the restatement of the FY 2006 financial statements and the material weakness have built up over several years. For example, FAA converted to the Delphi accounting system in FY 2004, and during the conversion, some CIP balances were transferred at the summary level, making the identification of individual assets in CIP more difficult, causing assets to remain in CIP long after they had been placed in service. Also, FAA experienced turnover in key PP&E accounting positions, especially at the HQ level, resulting in loss of continuity and institutional knowledge. Finally, until recently, programmatic and operational personnel did not always adhere to policies and procedures to enable the timely recording of assets placed in service.

As a result, FAA had not fully implemented internal controls required by the Federal Managers' Financial Integrity Act (FMFIA) and OMB Circular A-123, that will allow FAA management to provide reasonable assurance that controls over CIP and PP&E are properly designed and operating effectively. In addition, if FAA is unable to correct these conditions early in FY 2008, the CIP, PP&E, and related financial statement balances may not be fairly stated at the end of FY 2008 and beyond.

KPMG made seven recommendations to correct these deficiencies. FAA agreed with the KPMG recommendations and indicated it would continue to implement corrective actions in early FY 2008.

## SIGNIFICANT DEFICIENCIES

The following sections describe the significant deficiencies that we identified.

### Journal Entries and Account Relationships for the HTF Agencies

Since the audit of the FY 2003 HTF financial statements, we reported that material weaknesses existed in internal controls over financial management and reporting activities in the HTF agencies. In FY 2006, KPMG reported that the HTF agencies continued to have a material weakness in financial management, reporting, and oversight. The deficiencies reported by KPMG included (1) the preparation, approval, and processing of journal entries; (2) the preparation and analysis of the HTF financial statements; (3) the analysis of abnormal account balances; (4) the analysis of proprietary and budgetary account relationships; (5) the coordination with non-DOT agencies that receive HTF appropriations through FHWA; and (6) the estimation and reporting of grant accruals.

During FY 2007, the HTF agencies implemented significant improvements in internal controls over financial management and reporting activities. The deficiencies related to the preparation and analysis of the HTF financial statements, the analysis of abnormal account balances, and accounting for parent-child allocation transfers (with non-DOT agencies) have been corrected. In its FY 2007 audit report, KPMG identified controls over journal entries and analysis of proprietary and budgetary account relationships as a significant deficiency. In addition, KPMG reported the FTA grant accrual as a separate significant deficiency.

#### *Controls Over Journal Entries*

For the 114 journal entries reviewed by KPMG at September 30, 2007, KPMG noted 34 instances related to the FHWA, the Federal Motor Carrier Safety Administration (FMCSA), and the National Highway Traffic Safety Administration (NHTSA) in which either supporting documentation was not provided or the documentation provided was insufficient to support the entry. KPMG also noted the approvers for six journal entries related to FHWA and

NHTSA were unable to explain the purpose of the entry. While all journal entries reviewed had evidence of approval by other than the preparer, KPMG noted 12 entries related to FHWA, FMCSA, and NHTSA in which they could not determine if the entry was approved before it was posted to the general ledger. Failure to follow existing policies and procedures over journal entries increases the risk that financial statements may be misstated or not properly supported.

### *Analysis of Proprietary and Budgetary Account Relationships*

During FY 2007 the DOT Office of Financial Management developed a consistent and comprehensive set of proprietary and budgetary account relationship tests for all DOT agencies to use for the period ended June 30, 2007. During its review of account relationship tests at September 30, 2007, KPMG noted the following exceptions related to analyzing, resolving, or explaining the variances identified by the account relationship tests:

- FHWA did not analyze or resolve any of the 62 variances identified;

- FMCSA identified 26 variances, identified the cause of 18 variances, but provided no indication of the cause of the other 8 variances or when they would be resolved;

- NHTSA identified 28 variances, identified the cause of 11 variances, but provided no indication of the cause of the other 17 variances or when they would be resolved; and

- The Research and Innovative Technology Administration (RITA) identified 10 variances, identified the cause of 3 variances, but provided no indication of the cause of the other 7 variances or when they would be resolved.

KPMG reported that at the end of each quarter, journal entries were posted to balance certain proprietary and budgetary accounts without completely researching the related variance. These journal entries are reversed at the beginning of the next quarter in order to continue researching the variances.

The HTF agencies had not adequately implemented existing policies and procedures over the analysis and resolution of variances identified between proprietary and budgetary accounts. In addition, Office of the Secretary of Transportation (OST) policies and procedures did not establish a firm due date for the resolution of any variances identified. Failure to research and resolve proprietary and budgetary account variances increases the risk that financial statements may be misstated or not properly supported.

KPMG made six recommendations to improve controls over journal entries and proprietary and budgetary account relationship tests for the HTF agencies. Departmental management agreed to implement corrective actions.

## Financial System Controls

Last year, we reported DOT's financial system controls as a reportable condition (significant deficiency). This included system control weaknesses in Delphi and computer security deficiencies in FAA and HTF systems that provide financial data to Delphi.

In FY 2007, DOT made significant progress in strengthening the design and implementation of controls over Delphi. Enhanced computer security and other protective measures enabled auditors to rely on Delphi financial management system controls except for logical access controls. In addition, FAA and HTF systems were enhanced in areas such as security awareness training, user access, contingency planning, physical security, segregation of duties, and others. However, DOT's move to a new Headquarters building in Washington, D.C., resulted in other security concerns. Consequently, despite progress in some areas, continued improvements are needed to remediate various control deficiencies in the Delphi, FAA, and HTF financial systems.

Computer security controls can be improved in all 12 systems reviewed during the DOT financial statement audits.

- Departmental system: Delphi Financial Management System
- FAA systems: procurement system (PRISM), cost accounting system, timekeeping system (CASTLE), grant management system (System of Accounting and Reporting)
- FHWA systems: User Profile and Access Control System, Rapid Approval and State Payment System, Fiscal Management Information System, Delphi Interface Management System
- FTA Systems: Transportation Electronic Award Management System, Electronic Clearing House Operation, and Delphi Online Transaction System.

KPMG's audit reports dated November 5, 2007, included recommendations to improve the information technology environment applicable to FAA and HTF financial systems.

The Clifton Gunderson LLP review of the controls over the Enterprise Service Center's Delphi Financial Management System, again reported weaknesses in the design and implementation of access controls related to the Delphi financial management system. Departmental management agreed to implement corrective actions needed in the Delphi, FAA, and HTF financial systems.

## DOT Information Security Program

In October 2007, we issued our seventh annual report on DOT's Information Security Program. FY 2007 was a challenging year for the Department because of the Headquarters move and the need to review, test, and certify security protection for more than half of the departmental information systems. Because of this, the overall effectiveness of the Department's information security program declined. Specifically, management did not meet Government security standards to protect information systems and did not take sufficient action to correct identified security deficiencies. We also found that commercial software products used in departmental systems were not configured in accordance with security standards, and that security incidents were incompletely and/or inaccurately reported.

We made a series of recommendations to help the Department strengthen its information security program. The Department Chief Information Officer agreed that these are needed to resolve the current deficiencies.

## FTA Grant Accrual

For year-end reporting, the Federal Transit Administration (FTA) calculated and recorded an estimate (liability) for the amount of work performed by its grantees (including their contractors) but not yet billed to or reimbursed by FTA. During FY 2007 FTA hired a consultant to assist in the development of grant accrual using a nonstatistical sample of surveys to 49 grantees (29 large and 20 small) that accounted for about 70 percent of active obligations. The survey requested information that would assist FTA in calculating the FY 2007 grant accrual, such as billing cycle days and grantees' audited year-end accrual amounts.

While FTA received all the completed surveys, the responses varied in terms of reliability. FTA determined that only 18 of the 49 surveys (13 large and 5 small) were reasonably accurate and suitable for use in calculating FY 2007 grant accrual. KPMG determined that the 18 surveys constituted an inadequate basis on which to calculate the accrual. FTA agreed to follow up on the remaining surveys, and was ultimately able to use 45 of the 49 surveys. KPMG also noted that documentation supporting the work performed by FTA and its consultant was initially incomplete and there was no evidence that FTA properly reviewed the work performed by its consultant.

Controls are not in place in FTA to ensure that grant accrual is based on sufficient information provided by its grantees. KPMG made two recommendations to FTA to improve controls over the development of the grant accrual and oversight of work performed by its consultant. Departmental management agreed to implement corrective actions.

## C. COMPLIANCE WITH LAWS AND REGULATIONS

In planning and conducting our audit, we performed limited tests of DOT's compliance with laws and regulations, as required by OMB guidance. It was not our objective to express, and we do not express, an opinion on compliance with laws and regulations. Our work was limited to testing selected provisions of laws and regulations that would have a direct and material effect on the financial statements and be reportable under Generally Accepted Government Auditing Standards or under OMB guidance. Our work disclosed the following instances of noncompliance with laws and regulations.

### FEDERAL FINANCIAL MANAGEMENT IMPROVEMENT ACT OF 1996 (FFMIA)

Under FFMIA, we must report whether DOT's financial management systems substantially comply with Federal financial system requirements, generally accepted accounting principles, and the U.S. Government Standard General Ledger at the transaction level. DOT was not in compliance with FFMIA because FAA was unable to account for property, plant, and equipment transactions including the CIP account, and present balances in its periodic financial statements in accordance with generally accepted accounting principles as of and for the year ended September 30, 2007.

### ANTIDEFICIENCY ACT

Title 31, United States Code, Section 1517, provides that an officer or employee of the U.S Government may not make or authorize an expenditure or obligation exceeding an amount available in an allotment. In our report on the FY 2006 DOT financial statements, we reported that FAA still needed to report to the President and Congress, a $1.9 million violation associated with the Small Community Air Service Development Program first detected by FAA in FY 2005. On September 7, 2007, DOT reported the FAA Small Community Air Service Development Program violation to the President and Congress.

On June 1, 2006, DOT also reported to the President and Congress a $3.6 million violation in RITA's Research and Development Account. While departmental management was aware of this violation during FY 2006, it did not disclose the incident in the management representation letter prior to issuance of our audit report on the FY 2006 DOT Consolidated Financial Statements.

Also during FY 2007, the Maritime Administration (MARAD) CFO identified a potential violation at the U.S. Merchant Marine Academy that needs to be reviewed by MARAD and OST General Counsel and, if determined to be a violation, reported to the President and Congress.

## IMPROPER PAYMENTS INFORMATION ACT OF 2002 (IPIA)

OMB Circular A-123, Appendix C, issued on August 10, 2006, entitled "Requirements for Effective Measurement and Remediation of Improper Payments," implements the requirements of IPIA and is effective for FY 2006 reporting. The circular defines an improper payment as any payment that should not have been made or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirements. Incorrect amounts include overpayments and underpayments, payments made to an ineligible recipient or for an ineligible service, duplicate payments, payments for services not received.

The circular prescribes a four-step approach for use by agencies in evaluating improper payments: (1) review all programs and identify those susceptible to significant erroneous payments; (2) statistically estimate the annual amount of improper payments; (3) implement a plan to reduce erroneous payments; and (4) report estimates of the annual amount of improper payments and progress in reducing them.

In our FY 2006 report we stated that FHWA could not estimate the annual amount of improper payments made under the Federal-aid program, and that the estimate was limited to a period of 5 months—about $30 million. We also reported that FTA and FAA were still in the early stages of implementing the improper payments testing requirements. During FY 2006, FAA performed testing of grant payments made by one airport authority, and FTA tested payments made by two transit grantees.

During FY 2007 DOT reported it successfully completed its review of improper payments in 3 of the 4 DOT major grant programs; the FHWA Federal-aid Program, the FAA Airport Improvement Program, and the FTA Formula Grant Program. In addition, DOT reported it had developed and tested a model to test for improper payments in the FTA Capital Investment Program in FY 2008. However, we were not provided sufficient information by DOT and its consultant, before the issuance of the DOT FY 2007 PAR, to determine if the sampling plan used by DOT and its consultant was statistically valid. For example, we could not determine if the sample sizes or the projection of the sample results to the program totals were based on generally accepted conventional formulas. The Department planned to initiate another round of improper payments testing in all four grant programs next year. We will continue to work with DOT and its consultant to ensure the improper payment testing performed in FY 2008 is based on valid statistical sampling techniques.

### SFFAS 4, MANAGERIAL COST ACCOUNTING CONCEPTS AND STANDARDS

Statement of Federal Financial Accounting Standards (SFFAS) Number 4, Managerial Cost Accounting Concepts and Standards for the Federal Government, requires Federal entities to establish managerial cost accounting capabilities in order to provide reliable and timely information on the full cost of Federal programs, activities, and outputs. The managerial cost accounting capabilities must include (1) accumulating and reporting costs on a regular basis for management information purposes, (2) establishing responsibility segments to match costs with outputs, (3) determining full costs of goods and services, (4) recognizing the costs of goods and services provided among Federal entities, and (5) using appropriate costing methodologies to accumulate and assign costs to outputs.

Nine Operating Administrations (OA) (FHWA, MARAD, FMCSA, FRA, NHTSA, PHMSA, RITA, OST, and STB) have not fully implemented cost accounting processes in accordance with SFFAS Number 4. Using the FY 2007 OMB Circular A-123 (Appendix A) results, the DOT CFO has recommended that each of these nine OAs continue implementing their managerial cost accounting processes.

## D. CONSISTENCY OF OTHER INFORMATION

The Management Discussion and Analysis, Required Supplementary Information, Required Supplementary Stewardship Information, and Other Accompanying Information sections of the PAR contain a wide range of data, some of which are not directly related to the financial statements. We are not required to, and we do not, express an opinion on this information. As required by OMB guidance, we inquired of management about the methods of preparing this information, and we compared this information for consistency with the DOT consolidated financial statements and other knowledge obtained during the audit of the financial statements. Based on this work, we found no material inconsistencies with the DOT consolidated financial statements or nonconformance with OMB guidance.

## E. PRIOR AUDIT COVERAGE

Our report on the DOT Consolidated Financial Statements for FY 2006 and FY 2005 expressed a qualified opinion and made no new recommendations. Exhibit C displays the status of the prior year's findings.

Since our report on the DOT Consolidated Financial Statements for FY 2006 and FY 2005 was released, we have issued 19 additional reports related to the DOT Consolidated Financial Statements. The reports are listed in Exhibit D.

The Assistant Secretary for Budgets and Programs/Chief Financial Officer provided comments on a draft of this report (see Appendix). The response agreed with the material weakness and significant deficiencies cited in this report and stated that corrective actions have already been initiated. Management agreed to provide a detailed action plan addressing each finding by December 28, 2007.

This report is intended for the information of and use by DOT, OMB, the Government Accountability Office, and Congress. The report is a matter of public record, and its distribution is not limited.

Calvin L. Scovel III

Calvin L. Scovel III
Inspector General

November 9, 2007

# EXHIBIT A. LETTER TO TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

**U.S. Department of Transportation**

Office of the Secretary of Transportation

The Inspector General

Office of Inspector General

Washington, DC 20590

October 25, 2007

The Honorable J. Russell George
Treasury Inspector General for Tax Administration
U.S. Department of Treasury
1125 15th Street, NW
Washington, DC 20005

Dear Mr. George:

I would like to express my appreciation for your office's decision to perform a follow-up review of the Internal Revenue Service's (IRS) implementation of the Excise Files Information Retrieval System (ExFIRS). The IRS developed this system to combat motor fuel excise tax evasion. In October 2005, your office reported that the IRS had not effectively implemented ExFIRS and recommended corrective actions to help increase tax revenue collection for the Highway Trust Fund.[1]

The IRS collects between $30 billion and $40 billion annually in motor fuel tax revenues, which account for almost 90 percent of Highway Trust Fund receipts. This trust fund is the primary financial source for highway construction projects. Since fiscal year 1999, Congress has appropriated tens of millions of dollars from the Highway Trust Fund to help IRS develop ExFIRS and enhance tax examination and motor fuel excise tax evasion investigations. This tax evasion is estimated to cost the trust fund $1 billion per year.[2]

---

[1] "The Excise Files Information Retrieval System Has Not Been Effectively Implemented," Treasury Inspector General for Tax Administration, 2006-20-001.

[2] According to the IRS estimate, the Highway Trust Fund loses $1 billion annually because fuel owners mix motor fuel with other products—a practice aimed at increasing the fuel volume to reduce the effective tax rate.

In August 2007, my staff requested that your office do a follow-up review after we received the Department of the Treasury's mid-year evaluation of the Highway Trust Fund. Treasury increased its projection of fiscal year 2009 cash shortfalls from $230 million to $3.8 billion for the trust fund's highway account—a major escalation.

Reducing tax evasion is critical in view of the erosion of trust fund revenues and rising need for investments in the Nation's highway infrastructure.[3] Your review will provide critical insight into IRS efforts to collect more tax revenues for the Highway Trust Fund through ExFIRS.

We are particularly interested in the status of the following corrective actions to reduce motor fuel excise tax evasion.

1. *Enforcing electronic filing of motor fuel tax information.* The October 2005 report stated that the planned use of the automated matching process in ExFIRS to detect tax evasion was limited because only 70 percent of the fuel transactions were reported electronically.

2. *Revising the computer matching process to indentify potential noncompliant taxpayers.* The October 2005 report stated that the IRS deemed the matching results unreliable and that it planned to revise the matching process.

3. *Referring potential noncompliance cases for examination and actual recovery.* The October 2005 report stated that the IRS elected not to refer potential exception cases identified by computer matching for examination until electronic filing became mandated in 2006.

4. *Assessing penalties on companies that failed to file complete and accurate information documents.* The October 2005 report stated that data perfection issues would continue to pose a significant problem to ExFIRS operations. IRS, however, elected not to assess penalties on companies until after January 1, 2006.

5. *Mitigating "reporting gaps" in the movement of motor fuel.* The October 2005 report stated that while ExFIRS was designed to track all motor fuel movements into and out of approved terminals, reporting gaps hinder the effectiveness of ExFIRS to monitor fuel production and sales. For example,

---

[3] In January 2007, the Government Accountability Office identified financing the Nation's transportation system as a high-risk area. GAO High-Risk Series: An Update, January 2007 (GAO-07-310).

certain carriers were exempted from reporting fuel deliveries to the terminal. Also, ExFIRS would not include fuel distribution reporting at refineries, unregulated terminals, and bulk storage facilities.

6. *Enhancing coordination with the Federal Highway Administration.* The October 2005 report stated that the IRS and the Federal Highway Administration need to work more closely on ExFIRS development.

We look forward to the results of your review in these key areas. My office will be glad to assist you in coordinating with the Federal Highway Administration.

If you have any questions or would like to discuss this matter further, please contact me at (202) 366-1959 or Todd Zinser, Deputy Inspector General, at (202) 366-6767.

Sincerely,

Calvin L. Scovel III
Inspector General

cc: Administrator, Federal Highway Administration
Assistant Secretary for Budget and Programs/Chief Financial Officer

# EXHIBIT B. OBJECTIVES, SCOPE, AND METHODOLOGY

Our audit objectives for the DOT Consolidated Financial Statements for FY 2007 and FY 2006 were to determine whether (1) the basic DOT Consolidated Financial Statements and accompanying notes were presented fairly, in all material respects, in conformity with generally accepted accounting principles; (2) DOT had adequate internal controls over financial reporting, including safeguarding assets; (3) DOT complied with laws and regulations that could have a direct and material effect on the basic DOT Consolidated Financial Statements or that had been specified by OMB, including FFMIA; (4) financial information in the Management Discussion and Analysis, Required Supplementary Information, Required Supplementary Stewardship Information, and Other Accompanying Information was materially consistent with the information in the basic DOT Consolidated Financial Statements; and (5) internal controls were in place relating to the existence and completeness of performance measures.

DOT is responsible for (1) preparing the DOT Consolidated Financial Statements for FY 2007 and FY 2006 in conformance with generally accepted accounting principles; (2) establishing, maintaining, and assessing internal controls to provide reasonable assurance that broad control objectives of FMFIA are met; (3) ensuring that DOT financial management systems substantially comply with FFMIA requirements; and (4) complying with other applicable laws and regulations. DOT is responsible for maintaining an effective system of internal controls. The objectives of these controls are explained below.

- **Financial reporting.** Transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in accordance with generally accepted accounting principles; and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.
- **Compliance with laws and regulations.** Transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements; and any other laws, regulations, and policies identified by OMB.
- **Reliability of performance reporting.** Transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit the preparation of required performance information.

To fulfill these responsibilities, we (1) examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements; (2) assessed the accounting principles used and significant estimates made by management; (3) evaluated the overall presentation of the financial statements; (4) obtained an understanding and performed limited tests of internal controls related to financial reporting, compliance with laws and regulations, and performance measures; and (5) tested compliance with selected provisions of certain laws, including FFMIA. We did not evaluate all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to ensuring that programs achieve their intended results and that resources are used consistent with agency missions. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal controls, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected.

The Government Accountability Office performed agreed-upon procedures at the Internal Revenue Service on the excise taxes distributed to the HTF and the Airport and Airway Trust Fund during FY 2007. The Treasury Office of Inspector General reported on the effectiveness of controls placed in operation over the Bureau of Public Debt Trust Fund Management and Federal Investments branches for the period August 1, 2006, to July 31, 2007, and attained management's assurance on the effectiveness of controls through September 30, 2007. The Treasury Office of Inspector General also reported on selected schedules of assets and liabilities of the HTF and the Airport and Airway Trust Fund prepared by the Bureau of Public Debt Trust Fund Management Branch, as of and for the year ended September 30, 2007.

We did not test compliance with all laws and regulations applicable to DOT. We limited our tests of compliance to those laws and regulations required by OMB audit guidance that we deemed applicable to the DOT Consolidated Financial Statements for the years ended September 30, 2007, and September 30, 2006. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

The Chief Financial Officers of DOT and each Operating Administration have been assigned the responsibility to address the deficiencies identified in this report. Management's response to the findings and recommendations in this report is contained in the Appendix.

We performed our work in accordance with Generally Accepted Government Auditing Standards and OMB Bulletin 07-04, "Audit Requirements for Federal Financial Statements."

# EXHIBIT C. STATUS OF PRIOR YEAR FINDINGS

| Issue | As Reported September 30, 2006 | As Reported September 30, 2007 |
|---|---|---|
| Timely Processing of and Accounting for the FAA Construction-in-Progress Transaction | Material Weakness | **Material Weakness** |
| HTF Agencies' Financial Management, Reporting, and Oversight Activities | Material Weakness | **Several deficiencies corrected; Journal Entries and Analysis of Account Relationships continue as Significant Deficiency; FTA Grant Accrual is reported as a separate Significant Deficiency** |
| Reporting of Earmarked Funds for FTA | Reportable Condition | **Corrected** |
| Financial System Controls | Reportable Condition | **Significant Deficiency** |
| DOT Information Security Program | Reportable Condition | **Significant Deficiency** |
| Intragovernmental Transactions | Reportable Condition | **Management Letter** |
| Deobligating Unneeded Funds in the HTF Agencies | Reportable Condition | **Management Letter** |
| FAA Grants Management | Reportable Condition | **Corrected** |
| Federal Financial Management Improvement Act of 1996 | Noncompliance | **Noncompliance** |
| Antideficiency Act | Noncompliance | **Noncompliance** |
| Improper Payments Information Act of 2002 | Noncompliance | **Noncompliance** |

# EXHIBIT D. FINANCIAL-RELATED REPORTS

| Report Title | Report Number | Date Issued |
|---|---|---|
| Audit of Special-Purpose Financial Statements for Fiscal Years 2006 and 2005 | FI-2007-011 | November 17, 2006 |
| Oversight of Airport Improvement Program Hurricane Grants | AV-2007-014 | December 13, 2006 |
| Inspector General Review of Fiscal Year 2006 Drug Control Funds | FI-2007-029 | February 1, 2007 |
| Emergency Transportation Services Contract: Lessons Learned from the 2005 Gulf Coast Hurricanes | FI-2007-030 | February 5, 2007 |
| Opportunities to Free Up Unneeded FHWA Funds for Use in Hurricane Recovery Efforts | MH-2007-037 | March 6, 2007 |
| Value Engineering in FHWA's Federal-Aid Highway Program | MH-2007-040 | March 28, 2007 |
| FTA Procedures to Prevent Antideficiency Act Violations | FI-2007-047 | May 15, 2007 |
| More Incurred-Cost Audits of DOT Procurement Contracts Should Be Obtained | FI-2007-064 | August 29, 2007 |
| Review of Congressional Earmarks Within Department of Transportation Programs | AV-2007-066 | September 7, 2007 |
| Quality Control Review of the Report on Controls Over the Enterprise Service Center's Delphi Financial Management System | QC-2007-072 | September 13, 2007 |
| FAA's Oversight of Inactive Airport Improvement Program Grant Obligations | AV-2007-073 | September 13, 2007 |
| Growth in Highway Construction and Maintenance Costs | CR-2007-079 | September 26, 2007 |

| Report Title | Report Number | Date Issued |
|---|---|---|
| Information Security Program at the Department of Transportation | FI-2008-001 | October 10, 2007 |
| Prioritization of Airport Improvement Program Funding | AV-2008-002 | October 26, 2007 |
| Quality Control Review of Audited Financial Statements for Fiscal Year 2007 and Fiscal Year 2006: Federal Aviation Administration | QC-2008-005 | November 9, 2007 |
| Quality Control Review of Audited Financial Statements for Fiscal Year 2007 and Fiscal Year 2006 Highway Trust Fund | QC-2008-006 | November 9, 2007 |
| Quality Control Review of Audited Financial Statements for Fiscal Year 2007 and Fiscal Year 2006: Saint Lawrence Seaway Development Corporation | QC-2008-007 | November 9, 2007 |
| Quality Control Review of the Audited Financial Statements for Fiscal Year 2007 and Fiscal Year 2006 FAA Franchise Fund | QC-2008-010 | November 13, 2007 |
| Top Management Challenges | PT-2008-008 | November 15, 2007 |

**Exhibit D. Financial-Related Reports**

# APPENDIX. ASSISTANT SECRETARY FOR BUDGET AND PROGRAMS/CHIEF FINANCIAL OFFICER RESPONSE TO AUDIT REPORT

November 13, 2007

MEMORANDUM TO: Calvin L. Scovell, III
Inspector General

FROM: Phyllis F. Scheinberg Phyllis F. Scheinberg

SUBJECT: Management Response to the Audit Report on Consolidated Financial Statements for Fiscal Years (FY) 2007 and 2006

The Department is pleased to respond to your audit report on the Consolidated Financial Statements for FYs 2007 and 2006. We are very proud of the exceptional advancements that our Operating Administrations have made over the last year.

This year's audit concluded that DOT's consolidated financial statements are fairly presented in all material respects in conformity with generally accepted accounting principles.

We concur with the one material weaknesses and four significant deficiencies described in your report. Corrective action plans are being developed to address the findings in your report and will be forwarded to you by December 28. Our consolidated action plans will also address the findings in the audits of the Federal Aviation Administration (FAA) and the Highway Trust Fund (HTF) agencies.

This year the Department made significant progress in resolving long-standing financial management internal control issues, including the following highlights:

- The qualification on the FAA's FY 2006 audit opinion due to their Construction In Progress (CIP) account was lifted as a result of a comprehensive program of project-by-project reviews conducted by the FAA.

During FY 2008, the FAA will complete the remaining corrective actions in this area.

- The HTF agencies have eliminated the FY 2006 material weakness in financial reporting and oversight. During FY 2007 they significantly strengthened financial management processes and controls. This is the first audit year that no material weaknesses have been reported in the HTF audit. The Office of Management and Budget (OMB) has eliminated the requirement for the stand-alone HTF audit in the future; therefore, this is the last year that it will be conducted.

- Significant progress was also made on DOT's implementation of the Improper Payments Information Act (IPIA). In FY 2007, the Department developed improper payment rates for the Federal-Aid Highway Program, the Airport Improvement Program, and the Transit Formula Grants Program. The Department also developed and tested a model for determining the amount of improper payments in the Transit Capital Investment Grants Program. Per our agreement with OMB, DOT will be continuing a comprehensive IPIA program in FY 2008.

- This year the Department completed its comprehensive two-year implementation of OMB Circular A-123, *Management's Responsibility for Internal Control*. During FY 2007 DOT assessed our control environments and documented and tested the final seven key business processes. We are planning our A-123 program for FY 2008 while we continue to resolve the findings identified by our testing.

We agree with your recommendations and will use them to develop and implement corrective actions. We will continue to work closely with the Operating Administrations and the audit workgroups to ensure that the Department further improves financial management in FY 2008.

I would like to express my sincere appreciation for the cooperation and professionalism displayed by your staff and your contractors during the course of the audit. Please refer any questions to Laurie Howard, Director of Financial Management, at (202) 366-2135.