



# Memorandum

**U.S. Department of  
Transportation**

Office of the Secretary  
of Transportation  
Office of Inspector General

Subject: **ACTION:** Report on Consolidated Financial  
Statements for Fiscal Years 2003 and 2002, DOT  
FI-2004-031

Date: January 30, 2004

From: Kenneth M. Mead  
Inspector General

Reply to  
Attn. of: JA-20:x61496

To: The Secretary

I respectfully submit the Office of Inspector General (OIG) report on the Department of Transportation (DOT) Consolidated Financial Statements for Fiscal Years (FY) 2003 and 2002 (see attachment). This report is required by the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994.

## **UNQUALIFIED OPINION**

This audit report concludes that DOT's Consolidated Financial Statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles. This is the third fiscal year in a row—2001, 2002, and 2003—in which DOT achieved an unqualified or “clean” opinion. The clean audit opinion signals to users of the financial statements that they can rely on the information presented.

I want to acknowledge the extraordinary efforts made by each of the Operating Administrations, the Department's Office of Financial Management, and KPMG LLP and Clifton Gunderson LLP (contractors we engaged to audit the Federal Aviation Administration (FAA) and the Highway Trust Fund (HTF) financial statements). Also, this clean opinion would not have been possible without your long-standing commitment to improving financial management practices and your guidance to Department officials to take the actions necessary to overcome significant problems encountered this year when the Federal Highway Administration (FHWA) and the Federal Motor Carrier Safety Administration (FMCSA) converted to Delphi, the Department's new accounting system.

In FY 2004, the Department will continue to face significant challenges to complete its financial statements and obtain a clean opinion by the Office of Management and Budget's accelerated reporting date of November 15, 2004. As a result, we all need to focus immediately on implementing corrective actions to ensure that the Department meets the November 15, 2004 reporting date. Ultimately, the financial statement audit should be a routine task that does not divert excessive resources from ongoing financial management activities. This will require significant improvements in the systems, processes, and discipline needed to generate timely and reliable financial statements and the needed improvements are described on pages 3 to 6 of this letter. Implementing these improvements will also provide a solid foundation for more effective day-to-day financial management practices and better tools for ensuring the integrity of financial activities.

In terms of the size of its financial operations, DOT is comparable to several large corporations. In terms of year-end assets, DOT is similar to Chevron-Texaco, Hewlett-Packard, and Microsoft. In terms of year-end liabilities, DOT is similar to Home Depot and Microsoft. In terms of program costs (expenses), DOT is similar to IBM, Boeing, Hewlett-Packard, and Home Depot.

The DOT Consolidated Financial Statements for FY 2003 show year-end assets of about \$71 billion, year-end liabilities (debts) of \$13 billion, costs of operations (program costs) of \$58 billion, and total budgetary resources (available financial resources) of \$128 billion. It is important to note that, over the years, DOT has invested billions of dollars to build transportation infrastructure and to improve safety. Because most of those investments were in the form of grants to states and local governments, the resulting assets—highways, transit systems, and airport runways—are not included as assets on DOT's books. In contrast, investments related to the acquisition of property and equipment, such as radars and air traffic control computer systems, are considered DOT assets, and are reflected in the financial statements. The majority of DOT's budgetary resources come from two trust funds, the Highway Trust Fund and the Airport and Airway Trust Fund. Tax collections deposited into those Trust Funds totaled \$45 billion during FY 2003 to be used for surface and airway transportation investments.

Comparisons between the FY 2002 and FY 2003 DOT Consolidated Financial Statements need to recognize that both the Transportation Security Administration (TSA) and the U. S. Coast Guard transferred to the Department of Homeland Security on March 1, 2003. Consequently, the financial picture of DOT on September 30, 2003, is very different than it was on September 30, 2002. On March 1, 2003, when they transferred, TSA had a net value (assets less liabilities) of \$6.3 billion and Coast Guard had a negative net value of -\$14.9 billion. These amounts were off DOT's books entirely on September 30, 2003. However, TSA

and Coast Guard financial activities (such as revenues, costs, and budgetary resources) for the first 5 months of FY 2003 are reflected in the DOT financial statements on September 30, 2003. So, for example, \$4.6 billion of the \$58 billion costs of operations during FY 2003 were incurred by TSA and Coast Guard.

## INTERNAL CONTROLS

Extraordinary effort by DOT employees and the auditors were required to obtain this unqualified opinion. In particular this year, the HTF agencies,<sup>1</sup> the Department's Office of Financial Management, and the auditors had to overcome significant financial management and accounting deficiencies in order to generate auditable financial information and complete the audit on time. This year, FAA generated its financial statements from the old DOT accounting system. Due to the manual adjustments necessary to prepare auditable financial statements, FAA did not provide complete financial statements to DOT for consolidation until November 14, 2003. FAA converted to Delphi in November 2003, and an effective transition to the new system will be critical to meeting next year's November 15, 2004 reporting date.

We categorized these problems into four material weaknesses and five reportable conditions. Responding to a draft of this report, DOT agreed with these findings and committed to take timely corrective action. On December 30, 2003, as required by the Federal Managers' Financial Integrity Act of 1982, the Secretary of Transportation also reported the four material weaknesses to the President and Congress.

## Material Weaknesses

Material weaknesses are deficiencies in the design or operation of internal controls that do not reduce, to a relatively low level, the risk that significant errors, fraud, or noncompliance could occur and not be detected by employees in the normal course of performing their duties.

- **Information Security Program.** In September 2003, we issued our third annual report on DOT's Information Security Program as required by the Federal Information Security Management Act. DOT has made significant progress in protecting its systems against external attacks through the Internet. However, DOT is still behind in protecting its systems against internal attacks from employees, contractors, grantees, and industry

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<sup>1</sup> Federal Highway Administration (FHWA), National Highway Traffic Safety Administration (NHTSA), Federal Transit Administration (FTA), Federal Railroad Administration (FRA), Federal Motor Carrier Safety Administration (FMCSA), and the Bureau of Transportation Statistics (BTS).

associations. DOT must also do more to complete background checks on contractor employees performing sensitive work and to enhance contingency planning to ensure business continuity in an emergency. The Department has committed to correct these problems and is taking actions to do so.

- **Cost-Reimbursable Contracts at the Federal Aviation Administration (FAA).** We previously reported that FAA's management and oversight of billions of dollars of cost-reimbursable contracts, which have few inherent protections against cost overruns or improper payments for unallowable costs, were not adequate to ensure that the Government's interests were protected. FAA records indicate that over \$15 billion worth of cost reimbursable contracts are active. Although FAA has made significant progress closing out completed cost-reimbursable contracts, about \$3.4 billion worth of completed contracts remain to be closed. FAA needs to complete the closeout of cost-reimbursable contracts, ensure that it obtains appropriate audits for all active contracts, and strengthen the processes it uses to award and monitor cost-reimbursable contracts.
- **Financial Management and Reporting for Highway Trust Fund Agencies.** Material deficiencies exist in internal controls over financial management and reporting activities in the HTF agencies. HTF agencies lack adequate accounting and financial management policies and procedures. To illustrate, most HTF agencies did not routinely reconcile their accounts during the year, a basic management practice. Problems caused by these long-standing deficiencies were compounded this year because two major HTF agencies (FHWA and FMCSA) had not adequately planned or implemented their conversions to Delphi in February 2003. In particular, because these agencies did not correct bad data from the old system before converting to the new system, many transactions were either processed incorrectly or rejected by the new system. Without major improvements in accounting policies and procedures at all HTF agencies, the FY 2004 financial statements may not be completed by the Office of Management and Budget's deadline of November 15, 2004. HTF agencies and DOT officials have recognized the significance of these deficiencies and have committed to take timely corrective actions.
- **Reconciling Transactions With Other Federal Agencies (Intra-governmental Transactions).** DOT has not implemented effective processes to reconcile its transactions with other Federal agencies. This problem occurs, for example, when FAA performs reimbursable work for the Department of Defense. To prepare reliable Government-wide financial statements, these transactions, which are internal to the Federal

Government, must be tracked and eliminated. The General Accounting Office has reported that Federal agencies' inability to account for these transactions properly is a major impediment to a clean audit opinion on the Consolidated Financial Report on the United States. During FY 2003, some DOT agencies partially confirmed or reconciled their transactions with other Federal agencies, but most did not. DOT's asset, liability, and revenue balances included more than \$4.5 billion of transactions with other Federal agencies in FY 2003. DOT has agreed to implement reconciliation procedures to correct this problem.

## Reportable Conditions

Reportable conditions in internal controls, although not considered material weaknesses, represent significant deficiencies in the design or operation of internal controls that could adversely affect the DOT consolidated financial statements.

- **Delphi Computer Security.** In September 2003, we issued a report regarding the computer security and controls over DOT's new financial management system, Delphi. To achieve its full potential, DOT needs to enhance security and controls over Delphi operations. We also found that important security measures had not been implemented or enforced, system changes were not properly tested, and contingency planning was not adequate. DOT has agreed to correct the deficiencies and has begun to do so.
- **Financial Management Reviews of Grantees, FHWA.** FHWA frequently did not perform financial management reviews of grantees. FHWA relies on its Division Offices to periodically schedule and perform financial management reviews of grantees. However, Clifton Gunderson identified 25 instances when FHWA Divisions did not conduct financial reviews of grantees. One consequence of the lack of financial management reviews is the existence of unneeded obligations that could be used more productively on active projects. Preliminary results from our review of inactive obligations identified hundreds of millions of dollars of unneeded obligations that should be deobligated so the funds can be used on other active projects. This is especially important at a time of budget constraints.
- **Property, Plant and Equipment, FAA.** FAA has made substantial progress correcting material weaknesses in its controls over property, plant, and equipment. However, the value of these assets at September 30, 2003 was \$13.4 billion, and FAA does not yet fully adhere to established policies and procedures to ensure its property, plant, and equipment accounts were properly reported. To illustrate, during FY 2003, FAA's property system

was unable to communicate with the accounting system. This increased the likelihood of errors and required FAA to reconcile differences between the systems manually. Further, FAA had not implemented adequate controls to prevent errors when calculating property values and to record new assets in a timely manner. FAA agreed to implement recommendations to correct these problems.

- **Financial Management Practices, the Maritime Administration (MARAD).** MARAD needs to establish policies and procedures to ensure that its inventory, property, and environmental liabilities are reported properly. For example, we found that some new inventory purchases were not recorded and some inventory was incorrectly priced. On a related issue—MARAD’s implementation of the Title XI loan guarantee program—we previously reported that MARAD needs to improve its oversight of the loan-application process; borrowers; vessels and shipyards constructed under loan guarantees; and foreclosed assets. MARAD is in the process of implementing our recommendations to improve its Title XI oversight processes. In this report, we are recommending that MARAD improve the accounting for inventory, property, and environmental liabilities.
- **Accounting for Loans in Delphi.** DOT needs to improve the accounting for loans receivable in Delphi. The new DOT accounting system, Delphi, does not include a module or subsidiary ledger system to accurately account for loans receivable, valued at more than \$1 billion on September 30, 2003. FRA, FHWA, and MARAD recorded loan activity directly in the Delphi general ledger, and relied on information from outside the accounting system (such as commercial banks), for detailed loan transactions. In addition, FRA and FHWA did not routinely reconcile their recorded loan balances. We are making a recommendation to DOT to establish a module or subsidiary ledger system in Delphi to improve the accounting for loans receivable and permit routine reconciliations of loan balances.

## **COMPLIANCE WITH LAWS AND REGULATIONS**

Our tests of DOT’s compliance with laws and regulations identified instances where DOT could improve its compliance with the following laws.

- **The Federal Financial Management Improvement Act of 1996 (FFMIA).** Because several large Operating Administrations had not completely implemented DOT’s new accounting system, which is designed to comply with Federal standards, DOT did not meet FFMIA requirements to use a single

integrated financial management system that substantially complies with Federal system requirements, Federal accounting standards, and the standard general ledger. DOT expects to meet these requirements when the Delphi system is fully implemented during FY 2004. When it completes this conversion, DOT expects to be the first cabinet level agency to have implemented, Department-wide, a commercial-off-the-shelf financial management system that meets Federal financial management system requirements.

- **The Anti-Deficiency Act.** Two instances of noncompliance with the Anti-deficiency Act were identified at FAA. One potential instance was identified at FHWA. In addition, two instances reported in 2002 have not been fully resolved.
- **The Federal Managers' Financial Integrity Act of 1982 (FMFIA).** HTF agencies have not fully implemented formal procedures to identify, assess, and monitor management controls over programs and resources, including financial information systems, as required by FMFIA.
- **The Single Audit Act.** DOT has not effectively implemented certain provisions of the Single Audit Act, including tracking the receipt of single audit reports, distributing the reports in a timely manner, and making timely management decisions to address report recommendations. DOT has agreed to take action to improve its implementation of the Single Audit Act.

This report includes two new recommendations to improve financial management practices in MARAD and loan accounting in Delphi. We provided a draft of this report to the Acting DOT Assistant Secretary for Budgets and Programs, who concurred with the findings and agreed to implement the recommendations. DOT and its Operating Administrations have initiated corrective actions to address the internal control and compliance issues identified by KPMG and Clifton Gunderson in their reports.

We appreciate the cooperation and assistance of DOT, KPMG, and Clifton Gunderson representatives. If we can answer any questions, please call me at (202) 366-1959, or Ted Alves, Assistant Inspector General for Financial and Information Technology Audits at (202) 366-1496.

Attachment