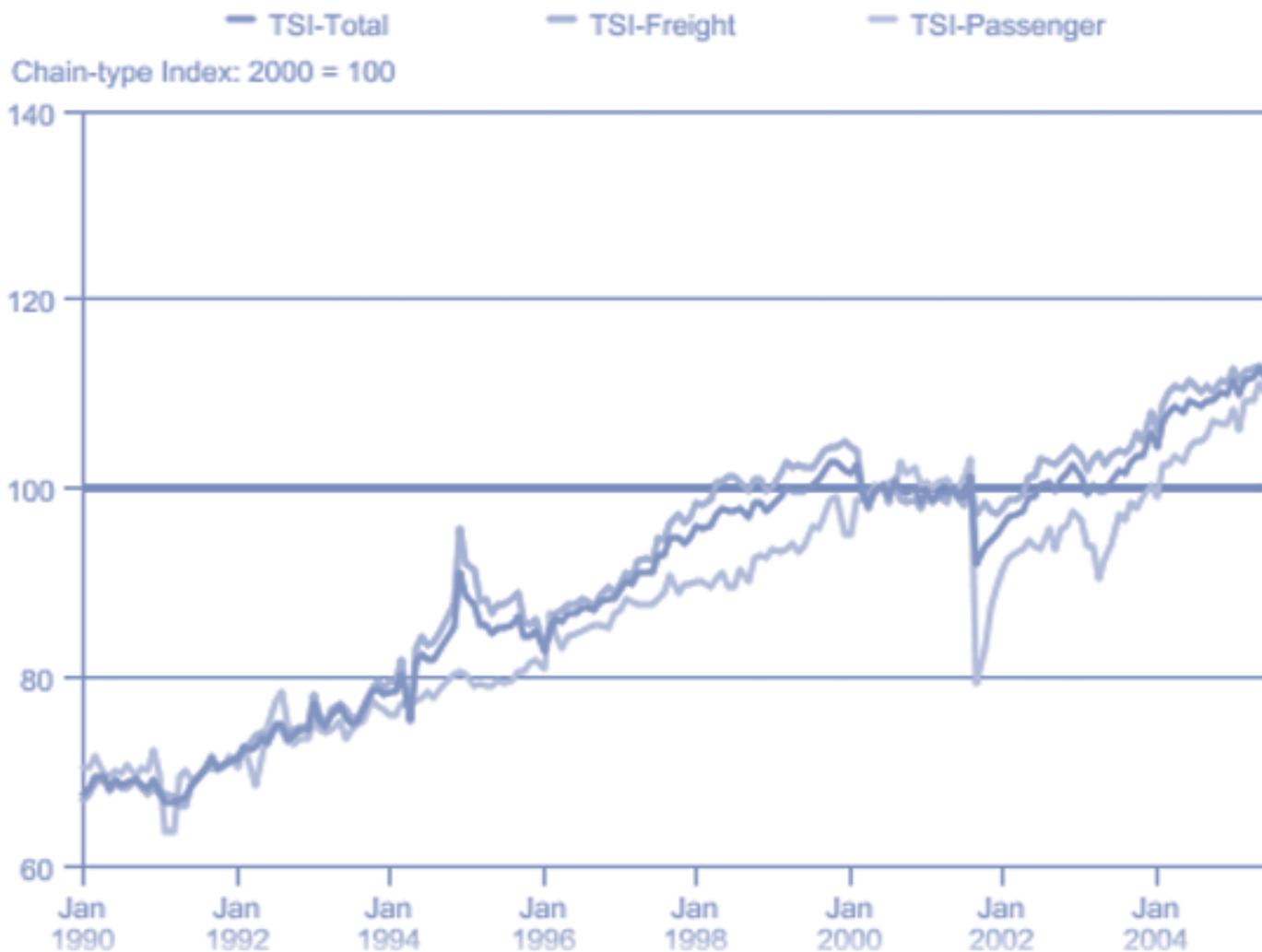


Jan 1990 - Jun 2005 (Seasonally Adjusted)



FINANCIAL REPORT



CONSOLIDATED FINANCIAL STATEMENTS FOR FISCAL YEARS 2005 AND 2004

Department of Transportation

Report Number: FI-2006-014

Date Issued: November 15, 2005



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 2005 and 2004, DOT FI-2006-014

Date: November 15, 2005

From: Kenneth M. Mead
Inspector General 

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) 2005 and 2004 (see attachment). This is the fifth year in a row that the Department has received an unqualified, or clean, opinion. The clean opinion signals to financial statement users that they can rely on the information presented, including the use of appropriated funds, the amount of outstanding obligations, expenditures made during the year, and costs by major program. It signals to the public that the Department can properly account for its revenues, expenditures, assets, and liabilities. Under contract to us and under our supervision, KPMG LLP also audited the Federal Aviation Administration's (FAA) financial statements and Clifton Gunderson LLP audited the Highway Trust Fund (HTF) financial statements. Their audit reports also expressed clean opinions.

The Department's ability to provide audited financial statements in time to meet the Office of Management and Budget's accelerated deadlines and get a clean opinion would not have occurred without your emphasis and commitment to improving financial management practices, along with that of the Operating Administrators and your senior leadership team. Your attention to this area from day one has moved the Department from the days of an obsolete accounting system and disclaimed or qualified audit opinions, to a modern Department-wide financial management system and the unqualified opinion in the attached report.

Generating timely, reliable, and useful financial information is no small task because DOT is a complex organization that is accountable for substantial resources. DOT's FY 2005 Financial Statements show assets of \$66 billion, liabilities of \$13 billion, program costs of \$57 billion, and available financial



resources of \$114 billion. In FY 2005, DOT received appropriations (revenue) of about \$62 billion. About \$49 billion, or about 79 percent of DOT's revenue, came from two trust funds, the HTF and the Airport and Airway (Aviation) Trust Fund, which are supported by passenger, fuel, and user taxes.

To put the size of our organization into perspective, DOT would rank among the top 20 corporations in America, based on revenues. In 2004, Bank of America ranked number 18 among U.S. corporations, with revenues of \$63 billion, and State Farm Insurance Companies ranked number 19, with revenues of \$59 billion. Other corporations of similar size include J.P. Morgan Chase, Kroger, and Pfizer. As for assets, DOT would also rank among the top 20 corporations but for the fact that other than the Air Traffic Control system, DOT assets do not include the billions of dollars we spend each year on highways, bridges, and airports. Those assets do not show up on our books because they are grants to states and municipalities, but we nonetheless remain accountable for those investments.

In addition to ensuring that DOT's books balance at the end of the year, our audit also looks at management and financial controls. These controls are important not just to balance the books on time, but also to improve management's ability to deliver the best value with the resources entrusted to the Department. The Operating Administrations have also made substantial progress in strengthening management controls and providing better oversight of resources. However, our audit shows that they still have a way to go to measure up to what is expected at large publicly held corporations—especially following implementation of the Sarbanes/Oxley Act.

In this regard, our report identifies three financial management matters that KPMG, Clifton Gunderson, and we consider material and several other reportable matters that are significant but not material. The material matters are that (1) FAA needs to process transactions and reconcile its accounts in a more timely manner; (2) the Federal Highway Administration (FHWA) needs better processes to support management's preparation of reliable financial statements during the year and at year-end; and (3) FHWA needs to strengthen its grants management and oversight practices, particularly at the Division Administrator and state DOT levels.

We believe FHWA and FAA have plans underway that, if implemented on a sustained basis during FY 2006, will result in these areas not being material next year. Addressing each area will position the Department to do the following:

- **Reauthorize aviation programs.** A central issue in the upcoming reauthorization is certain to be FAA finances, including who should pay for the services FAA provides and in what amounts, what the next generation air traffic control system will consist of, and how much it will cost. The ability to generate timely, reliable, and detailed financial information will be important to track the actual costs of providing services and to allocate these costs by unit of services delivered.



- **Address highway and aviation trust fund revenue shortfalls.** FAA faces financial challenges in the near term and FHWA faces financial challenges in the longer term, as revenues fail to keep up with growing demands for transportation investments. Better financial information can help DOT and the Congress better anticipate and deal with funding shortfalls.
- **Oversee transportation projects.** The Department, and FHWA in particular, has a responsibility to ensure that we get the best return on transportation investments, including preventing losses to fraud, waste, and abuse, and detecting them when they do occur. Improved FHWA processes, especially at the Division Office level, are important to provide assurance that the states are adequately overseeing federal aid projects.

Set forth below are the three areas we consider material and for which the Operating Administrations plan corrective actions:

- **Process transactions and reconcile accounts at FAA in a timely manner.** Problems implementing Delphi and a new procurement system adversely affected FAA's ability to process transactions and reconcile account balances in a timely manner. As a result, FAA needed to make adjustments totaling over \$2 billion to make its year-end financial statements reliable. FAA needs to address this issue so that it can make maximum use of its new cost accounting system, on which it has made significant progress this year. Detailed facility-level cost accounting information will also provide an important tool that managers can use to control operating and capital investment costs.

Further, the Air Traffic Organization will need to interface more effectively with the FAA Chief Financial Officer during the year, since much of the delay in processing transactions was the responsibility of Air Traffic Organization officials. To illustrate, because Air Traffic officials did not properly record assets when they were placed into service during the year, FAA's Chief Financial Officer had to make about \$1.3 billion in adjustments at the end of the year.

- **Improve financial accounting processes at FHWA.** Since FY 2003, we have reported that material deficiencies existed in internal controls over financial management and reporting activities in the HTF agencies. FHWA leadership deserves a great deal of credit, in response to your emphasis on this area, for initiating improvements in FY 2005. However, largely because many improvements were initiated late in the year (July 2005), they were not in effect for enough time to overcome the accounting problems.

As a result, FHWA officials had to undertake extraordinary efforts to prepare reliable financial statements at the end of the year. Some adjustments should be expected to any year-end statements, but in this case, FHWA needed to make over \$16 billion in audit adjustments to make the financial statements reliable. A closely



related matter was that FHWA needed to make many of those adjustments to make sure that costs were properly allocated to the various FHWA programs. However, I want to emphasize that this process went much more smoothly this year and necessary adjustments were far fewer than what was required last year.

- **Improve FHWA grants oversight practices.** Last year, we reported that FHWA needed to establish stronger financial and cost controls to ensure that grant funds are used effectively and are protected from fraud, waste, and abuse. To strengthen its oversight, in April 2005, FHWA initiated the Financial Integrity Review and Evaluation (FIRE) program. FIRE requires each FHWA Division Office to establish a comprehensive oversight program to include reviews of state grants management processes, Federal-aid billings, inactive obligations, and administrative processes. However, largely due to the late start, the FIRE program was not in place long enough to be substantially implemented by the end of the year, and FHWA's own implementation schedule calls for the program to be fully implemented in FY 2006.

We believe the FIRE program is both sound and comprehensive. To illustrate its potential to improve FHWA oversight, this year for the first time, FHWA was able to free hundreds of millions of dollars that have sat idle for years on completed, canceled, or modified highway projects. This year, we estimated that about \$660 million in unneeded obligations could be freed and used on active projects. FHWA Division Offices, under the FIRE program, identified and deobligated over \$750 million by the end of the year. The single most important key to success for the FIRE program will be ensuring that Division Administrators in the field implement the program in accordance with FHWA's schedule. While progress with FIRE can be monitored and overseen by Headquarters here in Washington, the fact is that the work must actually be done in the field and at state DOTs and that is why the Division Administrators will be the key to FHWA's success.

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 its recommendations. 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, Principal Assistant Inspector General for Auditing and Evaluation, at (202) 366-1992.

Attachment



**DEPARTMENT OF TRANSPORTATION
INSPECTOR GENERAL'S INDEPENDENT AUDIT REPORT
ON THE DEPARTMENT OF TRANSPORTATION
CONSOLIDATED FINANCIAL STATEMENTS
FOR FISCAL YEARS 2005 AND 2004**

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, 2005, and September 30, 2004. In our audit, "DOT Consolidated Financial Statements for Fiscal Years 2005 and 2004," we found:

- Financial statements that are fairly presented, in all material respects, in conformity with generally accepted accounting principles.
- Three material internal control weaknesses: timely processing of transactions and reconciliation of accounts for the Federal Aviation Administration (FAA), financial management and reporting for Highway Trust Fund agencies,¹ and financial oversight of highway grants; and six reportable conditions: reconciling intragovernmental transactions, financial system controls, DOT's information security program, the Maritime Administration's (MARAD) oversight of Title XI loan guarantees, FAA contract management, and FAA grants management.
- Instances of noncompliance with the Federal Financial Management Improvement Act of 1996, the Anti-Deficiency Act, the Federal Managers' Financial Integrity Act, the Government Performance and Results Act, and the FAA Franchise Fund Enabling Legislation.
- Financial information in the Management Discussion and Analysis was materially consistent with the financial statements.
- Supplementary and stewardship information was 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 01-02, "Audit Requirements for Federal Financial Statements." The following sections discuss these conclusions. Our audit objectives, scope, and methodology can be

¹ Federal Highway Administration, National Highway Traffic Safety Administration, Federal Transit Administration, Federal Railroad Administration, and Federal Motor Carrier Safety Administration.



found in Exhibit A. We believe that our audit provides a reasonable basis for our opinion.

A. UNQUALIFIED OPINION ON FINANCIAL STATEMENTS

In our opinion, the 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; budgetary resources; and reconciliation of net costs to budgetary obligations as of September 30, 2005, and September 30, 2004, and for the years then ended.

Under contract with OIG and under our supervision, KPMG LLP audited the financial statements of FAA as of and for the years ended September 30, 2005, and September 30, 2004. KPMG rendered an unqualified opinion on the FAA financial statements. Also under contract with OIG and under our supervision, Clifton Gunderson, LLP audited the financial statements of the Highway Trust Fund (HTF) as of and for the years ended September 30, 2005, and September 30, 2004. Clifton Gunderson rendered an unqualified opinion on the HTF financial statements. In addition, under contract with OIG and under our supervision, Williams, Adley & Company, LLP audited the Balance Sheets of the Office of the Secretary Working Capital Fund (WCF) and the Volpe National Transportation Systems Center as of September 30, 2005. Williams Adley rendered an unqualified opinion on the WCF and Volpe Balance Sheets. We performed a quality control review of the work performed by KPMG and Clifton Gunderson, and relied on their results in performing our work on the FYs 2005 and 2004 DOT Consolidated Financial Statements.

As discussed in note 18, the accompanying financial statements reflect actual excise tax revenues deposited in the HTF and the Airport and Airways Trust Fund through March 31, 2005, and excise tax receipts estimated by the Department of the Treasury Office of Tax Analysis for the two quarters ended June 30, 2005, and September 30, 2005.

As discussed in note 19, DOT restated the FY 2004 Statement of Budgetary Resources to properly report its FY 2004 budget authority for the Highway Trust Fund and the FHWA Transportation Infrastructure Finance and Innovation Act. We audited these adjustments and concluded that they were appropriate and properly applied.



B. CONSIDERATION OF INTERNAL CONTROLS

In planning and performing our audit, we considered DOT's internal controls over financial reporting and compliance with laws and regulations. We do not express an opinion on internal controls and compliance because the purpose of our work was to determine our procedures for auditing the financial statements and to comply with OMB Bulletin 01-02 audit guidance, not to express an opinion on internal controls.

For the controls we tested, we found three material weaknesses. A material weakness is a reportable condition 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 errors, fraud, or noncompliance that would be material to the financial statements, may occur and not be detected promptly by employees in the normal course of performing their duties.

Our work identified six reportable conditions in internal controls. Reportable conditions in internal controls, although not considered material weaknesses, represent significant deficiencies in the design and operation of internal controls that could adversely affect the amounts reported in the DOT Consolidated Financial Statements. Our internal control work would not necessarily disclose all material weaknesses or reportable conditions.

MATERIAL WEAKNESSES

The following sections describe the material weaknesses that we identified.

Timely Processing of FAA Transactions and Reconciliation of Accounts

Last year, FAA faced problems implementing Delphi and a new procurement system, but its financial managers were able to isolate and keep the problems contained. During FY 2005, the problems became more severe and adversely affected FAA's ability to process transactions and reconcile accounting balances in a timely manner. FAA needs to improve processes and controls to ensure that property plant and equipment is consistently and accurately capitalized, obligations are recorded in a timely manner, advances and prepayments are supported, suspense accounts are cleared in a timely manner, abnormal balances in budgetary to proprietary account relationships are investigated, and subsidiary systems and supporting documentation are reconciled to general ledger balances. Consequently, FAA's interim financial statements were not reliable and FAA needed to make adjustments totaling more than \$2.0 billion to the draft FY 2005



financial statements in order to make them reliable. FAA officials have committed to correct the problems during FY 2006.

Capitalizing Property Plant and Equipment. FAA did not have effective processes to capitalize headquarters-based projects in a timely manner. KPMG found that 131 of 142 property items tested (92 percent) were not capitalized within 30 days after the item was placed in service. Property placed in service during the year remained classified as “construction in process” in the accounting records, causing errors in the financial statements, including an understatement of depreciation expense of \$83 million. To correct the problem for year-end reporting, FAA capitalized about \$1.1 billion during September and another \$180 million in October.

Recording Obligations. FAA Southern Region procured services from a contractor related to hurricane disaster mission assignments received from FEMA, and did not record the obligation and did not confirm that funding was available. Obligations totaling more than \$222 million were not recorded at year-end, of which funding was available for only \$60 million, but the FAA and DOT Counsels determined that FAA did not violate the Anti-Deficiency Act.

Supporting Advances and Prepayments. FAA had advances and prepayments of \$24.8 million related to activity prior to October 2003 that was unsupported.

Clearing Suspense Accounts. FAA did not clear transactions held in suspense until after year-end. KPMG reported that the FAA suspense account balance was \$235.2 million at June 30, 2005; and 347.8 million at August 31, 2005, of which \$193.8 million was more than 60 days old.

Reconciling Budgetary to Proprietary Accounts. FAA has not established effective processes to investigate the cause of abnormal balances and budgetary to proprietary account discrepancies. In March 2005, FAA identified discrepancies in excess of \$600 million between certain proprietary and budgetary accounts, and these discrepancies existed throughout the year. FAA did not take action to fix these discrepancies until October 2005, and the resolution required substantial manual effort during the yearend closing process. In addition, FAA did not link the cause to a Delphi transaction posting error until after yearend, more than 9 months after they discovered the out-of balance condition.

Reconciling Subsidiary Systems General Ledger Balances. FAA did not perform timely reconciliations of subsidiary systems and supporting records to the Delphi general ledger balances. Consequently, FAA’s financial statements were not accurately and completely supported by detailed records during the year. For example, five of the seven subsidiary reconciliations that should have been



performed were not completed by June 30, 2005, 9 months after the beginning of the fiscal year. The differences were as much as \$122 million during the year.

Consequently, FAA was unable to prepare reliable financial statements in a timely manner during the year and at yearend. After material adjustments to year-end balances totaling more than \$2.0 billion, complete and accurate financial statements were not available until late October, or 4 weeks after the end of the fiscal year. Due to the requirement to submit audited financial statements 45 days after year-end, FAA's ability to meet this deadline in future years is questionable without substantial changes to FAA's processes and controls over recording transactions and reconciling accounts throughout the year.

KPMG made a series of recommendations to FAA to improve the processing of transactions and reconciliation of accounts in its financial statement audit report, dated November 8, 2005. FAA agreed to implement the recommendations, so we are not making additional recommendations in this report.

HTF Agencies' Financial Management and Reporting Activities

Since the audit of the FY 2003 HTF financial statements, we have reported that material deficiencies existed in internal controls over financial management and reporting activities in the HTF agencies. While FHWA began making organizational and procedural improvements during FY 2005, many of the improvements were initiated too late in the year and were not in effect for sufficient time to overcome the accounting problems that existed in prior years. In addition, extraordinary efforts were again needed to prepare the HTF financial statements during the year and at September 30, 2005. The remaining deficiencies to be overcome include (1) financial statement preparation and analysis, (2) resolving reconciliation differences during the year, (3) implementing managerial cost accounting, (4) tracking intragovernmental transactions, and (5) linking the FACTS II (Federal Agencies Centralized Trial-Balance System) reporting to the financial statement preparation process.

Clifton Gunderson reported that during FY 2005, FHWA began to reorganize and refocus its accounting functions at the management and staff levels. Clifton Gunderson commended FHWA for the improvements made during FY 2005 and their commitment to continue to improve the accuracy and timeliness of financial reporting. Some of the improvements made by FHWA during FY 2005 include (1) the automation of the Statement of Budgetary Resources and Statement of Financing, (2) expanded monitoring of the Treasury Statement of Differences, (3) expanded review and analysis of the September 30, 2005 financial statements, including involvement of program and division office personnel, (4) correcting child allocation accounts and transactions in the general ledger in September 2005,



(5) refining the grants reconciliation processes and reducing the differences between the subsidiary and general ledgers, and (6) involving budget personnel in the preparation of the Statement of Budgetary Resources.

However, Clifton Gunderson reported that deficiencies continued to exist in the internal control structure in the HTF agencies that ultimately prevented management from preparing accurate and timely financial statements during FY 2005. Certain components of the financial statements prepared during the year were not reliable, many matters were not resolved until the end of the year, and account discrepancies remained at September 30, 2005. The resolution of these discrepancies during the audit process resulted in material adjustments to the draft financial statements provided for audit in October 2005. Clifton Gunderson reported that improvements are need in the following areas.

Financial Statement Preparation and Analysis. HTF agencies' financial statement preparation and analysis process continued to be manually intensive because of the top-side non-standard journal entries needed to correct data in the accounting system. During FY 2005, HTF agencies posted hundreds of adjustments with an absolute value of \$425 billion, several of which were posted in the fourth quarter. The volume and amount of these adjustments suggest that the system is not working properly to accurately capture financial events at the transaction level at the time the transaction occurs. This manually intensive process has a high risk of error, is time consuming, and utilizes resources that should be spent on the analysis of the financial statements. In addition, the analysis of the HTF financial statements through June 30, 2005 was inadequate, and the relationships between proprietary and budgetary accounts were not adequately analyzed during the year or at year-end. Audit adjustments exceeding \$16 billion were made to the draft financial statements provided for audit.

Resolving Reconciliation Differences. While Clifton Gunderson reported improvements since last year, certain reconciliation differences were not resolved in a timely manner. Several deficiencies continued with the Fund Balance With Treasury, including reconciliations of parent and child allocation accounts, and aging, supporting, and reporting suspense account balances. The absolute value of the suspense accounts was \$467 million at September 30, 2005. Unreconciled differences continued between the grants subsidiary ledger and the general ledger by as much as \$578 million in absolute value. Finally, the HTF agencies recorded a significant number of adjustments in net position and budgetary accounts during the year resulting from nonexpenditure transfers and budgetary account reconciliations.

Implementing Managerial Cost Accounting. The HTF agencies did not have a cost accounting system in place to allocate costs to their programs. As a result, the



HTF agencies could not prepare a Statement of Net Cost or corresponding footnote in accordance with OMB requirements.

Tracking Intragovernmental Transactions. The HTF agencies did not consistently reconcile and eliminate intragovernmental transactions during FY 2005, and could not adequately support the Trading Partner schedule included in the HTF financial statements.

Linking FACTS II Reporting to the Financial Statements. The HTF agencies did not have a system in place to ensure that erroneous accounts are reviewed and corrected prior to the preparation of draft the financial statements.

Clifton Gunderson made a series of recommendations to improve financial management and reporting activities in its financial statement audit report, dated November 8, 2005. The DOT CFO agreed with the recommendations. Therefore, we are not making additional recommendations in this report.

Financial Oversight of Highway Grants

Last year, we reported that FHWA and the Federal Transit Administration (FTA) needed to establish stronger financial and cost controls to better ensure that grant funds are protected from fraud, waste, and abuse. FHWA and FTA have both implemented improved procedures and controls over grants during FY 2005. For example, FHWA initiated the Financial Integrity Review and Evaluation (FIRE) program in March 2005, and FTA instituted sufficient improvements in its oversight of transit grants to not to be included in the material weakness this year. However, FHWA needs to continue to improve its financial oversight of highway grants.

FHWA announced and started implementing its FIRE program in April 2005. FIRE requires each FHWA Division Office to establish a comprehensive oversight review program to include reviews of state grant management processes, Federal-aid billings, inactive obligations, and administrative processes. Partial FIRE reviews were to be completed for FY 2005, and FY 2006 will be the first complete year reviewed. During the FY 2005 audit, Clifton Gunderson reported that FHWA had not fully developed a mechanism to determine whether the Division Offices are consistently following the FIRE requirements, and controls to monitor, assess, and validate the Division Offices' implementation of FIRE. FHWA developed a timeline to fully implement FIRE by September 30, 2006.

Clifton Gunderson also reported that FHWA may still have a number of inactive grant projects as of September 30, 2005. They reported that FHWA had 1,542 undelivered orders more than a year old at a total value of \$42.2 billion. However, our review of inactive obligations in 14 states during FY 2005



concluded that FHWA had made significant progress in freeing up idle funds for other transportation projects. While we reported that an estimated \$661 million in idle funds existed nationwide, in commenting on our draft report, FHWA informed us that \$757 million would be deobligated nationwide. We commended FHWA for working aggressively with the states to provide more effective oversight of Federal funds, but reminded FHWA they needed to continue working with the states to institutionalize the processes to identify and release unneeded funds.

Clifton Gunderson made a series of recommendations to improve financial oversight of highway grants in its financial statement audit report dated November 8, 2005. The DOT CFO agreed with the recommendations. Therefore, we are not making additional recommendations in this report.

REPORTABLE CONDITIONS

Reportable conditions, 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.

Intragovernmental Transactions

Since the audit of the FY 2003 DOT Consolidated Financial Statements, we have reported a material weakness in the DOT processes and procedures to reconcile transactions among its Operating Administrations, and its transactions with other Federal agencies. Last year we reported that while DOT had made progress during FY 2004, DOT did not have an effective process for reconciling transactions with other Federal agencies and among its Operating Administrations. DOT made significant progress during FY 2005 in reconciling its intragovernmental transactions with its trading partners, but additional efforts are still needed. This issue is being downgraded from a material weakness to a reportable condition in FY 2005.

While DOT established a new reimbursable agreement reconciliation process in FY 2005, DOT did not fully eliminate its intragovernmental activity within DOT in the FY 2005 DOT Consolidated Financial Statements. We found intra DOT activity of \$402 million (\$293 million in assets and \$109 million in nonexchange revenue) that was not eliminated in the DOT Consolidated Financial Statements.

The DOT CFO has advised that the Office of Financial Management will continue working with the Operating Administrations to implement new processes and procedures, and anticipates completing all corrective actions during FY 2006. Therefore, we are not making additional recommendations in this report.



Financial System Controls

Last year, we reported a material weakness in DOT financial system controls. This included weaknesses in Delphi computer controls and computer security deficiencies in several FAA, FHWA, and FTA systems that provide financial data to Delphi. In FY 2005, DOT made significant progress in improving controls over its financial systems; we therefore believe that its financial control weaknesses should be downgraded to a reportable condition.

While noting progress, however, both independent auditors—KPMG and Clifton Gunderson—found areas needing further oversight. For example, they found that continued management oversight is needed to correct weaknesses in FAA and HTF subsidiary financial systems. According to KPMG, four FAA financial applications had potentially high-risk combinations of duties in which individuals could exceed or abuse their assigned authorities. They also found poor user administration, inadequate system configuration management, outdated change request process documentation, and inadequate system change documentation. In addition, financial application servers were not configured as securely as they should have been.

According to Clifton Gunderson, systems that track HTF grants, which feed information to the Department-wide Delphi financial management system, had weaknesses that could have a material effect on HTF's financial statements. Control weaknesses identified in FHWA and/or FTA financial systems included poor security program planning and management, inadequate program change control, weak logical access controls, lack of business security plans, and inadequate application controls.

KPMG's and Clifton Gunderson's financial statement audit reports, dated November 8, 2005, included recommendations to improve financial system controls. The DOT CFO agreed with the recommendations; therefore, we are not making any additional recommendations.

DOT Information Security Program

Last year, we reported that DOT had made significant progress in its information technology security program, yet it was still considered a reportable condition. In our fifth annual report on DOT's Information Security Program, issued in October 2005, we reported that while the quality of security certification reviews had improved, the Department still faced a challenge in recertifying systems security while enhancing certification quality. During FY 2005, about 15 percent of DOT systems were overdue for recertification.



DOT also needed to better manage correction of systems security deficiencies: it had about 3,000 weaknesses awaiting correction, but management could not effectively prioritize them because the importance of over half—1,600—had not been assessed. Further, DOT needed to enforce implementation of its security configuration policy, ensure that computer network vulnerabilities are corrected in a timely manner, complete deployment of the intrusion-detection system at one Internet connection point, and test contingency plans.

Further, FAA did not take aggressive action to enhance air traffic control systems security. While it committed to completing security reviews of all operational air traffic control systems—at en route, approach control, and airport terminal facilities—within 3 years, and to identifying a cost-effective alternative to restoring essential air service in the event of prolonged service disruption at an en route facility, the agency nonetheless made only limited progress during FY 2005 in fulfilling these commitments.

Finally, we reported that departmental oversight of major systems investments needed to be enhanced; the Department's Investment Review Board needed to perform more substantive and proactive reviews of information technology (IT) investments managed by individual operating administrations. This remains a challenge, especially for air traffic control modernization projects, which account for over 80 percent of the Department's IT budget. This year, the Board reviewed investment projects managed by various Operating Administrations, including FAA. While projects managed by most Operating Administrations have benefited from this oversight, the Board has had little impact on complicated air traffic control projects, which are still experiencing significant cost increases and schedule delays.

We believe that DOT's information security program should remain a reportable condition. We made a series of recommendations to improve the information technology security program, and the Chief Information Officer (CIO) agreed with them. Therefore, we are not making additional recommendations in this report.

MARAD Oversight of Title XI Loan Guarantees

Last year, we reported that (1) the Maritime Administration (MARAD) needed to enforce the requirements that borrowers establish and maintain specified financial reserves to mitigate the risks of noncompliant loans, (2) it lacked the expertise or resolve to effectively address troubled loans, and that (3) its rudimentary financial monitoring system was not adequate to effectively manage its \$3.2 billion loan portfolio. Further, this year, our Top Management Challenges report reiterated the importance of implementing reforms, including development of a computerized database to assess the financial conditions of companies in its portfolio.



MARAD's loan guarantees are designed to assist private companies in obtaining financing for the construction of ships or the modernization of U.S. shipyards—with the Government holding a mortgage on the equipment or facilities financed. Over 25 percent (\$800 million) of the portfolio remains on “Credit Watch,” meaning that it is at an elevated risk of default. MARAD has, however, reduced the proportion of its high-risk loans from 15 percent of total loan value at the end of FY 2004 to 4 percent at the end of FY 2005.

The reforms that we have recommended—timely financial monitoring and tracking of the portfolio and seeking compensating measures to address the increased risk associated with waivers or modifications—are fundamental to proper management and oversight of any credit program. While MARAD has made progress in these areas, it must remain vigilant and continue to closely monitor and manage its loan portfolio through completion of the computerized tracking system, enforcing reserve requirements, and pursuing remedies for any defaults.

FAA Contract Management

According to KPMG, FAA has weaknesses in the management and oversight of cost-reimbursable and support services contracts, two significant vehicles used by the agency to support its National Airspace System (NAS). Specifically, FAA (1) has a backlog of \$318 million in completed contracts awaiting closeout, (2) lacks an adequate tracking system to identify and monitor cost-reimbursable contracts, (3) has not formally analyzed the results of Defense Contract Audit Agency (DCAA) contract audits, and (4) has not consistently followed its own contract administration and procurement policies by awarding some support services contracts with little or no competition.

This situation exists because FAA fell seriously behind more than 5 years ago in its closeout of cost-reimbursable contracts, due to inadequate policies and procedures governing contract management. In fact, in FY 2001, FAA had more than \$6 billion in backlogged contracts awaiting closeout. Since that time, through the use of DCAA and a renewed emphasis on decreasing the contract closeout backlog, FAA has made significant progress—reducing the backlog some 95 percent.

However, according to FAA's own review of the management of its support services contracts, valued at \$1.3 billion, weaknesses exist in its controls to prevent waste, fraud, and abuse. Poor contract management processes increase the risk of undetected violations of appropriations laws, contract clauses, and mismanagement of funds, which could lead to inaccurate financial reporting by the FAA.



KPMG has made recommendations to improve contract management activities, which FAA has agreed to implement. Therefore, we are not making any additional recommendations.

FAA Grants Management

FAA is responsible for establishing and maintaining accounting and internal controls over expenditures related to the Airport Improvement Program (AIP). The program's size, availability of resources, and reliance on sponsors, among other risks, led to the potential for waste, fraud, and abuse of Federal funds, especially within the oversight and monitoring phases of the grants management process.

The DOT OIG has issued ten reports since 2003 detailing revenue diversion, embezzlement, and other malfeasance committed by grant sponsors and related contractors, citing the actual or possible misuse of about \$314 million in airports revenue and funding.

According to KPMG, FAA's specific internal control weaknesses in grants management include (1) lack of an effective, risk-based approach to oversight and monitoring of AIP grant sponsorship activities; (2) inadequate policies and procedures describing the roles and responsibilities of regional managers; and (3) disproportionate reliance on OMB Circular A-133, *Single Audit Act*, for assurances that grant recipients are administering Federal funds properly and have sufficient internal controls. More reliable grants administration and monitoring processes feature preventive front-end and early-detection controls.

These weaknesses arose from factors including the discretion of regional FAA project managers in determining their level of involvement and oversight. Elements contributing to such decisions include personnel availability, project proximity and complexity, and whether it is considered high profile. Over time, FAA has increased its potentially dangerous reliance on sponsors to provide oversight ("self-certification"), including inspection and fiscal compliance. The agency has, in effect, relegated reliance on internal controls to project sponsors, making them responsible for fiscal integrity and adherence to laws and regulations. Another factor contributing to this trend has been an expansion of AIP without a concomitant increase in regional administrative resources.

KPMG has made recommendations to improve grants management activities, which FAA has agreed to implement. Therefore, we are not making any additional recommendations.



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 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 system substantially complies with Federal requirements and standards in three specific areas. FFMIA requires agencies to produce timely, auditable financial statements based on data from the agency's financial system. KPMG concluded that FAA was not in substantial compliance for the year ended September 30, 2005, because five of its seven key financial systems—which support data entered into Delphi—do not substantially comply with FFMIA compliance categories listed in OMB Circular A-127, section 7. For example, four of the five key FAA systems lacked adequate internal controls.

KPMG recommended that FAA resolve the weaknesses noted in the key financial systems used to compile financial statements for FAA.

Given the difficulties that HTF Agencies encountered in generating reliable financial statements in a timely manner, Clifton Gunderson concluded that the systems used by HTF Agencies did not substantially comply with Federal financial management systems requirements, Federal Accounting Standards, and the Standard General Ledger at the transaction level.

ANTI-DEFICIENCY 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 2004 DOT Financial Statements, we reported that FHWA was reviewing four potential violations, in which obligations may have exceeded budget authority by about \$600,000 as of September 30, 2004. We also reported two additional violations



(\$495 million for FHWA and \$77 million for FTA), first reported in 2003 had not been fully resolved.

During FY 2005, Clifton Gunderson reported that all potential violations had been resolved as of September 30, 2005, except the \$5 million violation attributed to FHWA. KPMG reported that FAA had a \$1.9 million violation associated with the Small Community Air Service Development Program. The violation first occurred in FY 2004, was not detected by FAA until FY 2005, and FAA was in the process of reporting the violation to the President and Congress.

FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT (FMFIA)

During FY 2004, Clifton Gunderson reported that the HTF agencies, except the Federal Motor Carrier Safety Administration (FMCSA), had not formalized procedures to identify, assess, and monitor management controls. In addition, we found that two other DOT agencies, the Office of the Secretary and the Research and Special Projects Administration (RSPA), likewise had not fully assessed the effectiveness of their management controls under FMFIA.

Clifton Gunderson again reported that during FY 2005, no HTF agencies except FMCSA had formalized procedures to monitor management controls. And again, we found that the Office of the Secretary and the Research and Innovative Technology Administration (RSPA's new entity) had not fully assessed the effectiveness of their FMFIA management controls.

GOVERNMENT PERFORMANCE AND RESULTS ACT (GPRA)

GPRA requires agencies to manage their programs efficiently and effectively, based on reliable financial and performance information. To comply, agencies need systems to track costs and allocate them among individual activities, thereby allowing them to measure efficiency and effectiveness. According to Clifton Gunderson, because HTF agencies have not fully implemented managerial cost accounting systems, they could not present the full cost of each program in the Statement of Net Cost for FY 2005. Further, because DOT does not have systems in place to allocate costs by major program, performance measures did not provide cost-effectiveness data and were not linked to the cost of achieving targeted results.



FAA FRANCHISE FUND ENABLING LEGISLATION

The Department of Transportation and Related Agencies Appropriations Act, 1997 requires the FAA Administrative Services Franchise Fund to be paid in advance by its customers, prior to the performance of services. KPMG reported that the FAA Franchise Fund routinely performed work for its customers without being paid in advance. KPMG reported that of the seven lines of business, only the Logistics Center consistently received advanced funding from its customers, and as much as 40 percent of the Franchise Fund work in FY 2005 was performed without advances from their customers. KPMG made recommendations to correct this noncompliance in its financial statement audit report, dated November 8, 2005. FAA agreed to implement the recommendations. Therefore, we are not making additional recommendations in this report.

D. CONSISTENCY OF OTHER INFORMATION

The Management Discussion and Analysis, required supplementary information (including stewardship information), and other accompanying information 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 compared this information for consistency with the DOT Consolidated Financial Statements and discussed the methods of measurement and presentation with DOT officials. Based on this work, we found no material inconsistencies with the DOT Consolidated Financial Statements or nonconformance with OMB guidance. Further, because DOT does not have systems in place to allocate costs by major program, the performance measures did not provide information about cost effectiveness and were not linked to the cost of achieving targeted results or to the Statement of Net Cost.

E. PRIOR AUDIT COVERAGE

Our report on the DOT Consolidated Financial Statements for FYs 2004 and 2003 expressed an unqualified opinion and made no new recommendations. Our report on the DOT consolidated financial statements for FY 2002 and FY 2001 made one recommendation: that DOT confirm and reconcile intragovernmental balances with trading partners. DOT needs to continue to work to improve the accounting for intragovernmental balances. Exhibit B displays the status of the prior year's and new issues.



Since we issued our report on the DOT Consolidated Financial Statements for FYs 2004 and 2003, we issued 25 reports related to the DOT Consolidated Financial Statements. These reports are listed in Exhibit C.

The Assistant Secretary for Budget and Programs/Chief Financial Officer provided comments on a draft of the report (see Appendix). The response agreed with the material weaknesses and reportable conditions 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 31, 2005.

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

Kenneth M. Mead
Inspector General



EXHIBIT A. OBJECTIVES, SCOPE, AND METHODOLOGY

Our audit objectives for the DOT Consolidated Financial Statements for FYs 2005 and 2004 were to determine whether (1) principal DOT Consolidated Financial Statements and accompanying notes are presented fairly, in all material respects, in conformity with generally accepted accounting principles; (2) DOT has adequate internal controls over financial reporting, including safeguarding assets; (3) DOT has complied with laws and regulations that could have a direct and material effect on the DOT Consolidated Financial Statements or that have been specified by OMB, including FFMIA; (4) financial information in the Management Discussion and Analysis is materially consistent with the information in the principal DOT Consolidated Financial Statements; (5) internal controls ensured the existence and completeness of reported data supporting performance measures; and (6) supplementary, stewardship, and other accompanying information is consistent with management representations and the DOT Consolidated Financial Statements.

DOT is responsible for (1) preparing the DOT Consolidated Financial Statements for FYs 2005 and 2004 in conformity with generally accepted accounting principles; (2) establishing, maintaining, and assessing internal controls to provide reasonable assurance that broad control objectives of FFMIA are met; (3) ensuring that DOT financial management systems substantially comply with FFMIA requirements; and (4) complying with other applicable laws and regulations.

The OIG is responsible for obtaining reasonable assurance that the DOT Consolidated Financial Statements for FY 2005 and FY 2004 are presented fairly, in all material respects, in conformity with generally accepted accounting principles. 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 and stewardship information in conformity 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 Government-wide policies identified by OMB audit guidance.

Exhibit A. Objectives, Scope, and Methodology



- **Performance measures.** Transactions and other supporting data are properly recorded and summarized.

We are also responsible for (1) obtaining sufficient understanding of internal controls over financial reporting and compliance to plan the audit, (2) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and (3) performing limited procedures with respect to certain other information appearing in the DOT Consolidated Financial Statements for FYs 2005 and 2004.

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 reported in the Management Discussion and Analysis; and (5) tested compliance with selected provisions of certain laws, including FFMIA.

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 2005. The Treasury Office of Inspector General reported on the effectiveness of controls placed in operation over the Bureau of Public Debt Trust Fund Management Branch and Federal Investments Branch for the period October 1, 2004, to July 31, 2005, and attained management's assurance on the effectiveness of the controls through September 30, 2005. 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.

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. We also caution that our internal control testing may not be sufficient for other purposes and that projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that compliance with controls may deteriorate.

Exhibit A. Objectives, Scope, and Methodology



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, 2005, and September 30, 2004. 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 weaknesses 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 01-02, "Audit Requirements for Federal Financial Statements."

Exhibit A. Objectives, Scope, and Methodology



EXHIBIT B. STATUS OF PRIOR YEAR'S AND NEW ISSUES

Prior Year Condition	As Reported 9/30/2004	As Reported 9/30/2005
<p>FHWA/HTF: Financial Management and Reporting <i>Material deficiencies in internal controls over financial management and reporting activities in HTF agencies resulted in the need for extraordinary efforts to prepare FY 2005 financial statements. Progress has been made, yet remaining weaknesses exist in areas including reconciliation of differences, implementing managerial cost accounting, and tracking intragovernmental transactions.</i></p>	Material Weakness	Material Weakness
<p>FHWA: Financial Oversight of Highway Grants <i>Stronger financial and cost controls were needed to better protect grant funds from fraud, waste, or abuse. Improved procedures and controls were instituted in FY 2005, including FHWA's Financial Integrity Review and Evaluation (FIRE) program. It is not clear, however, whether Division Offices are consistently following FIRE requirements, and FHWA must continue to work with the states to institutionalize processes necessary to identify and release unneeded funds.</i></p>	Material Weakness	Material Weakness
<p>Intragovernmental Transactions <i>While progress has been apparent, DOT needs to continue implementing new processes for reconciling transactions among its Operating Administrations and with other Federal agencies.</i></p>	Material Weakness	Reportable Condition
<p>DOT Financial System Controls <i>In FY 2004 deficiencies were noted in Delphi computer controls and in computer security in several FAA, FHWA, and FTA systems from which Delphi receives financial data. Good progress has been made, yet better computer controls are needed for segregation of duties, user administration, and system configuration management.</i></p>	Material Weakness	Reportable Condition
<p>FAA: Timely Transaction Processing and Accounts Reconciliation <i>Problems in implementing Delphi and a new procurement system worsened in FY 2005, affecting FAA's ability to process transactions and reconcile balances in a timely manner.</i></p>		Material Weakness
<p>DOT Information Security Program <i>The quality of security certification reviews has improved, but DOT still faces the challenge of recertifying the security of hundreds of systems while enhancing certification quality. Further, over 1,600 of 3,000 security deficiencies that await correction have not yet been prioritized. FAA has not fulfilled its commitment to enhance air traffic control systems security.</i></p>	Reportable Condition	Reportable Condition

Exhibit B. Status of Prior Year's and New Issues



<p>MARAD Title XI Loan Guarantee Oversight <i>MARAD's financial monitoring system is not up to effectively managing its \$3.2-million loan portfolio, and the agency needs to enforce the requirement that borrowers maintain specified financial reserves. Progress has been made, but more is needed.</i></p>	<p>Reportable Condition</p>	<p>Reportable Condition</p>
<p>FAA Contract Management <i>FAA's controls over the management and oversight of cost-reimbursable and support services contracts are inadequate to prevent fraud, waste, or abuse. Issues include a closeout backlog, an ineffective tracking system, analysis of contracts performed by DCAA, and inconsistent adherence to its own contract administration and procurement policies.</i></p>		<p>Reportable Condition</p>
<p>FAA Grants Management <i>The program's size, availability of resources, and over-reliance on sponsors has increased its risk of fraud, waste, and abuse. Since 2003, the DOT OIG has cited actual or possible misuse of about \$314 million in airports revenue and funding.</i></p>		<p>Reportable Condition</p>
<p>Delphi Loans <i>Delphi lacked a mechanism for recording anticipated loan repayments, and loans receivable were not reconciled between FHWA and FRA. In FY 2004 DOT established a work group to address accounting for loan activity.</i></p>	<p>Reportable Condition</p>	<p>Management Letter^a</p>

^a Issued by Clifton Gunderson LLP.

Exhibit B. Status of Prior Year's and New Issues



EXHIBIT C. FINANCIAL-RELATED REPORTS

Subject	Report Number	Date Issued
2003 Assessment of Federal Aviation Administration Cost Accounting System and Practices	FI-2005-010	November 17, 2004
Special-Purpose Financial Statements for Fiscal Year 2004	FI-2005-014	November 18, 2004
Managing Risk in the Federal-Aid Highway Program	MH-2005-012	November 19, 2004
Terminal Modernization: FAA Needs to Address Its Small, Medium, and Large Sites Based on Cost, Time, and Capability	AV-2005-016	November 23, 2004
Agreed-Upon Procedures for Federal Intragovernmental Activity and Balances	FI-2005-017	December 2, 2004
FAA Inactive Obligations	FI-2005-044	January 31, 2005
Accounting for FY 2004 Drug Control	FI-2005-045	February 1, 2005
FHWA Needs to Capture Basic Aggregate Cost and Schedule Data to Improve Its Oversight of Federal-aid Funds	MH-2005-046	February 15, 2005
Office of the Chief Information Officer's Budget	FI-2005-055	March 31, 2005
Status of FAA's Major Acquisitions: Cost Growth and Schedule Delays Continue To Stall Air Traffic Modernization	AV-2005-061	May 26, 2005
Consolidation of DOT Accounting Functions	FI-2005-064	June 17, 2005
FAA's En Route Modernization Program Is On Schedule but Steps Can Be Taken to Reduce Future Risks	AV-2005-066	June 29, 2005
Quality Control Review of the Report On Controls over the Delphi Financial Management System	QC-2005-075	September 2, 2005
Quality Control Review of KPMG's Notice of Finding and Recommendation	QC-2005-076	September 22, 2005

Exhibit C. Financial-Related Reports



Report on the Agreed-Upon Procedures: Selected Personnel-Related Cost Items	FI-2005-077	September 27, 2005
Management of Land Acquired Under Airport Noise Compatibility Programs	AV-2005-078	September 30, 2005
Midway Atoll Cost Sharing	FI-2005-079	September 30, 2005
Actions to Prevent Fraud on Cooperative Agreements with Universities	FI-2005-080	September 30, 2005
DOT's Information Security Program	FI-2006-002	October 7, 2005
Quality Control Review of Audited Financial Statements, FY 2005 and 2004, for Saint Lawrence Seaway Development Corporation	QC-2006-009	November 8, 2005
Quality Control Review of Audited Financial Statements, FY 2005 and 2004, for the Federal Aviation Administration	QC-2006-010	November 14, 2005
FHWA Inactive Obligations	FI-2006-011	November 14, 2005
Quality Control Review of Audited Financial Statements, FY 2005 and 2004, for the Highway Trust Fund Agencies	QC-2006-012	November 15, 2005
Quality Control Review of Audited Balance Sheet, September 30, 2005, FAA Franchise Fund	QC-2006-013	November 15, 2005
Top Management Challenges	PT-2006-007	November 15, 2005

Exhibit C. Financial-Related Reports