DEPARTMENT OF HOMELAND SECURITY

Office of Inspector General

Independent Auditors' Report On FLETC's FY 2006 Consolidated Balance Sheet

(Excerpts from the FLETC Performance and Accountability Report)

OIG-07-46 **May 2007**

Office of Inspector General

U.S. Department of Homeland Security
Washington, DC 20528

May 30, 2007

Preface

The Department of Homeland Security (DHS) Office of Inspector General (OIG) was established by the Homeland Security Act of 2002 (*Public Law 107-296*) by amendment to the Inspector General Act of 1978. This is one of a series of audit, inspection, and special reports published by our office as part of our oversight responsibility to promote economy, effectiveness, and efficiency within the department.

The attached report represents Financial Information Part III excerpted from FLETC's *Performance and Accountability Report* (PAR). We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the audits. The contract required that KPMG perform its audits according to generally accepted government auditing standards and guidance from the Office of Management and Budget and the Government Accountability Office. KPMG issued an unqualified opinion on FLETC's consolidated balance sheet as of September 30, 2006. The FY 2006 auditors' report discusses six material weaknesses, two other reportable conditions in internal control, and instances of noncompliance with two laws and regulations. KPMG is responsible for the attached auditor's report dated December 8, 2006, and the conclusions expressed in the report. We do not express opinions on the balance sheet or internal control or conclusions on compliance with laws and regulations.

The recommendations herein have been discussed in draft with those responsible for implementation. It is our hope that this report will result in more effective, efficient, and economical operations. We express our appreciation to all of those who contributed to the preparation of this report.

Richard L. Skinner

Richard L. Skinner
Inspector General

U.S. DEPARTMENT OF HOMELAND SECURITY

Excerpts from the FLETC FY 2006 Performance and Accountability Report Financial Information Part III

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Office of Inspector General

U.S. Department of Homeland Security
Washington, DC 20528

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Homeland Security

MEMORANDUM FOR: Ms. Connie L. Patrick
Director
Federal Law Enforcement Training Center

FROM: Richard L. Skinner
Inspector General

SUBJECT: *Independent Auditors' Report on FLETC's FY 2006 Consolidated Balance Sheet*

The attached report presents the results of the Department of Homeland Security's (Department) Federal Law Enforcement Training Center (FLETC) consolidated balance sheet as of September 30, 2006. We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the audit.

Summary

KPMG issued an unqualified opinion on FLETC's consolidated balance sheet for FY 2006. The FY 2006 auditors' report discusses six material weaknesses, two other reportable conditions, and instances of non-compliance with two laws and regulations, as follows:

Reportable Conditions That Are Considered To Be Material Weaknesses

A. Financial Reporting
B. Environmental Cleanup Costs
C. Capital Lease Liabilities
D. Valuation of Inventories
E. Construction in Progress
F. Accounts Payable

Other Reportable Conditions

G. Deferred Revenue
H. Financial Systems Security

Non-Compliance with Laws and Regulations

I. Federal Financial Management Improvement Act of 1996 (FFMIA)
J. Prompt Payment Act (PPA)

KPMG also reported other matters related to compliance with the *Anti-Deficiency Act.*

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KPMG is responsible for the attached auditors' report dated December 8, 2006, and the conclusions expressed in the report. We do not express opinions on the balance sheet or internal control or conclusions on compliance with laws and regulations.

Consistent with our responsibility under the Inspector General Act, we are providing copies of this report to appropriate congressional committees with oversight and appropriation responsibilities over the Department. In addition, we will post a copy of the report on our website for public dissemination.

We request that a corrective action plan that demonstrates FLETC's progress in addressing the report's recommendations be provided to us within 90 days of the date of this letter.

We appreciate the cooperation extended to the auditors by your staff. Should you have any questions, please call me, or your staff my contact David M. Zavada, Assistant Inspector General for Audits, at 202-254-4100.

Attachment

KPMG LLP
2001 M Street, NW
Washington, DC 20036

INDEPENDENT AUDITORS' REPORT

Inspector General
U.S. Department of Homeland Security

Director
The Federal Law Enforcement Training Center

We have audited the accompanying consolidated balance sheet of the U.S. Department of Homeland Security's (DHS) Federal Law Enforcement Training Center (FLETC) as of September 30, 2006 (referred to herein as "balance sheet"). The objective of our audit was to express an opinion on the fair presentation of the balance sheet. In connection with our audit, we also considered FLETC's internal controls over financial reporting and performance measures; and tested FLETC's compliance with certain provisions of applicable laws, regulations, and contract agreements that could have a direct and material effect on the balance sheet.

SUMMARY

As stated in our opinion on the balance sheet, we concluded that FLETC's balance sheet as of September 30, 2006 is presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles (GAAP).

As discussed in our opinion, in fiscal year 2006, FLETC changed its method of accounting for and reporting of earmarked funds to adopt changes in accounting standards and changed its method of accounting for operating supplies inventory.

Our consideration of internal controls over financial reporting, and performance measures resulted in the following conditions being identified as reportable conditions:

A. Financial Reporting
B. Environmental Cleanup Costs
C. Capital Lease Liabilities
D. Valuation of Inventories
E. Construction in Progress
F. Accounts Payable
G. Deferred Revenue
H. Financial Systems Security

We consider reportable conditions A through F above to be material weaknesses.

The results of our tests of compliance with certain provisions of laws, regulations, and contract agreements, disclosed the following instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*:

I. Federal Financial Management Improvement Act of 1996 (FFMIA)
J. Prompt Payment Act (PPA)

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We also reported other matters related to compliance with the *Anti-deficiency Act.*

The following sections discuss our opinion on FLETC's balance sheet; our consideration of FLETC's internal control over financial reporting and performance measures; our tests of FLETC's compliance with certain provisions of applicable laws, regulations, and contract agreements; and management's and our responsibilities.

OPINION ON THE BALANCE SHEET

We have audited the accompanying balance sheet of the Department of Homeland Security's (DHS) Federal Law Enforcement Training Center (FLETC) as of September 30, 2006.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of FLETC as of September 30, 2006 in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the balance sheet, FLETC changed its method of accounting for and reporting earmarked funds in fiscal year 2006 to adopt the provisions of the Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards (SFFAS) No. 27, *Identifying and Reporting Earmarked Funds.* Also as discussed in Note 1 to the balance sheet, FLETC elected to change its method of accounting for and reporting operating supplies inventory in fiscal year 2006 from the consumption method to the purchase method in accordance with SFFAS No. 3, *Accounting for Inventory and Related Property.*

The information in the Management's Discussion and Analysis and Required Supplementary Information (RSI) sections is not a required part of FLETC's balance sheet, but is supplementary information required by GAAP and OMB Circular No. A-136, *Financial Reporting Requirements.* We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the balance sheet taken as a whole. The information in Part II - Strategic Plan and Performance and Part IV - Other Supplementary Information are presented for purposes of additional analysis and are not required as part of the balance sheet. This information has not been subjected to auditing procedures and, accordingly, we express no opinion on it.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect FLETC's ability to record, process, summarize, and report financial data consistent with the assertions by management in the balance sheet.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud, in amounts that would be material in relation to the balance sheet being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal control, misstatements due to error or fraud may nevertheless occur and not be detected.

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In our audit, we noted certain matters, described in Exhibits I and II, involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that the reportable conditions presented in Exhibit I are material weaknesses. Exhibit II presents the other reportable conditions. Exhibit IV presents the status of prior year reportable conditions.

INTERNAL CONTROLS OVER PERFORMANCE MEASURES

Under OMB Bulletin No. 06-03, the definition of material weaknesses is extended to other controls. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud, in amounts that would be material in relation to a performance measure or aggregation of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal control, misstatements due to error or fraud may nevertheless occur and not be detected.

Our consideration of the internal control over the existence and completeness assertions related to key performance measures would not necessarily disclose all matters involving the internal control and its operation related to the design and operation of the internal control over the existence and completeness assertions related to key performance measures that might be reportable conditions.

In our audit, we noted no matters involving the design and operation of the internal control over the existence and completeness assertions related to key performance measures that we considered to be material weaknesses as defined above.

COMPLIANCE AND OTHER MATTERS

Our tests of compliance with certain provisions of laws, regulations, and contract agreements, as described in the Responsibilities section of this report, exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed two instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 06-03, and are described in Exhibit III.

The results of our tests of compliance with certain provisions of other laws and regulations, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 06-03.

The results of our tests of FFMIA disclosed instances, described in Exhibit III, in which FLETC's financial systems did not substantially comply with Federal financial management system requirements, the United States Government Standard General Ledger at the transaction level, and Federal accounting standards.

Other Matters

FLETC management has initiated a review of the classification of certain liabilities recorded in their accounting records that may identify a violation of the Anti-deficiency Act, or other violations of appropriation law, that may have occurred during fiscal year 2006 or during earlier years.

* * * * *

RESPONSIBILITIES

Management's Responsibilities. The United States Code Title 31 Section 3515 and 9106 require agencies to report annually to Congress on their financial status and any other information needed to fairly

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present their financial position and results of operations. To assist DHS in meeting these reporting requirements, FLETC prepares and submits financial statements in accordance with GAAP.

Management is responsible for the balance sheet, including:

- Preparing the balance sheet in conformity with GAAP;
- Preparing the Management's Discussion and Analysis (including the performance measures) and Required Supplementary Information;
- Establishing and maintaining effective internal control; and
- Complying with laws, regulations, and contract agreements, applicable to FLETC, including FFMIA.

In fulfilling this responsibility, management is required to make estimates and judgments to assess the expected benefits and related costs of internal control policies.

Auditors' Responsibilities. Our responsibility is to express an opinion on the fiscal year 2006 balance sheet of FLETC based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 06-03. Those standards and OMB Bulletin No. 06-03 require that we plan and perform the audits to obtain reasonable assurance about whether the balance sheet is free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of FLETC's internal control over financial reporting. Accordingly, we express no such opinion.

An audit also includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the balance sheet;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall balance sheet presentation.

We believe that our audit provides a reasonable basis for our opinion.

In planning and performing our audit, we considered FLETC's internal control over financial reporting by obtaining an understanding of FLETC's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the balance sheet. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards* and OMB Bulletin No. 06-03. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to provide an opinion on the FLETC's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin No. 06-03, in our audit, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis and the Strategic Plan and Performance sections, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions and determined

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whether these internal controls had been placed in operation. We limited our testing to those controls necessary to test and report on the internal control over key performance measures in accordance with OMB Bulletin 06-03. However, our procedures were not designed to provide an opinion on internal control over reported performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether FLETC's balance sheet is free of material misstatement, we performed tests of FLETC's compliance with certain provisions of laws, regulations, and contract agreements, noncompliance with which could have a direct and material effect on the determination of the balance sheet amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 06-03, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, and contract agreements, applicable to FLETC. However, providing an opinion on compliance with laws, regulations, and contract agreements, was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 06-03 and FFMIA, we are required to report whether FLETC's financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

We also noted certain additional matters that we have reported to the management of FLETC in a separate letter dated December 8, 2006.

RESTRICTED USE

This report is intended solely for the information and use of FLETC management, DHS management, the DHS Office of Inspector General, OMB, the U.S. Government Accountability Office, and the U.S. Congress and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

December 8, 2006

Independent Auditors' Report
Exhibit I – Material Weaknesses

A. Financial Reporting

Background: Prior to the enactment of the Department of Homeland Security Act in 2003, FLETC was a component of the U.S. Department of the Treasury and underwent an annual full scope audit of its financial statements. Since March 2003, FLETC has been audited as a component of U.S. Department of Homeland Security (DHS), and as such represented a small component of a much larger Department. The decision to audit FLETC's FY 2006 balance sheet as a stand alone component resulted in a much closer examination of FLETC's transactions and balances than in previous years' Department level audits.

Conditions: We noted internal control weaknesses over six significant balance sheet line items that require immediate improvement. Those six instances are presented in more detail in this report and consist of deficiencies in the following areas:

- Policies and procedures to ensure completeness, accuracy and valuation of FLETC's estimated environmental liabilities;
- Policies and procedures to ensure the proper accounting and financial reporting of FLETC's lease transactions;
- Valuation of operating materials inventories;
- Capitalization of construction in progress accounts;
- Lack of a methodology for approximating accounts payable at fiscal year-end; and
- Lack of a timely reconciliation of deferred revenue accounts.

Criteria: OMB Circular A-136, *Financial Reporting Requirements,* requires DHS, and thus FLETC as a component of DHS, to report its financial transactions and related financial statement disclosures in accordance with the Circular. In addition, GAAP sets the requirements for the accounting treatment to be applied to transactions of Federal agencies, including the financial statement disclosures related to certain transactions.

OMB Circular A-123, Section I, Introduction, states the following:
"Management is responsible for developing and maintaining effective internal control. ... The importance of internal control is addressed in many statutes and executive documents. The FMFIA establishes overall requirements with regard to internal control. The agency head must establish controls that reasonably ensure that:...(iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets."

Cause/Effect: We believe this condition is a result of the following:

- Lack of training and experience by those Finance Division professionals charged with responsibility for ensuring FLETC's financial statements are prepared in accordance with GAAP; and
- Lack of formal guidance and continuous training of field staff to ensure that transactions are accounted for correctly at inception.

As a result of the above deficiencies, FLETC was unable to timely prepare its adjusted trial balance and was required to record numerous adjusting journal entries to ensure that the balance sheet as of September 30, 2006 was prepared in accordance with GAAP.

Recommendations: We recommend that FLETC Financial Division management:

- Provide immediate and ongoing training to all personnel responsible for the preparation of FLETC's financial statements;
- Design and implement a process that ensures all accounting transactions are recorded in accordance with GAAP;
- Establish formal channels of communication with each FLETC Division that provides the Finance Division estimates or information required for financial reporting and ensures, by training or other means, that the estimates and information provided are timely, properly supported, and compliant with GAAP; and
- Ensure that all FLETC personnel are made aware that financial reporting implications must be considered when entering into agreements and making budgetary decisions.

Management's Response: Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendations.

B. Environmental Cleanup Costs

Background: FLETC maintains firing ranges for use in training its students in the use of various firearms required in their capacity as agents and law enforcement officers. Although FLETC has begun using reduced-hazard, or "green" ammunition where possible, the ammunition used in the past and currently in use for certain training applications contains lead and contaminates the soil in and around the ranges. FLETC is responsible for remediation of lead contamination at 34 indoor and outdoor ranges.

FLETC also has numerous buildings that contain asbestos and lead-based paint. As these buildings are renovated for future use or demolished in preparation for construction of new buildings, the asbestos and lead-based paint contamination must be contained and remediated by FLETC.

Conditions: FLETC does not have policies and procedures in place to ensure that it is able to efficiently and effectively develop reasonable estimates of its environmental liabilities in accordance with GAAP. As a result, FLETC initially recorded a pre-audit liability of only approximately $7,000 for remediation of lead contamination at firing ranges, and a general liability of $500,000 for all other cleanup cost that might arise. The estimates recorded as liabilities lacked any auditable support. In addition, no comprehensive study of the extent of lead, asbestos, or lead-based paint contamination was conducted, nor was an estimate of the cost for the remediation of the various types of contamination developed or otherwise considered. The final audited re-estimated liabilities prepared in accordance with GAAP amounted to approximately $58 million as of September 30, 2006.

Criteria: OMB Circular A-123, Section I, Introduction, states the following:
"Management is responsible for developing and maintaining effective internal control. ... The importance of internal control is addressed in many statutes and executive documents. The FMFIA establishes overall requirements with regard to internal control. The agency head must establish controls that reasonably ensure that:...(iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets."

Independent Auditors' Report
Exhibit I – Material Weaknesses

Statement of Federal Financial Accounting Standards (SFFAS) #5, *Accounting for Liabilities of the Federal Government*, provides the definition and general principle for recognition of liabilities in paragraph 19: "A liability for federal accounting purposes is a probable future outflow or other sacrifice of resources as a result of past transactions or events."

Federal Financial Accounting and Auditing Technical Release #2, *Determining Probable and Reasonably Estimable for Environmental Liabilities in the Federal Government*, states in footnote 1 that "liabilities shall be recognized when the following conditions are met:

- A past transaction or event has occurred,
- A future outflow or other sacrifice of resources is probable, and
- The future outflow or sacrifice of resources is measurable."

SFFAS #6, *Accounting for Property, Plant, and Equipment*, defines clean-up costs in paragraph 85 as: "...the costs of removing, containing, and/or disposing of (1) hazardous waste from property, or (2) material and/or property that consists of hazardous waste at permanent or temporary closure or shutdown of associated PP&E." Furthermore, paragraph 87 clarifies that "Cleanup may include, but is not limited to, decontamination, decommissioning, site restoration, site monitoring, closure, and post closure costs."

Cause/Effect: FLETC does not have a process in place to periodically identify, estimate, and update as necessary the liability for environmental cleanup costs for use in complying with Federal accounting and financial reporting requirements.

As a result of the above deficiencies, FLETC was unable to timely prepare its adjusted trial balance and was required to record material adjusting journal entries to properly state its environmental liabilities as of September 30, 2006. Additionally, FLETC's note disclosures also required substantial modification to ensure compliance with GAAP.

Recommendations: We recommend that FLETC management:

- Train personnel in the Facilities Division and the Environmental and Safety Division on the accounting and financial reporting requirements for environmental liabilities, as well as development of the auditable support for the variables and assumptions that make up the estimate and recorded liability;
- Design and implement a process for periodically estimating, updating, and reporting environmental liabilities to the Finance Division for use in complying with financial reporting requirements;
- Ensure that all estimates of environmental liabilities are reviewed and approved by Finance Division management to ensure the estimates are reasonable and accompanied by auditable supporting documentation; and
- Formalize the policy on reporting and treatment of environmental liabilities by developing a written standard operating procedure (SOP) to help ensure FLETC's procedures are in accordance with the applicable accounting standards pertaining to environmental cleanup costs.

Management's Response: Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendations.

C. Capital Lease Liabilities

Background: FLETC entered into three 20-year, non-cancelable leases for dormitory buildings during FY 2001 and FY 2002. The leases were initially classified and recorded as operating leases. The FY 2002 independent auditors, however, analyzed the lease agreements and determined the leases met the requirements for treatment as capital leases, and proposed that FLETC account for them as such. The leases were reported as buildings and offset by a contingent liability in FLETC's FY 2002 financial statements and continued to be reported as a contingent liability through most of FY 2006. Since the inception of the leases, FLETC has depreciated the recorded cost of the buildings over the 20-year lease term. In addition, FLETC has recorded a reduction in the contingent liability and the related imputed interest expense with each lease payment. FLETC requested that the OMB review the details of the lease agreements and determine the classification of the leases as either capital or operating. OMB has not made a classification determination.

Conditions: FLETC does not have adequate policies and procedures and internal controls to ensure that its lease transactions are accounted for in accordance with GAAP. As a result, KPMG noted:

- Since FY 2002, FLETC has been incorrectly reporting the lease liability totaling approximately $50 million as of September 30, 2006, as an unfunded contingent liability;
- FLETC's recorded monthly imputed interest expense associated with the capital lease payments was not determined using the required interest rate method. The imputed interest was determined for the entire lease term and equal amounts were recognized with each payment; and
- The depreciation expense recorded on the three buildings was calculated incorrectly and would have resulted in full depreciation of the buildings in year 13 of the 20-year leases.

Cause/Effect: These conditions initially arose in FY 2001 because there were no formalized policies and procedures that required FLETC's Procurement Division to consult with the Budget and Finance Division prior to entering into lease transactions. The result was that three leases were unintentionally structured as capital leases. The lease liabilities were misclassified and improperly reported as contingent liabilities as a result of FLETC's attempts to support a position that these leases should be classified as operating leases, pending a determination of classification by OMB, and thus avoid the OMB Circular A-11 requirement to fully fund capital leases at lease inception.

The misstatement of imputed interest on the lease payments and the miscalculation of the annual depreciation cost resulted from calculation errors made at the inception of the leases, which were not detected by a management review process that should take place when non-routine financial transactions are entered into and recorded in FLETC's books and records. FLETC's financial reporting since the inception of the lease agreements has cumulatively understated the imputed interest expense by approximately $13.2 million, overstated the depreciation of the buildings by approximately $7.3 million, understated the net book value of the leased buildings by $134,000, and understated the lease liability by $12.4 million.

Criteria: OMB Circular A-123, Section I, Introduction, states the following:

Independent Auditors' Report
Exhibit I – Material Weaknesses

"Management is responsible for developing and maintaining effective internal control. ... The importance of internal control is addressed in many statutes and executive documents. The FMFIA establishes overall requirements with regard to internal control. The agency head must establish controls that reasonably ensure that:...(iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets."

SFFAS #5 defines capital leases as "leases that transfer substantially all the benefits and risks of ownership to the lessee." In paragraph 43, the following four criteria for determining whether leases should be classified as capital are detailed:

- The lease transfers ownership of the property to the lessee by the end of the lease term.
- The lease contains an option to purchase the leased property at a bargain price.
- The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property.
- The present value of rental and other minimum lease payments, excluding that portion of the payments representing executory cost, equals or exceeds 90 percent of the fair value of the leased property.

If, at its inception, a lease meets one or more of the above four criteria, the lease should be classified as a capital lease by the lessee. It is noted that the third and fourth criteria above are not applicable when the beginning of the lease term falls within the last 25% of the estimated economic life of the leased property. An operating lease, however, is "an agreement conveying the right to use property for a limited time in exchange for periodic rental payments."
OMB Circular A-11, Appendix A, *Scorekeeping Guidelines*, Section 11, *Scoring Purchases*, requires that all capital leases be fully funded at their inception and that risks should be carefully analyzed and managed. Specifically, OMB Circular A-11, Section 31.6, *Full funding*, states, "Requests for acquisition of capital assets must propose full funding to cover the full costs of the project or a useful segment of the project, consistent with the policy stated in section 300.6(b)." In addition, OMB Circular A-11, Appendix B, *Budgetary Treatment of Lease-Purchases and Leases of Capital Assets*, Section 1(b) states, "Unless otherwise specified by law, budget authority is available for liquidating obligations (i.e., outlays) for only five fiscal years after the authority expires. For leases financed by annual or multi-year budget authority, agencies should ensure that the appropriations language allows the budget authority to remain available for lease payments over the full term of the lease. If this period is expected to be longer than five fiscal years after the authority expires, the appropriations language should include the provision described in section 95.8."

The Anti-deficiency Act prohibits an officer or employee of the United States from making expenditures or incurring obligations before appropriations become available, unless otherwise authorized by law (31 U.S.C. § 1341).

Lastly, per the U.S. Government Standard General Ledger (USSGL), capital lease liabilities are to be recorded in account 2940, Capital Lease Liabilities, rather than as a Contingent Liability.

Recommendations: We recommend that FLETC management:

- Design and implement a process that ensures the Procurement Division consults with the Budget and Finance Division prior to entering into transactions or agreements to determine the budgetary and financial reporting effects of the proposed transactions or agreements; and

- Review all transactions prior to recording in FLETC's books and records to ensure transactions are recorded in accordance with GAAP.

Management's Response: Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our finding that the cause/effect was a result of no formalized procedures that required FLETC's Procurement Division to consult with the Budget and Finance Division prior to entering into lease transactions. However, management believes the misclassification of the lease liability as a contingent liability was a subsequent effect due to the fiscal year 2002 audit by other independent public auditors. Management stated that when the issue was raised during the 2002 audit, FLETC requested an OMB review and temporarily reported the lease liability as a contingent liability pending an OMB determination, which as yet has not been received.

Auditors' Response to Management's Response As summarized above, management has not resolved the misclassification of the lease liability as a contingent liability. The Government Accountability Office states in section 1001.08 of its *Financial Audit Manual* that management's representations to the auditor must acknowledge its responsibility for the financial statements and its belief that the financial statements are fairly presented in accordance with United States Generally Accepted Accounting Principles; completeness of financial information; recognition, measurement, and disclosure; and subsequent events. Therefore, we continue to believe that the misclassification of the lease liability was solely the responsibility of FLETC management, and that lack of resolution of the classification issue constitutes a material weakness in internal control.

D. Valuation of Inventories

Background: FLETC maintains inventories of ammunition, uniforms and operating supplies necessary for use by its students during their training. FLETC elected to use the consumption method of recording its inventory, whereby the inventory items are expensed upon being withdrawn from inventory for use. Inventories totaled approximately $9.6 million at June 30, 2006 and $10.3 million at September 30, 2006

Conditions: FLETC does not have adequate policies and procedures and internal controls to ensure that it is valuing its inventories of the above materials in accordance with GAAP. As a result, KPMG noted:

- FLETC was improperly applying the 'latest acquisition cost' method for valuing the inventory of uniforms. FLETC was not tracking the unrealized holding gain/loss related to the uniform inventory caused by a change in unit price.
- FLETC did not have a process in place for aging uniform inventory, nor was a uniform inventory obsolescence reserve established. A uniform that had been issued, worn, and laundered multiple times was recorded for financial reporting purposes at the same cost of an item that had never been worn.
- FLETC's Deputy Chief Financial Officer confirmed that the other components of FLETC's inventory (e.g., ammunition, gas & oil, and supplies, etc) were being valued in a similar manner as the uniforms.

Cause/Effect: FLETC's Finance Division did not adequately communicate the requirements for proper inventory valuation to the Student Services Division and the COTR over uniforms. In addition, the Finance Division did not review the inventory valuation methodology being employed by the Student Services Division. The effect was the consistent misstatement of the inventory value for financial reporting purposes. FLETC elected to change its method of accounting for inventories to another acceptable method, the purchases method, for reporting in its September 30, 2006 consolidated balance sheet.

Criteria: OMB Circular A-123, Section I, Introduction, states the following:

"Management is responsible for developing and maintaining effective internal control. ... The importance of internal control is addressed in many statutes and executive documents. The FMFIA establishes overall requirements with regard to internal control. The agency head must establish controls that reasonably ensure that:...(iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets."

SFFAS #3, *Accounting for Inventory and Related Property*, defines the purchases method of accounting for inventory as "A method of accounting for goods, such as materials and supplies, in which the acquisition cost is recognized as an expense upon purchase of the goods rather than upon their use. Additionally, the consumption method is described as "A method of accounting for goods, such as materials and supplies, where the goods are recognized as assets upon acquisition and are expensed as they are consumed."

Paragraph 20 of SFFAS #3 states that "Inventory shall be valued at either (1) historical cost or (2) latest acquisition cost." Furthermore, paragraph 23 continues: "The latest acquisition cost method provides that the last invoice price...be applied to all like units held including those units acquired through donation or non-monetary exchange. The inventory shall be revalued periodically but at least at the end of each fiscal year. Revaluation results in recognition of unrealized holding gains/losses in the ending inventory value." Paragraph 24 states: "An allowance for unrealized gains/losses in inventory shall be established to capture these gains/losses." The Department of Homeland Security (DHS) and its components (e.g. FLETC) must adhere to the requirements set forth in SFFAS #3.

Recommendation: We recommend that FLETC management continue its newly adopted purchases method of accounting for inventory, whereby inventory is expensed upon purchase.

Management's Response: Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendations.

E. Construction in Progress

Background: At any point in time, FLETC has multiple on-going construction projects. These projects often involve modification or renovation of multiple buildings under a single contract. FLETC records the cost of the on-going construction in Construction in Progress (CIP) accounts. Upon completion, the total cost of the project is removed from the CIP accounts and recorded as in-service buildings or as appropriate. At that point, the assets are in-use and depreciation of the asset cost begins.

Conditions: FLETC does not have adequate policies and procedures and internal controls in place to ensure that construction in progress accounts are accounted for in accordance with GAAP. As a result, KPMG noted:

- FLETC occasionally uses the same project number to track costs associated with multiple buildings and is not always able to separate the project cost to be applied to each building included in the contract. In addition, FLETC occasionally establishes multiple project numbers under the same contract/delivery order and does not consistently apply expenditures related to progress billings to the appropriate project number.
- FLETC does not always transfer completed CIP projects from CIP accounts to in-use property accounts on a timely basis. Our statistical selection of 22 projects from the CIP account revealed that 7 were completed projects during FY 2006 that should have been transferred to a property account and depreciated during FY 2006 by the Finance Division. The completed CIP projects that had not been transferred totaled approximately $5.2 million, and the evaluated statistical sample projected that the total account overstatement was approximately $12.1 million. FLETC reviewed the entire CIP list and made the necessary adjustments to transfer the completed CIP projects to the appropriate property accounts in accordance with GAAP.

Cause/Effect CIP projects are not always allocated to the correct capital assets because there is no process in place to require vendors to separate the cost billed to FLETC by capital asset. Additionally, there is no methodology in place to allocate the cost of progress payments when there are multiple projects, and in some cases, costs are allocated to the projects with the oldest available funds to ensure there is sufficient funding to complete the project.

CIP projects are not always transferred to property accounts and depreciated because Finance Division personnel do not routinely compare the Facilities Division's ongoing CIP list to the CIP account in the general ledger and inquire whether differences should be transferred as completed projects.

Criteria: OMB Circular A-123, Section I, Introduction, states the following:
"Management is responsible for developing and maintaining effective internal control. The importance of internal control is addressed in many statutes and executive documents. The FMFIA establishes overall requirements with regard to internal control. The agency head must establish controls that reasonably ensure that:...(iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets."

SFFAS #6, *Accounting for Property, Plant, and Equipment*, states:

"All general PP&E shall be recorded at cost. Cost shall include all costs incurred to bring the PP&E to a form and location suitable for its intended use. For example, the cost of acquiring property, plant, and equipment may include:
- amounts paid to vendors;
- transportation charges to the point of initial use;
- handling and storage costs;
- labor and other direct or indirect production costs (for assets produced or constructed);
- engineering, architectural, and other outside services for designs, plans, specifications, and surveys;

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Exhibit I – Material Weaknesses

- acquisition and preparation costs of buildings and other facilities;
- an appropriate share of the cost of the equipment and facilities used in construction work;
- fixed equipment and related installation costs required for activities in a building or facility;
- direct costs of inspection, supervision, and administration of construction contracts and construction work;
- legal and recording fees and damage claims;
- fair value of facilities and equipment donated to the government; and
- material amounts of interest paid."

Paragraph 34 of SFFAS #6 states: "PP&E shall be recognized when title passes to the acquiring entity or when the PP&E is delivered to the entity or to an agent of the entity. In the case of constructed PP&E, the PP&E shall be recorded as construction work in process until it is placed in service, at which time the balance shall be transferred to general PP&E."

Recommendations: We recommend that FLETC management take the following steps:

- Design and implement a process that ensures each project number applies to only one capital asset unit. (Conversely, FLETC may require the contractor to separate the costs of work performed on its contract invoices enabling FLETC to capture the cost to be applied to each unit).
- Develop and implement a formalized process to train project managers on the financial reporting requirements for CIP projects.
- Implement the *Real Property SOP* issued by FLETC on October 27, 2006. Among the procedures established, the SOP requires:
  a. The Facilities Division submit copies of all *Capitalization Reports* to the Property Management Division and the Finance Division within 10 days of project completion or final decision of additional cost resulting from litigation.
  b. The Finance Division validate construction/renovation project costs in *Capitalization Reports*.
  c. The Finance Division maintain the CIP subsidiary ledger by project numbers and funds. The Finance Division will compile copies of paid invoices/bills by CIP project numbers and provide copies to the Property Management Division upon validation of *Capitalization Report* costs. After submission of the *Capitalization Reports*, the Finance Division will follow-up with the Project Managers for completed construction/renovation projects listed in the CIP subsidiary ledger.
- Develop and implement a quarterly process to reconcile CIP projects listed in the subsidiary ledger with on-going construction projects as recognized by the Facilities Management Division.

Management's Response: Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendations.

F. Accounts Payable

Background: FLETC has an established process for estimating its accounts payable liability for financial reporting purposes at year end. We discussed the estimation methodology used for each of the following transaction areas prior to beginning our audit procedures over accounts payable:

travel expenses, purchase cards, goods and services received, recurring services, permanent change of station, and miscellaneous payables.

Conditions: FLETC does not have adequate policies and procedures and internal controls to ensure that it has developed a reasonable estimate of its accrued liabilities as of fiscal year end in accordance with GAAP. As a result, KPMG noted:

- FLETC's process for accruing liabilities at the end of the fiscal year did not capture all the outstanding liabilities that existed at September 30, 2006. Our statistical sample of FLETC's disbursements through October 25, 2006 resulted in 27 of the 96 selections containing unrecorded liabilities totaling approximately $3.8 million. A second non-statistical sample of disbursements through November 5, 2006 revealed another $3.8 million of liabilities not recorded as of September 30, 2006.
- The majority of the under-accrual was in the area of service and construction contracts.

Cause/Effect: FLETC's accounts payable & accrued expenses balances were significantly understated because the accrual process did not operate as designed. The failure of the process was not detected because of insufficient management review and oversight of the process and the accrual that resulted. FLETC management subsequently re-estimated the accounts payable and accrued expense accrual as of September 30, 2006. Adjustments to the books and records were recorded as a result of the re-estimation.

Criteria: OMB Circular A-123, Section I, Introduction, states the following:

"Management is responsible for developing and maintaining effective internal control. ... The importance of internal control is addressed in many statutes and executive documents. The FMFIA establishes overall requirements with regard to internal control. The agency head must establish controls that reasonably ensure that:...(iii) revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets."

Paragraphs 77-79 of the SFFAS #1, *Accounting for Selected Assets and Liabilities*, state:

> 77 When an entity accepts title to goods, whether the goods are delivered or in transit, the entity should recognize a liability for the unpaid amount of the goods. If invoices for those goods are not available when financial statements are prepared, the amounts owed should be estimated.
>
> 78 When a contractor provides the government with goods that are also suitable for sale to others, the liability usually arises when the contractor physically delivers the goods and the government receives them and takes formal title. However, when a contractor builds or manufactures facilities or equipment to the government's specifications, formal acceptance of the products by the government is not the determining factor for accounting recognition. Constructive or de facto receipt occurs in each accounting period, in accordance with the following paragraph.
>
> 79 For facilities or equipment constructed or manufactured by contractors or grantees according to agreements or contract specifications, amounts recorded as payable should be based on an estimate of work completed under the contract or the agreement. The

estimate of such amounts should be based primarily on the federal entity's engineering and management evaluation of actual performance progress and incurred costs.

DHS and its components (e.g. FLETC) must adhere to the requirements set forth in SFFAS #1.

Recommendations: We recommend that FLETC management take the following steps:

- Design, implement, and document an accrual process that will ensure each type of accounts payable is properly accrued for financial reporting purposes. This process should include a final review of the accrual details by senior management to ensure the process was properly executed and the accrual is reasonable.
- Require the use of the accrual process to capture the financial reporting information required for inclusion in FLETC's quarterly financial statements, as required by OMB Circular A-136.
- Provide comprehensive training to every person involved in the accrual process. The training should include a discussion of the objective of the process, what each type of accounts payable requires to be accrued properly, the timing of the procedures to be performed, what form the reported results should take, to whom the results must be reported, and exactly how the information and methods used to obtain the information or estimate are to be documented for later examination by persons internal or external to FLETC.
- Design and implement a plan to periodically review the reported accrual information provided by personnel both inside and outside the Finance Division. This will require a knowledgeable person going to the location of the individuals generating the accrual information and reviewing the accuracy of the information as well as the documentation as to how the information was obtained or estimated.
- Assign one person in the Finance Division the responsibility for ensuring that each person designated to submit the quarterly accrual information submits the information on time and in the format required. Any late, incomplete, or undocumented submissions should be reported to senior Financial Division management as well as Management of the Division in which the designated individual works.
- Include the timely and accurate submission of the accrual information as a part of each designated individual's performance evaluation.

Management's Response: Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendations.

G. Deferred Revenue

Background: FLETC's recognizes in proportion to the training completed, e.g. half of the revenue is recognized as earned when a student has completed half the training. FLETC has a small proportion of its students that individually pay for their training rather than their sponsoring agency paying upon receipt of an invoice from FLETC. At the time of the individual payment, FLETC has often not prepared an invoice and recorded an accounts receivable. FLETC records and reports these individual payments as deferred revenue until FLETC staff have an opportunity to research the payment and properly account for it as revenue. The event that triggers the recording of the deferred revenue is not related to whether the student has completed any or all of the training for which the payment is made, but whether at the time of payment an accounts receivable has been recorded.

Condition: We noted the following condition related to FLETC's deferred revenue:

- FLETC is not timely recognizing revenue from student tuition in those situations where payment is made prior to generation of an invoice and recording of the related accounts receivable. We statistically selected 23 payments for examination from the deferred revenue account and found that every selection was composed entirely or partially of unrecognized FY 2006 earned revenue from tuition. There were several instances where the student's training was completed more than 3 months prior to the end of the fiscal year, yet the payment amount was still reported as deferred revenue.

Cause/Effect: Lack of internal controls over the recognition of revenues related to cash receipts from students who pay individually prior to the receipt of an invoice from FLETC. Additionally, in the preparation of FLETC's consolidated balance sheet as of September 30, 2006, deferred amounts were not researched because management did not consider the potential misstatement material enough to justify the use of resources to correct the error. The effect is that deferred revenues are overstated by approximately $214,000 on the FLETC consolidated balance sheet as of September 30, 2006.

Criteria: Paragraph 85 of the Statement of Federal Financial Accounting Standards (SFFAS) #1, *Accounting for Selected Assets and Liabilities*, states, "Before revenues are earned, the current portion of the advances and prepayments should be recorded as other current liabilities. After the revenue is earned, the entity should record the current liabilities appropriate amount as a revenue or financing source and should reduce the liability accordingly." The U.S. Department of Homeland Security (DHS) and its components (e.g. FLETC) must adhere to the requirements set forth in SFFAS #1.

Recommendations: We recommend that FLETC management take the following steps:

- Design and implement a process that ensures the research and monthly adjustment of the deferred revenue account to recognize revenue that has been earned.

- Inform the Finance Division staff that the concept of "materiality" is not appropriate for use in determining whether to correctly record FLETC's transactions.

Independent Auditors' Report
Exhibit II – Reportable Conditions

Management's Response:
Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings and its comments were responsive to our recommendations.

H. Financial Systems Security

Background: Controls over the FLETC information technology (IT) and related financial systems are essential elements of financial reporting integrity. Effective general controls in an IT and financial systems environment are typically defined in six key control areas: entity-wide security program planning and management, access control, application software development and change control, system software, segregation of duties, and service continuity. In addition to general controls, financial systems contain application controls which are the structure, policies, and procedures that apply to separate, individual application systems, such as accounts payable, inventory, payroll, or loans.

During FY 2006, we performed audit procedures over the two key FLETC financial systems, Momentum and Procurement Desktop (PD), as well as those systems' supporting the general control environment. The overall objective of our IT audit procedures was to evaluate the effectiveness of IT general controls of FLETC's financial processing environment and related IT infrastructure as necessary to support the FY2006 FLETC consolidated balance sheet audit.

The Federal Information System Controls Audit Manual (FISCAM), issued by the Government Accountability Office (GAO), formed the basis of our review and was supplemented by the National Institute of Standards and Technology (NIST) Special Publication 800-53 and applicable DHS and FLETC policies and procedures.

To complement our general IT controls audit, we also performed technical security testing for key network and system devices, as well as testing over key financial application controls. The technical security testing was performed from within FLETC and was focused on test, development, and production devices that directly support FLETC financial processing and key general support systems. The application control testing included assessing the structure, policies, and procedures that apply to separate, individual application processes, such as accounts payable, and payroll. The application control testing was performed to assess the controls that support the financial system's internal controls over the input, processing, and output of financial data and transactions.

During FY 2006, we identified IT general control weaknesses at FLETC. The most significant weaknesses, from a balance sheet audit perspective, related to access controls and change controls. Collectively, the IT control weaknesses limited FLETC's ability to ensure that critical financial and operational data was maintained in such a manner to ensure confidentiality, integrity, and availability. In addition, these weaknesses negatively impacted the internal controls over FLETC financial reporting and its operations.

Conditions: In FY 2006, the following IT and financial system control weaknesses were identified related to Momentum, PD and the supporting IT control environment:

1. Regarding entity-wide security program planning and management, we noted:

- Background investigations of contractors employed to operate, manage and provide security over FLETC IT systems is not being properly conducted.
- Information technology security awareness training is in draft form.

2. Regarding access controls, we noted:
   - 5 instances of generic and shared accounts on key servers and databases.
   - Workstations, servers, or network devices were configured without necessary security patches, or were not configured in the most secure manner.
   - Password configurations for key systems were configured to permit passwords not in compliance with DHS password policies.
   - Physical access to the FLETC Telecom room was not adequately controlled.
   - Policies and procedures for access authorization and review were not developed.
   - Polices and procedures for restricting access to sensitive system software were not developed.
   - Policies and procedures for mobile code and voice of internet protocol (VOIP) technology were not developed.
   - Polices and procedures for review of Momentum audit logs were not developed.

3. Regarding application software development and change control, we noted:
   - The System Development Life Cycle for the Momentum system is in draft form.
   - Policies and procedures regarding configuration management controls were not in place.
   - The lack of documented test plan standards and procedures.
   - The lack of a documented comprehensive set of test transactions.
   - Test results are not maintained and a documented approval for the test results does not exist.

4. Regarding system software, we noted that the installation of the Momentum's system software is not logged or reviewed by management.

5. Regarding segregation of duties, we noted that policies and procedures for segregating incompatible duties in the Momentum's system were not developed.

6. Regarding service continuity, we noted:
   - Momentum's back up tapes were not tested or appropriately labeled.
   - Momentum's contingency plan has not been tested.

Cause/Effect: Many of the conditions identified in FY 2006 during our IT audit are the result of a lack of detail and defined IT policies and procedures, as well as a lack of monitoring of the control environment to ensure compliance with DHS, OMB, and NIST policies. Additionally, many of these weaknesses are inherent in FLETC's legacy systems, or system development activities that did not incorporate strong security controls from the outset and will take several years to fully address. Further, the lack of resources and competing responsibilities has prevented FLETC from implementing many of these controls and processes into their environment. And finally, there was no consistent and thorough testing of IT controls by FLETC to identify and mitigate weaknesses. The effect of the identified IT weaknesses has the potential to impact the integrity of the data processing and reporting of FLETC financial and operational data.

Independent Auditors' Report
Exhibit II – Reportable Conditions

Criteria: The Federal Information Security Management Act (FISMA) passed as part of the *Electronic Government Act of 2002* mandates that Federal entities maintain IT security programs in accordance with OMB and NIST guidance. OMB Circular A-130, *Management of Federal Information Resources*, and various NIST guidelines describe specific essential criteria for maintaining effective general IT controls. In addition, OMB Circular A-127 prescribes policies and standards for executive departments and agencies to follow in developing, operating, evaluating, and reporting on financial management systems. In addition, we assessed the FLETC financial systems to the Department's own security policies and procedures, such as the DHS *Information Technology Security Program Publication, 4300A.*

Recommendations: We recommend that FLETC management ensure that the following corrective actions are taken:

1. For entity-wide security program planning and management:
   a) Enforce DHS policy to ensure that all contractors go through the appropriate background/suitability check; and

   b) Finalize the IT System Security Awareness and Training and enforce by having all new and existing FLETC users and contractors complete the training.

2. For access control:
   a) Use unique database administrator (DBA) user accounts to allow for accountability when performing DBA duties on Procurement Desktop;

   b) Implement the corrective actions noted in the results of our IT audit's vulnerability scans on the Momentum and PD applications;

   c) Perform periodic scans of the FLETC network environment, including the financial processing environment, for the identification of vulnerabilities, in accordance with NIST SP 800-42;

   d) Implement corrective actions to mitigate the risks associated with any vulnerabilities identified during periodic scans. Configure the Momentum and Procurement Desktop applications to require a password to be a minimum of eight characters in length and contain a combination of alphabetic, numeric, and special characters to be in compliance with DHS Information Technology Security Program Publication, 4300A Password Policy;

   e) Configure the Procurement Desktop to lock out account users after three (3) invalid login attempts to be in compliance with DHS Information Technology Security Program Publication, 4300A;

   f) Develop policies and procedures regarding gaining access to the FLETC Telecom Room, including the use of a user authorization form;

   g) Perform a semi-annual review of the FLETC Telecom Room access listing in compliance with DHS Information Technology Security Program Publication 4300A;

h) Ensure that FLETC Manual 4330: User Identification and Authentication Management is finalized, promulgated to all FLETC employees and enforced;

i) Develop and implement policies and procedures for restricting access to Momentum system software, and promulgate it to all needed personnel, to be in compliance with DHS Information Technology Security Program Publication, 4300A;

j) Develop and implement FLETC specific policies and procedures over the authorization and use of mobile code and VOIP technologies to be in compliance with DHS Information Technology Security Program Publication 4300A; and

k) Develop and implement policies and procedures to proactively monitor sensitive access, via audit log review, to system software utilities for Momentum to be in compliance with DHS Information Technology Security Program Publication, 4300A.

3. For application software development and change control:
   a) Finalize and implement a SDLC methodology for Momentum, as well as incorporating security planning throughout the life cycle;

   b) Develop and implement documented policies and procedures over the Momentum and Procurement Desktop configuration management process modeled after the informal configuration management process currently in place; and

   c) Document a listing of all users with access to the Momentum and Procurement Desktop program libraries. Ensure that access is prohibited to development staff.

4. For system software, enable audit logging over the installation of Momentum's system software and ensure that logs are maintained and periodically reviewed by management.

5. For segregation of duties:
   a) Identify and document incompatible duties and system roles and responsibilities within Momentum; and

   b) Develop and implement policies and procedures segregating incompatible duties within the core financial system to be in compliance with DHS Information Technology Security Program Publication, 4300A.

6. For service continuity:
   a) Periodically test the backup compact discs maintained onsite in compliance with DHS Information Technology Security Program Publication 4300A;

   b) Affix external labels to the backup CDs indicating the distribution limitations and handling caveats of the information in compliance with DHS Information Technology Security Program Publication 4300A; and

   c) Perform a test of the Momentum's contingency plan, in compliance with DHS Information Technology Security Program Publication 4300A.

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Exhibit II – Reportable Conditions

Management's Response: Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings, and its comments were responsive to our recommendations.

I. Federal Financial Management Improvement Act of 1996 (FFMIA)

Background/Criteria: FFMIA requires that an agency's financial management systems substantially comply with Federal financial management system requirements, applicable Federal accounting standards, and the U.S. Standard General Ledger at the transaction level.

Conditions – Federal financial management system requirements: As explained in Exhibit II, FLETC has not complied with/performed:

- The Computer Security Act Requirements in accordance with FISMA, and OMB Circular A-130,
- The documentation requirements for financial management systems and processing instructions in accordance with JFMIP and other applicable requirements,
- The internal control requirements that ensure resource use is consistent with laws, regulations, and policies; resources are safeguarded against waste, loss, and misuse; and reliable data are obtained, maintained, and disclosed in reports,
- The training and user support requirements that should be provided to the users at all levels of the financial systems to enable them to understand, operate, and maintain the systems, and
- The maintenance required to enable the system to continue to operate in an effective and efficient manner.

Conditions – Applicable Federal accounting standards: As explained in more detail in Exhibit II, we noted internal control weaknesses over six significant balance sheet line items that when viewed together represent a general inattention to reporting transactions in accordance with Federal Accounting Standards. Those six instances are presented in more detail in Exhibit II and consist of deficiencies in the following areas:

1. Policies and procedures to ensure completeness, accuracy and valuation of FLETC's estimated environmental liabilities;
2. Policies and procedures to ensure the proper accounting and financial reporting of FLETC's lease transactions;
3. Valuation of operating materials inventories;
4. Capitalization of construction in progress accounts;
5. Lack of a methodology for approximating accounts payable at fiscal year-end; and
6. Lack of a timely reconciliation of deferred revenue accounts.

- In addition, Finance Division personnel generally focus on budgetary considerations, which although very important, must be accompanied by an appropriate recognition of FLETC's financial reporting requirements and adherence to Federal Accounting Standards.
- The Finance Division does not always ensure that other divisions providing information or estimates necessary for financial reporting are properly trained on what information and support is required by GAAP.

Conditions – Compliance with the U.S. Standard General Ledger at the transaction level:

- FLETC is recording a liability in Momentum for received goods and services in general ledger account 2190, other accrued liabilities, rather than account 2110, accounts payable.
- FLETC is not using the disbursements in transit, account 2120, when it processes an invoice for payment. FLETC delays recording the transaction until Treasury confirms that the

Independent Auditors' Report
Exhibit III – Compliance with Laws and Regulations

disbursement has been made, at which time accounts payable, account 1011, and fund balance with Treasury, account 1010, are reduced to reflect the disbursement.

Recommendation: We recommend that FLETC implement the recommendations related to the above conditions as detailed in Exhibits I and II as well as develop a process to ensure FLETC complies with all the provisions of FFMIA.

Management Response: Management has prepared an official response presented as a separate attachment to this report. In summary, management agreed with our findings, and its comments were responsive to our recommendations.

J. Prompt Payment Act

Background/Criteria: In 1982, Congress enacted the Prompt Payment Act (P.L. 97-177) (referred to herein as 'The Act'). The Act, as amended, is found at 31 U.S.C. Chapter 39. The Office of Management and Budget (OMB) included the Prompt Payment Act in OMB Circular A-125, which has since been rescinded and codified in Title 5 part 1315 of the Code of Federal Regulations on September 29, 1999.

The Prompt Payment final rule by OMB (5 CFR 1315) requires Executive Departments and Agencies to pay commercial obligations within a certain time period and to pay interest on payments that are late.

The Prompt Payment standards published in the Federal Register Volume 64, No. 188 section 1315.4, paragraph 4(i), state that "when payments are made after the due date, interest will be paid automatically…" Paragraph (j) further states that payments are to follow good stewardship and cash management practices, and that entities are to make payment "no more than seven days prior to the payment due date."

In determining when a payment is due, 5 CFR §1315.4(b)(1) states that "for the purposes of determining a payment due date and the date on which interest will begin to accrue if a payment is late, an invoice shall be deemed to be received on the later of: the date a proper invoice is actually received by the designated agency office… or the 7th day after the date on which the property is actually delivered." The term "designated agency office," is defined by 5 CFR §1315.2(m) to mean "the office designated by the purchase order, agreement, or contract to first receive and review invoices."

Furthermore, 31 U.S.C. 3902(b) states, "the interest penalty shall be paid for the period beginning on the day after the required payment date and ending on the date on which payment is made." According to 5 CFR 1315, simple interest is to be computed at the interest rate established by the Secretary of the Treasury, and published in the Federal Register which is in effect at the time the agency accrues the obligation to pay a late interest payment.

Conditions:

- FLETC is not calculating and paying interest on all past due invoices. A total of three of 32 sample items selected for testing were paid more than 30 days after the invoice receipt date. Two of the sample items were subject to interest in excess of the $1 de-minimus threshold established under the Prompt Payment Act. However, FLETC did not pay interest on these items.

- FLETC is not consistently annotating invoices with the date and time of receipt by the designated agency office. The date the invoice is received by the designated office is the log date entered into Momentum when the invoice is processed for payment. The Procurement Division does not consistently name the Finance Division as the designated agency office when issuing contracts, purchase orders, or modifications, and Accounting Technicians are not consistently verifying that the designated agency office annotated the invoice with the date and time of receipt. As a result, Accounting Technicians are relying on the date and time annotated by the Finance Division to indicate the date of initial receipt for use in determining the payment date and date on which interest begins to accrue.
- Accounting Technicians are not consistently entering the log date correctly when creating payment vouchers in Momentum Financials Desktop. KPMG noted one instance where an invoice was received and not annotated with a log date. The invoice was subsequently forwarded to the Contracting Officers Representative (COR) for certification. When the COR returned the invoice to the Finance Division, an acceptance date and time was annotated on the document. As a result, the incorrect log date was used when entering information into Momentum Financials Desktop.
- There were two instances where an invoice was received from a vendor and annotated with a log date. The invoices were subsequently forwarded to the COTR for certification. When the COTR returned the invoice to the Finance Division, a second acceptance date and time was annotated on the invoices. When creating the payment voucher in Momentum, the Accounting Technician used the latter of the two dates.
- Accounting Technicians are not consistently entering the acceptance date correctly when creating payment vouchers in Momentum Financials Desktop. KPMG noted two instances where the acceptance date entered in Momentum corresponded to the date the invoice was certified for payment, not the date the COTR indicated the goods were accepted.

Recommendations: We recommend that FLETC management:

- Develop and implement a training requirement for all personnel processing invoices and payments to ensure FLETC's compliance with 5 CFR 1315, the Prompt Payment Act.
- Develop and implement a quarterly review process to examine the documentation supporting payments for proper recording of receipt dates, ensure that dates and payment information are correctly entered into Momentum Financials Desktop, and ensure disbursements are scheduled in accordance with the requirements of the Prompt Payment Act.

Management Response: Management has prepared an official response presented as a separate attachment to this report. In summary, management disagreed with the significance of our findings because it believes that that the size of the audit sample of transactions was relatively small to conclusively determine that FLETC is noncompliant with the requirements of the Prompt Payment Act, the Act.

In addition, Management disagrees with the significance of our finding based on the total interest penalty payments made by FLETC when compared to total FLETC disbursements. Specifically Management believes that if total interest penalty payments are within the 2% interest threshold established by the DHS Office of Financial Management, they should be considered in compliance with the Act.

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Exhibit III – Compliance with Laws and Regulations

Auditors' Response to Management's Response As described above, we tested the attributes of internal controls that help to ensure compliance with the Act. Attribute testing and sample size is addressed in the Government Accountability Office *Financial Auditing Manual,* GAO FAM, Section 460.02. Our sample size was appropriately determined by that guidance.

Our testing of compliance with the Act was based on guidance provided by the GAO FAM that does not base compliance with the Act on an internally generated threshold.

Therefore we continue to believe that the findings as stated above constitute noncompliance with the Act.

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Exhibit IV – Status of Prior Year's Reportable Condition

Prior Year Condition	As Reported at September 30, 2005 (DHS Consolidated Report)	Status as of September 30, 2006 (FLETC Stand-Alone Balance Sheet Only Report)
Capital Leases	**Material Weakness:** FLETC had not properly classified as capital leases three build–to–lease dormitories.	**Continues as a Material Weakness:** FLETC reclassified the improperly recorded contingent lease liability to the appropriate capital lease liability account and corrected the accompanying misstatements of imputed interest, accumulated depreciation, depreciation, lease liability outstanding, and cumulative results of operations. This finding is reported as a material weakness in Exhibit I of this report.

Federal Law Enforcement Training Center
U. S. Department of Homeland Security
1131 Chapel Crossing Road
Glynco, Georgia 31524

Homeland
Security

January 8, 2007

KPMG LLP
Attn: Elizabeth Hacquard
2001 M Street, NW
Washington, DC 20036

Ladies and Gentlemen:

We are providing this letter in connection with your audit of the Federal Law Enforcement Training Center's (FLETC) consolidated balance sheet as of September 30, 2006, and the related Independent Auditors' Report. In response to the findings, our concurrence or nonconcurrence is as follows:

Exhibit I – Material Weaknesses

A. Financial Reporting – We concur with this finding.

B. Environmental Cleanup Costs – We concur with this finding.

C. Capital Lease Liabilities – We do not concur with this finding as described.

We agree that the *Cause/Effect* was an initial result of no formalized procedures that required FLETC's Procurement Division to consult with the Budget and Finance Division prior to entering into lease transactions. However, the misclassification as a contingent liability was a subsequent effect due to the fiscal year 2002 audit by other independent public auditors. When the issue was raised in 2002, FLETC requested an OMB review, and reported the contingent liability with the intention of it being a temporary classification until an OMB determination was rendered. That determination remains with OMB currently.

The *Recommendations* were implemented back in October 2002 as a result of the prior audit.

D. Valuation of Inventories – We concur with this finding.

E. Construction in Progress – We concur with this finding.

F. Accounts Payable – We concur with this finding.

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Exhibit II – Reportable Conditions

A. Deferred Revenue – We concur with this finding.

B. Financial Systems Security – We concur with this finding.

Exhibit III – Compliance with Laws and Regulations

A. FFMIA – We concur with this finding.

B. Prompt Pay Act – We do not concur with this finding.

The audit team's sample size of 32 documents drawn from an overall population of 21,600 vendor invoices subject to the Prompt Payment Act in FY 2006 is relatively small to conclusively determine that FLETC is noncompliant with the requirements of the Act.

FLETC's total interest penalty payment in FY 2006 is $15,422, which is negligible when compared to the total disbursements of $200M. Even if the interest penalty payment is multiplied 260 times, FLETC is still within the 2% penalty interest threshold established by DHS OFM to measure the timely payment of invoices.

FLETC will continue to train its staff and emphasize the importance of the Prompt Payment Act procedures in processing invoices. The formalized training process is well-documented in the Finance Division Accounts Payable standard operating procedures.

Additionally, invoices subject to the Act will be sampled on a quarterly basis by the FIN internal control staff.

Exhibit IV – Status of Prior Year's Reportable Condition

Capital Leases – We concur with this finding.

Sincerely,

Julie Martin
Deputy Chief Financial Officer
Federal Law Enforcement Training Center

Consolidated Balance Sheet

Department of Homeland Security

FEDERAL LAW ENFORCEMENT TRAINING CENTER
CONSOLIDATED BALANCE SHEET
As of September 30, 2006
(In Thousands)

ASSETS	
Intragovernmental assets	
Fund balance with Treasury (Note 3)	$ 202,290
Accounts receivable, net (Note 5)	14,838
Other (Note 6)	397
Total intragovernmental assets	217,525
Cash (Note 4)	27
Accounts receivable, net (Note 5)	1,280
Property, plant and equipment, net (Note 7)	409,955
TOTAL ASSETS	**$ 628,787**
LIABILITIES	
Intragovernmental Liabilities	
Other (Note 10)	$ 2,995
Total Intragovernmental Liabilities	2,995
Accounts Payable	2,982
Deferred Revenue	215
Accrued Payroll and Benefits	23,606
Environmental Clean-Up Liability (Note 9)	11,197
Capital Lease Liability (Note 11)	61,153
Other (Note 10)	14,753
TOTAL LIABILITIES	**$ 116,901**
NET POSITION	
Unexpended Appropriations	$ 197,114
Cumulative Results of Operations	314,772
TOTAL NET POSITION	**$ 511,886**
TOTAL LIABILITIES AND NET POSITION	**$ 628,787**

Notes to the Consolidated Balance Sheet

Note 1: Summary of Significant Accounting Policies

A. REPORTING ENTITY

The Federal Law Enforcement Training Center (FLETC), a component of the U.S. Department of Homeland Security (DHS), serves as an interagency law enforcement training center. The FLETC provides facilities, equipment, and support services for conducting law enforcement training for Federal agencies and specialized programs for State and local agencies and foreign governments. The FLETC was established on July 1, 1970, by Treasury Department Order No. 217, as an organizational entity within the Department of the Treasury. The FLETC was transferred from Treasury to the DHS on March 1, 2003, as an entity within the Directorate of Border and Transportation Security by the Homeland Security Act of 2002 (P.L. 107-296). Training sites and offices include Glynco, Georgia; Artesia, New Mexico; Washington, DC; Charleston, South Carolina; and Cheltenham, Maryland. Also, the FLETC conducts training in four International Law Enforcement Academies (ILEA) located in Budapest, Hungary; Bangkok, Thailand; Gaborone, Botswana; and San Salvador, El Salvador. The programs and operations of the FLETC are funded principally through Congressional appropriations on an annual, multi-year, and no-year basis. Accordingly, operating costs incurred and recorded as expenses are funded through either appropriated funds, reimbursable agreements or other financing sources.

B. BASIS OF ACCOUNTING AND PRESENTATION

The financial information presented is a consolidated balance sheet only, as of September 30, 2006. The consolidated balance sheet has been prepared from the accounting records of the FLETC in conformity with U.S. generally accepted accounting principles (GAAP), based on accounting standards issued by the Federal Accounting Standards Advisory Board, and with the Office of Management and Budget (OMB) Circular A-136, Financial Reporting Requirements. Under GAAP, as a general rule, revenues and related assets are recognized when earned, and expenses and related liabilities are recognized when incurred.

The consolidated balance sheet should be read with the realization that it is for a component of a sovereign entity, that liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation and that payment of liabilities other than for contracts can be abrogated by the sovereign entity.

C. ASSETS AND LIABILITIES

Entity intra-governmental assets and liabilities result from activity with other Federal agencies. All other entity assets and liabilities result from activity with parties outside the Federal government, such as domestic and foreign persons, organizations, or governments outside the U.S. Government. Assets represent tangible items that have probable economic benefits that can be obtained or controlled by the FLETC. Liabilities represent the amount of monies or other resources that are likely to be paid as a result of a transaction or event that has already occurred. However, no liability can be paid absent an appropriation. Liabilities for which an appropriation has not been enacted are, therefore, classified as Liabilities not covered by Budgetary Resources. Although future appropriations to fund the liabilities are likely and anticipated, it is not certain that appropriations will be enacted to fund these liabilities. Also, liabilities arising from other than contracts can be abrogated by the Government, acting in its sovereign capacity.

D. FUND BALANCES WITH TREASURY

Fund balances with Treasury represent funds available to pay liabilities and finance authorized expenditures.

E. ACCOUNTS RECEIVABLE AND RELATED ALLOWANCES FOR UNCOLLECTIBLE AMOUNTS

Outstanding billed reimbursable costs for goods and services provided to other Federal agencies and state and local governments comprise the majority of accounts receivable. The FLETC uses the allowance method for recognizing bad debt expense on state and local government accounts receivable. No allowance is recorded for accounts receivable from Federal agencies as these amounts are considered fully collectible.

F. OTHER INTRAGOVERNMENTAL ASSETS

Other intragovernmental assets consist of prior fiscal years governmental advances to the legacy Department of the Treasury Working Capital Fund (WCF) for expenses of operating and maintaining common administrative services of Treasury provided to the FLETC prior to its transfer to DHS. In accordance with the established Treasury WCF procedures, funds for services were collected in advance and expended as services were provided by the WCF. The FLETC expects the WCF to refund these advances.

G. OPERATING MATERIALS AND SUPPLIES

Operating materials and supplies (OM&S) are tangible personal property consumed in normal operations. In FY 2006, the FLETC implemented a change in accounting principle for the accounting of its OM&S. Prior to FY 2006, a financial resource was recognized when title passed to the FLETC, or goods were in the FLETC's possession. At the time the goods were used in the provision of a service, the asset was removed from the account. In FY 2006, the FLETC began applying the purchase method which provides that OM&S be expensed when purchased. The purchase method was adopted because it is not cost-beneficial to apply the consumption method, an allowable exception to using the consumption method. The effect of the adoption was a decrease of $8 million to the OM&S asset account and to the beginning cumulative results of operations (CRO) balance.

H. PROPERTY, PLANT, AND EQUIPMENT

The FLETC capitalizes property, plant, and equipment (PP&E) with an acquisition value of $50,000 or greater. Major alterations and renovations are also capitalized, while minor equipment costs are charged to expenses as incurred. Property and equipment transferred to the FLETC from the Department of Defense on the date that the FLETC relocated to Glynco, as well as the turnover of Cheltenham, Maryland and Charleston, South Carolina facilities are recorded at the net book value at the date they were transferred to the FLETC. There are no restrictions on the use or convertibility of general PP&E.

Depreciation is calculated on a straight-line basis over estimated useful lives ranging from five to thirty years, once the asset has been placed in service. Land is not depreciated. Buildings acquired under capital leases are amortized over the lease term. Routine repairs and maintenance are expensed as incurred.

The FLETC also capitalizes its internal use software. Internal use software includes purchased commercial off-the-shelf software (COTS), internally developed, or contractor-developed. For

COTS, the FLETC capitalizes the amount paid to the vendor for the software. For contractor developed software, the capitalized costs include the amount paid to a contractor to design, program, install and implement the software. Capitalized costs for internally developed software include the full costs (direct and indirect costs) incurred during the software development phase. Amortization of the capitalized software is calculated using the straight-line method beginning on the date of acquisition, if purchased, or the when successfully tested and placed in use, if developed.

I. ACCRUED PAYROLL AND OTHER BENEFITS

Accrued payroll and other benefits include annual leave, compensatory time, and other leave time. The accrual for these items represents the leave time earned by the FLETC employees but not taken as of the fiscal year end, and is computed using current compensation rates. Sick leave is not accrued when earned, but is expensed when taken as employees do not get paid for unused sick time upon separation from the organization.

J. PENSION COSTS AND OTHER RETIREMENT BENEFITS

The FLETC recognizes the full annual cost of its civilian employees' pension benefits; however, the assets of the plan and liability associated with these costs are recognized by the Office of Personnel Management (OPM) rather than the FLETC.

In general, employees hired prior to January 1, 1984, participate in the Civil Service Retirement System (CSRS), while employees hired after that date participate in the Federal Employees' Retirement System (FERS). The FLETC and its employees contribute to the retirement plan at a certain percent of base pay as provided by the OPM. The cost of providing these benefits by OPM is more than the amount contributed by the FLETC and its employees. The difference between the full annual cost of CSRS and FERS retirement plans and the amount paid by the FLETC is recorded as an imputed cost on the FLETC's Statement of Net Costs, and also as an offsetting imputed financing source in the FLETC's Statement of Net Position.

Similar to the retirement plans, the OPM, not the FLETC, reports the liability for future payments to retired employees who participate in the Federal Employees Health Benefits Program (FEHB) and the Federal Employees Group Life Insurance Program (FEGLI). The full cost of these benefits, however, is recorded in the FLETC's financial statements with an offsetting imputed financing source.

K. FEDERAL EMPLOYEE BENEFITS PAYABLE – FECA ACTUARIAL LIABILITY

The Federal Employees Compensation Act (FECA) program is administered by the U.S. Department of Labor (DOL) and provides income and medical cost protection to covered Federal civilian employees who have been injured on the job or have incurred a work-related occupational disease. Beneficiaries of employees whose death is attributable to a job-related injury or occupational disease receive compensation. The DOL initially pays valid FECA claims for all of the Federal government and seeks reimbursement two fiscal years later from the Federal agencies employing the claimants. Estimated future FECA costs are determined by the DOL for the DHS, which in turn, allocates to the FLETC actuarial liabilities not covered by budgetary resources. This governmental liability is determined by using the paid losses extrapolation method calculated over the next 37-year period. This method utilizes historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period.

L. LITIGATION CONTINGENCIES AND SETTLEMENTS

Probable and estimable unsettled litigation and claims against the FLETC are recognized as a liability and expensed for the full amount of the expected loss. Expected litigation and claim losses include settlements to be paid from the Treasury Judgment Fund on behalf of the FLETC and settlements to be paid from the FLETC appropriations. Settlements to be paid from the Judgment Fund for the FLETC are recognized as an expense and imputed financing.

M. ENVIRONMENTAL LIABILITY

Cleanup costs, which are the costs of removing, containing and/or disposing of hazardous waste, represent an environmental liability. At September 30, 2006, the FLETC has recorded an accrual for the estimated total cleanup costs associated with its firearms ranges. Based on new accounting guidance to be adopted in FY 2007, future liability estimates will include cleanup costs of buildings containing friable and non-friable asbestos. Cost estimates are subject to revision as a result of changes in technology, environmental laws and regulations, inflation and plans for remediation. Any changes in the estimated total cleanup costs will be expensed when re-estimates occur and the liability balance is adjusted.

N. EARMARKED FUNDS AND ADOPTION OF A NEW ACCOUNTING STANDARD

The FLETC has adopted SFFAS No. 27. Identifying and Reporting Earmarked Funds. Earmarked funds are financed by specifically identified revenues and are required by statute to be used for designated activities or purposes.

Earmarked non-exchange revenue and other financing sources, including appropriations and net cost of operations, are shown separately on the Statement of Changes in Net Position. The portion of cumulative results of operations attributable to earmarked funds is shown separately

on both the Statements of Changes in Net Position and the Balance Sheets. The FLETC has only one earmarked fund of less than $500 in FY 2006. Due to the immaterial balance, it is not separately reported as of September 30, 2006.

O. REVENUES AND FINANCING SOURCES

The FLETC receives the majority of its funding through annual, multi-year, no-year, and trust fund appropriations that may be used within statutory limits for operating and capital expenditures. Appropriations are recognized as financing sources when the related expenses are incurred. The FLETC enters into reimbursable agreements with the Department of Homeland Security and other Federal entities for services or goods provided. Under these arrangements, one entity provides goods or services to another at an agreed-upon price, and revenue from reimbursable agreements is recognized when the services are provided. Other minor financing sources include gifts and transfers from the Department of Justice's Violent Crime Reduction Trust Fund.

P. IMPUTED COSTS/FINANCING SOURCES

The FLETC often receives goods and services from other Federal Government entities without reimbursing the providing entity for all related goods. These are subsidized costs that are recognized as imputed costs by the FLETC. Conversely, the FLETC often incurs costs that are partially or totally paid for by other entities. These are recorded as imputed financing sources. The FLETC recognizes both imputed costs and financing sources to the extent directed by the OMB and DHS. The FLETC started recording intra-departmental imputed costs for law enforcement instructors detailed from the other DHS bureaus in Fiscal Year (FY) 2005.

Q. TAX STATUS

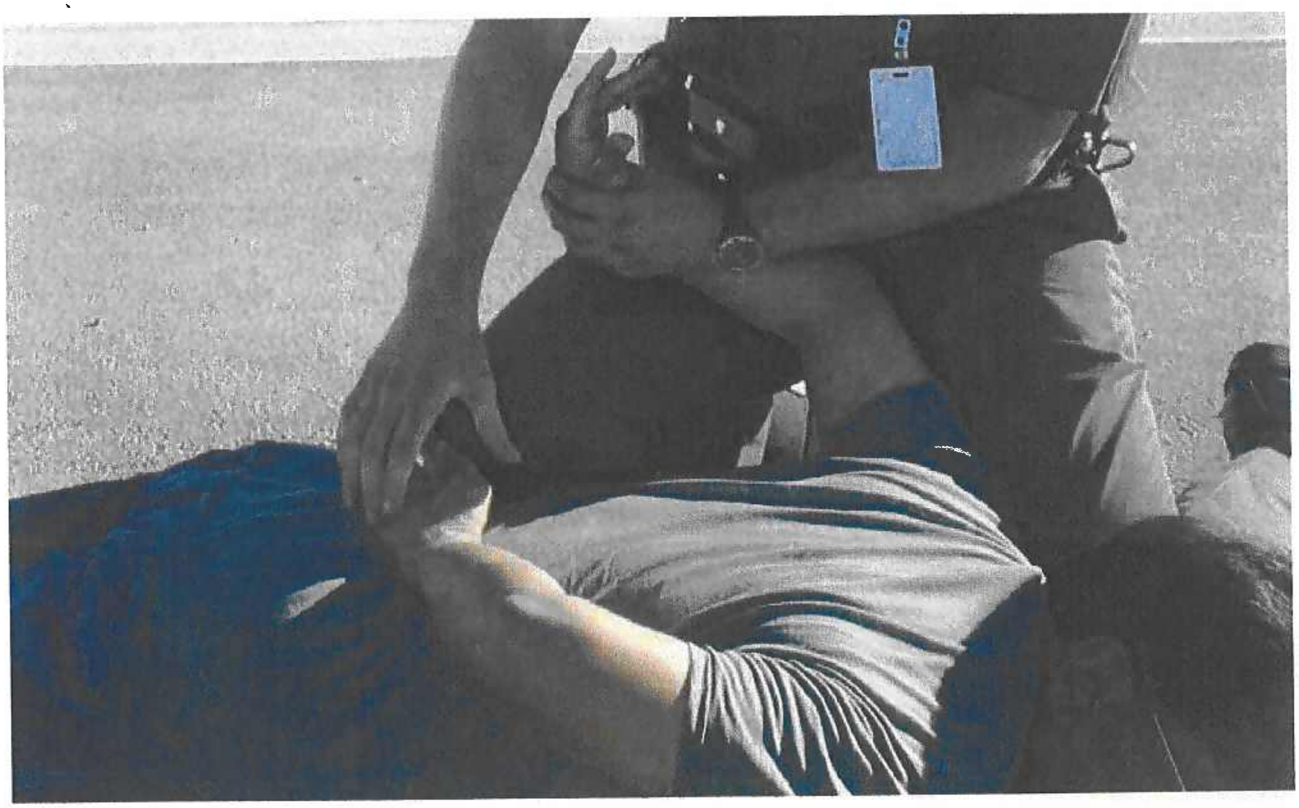
The FLETC is a Federal entity, and therefore is not subject to Federal, state or local income taxes. Accordingly, no liability for income taxes is required in the accompanying balance sheet.

R. USE OF ESTIMATES

The preparation of the financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from these estimates. Useful lives of fixed assets, allowance for doubtful accounts related to accounts receivable, likelihood of outcomes related to contingent liabilities and the actuarial estimates associated with the FECA liabilities are estimates that have the most significant impact on the accompanying balance sheet.

Note 2: Non-Entity Assets

There are no non-entity assets as of September 30, 2006. All assets are entity assets of the FLETC.



Note 3: Fund Balance with Treasury

A. Fund Balances as of September 30, 2006 (in thousands):

Fund Type	
Trust Funds	$ -
Appropriated Funds	201,838
Other Fund Types	452
Total	$ 202,290

Trust fund balances are comprised of gifts and transfers from the Department of Justice's Violent Crime Reduction Trust Fund. At September 30, 2006 trust fund balances are nominal. Other fund balances result from the FLETC's authority to use the proceeds from the sale of surplus items and recyclable materials to purchase like-items. If these funds are not used for this restricted purpose within two years, the FLETC is required to transfer the funds to the Department of Treasury.

B. Status of Fund Balance with Treasury as of September 30, 2006 (in thousands):

Status	
Unobligated balance	
Available	$ 73,193
Unavailable	16,662
Obligated balance not yet disbursed	111,983
Restricted unobligated balance - Deposit funds	452
Total	$ 202,290

Note 4: Cash

The cash amount totaling $27 thousand as of September 30, 2006 represents collections on hand, not yet deposited.

Note 5: Accounts Receivable, Net

A. Intragovernmental Accounts Receivable

Intragovernmental accounts receivable due from other Federal agencies as of September 30, 2006, total $14.8 million, and are considered fully collectible.

B. Public Accounts Receivable

Receivables due from the public are recognized for law enforcement training provided to state, local and foreign governments. As of September 30, 2006, receivables from the public total $1.3 million, net of an allowance for doubtful accounts totaling $45 thousand. The allowance for estimated uncollectible accounts receivable due from the public is determined by using the Percentage Analysis Method. The Percentage Analysis Method derives an estimated percentage of uncollectible accounts receivable by account type that is based on the experience of collecting past due accounts. The Specific Identification Method is used when actual uncollectible amounts of receivables are known.

Note 6: Other Assets

Other intragovernmental assets are comprised of $0.4 million as of September 30, 2006 for advances paid to the legacy Department of the Treasury Working Capital Fund. The balances are expected to be refunded from the Treasury.

Note 7: General Property, Plant, and Equipment, Net

Property, plant, and equipment (PP&E) consists of the following as of September 30, 2006 (in thousands):

Category	Service Life (Years)	Acquisition Cost 2006	Accumulated Depreciation/Amortization 2006	Net Book Value 2006
Land and Land Rights	N/A	$ 4,077	$ -	$ 4,077
Construction in Progress	N/A	48,059	-	48,059
Buildings, Structures, and Facilities	20-30	404,112	107,850	296,262
Equipment:				
ADP	5	257	257	0
Vehicles	5-8	5,979	3,517	2,462
Other Equipment	5	3,767	3,223	544
Assets Under Capital Lease	20	68,164	11,937	56,227
Internally Developed Software	N/A	2,324	-	2,324
Total Property, Plant and Equipment		**$ 536,739**	**$ 126,784**	**$ 409,955**

Note 8: Liabilities Not Covered By Budgetary Resources

Property, plant, and equipment (PP&E) consists of the following as of September 30, 2006 (in thousands):

Intragovernmental:	
Unfunded FECA liability	$ 2,991
Total Intragovernmental Not Covered	2,991
Public:	
Accrued payroll and benefits	18,552
Accrued cleanup cost liability	11,197
Capital lease liability	61,153
Contingent liabilities	350
Total Public Not Covered	91,252
Total Liabilities Not Covered by Budgetary Resources	$ 94,243
Total Liabilities Covered by Budgetary Resources	$ 22,658
Total Liabilities	$ 116,901

The FLETC anticipates that the liabilities not covered by budgetary resources will be funded from future budgetary resources when required.

Note 9: Environmental Clean-Up Liability

The FLETC is responsible to clean up its sites with environmental contamination based on compliance with Federal, state and/or local environmental laws and regulations. The primary Federal laws associated with environmental clean up are the Comprehensive Environmental Response, Compensation, and Liability Act and the Resource Conservation and Recovery Act.

The FLETC has recorded $11.2 million for environmental cleanup cost liability as of September 30, 2006. The amount represents the total estimated cleanup costs for thirty-four firing ranges (19 in Artesia, NM; 6 in Charleston, SC; 1 in Cheltenham, MD and 8 in Glynco, GA). Currently, there are no plans to close or clean up the ranges; however, the estimated costs of future cleanup represent a liability for financial reporting purposes. Included in the September 2006 amount is a $7 thousand balance from actual cleanup of four Glynco outdoor firearms ranges completed in FY 2005. The FLETC is waiting for State of Georgia environmental regulators to approve the completed cleanup of the four ranges and formally close the project. The requirements for the Glynco firearms ranges are governed by the State of Georgia Hazardous Waste Management Act (O.C.G.A. Section 12.8.60).

In addition to the contamination associated with the firearms ranges, the FLETC is responsible to clean up its buildings that contain asbestos and/or lead-based paints, in accordance with applicable laws. As of September 30, 2006, no buildings contained friable asbestos and there were no plans to dispose of or clean up any buildings. Therefore, no liability was recorded for financial reporting purposes. Next year, however, the FLETC will adopt new accounting guidance that will require the recording of a liability for both friable and non-friable asbestos cleanup costs that are both probable and reasonably estimable. The FLETC will perform an environmental study in FY 2007 to determine cost estimates.

The estimated costs recognized as of September 30, 2006 are based on the most current information on prior experience as well as environmental studies, but will be monitored on an ongoing basis. Cost estimates are subject to revision as a result of changes in technology, environmental laws and regulations, inflation and plans for remediation. Any changes in the estimated total cleanup costs will be expensed when re-estimates occur and the liability balance adjusted.

Note 10: Other Liabilities

Other liabilities are as follows as of September 30, 2006 (in thousands):

	2006		
	Non-Current	Current	Total
Intragovernmental:			
Unfunded FECA liability	$ 2,991	$ -	$ 2,991
Employee benefits contributions and payroll taxes	-	4	4
Total Other Intragovernmental	2,991	4	2,995
Public:			
Capital lease liability	58,895	2,258	61,153
Contingent liabilities	350		350
Accrued cleanup cost liability	11,197	-	11,197
Other accrued liabilities	-	14,403	14,403
Total Other Nongovernmental Liabilities	$ 70,442	$ 16,661	$ 87,103

Other accrued liabilities represent primarily accruals for goods and services received, but unbilled at year-end.

Contingent Liabilities:

The FLETC is involved in various administrative proceedings incidental to its operations. The estimated contingent liability recorded at September 30, 2006 is $350 thousand. Other claims for which loss probability is reasonably possible is estimated as $200 thousand. Management vigorously contests all claims and lawsuits.

Note 11: Leases

A. FLETC as a Lessee

Capital Leases:
In FY 2001 and FY 2002, the FLETC entered into 20-year leases for the construction and operation of three private, hotel-type facilities to meet an urgent need for additional law enforcement student housing. At September 30, 2006, the FLETC has recorded the remaining net present value of the net lease payments for the three facilities as a capital lease liability. The minimum lease payments are being allocated between the reduction of the capital lease liability and interest expense. The unamortized capital lease liability is $61.2 million.

Summary of Assets Under a Capital Lease (in thousands):

	2006
Land and Buildings	$68,164
Accumulated Amortization	(11,938)
Net Assets Under a Capital Lease	$56,226

Future Payments Due:

Fiscal Year	Building
2007	$ 6,103
2008	6,103
2009	6,103
2010	6,103
2011	6,103
Beyond 2011	69,903
Total Future Lease Payments	$ 100,418
Less: Imputed Interest	(34,972)
Less: Executory Costs	(4,293)
Net Capital Lease Liability	$ 61,153

Lease liabilities covered by budgetary resources	$ -
Lease liabilities not covered by budgetary resources	$61,153

Operating Leases:

The FLETC leases various properties that are accounted for as operating leases, including an office space in Washington, DC that is leased from the General Services Administration (GSA). The GSA-leased equipment consists of various vehicles used for training. The non-GSA leases consist of office equipment such as copiers and postage meters. Lease arrangements are normal business practices by the GSA and commercial vendors as stipulated in the applicable GSA Federal supply schedule contracts. The future lease payments under the current non-cancellable leases are as follows (in thousands):

Future Payments Due:

	Asset Category			
Fiscal Year	GSA-Leased Building	GSA-Leased Equipment	Non-GSA Leased Equipment	Totals
2007	$ 233	$ 1,037	$ 549	$ 1,819
2008	234	1,037	518	1,789
2009	234	1,037	23	1,294
2010	234	1,037	18	1,289
2011	234	1,037	-	1,271
Beyond 2011	1,168	5,185	-	6,353
Total Future Lease Payments	$ 2,337	$ 10,370	$ 1,108	$ 13,815

B. FLETC as a Lessor

The FLETC purchased a 20-acre parcel of real property in Brunswick, Georgia, in FY 2003, that has an irrevocable 50-year lease for a communications tower by SBA Properties, Inc. The lease is for an initial term of five years and renews up to ten additional terms of five years each, unless the lessee notifies the FLETC of its intent of non-renewal. The lease receipt for the first five years is $800 monthly or $9,600 annually and increases by 15% with the sixth year and every fifth year thereafter. The lease receipts are miscellaneous revenues in the FLETC Custodial Account and deposited to the Treasury General Fund (in thousands):

Future Projected Receipts:

Fiscal Year	Communication Tower
2007	$ 10
2008	11
2009	11
2010	11
2011	11
Beyond 2011	44
Total Future Lease Payments	$ 98

Required Supplementary Information (Unaudited)

DEFERRED MAINTENANCE

The FLETC performs maintenance on its facilities. Maintenance includes preventive maintenance, normal repairs, replacement of parts and structural components, and other activities needed to preserve the asset so that it continues to provide acceptable services and achieves its expected life.

Deferred maintenance is maintenance that was not performed when it should have been or was scheduled to be and which, therefore, is put off or delayed for a future period. The chart below presents information on the FLETC's deferred maintenance. The information is measured by condition assessment survey, which includes periodic inspections of PP&E.

	Asset Condition /1. (check all applicable box with "x")			(Dollars in thousands) Deferred Maintenance Estimated Range	
Asset Category	Good	Fair	Poor	Low	High
Buildings, Structures, and Facilities	x	x	-	$40,747	$45,036
Equipment - Vehicles and Vessels	x	x	-	$0	$0
Equipment - Other	x	x	-	$0	$0
Stewardship/Heritage Assets				$0	$0
Total				**$40,747**	**$45,036**

/1. Asset Condition

Good. Facility/equipment condition meets established maintenance standards, operates efficiently, and has a normal life expectancy. Scheduled maintenance should be sufficient to maintain the current condition, and there is no deferred maintenance on assets in good condition.

Fair. Facility/equipment condition meets minimum maintenance standards, but requires additional maintenance or repair to prevent further deterioration, increase operating efficiency, and to achieve normal life expectancy.
Deferred maintenance may need to be recognized.

Poor. Facility/equipment does not meet most maintenance standards and requires frequent repairs to prevent accelerated deterioration and provide a minimal level of operating function. In some cases, this includes condemned or failed facilities.

Department of Homeland Security

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Deputy Secretary
Chief of Staff
Deputy Chief of Staff
General Counsel
Executive Secretary
Under Secretary, Management
Chief Financial Officer
Chief Information Officer
Director, Federal Law Enforcement Training Center
Assistant Secretary for Policy
Assistant Secretary for Public Affairs
Assistant Secretary for Legislative and Intergovernmental Affairs
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GAO/OIG Liaison

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DHS OIG Program Examiner

Congress

Committee on Homeland Security and Governmental Affairs
United States Senate

Committee on Homeland Security
United States House of Representatives

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