

**DEPARTMENT OF HOMELAND SECURITY**  
**Office of Inspector General**

**Independent Auditors' Report On  
DHS' FY 2006 Financial Statements**



**(Excerpts from the DHS Performance  
and Accountability Report)**



Homeland  
Security

November 15, 2006

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 prepared as part of our oversight responsibilities to promote economy, efficiency, and effectiveness within the department.

The attached report represents Financial Information Part III excerpted from DHS' *Performance and Accountability Report* (PAR) and the results of the DHS financial statement audits for fiscal year FY 2006 and FY 2005. 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 was unable to provide an opinion on DHS' balance sheet as of September 30, 2006 and 2005. The FY 2006 auditors' report discusses 10 material weaknesses, 2 other reportable conditions in internal control, and instances of noncompliance with 8 laws and regulations. KPMG is responsible for the attached auditor's report dated November 15, 2006, and the conclusions expressed in the report. We do not express opinions on DHS' financial statements 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.

A handwritten signature in cursive script that reads "Richard L. Skinner".

Richard L. Skinner  
Inspector General

**U.S. DEPARTMENT OF HOMELAND SECURITY**

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

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**Homeland  
Security**

November 15, 2006

MEMORANDUM FOR: The Honorable Michael Chertoff  
Secretary

FROM:   
Richard L. Skinner  
Inspector General

SUBJECT: Independent Auditors' Report on DHS' FY 2006 Balance Sheet and  
Statement of Custodial Activity

The attached report presents the results of the Department of Homeland Security's financial statement audits for fiscal year FY 2006 and FY 2005. These audits were required by the *Chief Financial Officers Act of 1990*. This report is incorporated into the *Department's FY 2006 Performance and Accountability Report*. We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the audits.

The department made some progress at the component level to improve financial reporting during FY 2006, although overall it still has much work remaining. For the third year, KPMG was unable to provide an opinion on the department's balance sheet, and the number of material weaknesses remains at 10.

### **Summary**

KPMG was unable to express an opinion on the department's balance sheets as of September 30, 2006 and 2005, and on the statement of custodial activity for the year ended September 30, 2006. The disclaimer of opinion was due primarily to financial reporting problems at 4 bureaus and at the department level. The FY 2006 auditors' report discusses 10 material weaknesses, 2 other reportable conditions in internal control, and instances of non-compliance with 8 laws and regulations, as follows:

#### **Reportable Conditions That Are Considered To Be Material Weaknesses**

- A. Financial Management and Oversight (Entity-level Controls)
- B. Financial Reporting
- C. Financial Systems Security
- D. Fund Balance with Treasury
- E. Property, Plant, and Equipment

- F. Operating Materials and Supplies
- G. Legal and Other Liabilities
- H. Actuarial Liabilities
- I. Budgetary Accounting
- J. Intragovernmental Balances

**Other Reportable Conditions**

- K. Environmental Liabilities
- L. Custodial Revenue and Drawback

**Non-compliance with Laws And Regulations**

- M. Federal Managers' Financial Integrity Act of 1982 (FMFIA)
- N. Federal Financial Management Improvement Act of 1996 (FFMIA)
- O. Federal Information Security Management Act of 2002
- P. Single Audit Act Amendments of 1996, and Laws and Regulations Supporting OMB Circular No. A-50, Audit Follow-up, as revised
- Q. Improper Payments Information Act of 2002
- R. Chief Financial Officers Act of 1990
- S. Government Performance and Results Act of 1993
- T. Debt Collection Improvement Act of 1996

**Moving DHS' Financial Management Forward**

In FY 2006, the department gained new leadership in financial management with the confirmation of a Presidentially appointed Chief Financial Officer. However, the department continued to struggle with financial reporting during FY 2006. The Office of Financial Management, Coast Guard, TSA, Federal Emergency Management Agency (FEMA), Immigration and Customs Enforcement (ICE), and Management Directorate were unable to provide sufficient evidence to support account balances presented in the financial statements and collectively contributed to the auditors' inability to render an opinion. Further, DHS management and three of its major components (Coast Guard, TSA, and ICE) were unable to represent that the financial statements were presented in conformity with U.S. generally accepted accounting principles.

At the component level, there was some progress in addressing internal control weaknesses. ICE achieved the greatest improvement in financial management and reporting in FY 2006. Contributing to 10 material weaknesses in FY 2005, it contributed to only 1 material weakness in FY 2006. ICE mitigated the severity of its material weaknesses through corrective actions implemented during 2006, but has not completely resolved its internal control problems.

The Coast Guard began FY 2006 with a focus on financial management oversight, financial reporting, and fund balance with Treasury. Unfortunately, progress has been slow and the auditors again reported that the Coast Guard did not have an organizational structure that fully supported the development and implementation of effective policies, procedures, and internal controls. Management officials within the Coast Guard acknowledged to the auditors that longstanding procedural, control, personnel, and cultural issues existed and had impeded their progress in installing an effective financial management structure. The auditors reported that the Coast Guard's

personnel rotation policy, among other issues, made it difficult for the Coast Guard's Chief Financial Officer to institutionalize internal controls related to financial management and reporting.

Many of the department's difficulties in financial management and reporting can be attributed to the original stand-up of a large, new, and complex executive branch agency without adequate organizational expertise in financial management and accounting. The department has recently committed to obtaining additional human resources and other critical infrastructure necessary to develop reliable financial processes, policies, procedures, and internal controls that will enable management to represent that financial statements are complete and accurate. These resources and infrastructure are critical to the implementation of effective corrective actions and to establishing an effective financial management oversight function. During the past year, the department and its components began an extensive effort to develop meaningful corrective action plans to address specific material internal control weaknesses. We are evaluating the effectiveness of those corrective action plans in a separate series of audits.

\* \* \* \* \*

KPMG is responsible for the attached independent auditor's report dated November 15, 2006, and the conclusions expressed in the report. We do not express opinions on the financial statements 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 public website.

We requested that each of the department's financial officers provide us with a corrective action plan that demonstrates their progress in addressing the report's recommendations.

We appreciate the cooperation extended to the auditors by the department's financial offices. Should you have any questions, please call me, or your staff may 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

Secretary and Inspector General  
U.S. Department of Homeland Security:

We were engaged to audit the accompanying balance sheets of the U.S. Department of Homeland Security (DHS) as of September 30, 2006 and 2005, and the related statement of custodial activity for the year ended September 30, 2006 (referred to herein as "financial statements"). In connection with our fiscal year 2006 audit, we also considered DHS' internal controls over financial reporting, Required Supplemental Stewardship Information (RSSI), and performance measures, and DHS' compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on these financial statements. We were not engaged to audit the accompanying statements of net cost, changes in net position, budgetary resources, and financing, for the years ended September 30, 2006 and 2005, or the statement of custodial activity for the year ended September 30, 2005 (referred to herein as "other fiscal year 2006 and 2005 financial statements").

### Summary

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the DHS balance sheets as of September 30, 2006 and 2005, or the related statement of custodial activity for the year ended September 30, 2006.

Our report indicates that DHS adopted new reporting requirements for earmarked funds in fiscal year 2006.

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

- A. Financial Management and Oversight (Entity-level Controls)
- B. Financial Reporting
- C. Financial Systems Security
- D. Fund Balance with Treasury
- E. Property, Plant, and Equipment
- F. Operating Materials and Supplies
- G. Legal and Other Liabilities
- H. Actuarial Liabilities
- I. Budgetary Accounting
- J. Intragovernmental Balances
- K. Environmental Liabilities
- L. Custodial Revenue and Drawback

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

The results of our tests of compliance with certain provisions of laws, regulations, contracts, and grant 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*:

- M. *Federal Managers' Financial Integrity Act of 1982*



- N. *Federal Financial Management Improvement Act of 1996 (FFMIA)*
- O. *Federal Information Security Management Act of 2002*
- P. *Single Audit Act Amendments of 1996*, and Laws and Regulations Supporting OMB Circular No. A-50, *Audit Follow-up* (as revised)
- Q. *Improper Payments Information Act of 2002*
- R. *Chief Financial Officers Act of 1990*
- S. *Government Performance and Results Act of 1993*
- T. *Debt Collection Improvement Act of 1996*

We also reported other matters related to compliance with the *Anti-deficiency Act* at Transportation Security Administration (TSA) and the Federal Law Enforcement Training Center (FLETC).

Other internal control matters and other instances of non-compliance may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS balance sheets as of September 30, 2006 and 2005, and the related statement of custodial activity for the year ended September 30, 2006, and had we been engaged to audit the other fiscal year 2006 and 2005 financial statements.

The following sections discuss the reasons why we are unable to express an opinion on the accompanying DHS balance sheets as of September 30, 2006 and 2005, and on the statement of custodial activity for the year ended September 30, 2006; our consideration of DHS' internal controls over financial reporting, RSSI, and performance measures; our tests of DHS' compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements and other matters; and management's and our responsibilities.

### **Report on the Financial Statements**

We were engaged to audit the accompanying balance sheets of the U.S. Department of Homeland Security as of September 30, 2006 and 2005, and the related statement of custodial activity for the year ended September 30, 2006. We were not engaged to audit the accompanying statements of net cost, changes in net position, budgetary resources, and financing for the years ended September 30, 2006 and 2005, and the statement of custodial activity for the year ended September 30, 2005.

The United States Coast Guard (Coast Guard) was unable to provide sufficient evidential matter or make knowledgeable representations of facts and circumstances, that support transactions and account balances of the Coast Guard, as presented in the DHS balance sheets at September 30, 2006 and 2005; particularly with respect to fund balance with Treasury, accounts receivable, actuarially-derived liabilities, environmental and legal liabilities, operating materials and supplies, certain categories of property, plant and equipment, undelivered orders and changes in net position, and adjustments, both manual and automated, made as part of Coast Guard's financial reporting process. The Coast Guard was unable to complete corrective actions, and make adjustments, as necessary, to these and other balance sheet amounts, prior to the completion of the DHS 2006 *Performance and Accountability Report (PAR)*. Because of the significance of these account balances and/or transactions and conditions noted above, Coast Guard management was unable to represent that the Coast Guard's balance sheets as of September 30, 2006 and 2005, were fairly stated in conformity with U.S. generally accepted accounting principles. The total assets of Coast Guard, as reported in the accompanying DHS balance sheet as of September 30, 2006, were \$12.5 billion or 16 percent of total DHS consolidated assets. The total assets of Coast Guard, as reported in the accompanying DHS balance sheet as of September 30, 2005, were \$11.4 billion or 10 percent of total DHS consolidated assets.

DHS Office of Financial Management (OFM) was unable to provide sufficient evidential matter supporting the completeness and accuracy of the Department's accrued legal liability totaling \$71 million as of September 30, 2006, and related contingent legal liabilities as disclosed in Note 21 of the financial statements. In addition, OFM was unable to reconcile intragovernmental transactions and balances with other Federal trading partners totaling approximately \$3.5 billion, as of September 30, 2006, which could





affect the intragovernmental information presented in the balance sheet; and was unable to provide sufficient evidential matter or make knowledgeable representations of the facts and circumstances that support its implementation of Statement of Federal Financial Accounting Standard (SFFAS) No. 27, *Identifying and Reporting Earmarked Funds*, prior to the completion of DHS' 2006 PAR. In fiscal year 2005, OFM was unable to reconcile intragovernmental transactions and balances with other Federal trading partners totaling \$1.6 billion, as of September 30, 2005 prior to the completion of DHS' 2005 PAR.

TSA was unable to provide sufficient evidential matter or make knowledgeable representations of facts and circumstances that support certain transactions and account balances of TSA, as presented in the DHS balance sheet at September 30, 2006, particularly with respect to property and equipment, accounts payable, accrued unfunded employee leave, and the components of net position. TSA was unable to complete corrective actions and make adjustments, as necessary, to these and other balance sheet amounts, prior to the completion of the DHS' 2006 PAR. Because of the significance of these account balances and/or transactions and conditions noted above, TSA management was unable to represent that TSA's balance sheet as of September 30, 2006, was fairly stated in conformity with U.S. generally accepted accounting principles. The total assets of TSA as reported in the accompanying DHS balance sheet as of September 30, 2006, were \$4.1 billion or 5 percent of DHS consolidated assets. In fiscal year 2005, TSA was unable to fully reconcile and support the accuracy and completeness of its accounts payable with the public and net position as of September 30, 2005 prior to the completion of DHS' 2005 PAR. The total TSA accounts payable with the public as reported in the accompanying DHS balance sheet as of September 30, 2005, was \$864 million or 26 percent, of DHS consolidated accounts payable with the public and 1.2 percent of DHS consolidated liabilities at September 30, 2005. The total net position of TSA as reported in the accompanying DHS balance sheet as of September 30, 2005, was \$2.4 billion or 5.4 percent of DHS consolidated net position at September 30, 2005.

FEMA was unable to fully support the accuracy and completeness of certain unpaid obligations and accounts payable, and the related effect on net position, if any, prior to the completion of DHS' 2006 PAR. These unpaid obligations, as reported in the accompanying DHS balance sheet as of September 30, 2006, were \$22.3 billion or 46 percent of DHS consolidated unexpended appropriations at September 30, 2006. These accounts payable, as reported in the DHS balance sheet as of September 30, 2006, were \$1.5 billion or 32 percent of DHS consolidated accounts payable at September 30, 2006. In fiscal year 2005, FEMA was unable to fully support the accuracy and completeness of certain components of its deferred revenue and accounts payable, and the related effect on net position, if any, prior to the completion of DHS' 2005 PAR. These liabilities, as reported in the accompanying DHS balance sheet as of September 30, 2005, were \$1.7 billion or 2.4 percent of consolidated total liabilities at September 30, 2005.

Immigration and Customs Enforcement (ICE), was unable to fully support the accuracy and completeness of certain accounts payable and undelivered orders, and the related effect on net position, if any, prior to the completion of DHS' 2006 PAR. These accounts payable and undelivered orders, as reported in the accompanying DHS balance sheet as of September 30, 2006, were \$309 million or 7 percent of consolidated total accounts payable, and \$1.2 billion or 2.5 percent of DHS consolidated unexpended appropriations at September 30, 2006, respectively. In fiscal year 2005, ICE management did not perform timely reconciliations and was unable to provide sufficient evidential matter that supported the balance sheet accounts of ICE and certain other DHS components (for which ICE is the accounting service provider), as presented in the accompanying DHS balance sheet as of September 30, 2005, and could not make knowledgeable representation of facts and circumstances regarding accounting and budgetary transactions that occurred in fiscal year 2005. Because of the significance of these account balances and transactions, and condition noted above, ICE management was unable to represent that ICE balance sheet as of September 30, 2005, was fairly stated in conformity with U.S. generally accepted accounting principles. The total assets of ICE and other DHS components, as reported in the accompanying DHS balance sheet as of September 30, 2005, were \$5.9 billion or 5.1 percent of DHS consolidated assets at September 30, 2005.



The Management Directorate was unable to fully support the accuracy and completeness of certain accounts payable and undelivered orders, and the related effect on net position, if any, prior to the completion of DHS' 2006 PAR. These accounts payable and undelivered orders, as reported in the accompanying DHS balance sheet as of September 30, 2006, were \$70 million or 1.5 percent of consolidated total accounts payable, and \$529 million or 1.1 percent of DHS consolidated unexpended appropriations at September 30, 2006, respectively.

In fiscal year 2005, Grants and Training (G&T) (formerly State and Local Government Coordination and Preparedness) was unable to resolve discrepancies identified in the data underlying the calculation of its grants payable liability, and the related effect on net position, if any, at September 30, 2005, prior to the completion of DHS' 2005 PAR. G&T grants payable, as reported in the accompanying DHS balance sheet at September 30, 2005, is \$171 million or 0.2 percent of consolidated total liabilities.

In addition, we were unable to obtain appropriate representations from DHS management, including certain representations as to compliance with U.S. generally accepted accounting principles, with respect to the accompanying DHS balance sheets as of September 30, 2006 and 2005, and were unable to determine the effect of the lack of such representations on 2006 and 2005 DHS' financial statements.

It was impractical to extend our procedures sufficiently to determine the extent, if any, to which the DHS balance sheets as of September 30, 2006 and 2005, and statement of custodial activity for the year ended September 30, 2006, may have been affected by the matters discussed in the eight preceding paragraphs. Accordingly, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying DHS balance sheets as of September 30, 2006 and 2005, and the statement of custodial activity for the year ended September 30, 2006.

We were not engaged to audit the accompanying statements of net cost, changes in net position, budgetary resources, and financing for the years ended September 30, 2006 and 2005, and the statement of custodial activity for the year ended September 30, 2005, and accordingly, we do not express an opinion on these financial statements.

As discussed in Note 34, DHS restated its fiscal year 2005 financial statements to correct multiple errors identified by the Coast Guard, TSA, ICE and other DHS components, that required adjustment of balances previously reported in DHS' fiscal year 2005 financial statements. Because of the matters discussed above regarding our audits of Coast Guard, TSA and ICE, we were unable to audit the restatements discussed in Note 34, and accordingly, we have not concluded on the appropriateness of this accounting treatment or the restatement of the DHS balance sheet as of September 30, 2005.

As discussed in Note 22, DHS adopted the provisions of SFFAS No. 27, in fiscal year 2006. Because of the matters discussed above in the third paragraph of this section, we have not concluded on the appropriateness of the accounting or presentation of earmarked funds in the September 30, 2006 balance sheet or notes thereto.

The information in the Management's Discussion and Analysis (MD&A), RSSI, and Required Supplementary Information (RSI) sections is not a required part of the financial statements, but is supplementary information required by U.S. generally accepted accounting principles and OMB Circular No. A-136, *Financial Reporting Requirements*. We were unable to complete limited procedures over MD&A, RSSI, and RSI as prescribed by professional standards, because of the limitations on the scope of our audit described in the previous paragraphs of this section of our report. Certain information presented in the MD&A, RSSI, and RSI is based on fiscal year 2006 and 2005 financial statements on which we have not expressed an opinion. We did not audit the MD&A, RSSI, and RSI and, accordingly, we express no opinion on it. However, in fiscal year 2006 we noted that DHS did not present five years of RSSI information as required by SFFAS No. 8 *Supplementary Stewardship Reporting* and OMB Circular A-136.

The information in pages 1 through 4, Section II – Performance Information, Section IV – Other Accompanying Information, and Section V – Appendices, of DHS' 2006 PAR are presented for purposes



of additional analysis, and are not a required part of the financial statements. 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 DHS' ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements.

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 financial statements 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.

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 reportable conditions A through J presented in Exhibit I are material weaknesses. Exhibit II represents other reportable conditions K and L. As discussed in the report on the financial statements section, the scope of our work was not sufficient to express an opinion on the balance sheets as of September 30, 2006 and 2005, and the statement of custodial activity for the year ended September 30, 2006, and accordingly, other internal control matters may have been identified and reported had we been able to perform all procedures necessary to express an opinion on those financial statements, and had we been engaged to audit the other fiscal year 2006 and 2005 financial statements. A summary of the status of fiscal year 2005 reportable conditions is included as Exhibit IV.

We also noted other matters involving internal control over financial reporting and its operation that we will report to the management of DHS in a separate letter dated November 15, 2006.

### **Internal Controls over Required Supplementary Stewardship Information and Performance Measure**

Under OMB Bulletin No. 06-03, the definition of material weaknesses is extended to other controls as follows. 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 RSSI or material 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 RSSI and the design and operation of 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 RSSI or the design and operation of the internal control over the existence and completeness assertions related to key performance measures that might be reportable conditions.

We noted reportable conditions in internal control over RSSI in Exhibit I – Comment B – *Financial Reporting* that, in our judgment, could adversely affect the DHS' ability to collect, process, record, and



summarize RSSI. We believe that the reportable conditions presented in Exhibit I are material weaknesses as defined above.

As discussed in the report on the financial statements section, the scope of our work was not sufficient to express an opinion on the balance sheets as of September 30, 2006 and 2005, and the statement of custodial activity for the year ended September 30, 2006 and accordingly, other internal control matters affecting RSSI and performance measures may have been identified and reported had we been able to perform all procedures necessary to express an opinion on those financial statements, and had we been engaged to audit the other fiscal year 2006 and 2005 financial statements.

### **Compliance and Other Matters**

Our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, as described in the Responsibilities section of this report, exclusive of those referred to in the FFMIA, disclosed seven instances of noncompliance 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 Exhibits I and II – Comments B through L, where DHS’ financial management systems did not substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level.

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the balance sheets as of September 30, 2006 and 2005, and the statement of custodial activity for the year ended September 30, 2006, and accordingly, other instances of non-compliance with laws, regulations, contracts, and grant agreements may have been identified and reported, had we been able to perform all procedures necessary to express an opinion on those financial statements, and had we been engaged to audit the other fiscal year 2006 and 2005 financial statements.

**Other Matters.** TSA management reviewed the completeness of obligations recorded in its accounting records, and concluded that a violation of the *Anti-deficiency Act* may have occurred in fiscal years prior to 2006. This matter has been referred to the Chief Financial Officer for further review and disposition. In addition, 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.

### **Management’s Response to Internal Control and Compliance Findings**

DHS management has indicated, in a separate letter immediately following this report that it concurs with the findings presented in Exhibits I, II and III of our report. Further, they have responded that they will take corrective action, as necessary, to ensure that the Chief Financial Officer and the respective bureau management within DHS address the matters presented herein.

### **Responsibilities**

**Management’s Responsibilities.** The United States Code, Title 31, Sections 3515 and 9106 require agencies to report annually to Congress on their financial status and any other information needed to fairly present their financial position and results of operations. To meet these reporting requirements, DHS prepares and submits financial statements in accordance with OMB Circular No. A-136.

Management is responsible for the financial statements, including:



- Preparing the financial statements in conformity with U.S. generally accepted accounting principles;
- Preparing the MD&A (including the performance measures), RSI, and RSSI;
- Establishing and maintaining effective internal control; and
- Complying with laws, regulations, contracts, and grant agreements applicable to DHS, 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.*** As discussed in the report on the financial statements section, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the DHS balance sheets as of September 30, 2006 and 2005, or on the statement of custodial activity for the year ended September 30, 2006, and we were not engaged to audit the accompanying statements of net cost, changes in net position, budgetary resources, and financing for the years ended September 30, 2006 and 2005, and the statement of custodial activity for the year ended September 30, 2005.

In connection with our fiscal year 2006 engagement, we considered DHS' internal control over financial reporting by obtaining an understanding of DHS' internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our procedures. 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 engagement was not to provide an opinion on DHS' internal control over financial reporting. Consequently, we do not provide an opinion thereon. Further, other matters involving internal control over financial reporting may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS balance sheet as of September 30, 2006, and the statement of custodial activity for the year then ended, and had we been engaged to audit the other fiscal year 2006 financial statements.

In connection with our fiscal year 2006 engagement, we considered DHS' internal control over the RSSI by obtaining an understanding of DHS' internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. We limited our testing to those controls necessary to test and report on the internal control over RSSI in accordance with OMB Bulletin No. 06-03. However, our procedures were not designed to provide an opinion on internal control over the RSSI and, accordingly, we do not provide an opinion thereon. Further, other matters involving internal control over RSSI may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS balance sheet as of September 30, 2006, and statement of custodial activity for the year then ended, and had we been engaged to audit the other fiscal year 2006 financial statements.

OMB Bulletin No. 06-03 requires auditors, with respect to internal control related to performance measures determined by management to be key and reported in the MD&A and Performance Information sections, to obtain an understanding of the design of internal controls relating to the existence and completeness assertions and to determine 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 No. 06-03. Our procedures were not designed to provide assurance on internal controls over performance measures and, accordingly, we do not provide an opinion thereon. As discussed in our report on the financial statements, we were unable to complete procedures over the MD&A and performance measures presented in DHS' 2006 PAR.

In connection with our fiscal year 2006 engagement, we performed tests of DHS' compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of the balance sheet amounts as of September 30, 2006, and the statement of custodial activity for the year then ended, 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, contracts, and grant agreements applicable to the DHS. However, providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our engagement and, accordingly, we do not express such an opinion. In addition, other matters involving compliance with laws, regulations, contracts, and grant agreements may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS balance sheet as of September 30, 2006, and the statement of custodial activity for the year then ended, and had we been engaged to audit the other fiscal year 2006 financial statements.

Under OMB Bulletin No. 06-03 and FFMIA, we are required to report whether DHS' 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. However, as discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the balance sheet as of September 30, 2006, and the statement of custodial activity for the year then ended, and accordingly, other instances of non-compliance may have been identified and reported, had we been able to perform all procedures necessary to express an opinion on the those financial statements, and had we been engaged to audit the other fiscal year 2006 financial statements.

#### **Restricted Use**

This report is intended solely for the information and use of DHS management, DHS Office of Inspector General, OMB, 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**

November 15, 2006

**Independent Auditors' Report**  
**Exhibit I – Material Weaknesses in Internal Control**

**Introduction and Summary of Findings by Component**

Our report on internal control over financial reporting is presented in accordance with *Government Auditing Standards*, published by the U.S. Government Accountability Office (GAO). Exhibit I presents the reportable conditions that we consider to be material weaknesses, and Exhibit II presents other reportable conditions. The internal control weaknesses presented in Exhibits I and II were identified during our engagement to audit the Department of Homeland Security (DHS or Department) balance sheet and statement of custodial activity as of and for the year ended September 30, 2006.

We have also performed follow-up procedures on findings identified in previous engagements. As stated in our report, our consideration of internal control over financial reporting would not necessarily disclose all matters that might be reportable conditions. We were not engaged to audit all of the Department's financial statements in fiscal year 2006. In addition, the scope of our work was not sufficient to express an opinion on the financial statements that we were engaged to audit, consequently, other internal control matters may have been identified and reported had we been engaged to audit all fiscal year 2006 financial statements, and had we been able to perform all procedures necessary to express an opinion on those financial statements.

Within each finding, except for Financial Systems Security, we have separately reported the conditions at each DHS component that contribute to the overall internal control weakness. The determination of which findings rise to the level of a material weakness is based on an evaluation of how all component conditions, considered in aggregate, may affect the DHS balance sheet as of September 30, 2006 or the statement of custodial activity for the year then ended. The DHS components that contributed to each internal control weakness are identified in the following table:

<u>Internal Control Finding</u>	<u>Contributing DHS Component</u>									
	<u>OFM</u>	<u>USCG</u>	<u>TSA</u>	<u>FEMA</u>	<u>CBP</u>	<u>ICE</u>	<u>G&amp;T</u>	<u>US- Visit</u>	<u>FLETC</u>	<u>MGT</u>
<b>Material Weaknesses:</b>										
A Financial Management & Oversight	X	X								
B Financial Reporting	X	X	X							
C Financial Systems Security <sup>1</sup>										
D Fund Balance with Treasury		X								
E Property, Plant, and Equipment		X	X					X		
F Operating Materials and Supplies		X								
G Legal and Other Liabilities	X	X	X	X			X			
H Actuarial Liabilities		X								
I Budgetary Accounting		X	X	X		X		X		X
J Intragovernmental Balances	X									
<b>Other Reportable Conditions:</b>										
K Environmental Liabilities		X							X	
L Custodial Revenue and Drawback					X					

The severity of the conditions discussed in Exhibit I caused the Secretary and CFO to issue a statement of “no assurance” on internal control over financial reporting in 2006. In addition, the CFOs of various DHS components were unable to render unqualified assurances on the accuracy and completeness of certain financial statement line items.

<sup>1</sup> All DHS components contribute to the Financial Systems Security finding.

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**A. Financial Management and Oversight (Entity-Level Controls)**

*Background:* In fiscal year 2005, we reported that the DHS Office of the Chief Financial Officer (OCFO) had taken several positive steps during the year to correct control weaknesses we reported in previous years. Progress continued in fiscal year 2006, and we have seen signs of momentum through the leadership of the Department's recently confirmed Chief Financial Officer (CFO). However, challenges remain due, in part, to the continued transition of the Department. DHS' Office of Financial Management (OFM) is responsible for establishing and maintaining financial policies that guide financial reporting throughout the Department, implementing internal controls to ensure the overall integrity of financial data, and preparing periodic financial statements, as well as drafting the annual *Performance and Accountability Report* (PAR). Several conditions cited in the prior year are repeated this year, and we identified additional weaknesses in OFM financial management and oversight controls.

In fiscal year 2005, we reported that significant weaknesses in financial management oversight hindered the United States Coast Guard's (Coast Guard) ability to prepare accurate, complete, and timely financial information. Those conditions have not been corrected since the inception of the Department in 2003, and continue to affect Coast Guard's financial management and reporting processes. Further, as described below, the Coast Guard is presently developing its Corrective Action Plan (CAP)'s however, has not yet taken significant actions to address the condition cited below.

In fiscal year 2005, we also reported that financial management and oversight at Immigration and Customs Enforcement (ICE) was a material weakness, principally because its financial systems, processes, and control activities were inadequate to provide accounting services to itself and five other substantial DHS components. In fiscal year 2006, ICE initiated a CAP to remediate control weaknesses reported in previous years. While ICE has not fully completed its CAPs in all processes, sufficient progress has been made to remove the ICE financial management and oversight conditions cited in our 2005 report.

*Conditions:* Many of the conditions described below are indicators of a weak control environment<sup>2</sup> or entity-level controls. The control environment begins at the top with the Secretary, and permeates the organization with a mindset of quality, care, and commitment of resources to reasonably ensure the integrity of DHS' financial processes, controls, and information technology (IT) systems. We noted the following conditions related to the control environment which existed in prior years, and have been updated for this report.

1 Coast Guard has not:

- Fully implemented a financial management organizational structure that supports the development and implementation of effective policies, procedures, and internal controls to determine data supporting financial statement assertions are complete and accurate.
- Established clear financial management oversight responsibilities and processes to review adjustments to account balances, identify the cause of abnormal balances, and account relationship discrepancies, e.g., budgetary to proprietary reconciliations, and assess potential financial system problems, such as potential posting logic errors and automated changes to financial data through scripts (system modifications).

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<sup>2</sup> Regarding the control environment, the GAO *Standards for Internal Control in the Federal Government*, states; "Management and employees should establish and maintain an environment throughout the organization that sets a positive and supportive attitude toward internal control and conscientious management."



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- Fully established financial management oversight functions with the appropriate skills and resources to determine that accounting principles are correctly applied and to provide accounting operational guidance to other offices and facilities within the Coast Guard.
- Completed a comprehensive CAP to correct longstanding internal control weaknesses that are contributing to each of the ten Department level material weaknesses, as required by Office of Management and Budget (OMB) Circular No. A-50, *Audit Follow-up*, as revised.

2 OFM:

- While the OFM is staffed with exceptionally dedicated management and staff, additional managerial level skill sets are needed to fully accomplish OFM responsibilities. OFM does not have a sufficient number of management personnel who have the requisite financial accounting background, knowledge, and expertise, to both (i) set-up, and (ii) effectively manage the financial reporting and internal control infrastructure of a large and complex Executive Branch agency. Supporting conditions include the need to:
  - Establish an organizational structure and complete job descriptions, based on a comprehensive independent human capital needs assessment, to determine the roles, responsibilities, and functions to be performed, and the skill sets of personnel necessary to perform those functions. Consequently, some critical responsibilities of a headquarters financial reporting operation are not well defined or are not performed timely and effectively; and
  - Develop the capacity to completely and timely address non-routine or complex accounting and reporting matters, such as the implementation of new accounting standards. For example, the Department did not complete its implementation of Statement of Federal Financial Accounting Standard (SFFAS) No. 27, *Identifying and Reporting Earmarked Funds*, until we notified OFM of the information and analysis required, and OFM was unable to provide sufficient evidential matter or make knowledgeable representations of the facts and circumstances to support its implementation of SFFAS No. 27, prior to the completion of DHS' 2006 PAR.
- Has not yet established effective oversight and control procedures throughout the year to monitor the operations of DHS components to promptly identify and raise issues to the CFO that may affect the quality of the financial statements. This weakness contributed to the need for more than six restatements of the fiscal year 2005 financial statements to correct material errors presented in the 2005 PAR. Further, several components submitted restatements that were not fully identified, analyzed, and recorded in the 2005 financial statements, until two weeks before the submission of the 2006 PAR.
- Has not yet established a process to support the timely completion of the annual financial statement audit. For example, OFM was unable to coordinate requests for sufficient evidential matter supporting the completeness and accuracy of the Department's accrued legal liability, totaling \$71 million as of September 30, 2006, as necessary to complete our testwork prior to the completion of DHS' 2006 PAR. In addition, many routine audit testwork procedures typically performed throughout the year were delayed until year-end, further hindering the timely completion of our engagement.

*Cause/Effect:* DHS has attempted the stand-up of a large, new, and complex Executive Branch agency, without the assistance of specialized organizational and accounting expertise. The Department has recently made commitments in financial management and accounting personnel and other critical infrastructure necessary to develop reliable financial processes, policies and

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procedures, and internal controls that enable management to represent that the Department's financial statements are complete and accurate. In fiscal year 2006, the OCFO and OFM were affected by the departure and transition to a new CFO, the departure of the Under Secretary of Management; and a restructuring and redistribution of roles and responsibilities within OFM. However, these transitions have resulted in a continued heavy dependency on the independent auditor to inform OFM of the steps needed to implement new accounting standards, record non-routine transactions, issue accounting guidance to components, identify errors in accounts, and establish appropriate controls.

The Coast Guard's management has acknowledged that longstanding procedural, control, personnel, and cultural issues have impeded progress toward installing an effective financial management structure. In addition, the Coast Guard's CFO must coordinate with heads of various divisions who have a role in the accounting and financial reporting processes, but who otherwise have limited exposure to financial statement audits. Further, these division heads change regularly as part of the Coast Guard military assignment and rotation policies, making it difficult for the CFO to institutionalize internal controls related to financial management and reporting that are outside the CFO's direct organization. However, control weaknesses at the Coast Guard significantly impede the Department's ability to produce reliable financial statements and the conditions causing the weaknesses have existed nearly unchanged since 2003.

The conditions described above continue to prevent DHS from timely preparation of accurate financial information and reports and have also contributed to the conditions reported in Comment B – *Financial Reporting* of this Appendix.

*Criteria:* The *Federal Managers' Financial Integrity Act of 1982 (FMFIA)* requires that agencies establish internal controls according to standards prescribed by the Comptroller General and specified in the GAO's *Standards for Internal Control in the Federal Government (Standards)*. The GAO defines internal control as an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. The GAO *Standards* identify the control environment, as one of the five key elements of control, which emphasizes the importance of control conscientiousness in management's operating philosophy and commitment to internal control. These standards cover controls such as human capital practices, supervisory reviews, and segregation of duties, policies, procedures, and monitoring.

According to OMB Circular No. A-50, corrective action taken by management on audit findings and recommendations is essential to improving the effectiveness and efficiency of Government operations. Each agency shall establish systems to assure the prompt and proper resolution and implementation of audit recommendations. These systems shall provide for a complete record of action taken on both monetary and non-monetary findings and recommendations.

*Recommendations:* We recommend that:

1. Coast Guard:
  - a) Evaluate the existing financial management organizational and internal control structure and conduct an assessment to determine the number and type of personnel and resources needed, along with the requisite skills and abilities necessary, to provide effective guidance and oversight to program offices that are significant to financial management and reporting, and make recommendations to senior management for appropriate changes;

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- b) Consider the establishment of an Office of Financial Management within the Coast Guard, that would have the authority, ability, and appropriate resources to oversee all Coast Guard financial management policy, systems, and reporting functions;
  - c) Establish internal controls and related procedures for performing periodic reviews and oversight to assess the appropriateness, to include compliance with generally accepted accounting principles, of financial policies and procedures, and the design and operating effectiveness of internal controls, and prioritize remediation of material weaknesses given the available resources;
  - d) Establish clear management oversight responsibilities and processes to effectively review adjustments to account balances, identify the cause of abnormal balances, and account for relationship discrepancies, e.g., budgetary to proprietary reconciliations, and investigate potential financial system problems such as potential posting logic errors and automated changes to financial data through scripts (system modifications); and
  - e) Develop and implement a comprehensive CAP to correct conditions that contribute to the Department-level material weaknesses in internal controls.
2. OCFO (in particular OFM):
- a) Clearly define the roles and responsibilities, organizational structure of OFM, and critical success factors that are necessary to set-up and then manage the financial reporting operations of DHS;
  - b) Perform a human capital needs assessment, with particular focus on OFM leadership and management skills needed to set-up and then manage the daily operations of OFM. The assessment should be conducted by an independent specialist, and should identify the additional managerial skill sets, e.g., financial accounting background, knowledge, and expertise, required to both establish and strengthen the financial accounting and reporting infrastructure throughout the Department, and, once established, to effectively manage the processes, gradually correct control weakness, and produce reliable and timely financial statements throughout the year;
  - c) Exercise the authority provided by the Secretary to require bureaus that contribute to material weaknesses to develop and implement sound, appropriately funded, CAPs that will eliminate material weaknesses and result in timely, accurate financial reporting. This initiative will likely require assistance from the Secretary to emphasize the necessity of good financial management, hold other departmental management accountable for progress, and, in some cases, will require substantial cultural shifts and a commitment of resources;
  - d) Implement procedures that will allow the auditors to complete more audit procedures earlier in the year, and ensure that audit requests for information are provided completely and timely. This will involve improved coordination with other operating departments of DHS, such as the Office of General Counsel for timely and accurate updates to legal liabilities; and
  - e) Continue with the CAP program to develop and implement Department wide CAPs, to promptly address audit findings of all auditors, e.g., Inspector General, GAO, and financial statement auditors, in compliance with OMB Circular No. A-50.

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#### B. Financial Reporting

*Background:* Under the current financial reporting structure, the OFM prepares financial statements, including footnote and supplementary data, from trial balances and other financial data submitted by the components to the OFM through the Treasury Information Executive Repository (TIER) system. OFM is dependent on the components for complete, accurate, and timely submission of monthly financial data, and is not structured to consistently identify and resolve potential errors or abnormalities in the data received. The OFM is also responsible for development and communication of appropriate accounting policies, ensuring that financial reporting controls exist, and performing certain quality control procedures to monitor financial information. The components are not required to prepare complete financial statements with footnotes and supplementary data that comply with generally accepted accounting principles.

In fiscal year 2005, we reported that OFM, Coast Guard, and ICE had numerous serious internal control weaknesses that led to a material weakness in financial reporting. While each component developed a CAP to address the control weaknesses, only ICE was able to make substantial progress during the year. The OFM and Coast Guard lag behind in both development and execution of their CAP, and, consequently, many of the conditions reported in the prior year are repeated below, together with new weakness discovered during our fiscal year 2006 engagement.

We also reported in fiscal year 2005 financial reporting weaknesses at the Transportation Security Administration (TSA), Office of Grants and Training (G&T) (formerly SLGCP), and the Federal Emergency Management Agency (FEMA) (formally included in the EPR Directorate). G&T and FEMA successfully executed CAPs to address the conditions reported last year. TSA's financial reporting weaknesses reported last year have been repeated again in fiscal year 2006.

*Conditions:* We noted the following internal control weaknesses related to financial reporting in the OFM and DHS components:

##### 1 OFM:

- Continued to have significant difficulty coordinating delivery of financial data from components and preparing financial statements and disclosures throughout the year. We identified numerous errors, inconsistencies, and out-of-balance conditions, inadequate or incomplete disclosures, lack of supporting documentation, e.g., for journal entries posted, and lack of due diligence to follow-up on questionable information provided by components. We noted weaknesses in year-end close-out and beginning balance reconciliations and delays in completion of the interim and year-end PAR.
- Has not established adequate Departmental policies and procedures, or issued timely guidance, to ensure that financial statements are accurate and complete during the year. For example, OFM did not issue comprehensive, timely guidance to the components on Interpretation of SFFAS No. 6, *Accounting for Imputed Intra-departmental Costs*, on implementation of SFFAS No. 27, or on resolving intradepartmental and elimination discrepancies or reconciling intergovernmental balances with significant federal government trading partners. In some cases, guidance was issued only after the external auditor notified OFM of the requirements. This condition contributed to the Department's self-reporting of noncompliance with the *Debt Collection Improvement Act*, and submission of erroneous intragovernmental balances to U.S. Department of the Treasury during the year.
- Has not established effective monitoring controls over the financial data periodically submitted by the DHS components. The component TIER submissions contained numerous abnormal balances and potential errors totaling billions of dollars that affected

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the accuracy of the DHS financial statements throughout the year without adequate investigation or resolution until after year-end.

2 Coast Guard:

- Has not developed and implemented an effective general ledger system. The Core Accounting System (CAS), Aircraft Logistics Management Information System (ALMIS), and Naval Engineering Supply Support System (NESSS) general ledgers are significantly noncompliant with the requirements of the *Federal Financial Management Improvement Act* (FFMIA). Specifically:
  - The general ledgers are not compliant with the United States Standard General Ledger (USSGL) at the transaction level, include non-compliant chart of account definitions, invalid accounts, improper posting logic codes and inconsistent crosswalks to the Coast Guard TIER database as well as static balances related to a legacy general ledger conversion and unsubstantiated automated changes to CAS financial data through the use of hundreds of scripts, implemented without effective controls to correct system problems;
  - The Coast Guard's TIER submissions to OFM are from a database that does not have detail at the transactional level, and is not reconciled or supported by the transaction level detail in the Coast Guard's three general ledgers; and
  - The financial reporting process is overly complex and labor-intensive, and requires a significant number of "on-top" adjustments (adjustments made outside the core accounting system for presentation of financial information given to DHS for consolidation). These topside adjustments are not supported at the transaction level and are not recorded to the respective general ledgers. Thus, period-end and opening balances are only supported by the Coast Guard TIER database, and the three general ledgers do not support the financial statements.
- Has a serious deficiency in its policies, procedures and controls surrounding its financial reporting process. For example, the Coast Guard:
  - Does not record all financial transactions, either in detail or at the summary level, to the general ledger systems. Consequently, the Coast Guard can not be reasonably certain that its financial statements are complete or accurate at any time;
  - Does not have adequate beginning balance and year-end close-out procedures. For example, no reconciliation is performed to ensure that opening balances agree to the prior year ending balances. Year-end closing procedures do not include sufficient supporting documentation such as evidence of effective management review, approval of individual adjusting entries, or procedures to determine that all necessary adjustments were identified;
  - Routinely uses high level analytical comparisons to identify adjusting entries. Adjusting entries are then recorded, without support or verification that the adjustment is valid. For example, budgetary accounts are forced to equal proprietary accounts, without determining the underlying cause for the imbalance at a transactional level of detail to support the correct ending balances;
  - Does not have written policies and procedures for analyzing revolving, special, and trust funds, and there is inconsistent treatment of inter-entity balances for the Supply, Cadet, and Yard funds; and

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- Does not have effective policies and procedures to identify and resolve abnormal balances and identified potential errors in its financial data. A significant number of abnormal account balances, totaling billions of dollars, exist throughout the year in its three general ledgers that are not investigated.
  - Does not have adequate procedures and internal controls over the process of preparing and reviewing the financial statement disclosures. Certifications were made to the DHS CFO without reviewing appropriate supporting documentation to determine that the footnotes are accurate and complete.
  - Does not have an adequate process to record, review, and monitor accounts receivable activity. The accounts receivable CAPs developed by the six Coast Guard processing locations do not provide detailed procedures necessary to evaluate and remediate their accounts receivable balances and support Coast Guard management's financial reporting assertions. The current standard operating procedures (SOPs) are out of date or in draft format, lack detail, and do not identify and describe the internal controls over the process. In addition, the SOPs do not clearly identify and define proper supporting documentation for the various types of accounts receivable or the policies/process for conducting research to (1) resolve variances between the accounts receivable sub-ledgers and the system general ledger, and (2) determine if aged receivables are valid.
- 3 TSA continued to experience difficulties related to financial reporting. Specifically, we noted:
- Certain accrual amounts were not posted, and certain property amounts were misstated, in the final financial data submission for the June 30, 2006 hard-close; numerous other on-top adjustments were made thereafter; certain account reconciliations were not performed timely or completely throughout the year; and material abnormal balances and analytical account variances were not resolved timely throughout the year.
  - Sufficient processes and procedures have not been established to enable the successful completion of a financial statement audit in two successive years. In fiscal year 2005, the financial statement auditor did not issue a report because of TSA's inability to provide requested information related to its accounting and reporting for aviation security fees. In fiscal year 2006, TSA resolved prospective accounting for the aviation security fee issue, but did not complete its analysis to determine retroactive adjustments, if any; and additional circumstances caused significant inefficiencies and unnecessary delays that prevented the completion of the testwork prior to DHS' submission of its 2006 PAR.
  - TSA could not provide complete supporting documentation for numerous journal vouchers, and we identified several journal vouchers that were not approved prior to posting in the general ledger.
- 4 OFM and certain components did not have effective financial information systems or sufficiently documented processes to accumulate cost data by DHS strategic goal, as required by SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards*.

*Cause/Effect:* Many of the issues mentioned above stem from the conditions described in Comment A - *Financial Management and Oversight*. The OFM is still working to set-up the Department with effective financial policies and procedures that will ensure a smooth and reliable month-end close for all components and the consolidated entity. Policies developed by OFM often take months, even more than a year in some cases, before they are approved for release, due in part to a lack of defined authority for financial policy within the Department. By design, OFM is not staffed to function as a control over the accuracy of financial data received by the components. Consequently, errors and abnormal balances that exist in data submitted by

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components to OFM, or a lack of component responsiveness to OFM requests, have remained unresolved throughout the year and are reflected in the financial statements even though OFM and the component are aware of the conditions.

At the Coast Guard, the accuracy of financial information is highly dependent on the knowledge and experience of a limited number of key financial personnel rather than on clearly documented procedures manuals and process flow documentation. In addition, the Coast Guard suffers from serious structural system deficiencies that make the financial reporting process more complex and difficult.

The quality of TSA's financial data and reliability of the financial reporting process has been negatively impacted by the recent transition to the Coast Guard's accounting system and resulting changes to the financial reporting process.

*Criteria:* FMFIA requires that agencies establish internal controls according to standards prescribed by the Comptroller General and specified in the GAO *Standards*. These standards define internal control as an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. The GAO *Standards* require that internal controls be documented in management directives, administrative policies, or operating manuals; transactions and other significant events be clearly documented; and information be recorded and communicated timely with those who need it within a timeframe that enables them to carry out their internal control procedures and other responsibilities. According to these standards, the five essential control elements are control environment, risk assessment, control activities, information and communication, and monitoring.

*Recommendations:* We recommend that:

1. OFM:
  - a) Implement a standardized financial reporting process, including formal policies and procedures that require components to prepare financial reporting closing packages with footnotes and supplementary data that comply with generally accepted accounting principles to assist the components and the OCFO to execute a monthly close that results in complete and reliable financial reporting on an interim basis, and at year-end. The OCFO should perform several "test runs" during fiscal year 2007, e.g., each quarter, to critically evaluate and improve the process as necessary;
  - b) Perform a review to determine processes, procedures and methods to make the role of the desk officer a more effective monitoring control. The objective should be to consistently identify potential errors in financial data submitted by components, and to engage the Director of OFM or the CFO, if necessary, to have the potential errors investigated and corrected, if necessary, before the next period component TIER submission;
  - c) Complete a formal risk assessment to identify significant risks to the financial reporting process and continue to develop and implement its Internal Control over Financial Reporting (ICOFR) playbook and OMB Circular No. A-123 process to manage and mitigate those risks; and
  - d) Establish new or improve existing policies and procedures to ensure that:
    - i) Instances of noncompliance with laws and regulations that could have a direct and material impact on the financial statements are promptly identified and reported to OCFO;

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- ii) New policies and guidance that affect the quality and consistency of financial reports and data, including accounting guidance needed by the components for intradepartmental transactions, is approved by the CFO and issued in a timely manner;
  - iii) Intradepartmental and intragovernmental elimination discrepancies and reconciling differences are promptly identified and addressed throughout the year;
  - iv) The financial statements are updated to include all disclosures, including the adoption of new accounting standards and restatements of prior year financial statements, and are addressed early each fiscal year, e.g., first and second quarter, to give management and the auditors an opportunity to review changes before year-end; and
  - v) Adequate supporting documentation is maintained for all elimination and other adjusting entries made at the financial statement level.
2. Coast Guard:
- a) Conduct an assessment of its current financial reporting process, including a review of its three general ledger systems, with the goal of reducing complexity, implementing appropriate internal controls, improving financial systems integration and automating manual processes. Processes should be designed to ensure that all financial statement line items are fully reconciled and supported by transactional detail contained in the general and subsidiary ledgers, and causative research performed for imbalances and abnormalities;
  - b) Establish new or improve existing policies and procedures to ensure that:
    - i) All financial transactions are recorded in the general ledger at the detail USSGL level as they occur;
    - ii) The year-end close-out process and reconciliations are supported by documentation, including evidence of effective management review and approval, clear identification of all on-top adjustments with all associated general ledger account entries, and beginning balances in the following year are determined to be reliable and auditable;
    - iii) Account reconciliations, for each of the three general ledgers and the monthly TIER submission, are performed timely and completely each month and differences are researched and resolved before the next months reporting cycle. Reconciliations should include all funds maintained by the Coast Guard, including revolving, special and trust funds;
    - iv) Eliminate the practice of using high level analytics as the sole source of support for adjusting journal entries; and
    - v) Significant abnormal balances are investigated and resolved at a transaction level before the monthly TIER is submitted to OFM.
  - c) Establish a task force of outside experts to analyze the Coast Guard's financial reporting process, and IT systems functionality, in order to develop effective CAPs, including a timeline for action with verifiable milestones, to correct identified deficiencies, to include researching all differences/imbalances identified as a result of past practices at a transactional level and to assess and report the effects on current and prior financial reporting; and
  - d) Identify all Coast Guard accounts receivables and then implement comprehensive Coast Guard-wide policies and procedures, including internal controls, at a sufficient level of



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detail to determine that the accounts receivable process is effective to support management assertions, in compliance with generally accepted accounting principles, for the accounts receivable balance reported on the Coast Guard balance sheet.

3. TSA:
  - a) Conduct an assessment of the closing process to identify and correct weaknesses that impede timely and efficient reporting processes; reduce the number of on-top adjustments; and perform regular quality control reviews of financial reports;
  - b) Document key standard operating procedures for significant financial reporting processes, including the TIER submissions;
  - c) Complete and document a year-by-year analysis (since TSA's inception) of the impact of the change in the accounting treatment of aviation security fees on the year-end account balances, and prepare appropriate adjusting entries, as necessary;
  - d) Assess the reason why TSA experienced significant delays and had difficulty responding to information requests from the auditors in fiscal year 2006, and implement corrective actions; and
  - e) Document and consistently implement policies and procedures for the preparation and approval of journal vouchers for submission to its accounting services provider. Policies and procedures should include requirements for (a) full completion of the journal voucher form itself, and (b) attached documentation to support each journal voucher.
4. OFM and applicable component entities should develop financial information systems and document processes to accumulate and present cost data by DHS strategic goal, as required by SFFAS No. 4.

**C. Financial Systems Security**

Background: Controls over 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 control access to an application, separate individuals from accessing particular application modules such as accounts payable, inventory, payroll, grants, or loans, and assess if the specific interface and edit controls are in place, as defined by management.

During fiscal year 2006, a few DHS components took actions to improve their IT general and application control environment and to address prior year IT control issues; however, some DHS components did not make necessary improvements, during the year. During the 2006 we identified over 200 separate findings, some in each DHS component. DHS was able to close approximately 45% of our prior year IT findings; however, we identified over 130 new IT findings through our test work this year. In addition, a significant number of findings were repeated in fiscal year 2006.

The control areas where the increases in findings present an increased risk of impacting financial data integrity include: 1) excessive access to key DHS financial applications, 2) misconfigured logical security controls to key DHS financial applications and support systems, and 3) application change control processes that are inappropriate, and in other locations not fully defined, followed, or effective. The re-issuance and additionally identified internal control

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weaknesses were the result of a lack of needed prioritization of taking the necessary corrective actions. Despite the improvements in a few DHS components, several significant general IT and application control weaknesses remain that collectively limit DHS' ability to ensure that critical financial and operational data is maintained in a manner to ensure confidentiality, integrity, and availability.

*Conditions:* In fiscal year 2006, the following IT and financial system control weaknesses were identified at DHS and its components. Many of the issues identified during our fiscal year 2006 engagement were also identified during fiscal year 2005:

- 1 Entity-wide security program planning and management – we noted:
  - Despite continued improvements in the process of performing Certification and Accreditation (C&A) of IT systems, nine DHS component financial and associated feeder systems, at three DHS components, were not properly certified and accredited, in compliance with DHS 4300A.
  - Instances of incomplete or inadequate policies and procedures associated with computer incident response capabilities at four DHS components.
  - Instances where background investigations of contractors employed to operate, manage and provide security over IT systems were not being properly conducted related to DHS components or sub-components, at three DHS components.
  - Instances of lack of compliance with DHS computer security awareness training requirement, and / or lack of component policies for IT-based specialized security training at three DHS components.
- 2 Access controls – we noted:
  - A large number of instances of missing and weak user passwords on key servers and databases which process and house DHS financial data at six DHS components.
  - A large number of instances where user account lists were not periodically reviewed for appropriateness, and inappropriate authorizations and excessive user access privileges were allowed at nine DHS components.
  - Instances where workstations, servers, or network devices were configured without necessary security patches or were not configured in the most secure manner at five DHS components.
  - Instances where physical access to sensitive computer operations were not adequate at four DHS components.
- 3 Application software development and change control – we noted:
  - One DHS component had implemented a separate and secondary change control process outside of and conflicting with the established change control process. During our testing of this separate process, we identified it to be informal, undocumented, and not effective.
  - Instances where policies and procedures regarding change controls were not in place to prevent users from having concurrent access to the development, test, and production environments of the system at four DHS components.
  - Instances where changes made to the configuration of the system were not always documented through System Change Requests (SCRs), test plans, test results, or software modifications at seven DHS components. Additionally, documented approval did not exist, or was not always retained, for emergency enhancements, “bug” fixes, and data

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- fixes, and in some cases, audit logs for tracking changes to the data or systems were not activated.
- 4 System software – we noted:
- Instances where policies and procedures for restricting and monitoring access to operating system software were not implemented or were inadequate at six DHS components. In some cases, the ability to monitor security logs did not exist.
  - Instances where changes to sensitive operating system settings and other sensitive utility software and hardware were not always documented.
- 5 Segregation of duties – we noted:
- Instances where individuals were able to perform incompatible functions, such as the changing, testing, and implementing of software, without sufficient compensating controls in place at four DHS components.
  - An instance where the policy and procedures to define and implement segregation of duties were not properly developed and/or implemented at one DHS component.
  - Access control weaknesses identified during our IT testing also contributed to numerous instances where access to data could lead to various incompatible function issues, including the override of transactions at five DHS components.
- 6 Service continuity – we noted:
- Instances where incomplete or outdated business continuity plans and systems with incomplete or outdated disaster recovery plans were noted at four DHS components. Some plans did not contain current system information, emergency processing priorities, procedures for backup and storage, or other critical information.
  - Service continuity plans were not consistently and/or adequately tested, and individuals did not receive training on how to respond to emergency situations at four DHS components.
- 7 Application controls – we noted:
- Instances of weak or expired user passwords, user accounts that were not kept current, users with access privileges to certain key processes of an application, and key edit and business rules not working as designed by management at nine DHS components. Many of the weaknesses that were identified during our general control testing of an application's access controls and segregation of duties are also relevant to this area, since access and segregation of duty controls are controls over the application. Since these same issues also impact controls over specific key financial applications, they are reported here as well.

*Cause/Effect:* Many of these weaknesses were inherited from the legacy agencies that came into DHS or system development activities that did not incorporate strong security controls from the outset and will take several years to fully address. At many of the larger components, IT and financial system support operations are decentralized, contributing to challenges in integrating DHS IT and financial operations. In addition, financial system functionality weaknesses, as discussed throughout our report on internal controls in various processes, can be attributed to non-integrated legacy financial systems that do not have the embedded functionality required by OMB Circular No. A-127, *Financial Management Systems*.

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Further, there is no consistent and thorough testing of IT controls by individual DHS components and by the DHS CIO to identify and mitigate weaknesses. The most prevalent reason as to why these weaknesses are present is the lack of prioritization in taking the necessary actions to improve the IT control environment around the Department's financial management systems. The effect of these numerous IT weaknesses identified during our testing impacts the reliability of DHS' financial data. Many of these weaknesses, especially those in the area of change control, may result in material errors in DHS' financial data that are not detected, in a timely manner, in the normal course of business. In addition, as a result of the continuous presence of serious IT deficiencies, there is added pressure on the mitigating manual controls to be operating effectively at all times. Since manual controls are operated by people, there cannot be a reasonable expectation that they would be able to be in place at all times and in all areas.

*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 National Institute of Standards and Technology (NIST) guidance. OMB Circular No. 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 No. A-127 prescribes policies and standards for executive departments and agencies to follow in developing, operating, evaluating, and reporting on financial management systems. The *Information Technology Security Program Publication*, section 4300A, also provides criteria and guidance that is applicable to DHS financial systems security and general controls.

*Recommendations:* We recommend that the DHS Office of Chief Information Officer in coordination with the OCFO make the following improvements to the Departments financial management systems:

1. For entity-wide security program planning and management:
  - a) Enforce through the DHS C&A program across all DHS components, a testing process which goes beyond an assessment of in-place policies and procedures, to include tests of password "strength", access lists, and software patches, of an application, for example,;
  - b) Enforce the consistent implementation of security programs, policies, and procedures, including incident response capability and IT security awareness and training; and
  - c) Enforce DHS' policy to ensure that all contractors go through the appropriate background/suitability check.
2. For access control:
  - a) Enforce password controls that meet DHS' password requirements on all key financial systems;
  - b) Implement an account management certification process within all the components to ensure the periodic review of user accounts for appropriate access;
  - c) Implement a DHS-wide patch and security configuration process, and enforce the requirement that systems are periodically tested by individual DHS components and the DHS-CIO; and
  - d) Conduct periodic vulnerability assessments, whereby systems are periodically reviewed for access controls not in compliance with DHS and Federal guidance.
3. For application software development and change control:

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- a) Implement a single, integrated change control process over the DHS components' financial systems with appropriate internal controls to include clear lines of authority to the components' financial management personnel and to enforce responsibilities of all participants in the process and documentation requirements;
  - b) Develop policies and procedures regarding change controls, and implement to ensure segregation of change control duties; and
  - c) Enforce policies that require changes to the configuration of the system are approved and documented, and audit logs are activated and reviewed on a periodic basis.
4. For system software, actively monitor the use of and changes related to operating systems and other sensitive utility software and hardware.
5. For segregation of duties:
- a) Document the user responsibilities so that incompatible duties are consistently separated. If this is not feasible given the smaller size of certain functions, then sufficient compensating controls, such as periodic peer reviews, should be implemented; and
  - b) Assign key security positions, and ensure that position descriptions are kept current.
6. For service continuity:
- a) Develop and implement complete current business continuity plans and system disaster recovery plans; and
  - b) Perform component-specific and DHS-wide testing of key service continuity capabilities, and assess the need to provide appropriate and timely emergency training.
7. For application controls:
- a) Implement policies to ensure that password controls meet DHS password requirements on all key financial applications and feeder systems;
  - b) Implement an account management certification process within all the components to ensure the periodic review of user accounts for appropriate access,
  - c) Document the user responsibilities so that incompatible duties are consistently separated. If this is not feasible given the smaller size of certain functions, then sufficient compensating controls, such as periodic peer reviews, should be implemented; and
  - d) Implement the appropriate oversight over the edit and interface controls to ensure that the financial processes are operating as management had designed.

**D. Fund Balance with Treasury**

*Background:* Fund Balance with Treasury (FBwT) represents accounts held at Treasury from which an agency can make disbursements to pay for its operations. Regular reconciliation of an agency's FBwT records with Treasury is essential to monitoring and safeguarding these funds, improving the integrity of various U.S. Government financial reports, and providing a more accurate measurement of budget resources and status.

In fiscal year 2005, we reported the existence of material weaknesses in FBwT at ICE and the DHS components for which it performs accounting services. Early in fiscal year 2006, ICE implemented a CAP to fully reconcile its funds with Treasury, clear suspense accounts, and establish improved processes and controls for itself and the components, to address the material weakness. The results of our follow-up procedures performed in fiscal year 2006, allow us to remove the ICE conditions reported in fiscal year 2005 from this material weakness.

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In fiscal year 2005, we also reported the existence of a material weakness in FBwT at Coast Guard. The Coast Guard has not yet developed or implemented comprehensive FBwT CAPs, and consequently, we are repeating and expanding the conditions cited in last year's report. FBwT at the Coast Guard totaled approximately \$4.5 billion, or 7.5 percent of total DHS assets, at September 30, 2006. The majority of these funds represented appropriated amounts that were obligated, but not yet disbursed, at September 30, 2006.

*Conditions:* The Coast Guard:

- Was unable to provide military and civilian payroll data to support payroll transactions processed through Coast Guard's FBwT, USSGL account 1010. Coast Guard did not properly report and reconcile these transactions or maintain appropriate supporting documentation.
- Did not effectively manage or monitor its suspense accounts, to include accurately aging and clearing items carried in suspense clearing accounts in a timely manner during the year. The Coast Guard's processes and accounting for suspense account transactions is not effective. Coast Guard made inappropriate changes to suspense accounting procedures in the current year and continues to lack documented procedures and internal controls in this area.
- Did not maintain adequate supporting documentation that validated the accuracy of the FBwT reconciliations and the clearing of suspense items, to include posting unsupported adjustments to Coast Guard reported general ledger activity submitted to Treasury and to agree Coast Guard balances to Treasury records without support documentation. Approximately 85% of the balances were not recorded correctly or supported by proper documentation.
- Did not properly design policies, procedures, and internal controls over Coast Guard's process of initiating, authorizing, and recording budgetary authority in Coast Guard's FBwT, USSGL account 1010. Deficiencies include a lack of segregation of duties and management review of the proprietary journal vouchers for recording and reconciling budgetary authority (see Comment I – *Budgetary Accounting*).

*Cause/Effect:* The Coast Guard has not designed and implemented policies, procedures, and internal controls, including effective reconciliations and the use of a financial system that complies with Federal Financial System Requirements, as defined in OMB Circular A-127 and the requirements published by the Joint Financial Management Improvement Program (JFMIP), to fully support the fiscal year 2006 FBwT activity and balance at September 30, 2006. The Coast Guard did not maintain sufficiently detailed records to clear suspense accounts in a timely manner, and did not use tools available to them properly to improve the process, such as the *Government-wide Accounting System (GWA)*. Failure to implement timely and effective reconciliation processes could increase the risk of fraud, abuse, undetected violations of appropriation laws, including instances of undiscovered *Anti-deficiency Act* violations, and mismanagement of funds, which could lead to inaccurate financial reporting and affects DHS' ability to effectively monitor its budget status.

*Criteria:* The Treasury Financial Manual (TFM)<sup>3</sup> states, "Federal agencies must reconcile their USSGL account No.1010, and any related sub-accounts, with the FMS 6652, 6653, 6654 and 6655 on a monthly basis (at minimum). Federal agencies must research and resolve differences between the balances reported on their general ledger FBwT accounts and balances reported on the FMS 6653, 6654 and 6655." In addition, Section 803(a) of FFMIA requires that Federal

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<sup>3</sup> TFM, Supplement I TFM 2-5100 (November 1999)

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financial management systems comply with (1) Federal accounting standards, (2) Federal system requirements, and (3) the USSGL at the transaction level. FFMIA emphasizes the need for agencies to have systems that can generate timely, reliable, and useful information with which to make informed decisions to ensure ongoing accountability.

According to OMB Circular No. A-123, transactions should be promptly recorded, and properly classified and accounted for, in order to prepare timely and reliable financial and other reports. Documentation for transactions, management controls, and other significant events must be clear and readily available for examination.

*Recommendations:* We recommend that Coast Guard:

- a) Establish policies and procedures to ensure payroll data, supporting payroll transactions processed through FBwT (account 1010), is properly maintained and available for audit testwork, as needed;
- b) Establish policies and procedures to better manage its suspense accounts to include researching and clearing items carried in suspense clearing accounts in a timely manner during the year, and maintaining documentation of periodic reconciliations of FBwT;
- c) Establish policies and procedures to improve segregation of duties and management review of the journal vouchers for recording and reconciling budgetary authority. The policies should be based on Treasury guidance and tailored to the Coast Guard's operations; and
- d) Enhance financial accounting system(s) to ensure compliance with federal financial management system requirements.

#### **E. Property, Plant, and Equipment**

*Background:* Property, plant, and equipment (PP&E) represents approximately 8.5 percent of total DHS assets, and the Coast Guard maintains more than 50 percent of all DHS PP&E, including a large fleet of aircraft and vessels. Many of the Coast Guard's assets are constructed over a multi-year period, have long useful lives, and undergo extensive routine servicing that may increase their value or extend their useful lives, and require comprehensive policies and procedures to ensure accurate and timely accounting. As reported in prior years, the Coast Guard has been unable to provide auditable documentation for certain categories of PP&E, due to a number of policy, control, and process deficiencies that will require several years to correct, and consequently, most of the conditions cited below have been repeated from our 2005 report and have existed since the Department's inception in 2003. In addition, as noted in our 2005 report, DHS has several internal use software development projects underway that will result in capitalized software balances in future years, particularly in the US-Visit directorate. Consequently, application of proper accounting standards to account for PP&E is important to the accuracy of DHS' financial statements. In fiscal year 2006 we identified new issues related to TSA's PP&E balances.

*Conditions:*

- 1 Coast Guard has not:
  - Implemented appropriate controls and related processes to accurately, consistently, and timely record PP&E, to include additions, transfers from other agencies, and disposals in its fixed asset system. Significantly, Coast Guard has not designed or implemented effective controls to manage, account for, and properly support costs recorded its General

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PP&E Construction in Progress projects, as amounting to approximately \$2.3 billion on the DHS balance sheet as of September 30, 2006.

- Consistently applied policies and procedures to ensure appropriate documentation supporting PP&E acquisitions and their existence is maintained and readily available for audit testwork.
  - Developed and documented methodologies and assumptions to support the value of PP&E that is not supported by original acquisition or other documentation.
  - Implemented accurate and complete asset identification, system mapping, and tagging processes that include sufficient detail, e.g., serial number, to clearly differentiate and accurately track physical assets to assets recorded in the fixed asset system.
  - Developed an effective physical inventory process and appropriate support for the valuation method and classification of repairable PP&E.
  - Properly accounted for some improvements and impairments to buildings and structures, and selected useful lives for depreciation purposes, consistent with generally accepted accounting principles.
- 2 US-Visit did not consistently apply procedures to identify and capitalize software development costs or to reclassify software placed into production from software in development. Consequently, US-Visit was unable to fully support the accuracy and completeness of certain property, plant and equipment balances, to allow us to complete our testwork, prior to the completion of DHS' 2006 PAR. At September 30, 2006, software development costs for US-Visit totaled over \$300 million and are expected to increase in future years.
- 3 TSA has not implemented adequate policies and procedures to properly account for and support its property balances. Specifically, we noted:
- Subsidiary records i.e., Sunflower and the Fixed Asset Module, have not been reconciled timely to the general ledger. A fixed asset holding account used by TSA's accounting services provider interferes with the performance of timely reconciliations.
  - The Fixed Asset Module, a subcomponent of the general ledger, had not been updated for depreciation, additions and disposals related to certain property and equipment items since fiscal year 2004.
  - TSA maintains idle property where accounting for idle and impaired value of property has not been considered. Consequently, TSA may have overvalued assets on its balance sheet at September 30, 2006.
  - TSA was unable to provide adequate supporting documentation for a statistical sample of property and equipment items held at August 31, 2006, in a timely manner.

*Cause/Effect:* Coast Guard policies and procedures are not adequate to ensure that PP&E and construction in process transactions are completely and properly accounted for and consistent with generally accepted accounting principles. In addition, the policies and procedures that are in place are not consistently followed, or do not include sufficient controls to ensure compliance with policy or to ensure complete supporting documentation is maintained and available for audit testwork. The fixed asset module of the Coast Guard's CAS is not updated for effective tracking of all PP&E, and its capabilities are not fully utilized to clearly differentiate and accurately track assets.



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While US-Visit has developed adequate accounting policies for tracking software development costs, these policies are not fully or adequately implemented. Over the next few years, significant resources for the development of new software, such as the US-Visit program, will likely be spent. Therefore, the lack of full implementation of these policies increases the risk of financial statement errors due to misapplication of accounting standards for software.

Change in personnel and IT system interface difficulties likely contributed to TSA's conditions affecting property balances. These conditions caused material errors in the interim financial statements and continued until the problem was identified by the external auditor.

*Criteria:* SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, requires that:

- PP&E is recorded at historical cost with an adjustment recorded for depreciation. In the absence of such information, estimates may be used based on a comparison of similar assets with known values or inflation-adjusted current costs; and
- PP&E accounts be adjusted for disposals, retirements and removal of PP&E, including associated depreciation.

According to OMB Circular No. A-123, transactions should be promptly recorded, and properly classified and accounted for, in order to prepare timely and reliable financial and other reports. Documentation for transactions, management controls, and other significant events must be clear and readily available for examination.

GAO *Standards* state that internal controls should generally be designed to assure that on-going monitoring occurs in the course of normal operations. Management is responsible for developing control activities, which are the policies, procedures, techniques, and mechanisms that enforce management's directives and help ensure actions address risks. The activities include reviews by management at the functional or activity level, proper execution of transactions and events, accurate and timely recording of transactions and events, and appropriate documentation of transactions and internal control.

FFMIA Section 803(a) requires each agency to implement and maintain a system that complies substantially with Federal financial management system requirements as stipulated in OMB Circular No. A-127. That Circular requires an agency's system design "to have certain characteristics that include...consistent internal controls over data entry, transaction processing, and reporting throughout the system to ensure the validity of the information."

SFFAS No. 10, *Accounting for Internal Use Software*, provides requirements for the capitalization and reporting of software development costs. GAO *Standards* require that internal control and all transactions and other significant events be clearly documented and readily available for examination. The Joint Financial Management Improvement Program, *Property Management Systems Requirements*, state that the agency's property management system must create a skeletal property record or have another mechanism for capturing information on property in-transit from the providing entity (e.g., vendor, donator, lender, grantor, etc.).

*Recommendations:* We recommend that:

1. Coast Guard:
  - a) Improve controls and related processes and procedures to ensure that PP&E, including additions, transfers, and disposals, are recorded accurately, consistently, and timely in the fixed asset system; that an identifying number is entered in the fixed asset system at the time of asset purchase to facilitate identification and tracking; and that the status of assets is accurately maintained in the system;

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- b) Develop and implement internal controls to ensure the quality, sufficiency, and retention of documentation for future PP&E acquisitions and disposals;
  - c) Develop and document methodologies and assumptions to support the value of PP&E that is not evidenced by original acquisition or other sufficient documentation;
  - d) Revise procedures for performing physical inventories of repairable items, to include procedures for resolving differences, and reporting results, to ensure that repairable PP&E is accurately and completely classified and recorded. Support the pricing methodology used to value repairable PP&E to ensure that balances, as presented in the financial statements, approximate amortized historical cost; and
  - e) Review policies and procedures to account for improvements and impairments to buildings and structures, and identify proper useful lives for depreciation purposes.
2. US-Visit should implement procedures for developers to track and notify accounting personnel when software has been placed into production so that accounting personnel can properly classify and amortize the software costs, and appropriate and sufficient evidence is maintained to document management's decisions that lead to significant accounting transactions.
3. TSA:
- a) Work with its accounting services provider to ensure that the interface between Sunflower and the general ledger functions properly and discontinue the use of the fixed asset holding account;
  - b) Ensure that accounting records are updated timely based on the results of the periodic inventories;
  - c) Update and maintain the activity for all property and equipment items in Sunflower and the Fixed Assets Module;
  - d) Perform and document timely reconciliations between Sunflower, the Fixed Asset Module and general ledger;
  - e) Review those items identified as idle, determine the appropriate accounting treatment and document the related rationale; and
  - f) Ensure adequate supporting documentation exists and is readily available to support the acquisition cost and date of property and equipment items.

**F. Operating Materials and Supplies**

*Background:* Operating Materials and Supplies (OM&S) are maintained by the Coast Guard in significant quantities, and consist of tangible personal property to be consumed in normal operations to service marine equipment, aircraft, and other operating equipment. The majority of the Coast Guard's OM&S is physically located at either two Inventory Control Points (ICPs) or in the field. The ICPs use the NESSS and the ALMIS systems to track inventory. Field held OM&S is recorded in the Fleet Logistics System. These three systems provide the subsidiary records that support the general ledger's OM&S balance. The Coast Guard's policy requires regularly scheduled physical counts of OM&S, which are important to the proper valuation of OM&S and its safekeeping. The conditions cited below for Coast Guard are based on findings reported in fiscal 2005, updated as necessary to reflect the conditions noted in fiscal year 2006.

*Conditions:* We noted the following internal control weaknesses related to OM&S at the Coast Guard:

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- Internal controls over physical counts at field locations were not fully designed and implemented to remediate conditions identified during fiscal years 2003, 2004 and 2005. In fiscal year 2005, we reported that items were not always properly bar-coded or tagged, on-hand quantities frequently did not agree to the perpetual inventory records, and procedures did not sufficiently address whether all inventory on hand was properly recorded in the perpetual records or require discrepancies to be resolved timely. Coast Guard has acknowledged that these weaknesses continued to exist in fiscal year 2006, and represented their intent to complete corrective action over field held OM&S, to include implementation of internal controls, no later than September 30, 2009.
- Policies, procedures, and controls designed to remediate conditions related to conducting physical inventories of OM&S at the ICPs were not completely implemented in fiscal year 2006. ICP physical inventory procedures lacked key elements of an effective physical inventory, e.g., reconciliation of sample population to perpetual records, statistically valid methods of sampling, and proper evaluation and reporting of results. Comprehensive step-by-step physical inventory instructions that clearly addressed each objective of a physical inventory were not fully implemented in fiscal year 2005, and the Coast Guard has acknowledged that these weaknesses continued to exist in fiscal year 2006. Coast Guard management has represented their intent to implement corrective action over ICP physical inventory procedures, to include implementation of internal controls, no later than September 30, 2009.
- Processes and controls were not in place to fully support the calculated value of field-held and ICP OM&S to approximate historical cost. Coast Guard management has represented their intent to implement corrective actions over valuation of OM&S no later than September 30, 2009.

*Cause/Effect:* Coast Guard management deferred correction of most OM&S weaknesses reported in fiscal years 2003 through 2005 until fiscal year 2007, and acknowledged that the conditions we reported in prior years remained throughout fiscal year 2006. Lack of comprehensive and effective policies and controls over the performance of physical counts, and appropriate support for valuation, may result in errors in the physical inventory process or inventory discrepancies that could result in financial statement misstatements.

*Criteria:* According to GAO *Standards*, assets at risk of loss or unauthorized use should be periodically counted and compared to control records. Policies and procedures should be in place for this process. The Financial Systems Integrated Office (FSIO) publication, *Inventory, Supplies, and Material System Requirements*, states that “the general requirements for control of inventory, supplies and materials consist of the processes of receipt and inspection. An agency’s inventory, supplies and materials system must identify the intended location of the item and track its movement from the point of initial receipt to its final destination.” SFFAS No. 3, *Accounting for Inventory and Related Property*, states OM&S shall be valued on the basis of historical cost.

*Recommendations:* We recommend that the Coast Guard:

- a) Update OM&S physical count policies, procedures, and controls, and provide training to personnel responsible for conducting physical inventories;
- b) Implement effective oversight and monitoring procedures to ensure that physical inventory counts are performed and evaluated in accordance with policies and procedures;
- c) Perform a review of the inventory information contained in subsidiary ledgers to identify and correct discrepancies between the perpetual records and actual physical item counts at warehouse locations;

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- d) Consider developing risk-based cycle counting procedures for OM&S; and
- e) Provide adequate support for the value of OM&S to approximate historical cost.

**G. Legal and Other Liabilities**

*Background:* The Department has legal claims totaling over \$10 billion made against it and its components at September 30, 2006. The Department's Office of General Council (OGC) has determined the probability of loss as "remote" on all claims except for a small fraction, less than 1 percent, of total claims which has been accrued as a liability in the financial statements. The dollar size and number of legal claims against the Department requires management, working with the OGC, to have a rigorous process in place and operating effectively to ensure that all legal cases are properly evaluated to determine the likelihood of loss, and liabilities are accrued and/or disclosed in the financial statements, consistent with generally accepted accounting principles, throughout the year.

Most of the DHS components estimate accounts payable at year-end for accelerated financial reporting purposes as a percentage of undelivered orders (UDOs) based on historical trends. As described in Comment I – *Budgetary Accounting*, reliable accounting processes surrounding the recording of obligations and disbursements, and tracking of UDOs are key to the accurate reporting of accounts payable in DHS' financial statements.

G&T uses its accounting services provider's grants management system to support G&T's grant making activities. The grants management system allows grantees to submit their financial status reports electronically via web-based connections. In addition, a majority of the grant programs that TSA administered have been transferred to G&T. TSA has retained responsibility for administering grants issued prior to 2004 until closeout, as well as certain other grant programs.

In addition to issuing significant grant awards each year, FEMA's mission assignment and flood insurance claims activities have increased considerably after the 2005 hurricane season.

*Conditions:* We noted the following internal control weaknesses related to legal and other liabilities (specifically accounts and grants payable):

- 1 OFM, in association with OGC, has not:
  - Implemented adequate policies and procedures to ensure that OFM is provided with sufficient information to accurately and completely present legal liabilities and related disclosures in the financial statements throughout the year. We noted the following deficiencies with management's process:
    - OGC did not provide information to management or the auditors in a timely manner. Requests by the auditors to perform interim procedures were denied. We did not receive certain requested information on legal cases until mid-October 2006;
    - OGC did not provide complete responses for all cases, e.g., nature of the matter, progress of the matter to date, the governments planned response, etc., as requested by the CFO. Consequently, we were unable to complete our testing procedures on legal liabilities prior to the completion of the Department's 2006 PAR; and
    - The OFM did not perform an assessment of responses received by OGC, in sufficient detail to identify inadequacies before the information was provided to the auditor. OFM also made representations to the auditor that contingent legal liabilities were accurately and completely presented in the financial statements in accordance with GAAP, without a clear rationale for that representation other than the information

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provided by OGC, which, as described above, was not received timely and did not contain sufficient information for all cases.

2 Coast Guard:

- Does not use a reliable methodology to estimate accounts payable. The method used was not supported as to the validity of data, assumptions, and criteria used to develop and subsequently validate the reliability of the estimate for financial reporting.
- Does not have adequate policies, procedures and internal controls over Coast Guard's process for reconciling military payroll recorded in the CAS general ledger to detail payroll records. Military personnel data changes, including changes in leave balances and payroll corrections, are not processed to be reflected in the appropriate payroll and/or reporting periods, and consequently impact the completeness and accuracy of leave and payroll accruals as well as data used for actuarial projections.
- Does not have documented policies and procedures, including appropriately designed internal controls, to ensure that the Coast Guard legal liabilities, included with the Department's accrued and disclosed contingent liabilities in the balance sheet at September 30, 2006, are accurate and complete. In addition, information is not prepared on a quarterly basis as necessary to prepare accurate timely financial statements throughout the year.

3 G&T did not establish a reliable method, including validity of data and assumptions made, to estimate its grants payable [or advances] for accrual in the financial statements until the end of the fourth quarter of fiscal year 2006. The initial estimate contained errors that were discovered during our testwork and, when corrected, resulted in material adjustment to management's original estimate. G&T made the necessary corrections before the issuance of the year-end financial statements.

4 TSA:

- Did not implement a new grant accrual methodology until August 2006, and the new methodology did not consider non-reporters. Therefore, the underlying expenditure data used in the accrual percentage and the actual expenditure data subsequently used for comparison/validation purposes may not be complete.
- Was unable to reconcile its annual leave subsidiary ledger to the general ledger during the year, creating an out-of-balance condition in July of approximately \$165 million.

5 FEMA:

- Did not estimate and accrue accounts payable for all material open mission assignments at year-end. FEMA only accrued for mission assignments for which a payable confirmation had been received from the other Federal agency.
- Did not have fully effective policies and procedures to ensure that insurance company financial data collected through a third-party service provider was accurate and complete, affecting the reliability of its accounts payable balance as of September 30, 2006.

6 FEMA and TSA did not have sufficient policies and procedures in place to fully comply with the OMB Circular No. A-133, *Audits of States, Local Governments, and Non-profit Organizations*.

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#### *Cause/Effect:*

Coast Guard has not yet developed comprehensive policies and procedures or corrective action plans to address the conditions above, and consequently, management is unable to assert to the accuracy and completeness of accounts payable, payroll accruals, and legal liabilities recorded as of September 30, 2006.

G&T and its accounting services provider were in the process of formalizing the current year's grant accrual review process during the first three quarters of FY 2006, and as a result, had not yet performed sufficient analysis to ensure that the historical analyses and the related grant accrual calculations were accurate.

During fiscal year 2005, the majority of TSA's grant functions transferred to G&T, and TSA currently issues very few new grants. Because TSA is not considered a grant-making agency, the systems supporting grants do not provide for the level of sophistication needed to develop a robust grant accrual methodology.

FEMA did not perform an analysis to prepare an estimated accrual for related mission assignments because certain other Federal agencies did not provide payable confirmations. As a result, intragovernmental accounts payable is likely understated at September 30, 2006. Additionally, FEMA relies on its third-party service provider to collect reliable and complete data from the insurance companies participating in the flood insurance program.

At FEMA, G&T, and TSA, if grants are not appropriately monitored, it is possible that funding will not be used for its intended purpose.

*Criteria:* GAO Standards hold that transactions should be properly authorized, documented, and recorded accurately and timely. OMB Circular No. A-123 states that "transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports." SFFAS No. 1, *Accounting for Selected Assets and Liabilities*, states, "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."

Statement on Auditing Standards (SAS) No. 57 (AU 342.06) states "An entity's internal control may reduce the likelihood of material misstatements of accounting estimates. Specific relevant aspects of internal control include the following...Accumulation of relevant, sufficient, and reliable data on which to base an accounting estimate...Comparison of prior accounting estimates with subsequent results to assess the reliability of the process used to develop estimates."

OMB Circular A-133 states that grants should be monitored by the grant making organization.

*Recommendations:* We recommend that:

1. OFM:
  - a) Establish a time-table with OGC early in the year to perform quarterly updates of the legal cases, to ensure that interim period financial statements contain an accurate and complete presentation of legal liabilities;
  - b) Clearly define the type and extent of information needed from OGC on each case, to allow OFM to make an assertion on the completeness and accuracy of the financial statements. Both the CFO and auditor need to be provided with sufficient information, on each template, to understand the basis for the attorney's conclusion. Cases of greater significance, complexity, or liabilities that involve mathematical calculations may require an attachment to the template showing more detail to support the estimated liabilities and rationale for the attorney's conclusion. There should be a logical extension to the

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**Exhibit I – Material Weaknesses in Internal Control**

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- conclusion (likelihood of unfavorable outcome) based on the information provided in the case template; and
- c) Perform a thorough assessment of the response received by OGC to determine the sufficiency of the information and maintain documentation of their analysis in sufficient detail to allow the auditor to reach the same conclusion as management, based on the facts stated in the attorney's response, or other documented evidence obtained by OFM.
2. Coast Guard:
    - a) Analyze and make appropriate improvements to the methodology used to estimate accounts payable and support all assumptions and criteria with appropriate documentation to develop and subsequently validate the estimate for financial reporting;
    - b) Implement corrective action, including appropriately designed and implemented internal controls, to support the completeness, existence and accuracy of changes in member personnel data records and military payroll transactions, and to include recorded accrued military leave and payroll liabilities; and
    - c) Develop, document and implement formal policies and procedures, to include internal controls to verify and support management assertions of completeness and accuracy of the legal liability estimate and related disclosures on a quarterly basis.
  3. G&T:
    - a) Develop and implement policies and procedures to periodically validate the accuracy of the calculations used to derive the quarterly grant accrual, and should continue to improve and formalize its review process of the grant data files, specifically the completeness and accuracy of the information contained in the files;
    - b) Perform independent reviews to ensure that all information included in the files is complete and that the correct amounts are recorded in the financial statements;
    - c) Perform analyses over its grant portfolio to better understand the behavior of its grants in order to more accurately estimate its grant accrual;
    - d) Work with DHS management to migrate G&T's general ledger and grants management system to a system maintained by a component within DHS; and
    - e) The OGO should complete and formalize its policies and procedures for the financial monitoring process, and OGO staff should be made aware of these policies which should be strictly enforced. Policies should be established to ensure that OGO staff are able to complete all of the required documentation within the set timelines.
  4. TSA:
    - a) In coordination with G&T, implement monitoring procedures to ensure that grantees submit requests for reimbursement and related reports in a timely manner, and continue to refine its grant accrual methodology to properly consider grantees that do not submit requests for reimbursement in a timely manner (non-reporters); and
    - b) Review the programming logic used by the service provider to summarize annual leave to be recorded in the general ledger. Make corrections where required to properly report the annual leave balance in the general ledger. Implement policies and procedures to periodically reconcile its annual leave subsidiary records to the general ledger.

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5. FEMA:
  - a) Establish procedures to coordinate with other federal agencies with outstanding mission assignments to provide a payable confirmation on a quarterly basis;
  - b) Develop and implement an estimation methodology to accrue for unpaid mission assignment services provided prior to the end of an accounting period if the other federal agency does not provide a payable confirmation; and
  - c) Work with its third-party service provider to clarify with the insurance companies the information that should be included with accounts payable, and to implement policies and procedures to ensure that consistent, reliable and complete accounts payable data is transmitted from the companies to the third-party service provider on a monthly basis.
6. FEMA and TSA implement policies and procedures to ensure full compliance with OMB Circular No. A-133.

**H. Actuarial Liabilities**

*Background:* The Coast Guard maintains pension, medical and post-employment travel benefit programs that require actuarial computations to record related liabilities for financial reporting purposes. The Military Retirement System (MRS) is a defined benefit plan that covers both retirement pay and health care benefits for all active duty and reserve military members of the Coast Guard. The medical plan covers active duty, reservists, retirees / survivors and their dependents who are provided care at Department of Defense (DoD) medical facilities. The DoD invoices the Coast Guard for the cost of medical care as services are provided. The post-employment travel benefit program pays the cost of transportation for uniformed service members upon separation from the Coast Guard. A combined unfunded accrued liability of approximately \$27.2 billion for the plans is reported in the DHS balance sheet at September 30, 2006. Annually, participant and cost data is extracted by Coast Guard from its records and provided to an actuarial firm, as input for the liability calculations. The accuracy of the actuarial liability as reported in the financial statements is dependent on the accuracy and completeness of the underlying participant and cost data provided to the actuary.

*Conditions:* Coast Guard:

- Does not have adequate policies, procedures, and controls to ensure the completeness and accuracy of participant data, medical cost data, and trend and experience data provided to, and used by, the actuary for the calculation of the MRS pension, medical, and post employment transportation benefit liabilities. The Coast Guard:
  - Does not have complete policies to ensure that personnel data records are processed timely. During the month of August 2006, approximately 2,000 personnel changes were performed, some of which were more than three years old;
  - Did not follow standard operating procedures to extract and define personnel data used by the actuary in the experience study. Four out of 45 records we tested did not have supporting documentation; and
  - Submitted incomplete or inaccurate attribute data to the actuary. Of the records we reviewed; 200 active member data records did not contain a key attribute, e.g., date of initial entry to service; 10 records had invalid data, e.g., date of birth; 27 records had inappropriate object codes affecting personnel classification; 2 records had incorrect base pay; and 7 records were not supported by information in personnel files.



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### Exhibit I – Material Weaknesses in Internal Control

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- Has not performed timely or effective reconciliations between the medical expenditures subsidiary ledger and the general ledger, which would have identified errors in underlying data prior to the submission of data to the actuary.
- Did not have effective policies, procedures, and controls to review invoices from the DoD for medical care, e.g., proper pay rates, classification of participants, etc. Coast Guard could not resolve anomalies and errors in cost data provided to the actuary or reconcile files provided to the actuary to files presented to the auditors. Consequently, the Coast Guard did not identify errors in DoD billings that, over a period of several years, resulted in an overstatement of \$444 million of the fiscal year 2005 post-retirement medical liability and required DHS to restate its published 2005 financial statements. Further, more than six months after the errors were discovered, the Coast Guard has not implemented corrective actions and has not initiated a review of all invoices from other DoD military treatment facilities to validate the accuracy and completeness, or established procedures and controls to prevent similar errors from reoccurring. The Coast Guard does not have an established process to inform the actuary of Congressional legislation that changed allotments, entitlements, calculation methods, and amounts of military pay, which could materially affect the calculation of actuarial liabilities.

*Cause/Effect:* Much of the data required by the actuary comes from personnel and payroll systems that are outside of Coast Guard's accounting organization and are instead managed by Coast Guard's Personnel Service Center (PSC). The PSC does not perform a reconciliation of basic pay information provided to the actuary with actual disbursements recorded in the general ledger. As a result of weak policies, procedures and controls, the actuary was provided with erroneous data, and the problem was discovered too late in the year to recompute pension and other post-retirement liabilities. Consequently, the Coast Guard management is unable to provide assurance on the completeness and accuracy of actuarially determined liabilities as stated in the DHS balance sheet at September 30, 2006. In addition, the Coast Guard does not have sufficient controls to prevent overpayments to the DoD for medical services, and inaccurate medical costs submitted to the Coast Guard actuary could result in a misstatement of the actuarial medical liability and related expenses. Also, the conditions noted exist, in part, because of ineffective entity-level controls, in particular, with regard to financial management oversight – see Comment A – *Financial Management and Oversight*.

*Criteria:* GAO Standards state that management is responsible for developing policies, procedures, techniques, and mechanisms that enforce management's directives. Control activities include approvals, authorizations, verifications, reconciliations, performance review, and the creation and maintenance of related records that provide evidence of execution of these activities, as well as appropriate documentation.

According to SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, paragraph 95, the employer should recognize an expense and a liability for other post-employment benefits (OPEB) when a future outflow or other sacrifice of resources is probable and measurable on the basis of events occurring on or before the reporting date. Further, the long-term OPEB liability should be measured at the present value of future payments, which requires the employer to estimate the amount and timing of future payments, and to discount the future outflow over the period for which the payments are to be made.

*Recommendations:*

We recommend that Coast Guard:

- a) Establish and document policies, procedures, and effective controls to ensure the completeness and accuracy of participant data, medical cost data, and trend and

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### **Exhibit I – Material Weaknesses in Internal Control**

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- experience data provided to, and used by, the actuary for the calculation of the MRS pension, medical, and post employment travel benefit liabilities; perform an analysis of its personnel data IT systems to determine why certain IT system interfaces or query programs did not reliably process attribute data provided to the actuary and to identify key controls that were absent or ineffective; and take corrective action regarding any data anomalies identified and consider the need to revise trend and experience data;
- b) Perform a periodic reconciliation between the medical expenditures recorded in the subsidiary ledger and those recorded in the CAS, and address differences before data is provided to the actuary. This reconciliation should be performed for all significant sources of medical actuarial data, including TriCare, and DoD Military Treatment Facilities (MTFs). In addition, this reconciliation should be reviewed by someone other than the preparer to ensure accuracy;
  - c) Establish policies, procedures, and controls to review invoices received from the DoD for medical care including incurred but not reported costs. These procedures could include analysis of monthly medical cost payment trends, and related evaluations of trends, to assess the accuracy and consistency of billings (between the military services), and for various treatment types (e.g., in-patient, out-patient). The Coast Guard should also verify that MTFs only bill for services provided to eligible Coast Guard participants and sponsors; and
  - d) Establish a process to inform the actuary of Congressional legislation that changed allotments, entitlements, calculation methods, and amounts of military pay, which could materially affect the calculation of actuarial liabilities.

#### **I. Budgetary Accounting**

*Background:* Budgetary accounts are a category of general ledger accounts where transactions related to the receipt, obligation, and disbursement of appropriations and other authorities to obligate and spend agency resources are recorded. Combined, DHS has over 300 separate Treasury fund symbols (TAFS), each with separate budgetary accounts that must be maintained in accordance with OMB and Treasury guidance. The TAFS cover a broad spectrum of budget authority, including annual, multi-year, and no-year appropriations; and several revolving, special, and trust funds. The DHS components discussed below account for more than 85 percent of all DHS TAFS. Accounting for budgetary transactions in a timely and accurate manner is essential to manage the funds of the Department and prevent overspending of allotted budgets.

Most of the DHS components estimate accounts payable at year-end as a percentage of UDOs based on historical trends. UDOs are obligations, or budgetary funds reserved, for good and services ordered but not yet delivered to DHS. At year-end, DHS reported over \$440 billion in UDOs. Reliable accounting processes surrounding obligations, UDOs, and disbursements are key to the accurate reporting of accounts payable in DHS' financial statements (see Comment G – *Legal and Other Liabilities*).

The majority of conditions cited below for Coast Guard are repeated from our fiscal year 2005 report. The Coast Guard has initiated a review of its obligation and procurement processes, including those related to the Integrated Deepwater System.

TSA's ability to monitor and account for its budgetary accounts, including UDOs and accurately estimate accounts payable is partially dependent on the Coast Guard as TSA's accounting service provider.

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### **Exhibit I – Material Weaknesses in Internal Control**

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FEMA budgetary accounts were significantly affected by a large increase in appropriated funds provided at the end of fiscal year 2005.

Consistent with ICE's multi-year CAP to address its internal control weakness, ICE has not fully implemented corrective actions over budgetary accounts, including UDOs. In addition, management is continuing to evaluate and validate the propriety of certain prior year obligations of the Federal Protective Service (FPS). Management was unable to assert to the completeness and validation of the UDO balances and, consequently, we were unable to complete our testing of FPS UDOs and the related effects on accounts payable and net position in fiscal year 2006.

While ICE performs accounting services for other DHS components, such as the Management Directorate and US-Visit, each component has certain responsibilities within the budgetary and disbursement process, e.g., the timely and accurate recording of obligations that they must perform, to ensure accurate overall financial reporting.

*Conditions:* We noted the following internal control weaknesses related to budgetary accounting, many of which were repeated from fiscal year 2005:

#### 1 Coast Guard:

- The policies, procedures and internal controls over Coast Guard's process for validation and verification of UDO balances are not effective to ensure that recorded obligations were valid, obligations incurred were recorded timely, and that proper approvals and supporting documentation is maintained. Coast Guard has not designed or implemented a comprehensive internal control program across all components of the organization to prevent or detect and correct misstatements to UDO balances reported on the financial statements. In addition, programming logic and transaction codes used to record advances for which an obligation was not previously recorded are not operating effectively to ensure the obligation and UDO are properly recorded.
- Policies were not fully implemented to ensure that contract awards were recorded in the general ledger in a timely manner, and as a result, obligations might have been temporarily understated. In addition, we noted a lack of segregation of duties associated with the creation and approval of purchase requisitions, certification of funds availability, and the recording of the obligations.
- Procedures and controls are not adequate to prevent a commitment or obligation of funds in excess of established appropriations. While the Coast Guard did take action to correct this weakness during fiscal year 2006, the system edits could not be demonstrated to be fully functional during our engagement. In addition, the Coast Guard did not effectively monitor unobligated commitment activity in its procurement system. As of July 2006, there were over 17,000 unobligated commitment transactions totaling approximately \$442 million. In addition, the policy does not require all procurement units to fully utilize IT system controls, and therefore, Financial Procurement Desktop (FPD) users have the ability to create Purchase Requisition (PR) document numbers with less than the standard 16 characters/digits.
- FPD was also not properly reconciled to the CAS, affecting the completeness, existence and accuracy of the year-end "pipeline" adjustment that was made to record obligations executed before year-end, but which were not made into the system prior to year-end close. Obligations were recorded in FPD, but were not properly interfaced with the CAS, and were not supported by adequate documentation.
- Obligations related to post-employment permanent changes of station (PCS) were not recorded at the time orders were approved and issued.

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- Automated system controls are not effectively used to prevent the processing of procurement transactions by contracting officer's with expired warrant authority, and a manual compensating control was not effective since listings of warranted contracting officers were not complete.
- 2 TSA:
- Did not maintain, documentation supporting UDOs and related purchase information in a manner that is readily available to management and the auditors. Consequently, TSA was unable to provide sufficient documentation to support a sample of UDO balances at year-end prior to the completion of the DHS' 2006 PAR.
  - Has developed, but not fully implemented, IT system programming logic which allows the accounting system to record obligations recovered at the transaction level in accordance with SGL requirements.
- 3 FEMA:
- Does not have adequate resources to monitor the status and ensure the timely deobligation of mission assignments<sup>4</sup>, resulting in an overstatement of UDOs at the time of our testwork. In our June 30<sup>th</sup> and September 30<sup>th</sup> samples, we identified numerous exceptions that prevented us from concluding on the mission assignment portion of the UDO balance.
  - Did not maintain adequate communications with its grants disbursements service provider regarding the reliability of its internal controls. In fiscal year 2006, FEMA's grant disbursement service provider received a qualified opinion over the effectiveness of its internal controls for the period October 1, 2005, to June 30, 2006. However, FEMA was not aware of these control deficiencies until late October 2006, and consequently, payment information from the third-party service provider used to reduce obligations in its general ledger may not be accurate.
- 4 ICE has not completed its validation and verification of FPS prior year obligations, in order to determine the propriety of the completeness, existence, and accuracy of those obligations.
- 5 Management Directorate has not:
- Established policies and procedures to ensure that obligations are recorded timely. Specifically, in a sample of 45 items, we noted that (a) the period of performance was prior to the obligation being recorded in Federal Financial Management System (FFMS) for three samples items; (b) the invoice was received prior to the obligation being recorded in FFMS for three items, and (c) Intergovernmental Payments and Collections (IPAC)s were paid prior to the obligation being recorded in FFMS for two items; thus, it appears that services were rendered before the obligation was recorded in FFMS.
  - Established policies and procedures to ensure that all key attributes of an obligation and purchase are recorded in the financial accounting system. In a sample of 45 items, we noted that four purchases were not classified properly at the time of acquisition, e.g., as a good or service. Proper classification of the purchase is important for system controls to be effective at the time of receipt of the good or service and when estimating accounts payable.

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<sup>4</sup> In accordance with FEMA's National Response Plan (NRP), FEMA may require the assistance of other Federal agencies to assist with Disaster Relief, as needed. The NRA defines a Mission Assignment as the vehicle used by DHS/FEMA to engage and fund services of other Federal agencies to respond to a disaster or emergency declaration.

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- 6 US-Visit has not established policies and procedures to ensure that documentation supporting obligations and subsequent disbursements is filed and readily available for management and auditor review.

*Cause/Effect:*

Several of the Coast Guard's budgetary control weaknesses can be corrected by modifications or improvements to the financial accounting system, process improvements, and strengthened policies. The Coast Guard has deferred correction of these conditions until fiscal year 2007. The Coast Guard also serves as TSA's accounting service provider; therefore, some financial accounting system and process weaknesses at the Coast Guard may affect TSA's accounting records as well. Further, TSA fund managers do not periodically reconcile and research outstanding obligation balances to determine their continued validity. FEMA's ability to monitor and manage mission assignments was significantly affected by resource limitations, and an exceptionally high volume of transactions related to significant hurricanes in 2005. In addition, FEMA did not maintain sufficient contact during the year with its third-party service provider for grant disbursements to ascertain that control weaknesses existed and were reported timely.

Weak controls in budgetary accounting, and associated contracting practices increase the risk that DHS and its components could violate the *Anti-deficiency Act* and overspend their budget authority. The financial statements are also at greater risk of misstatement. The untimely release of commitments may prevent funds from being used timely for other purposes.

*Criteria:* According to JFMIP's *Core Financial System Requirements*, an agency's core financial management system must ensure that an agency does not obligate or disburse funds in excess of those appropriated and/or authorized and specific system edits and user notifications related to funds control must be in place. The *Federal Acquisition Regulation (FAR)* Section 1.16 addresses the authorities and responsibilities granted contracting officers. Treasury's USSGL guidance specifies the accounting entries related to budgetary transactions.

According to OMB Circular No. A-123, "agency managers should continuously monitor and improve the effectiveness of internal control associated with their programs." This continuous monitoring, and other periodic evaluations, should provide the basis for the agency head's annual assessment of and report on internal control, as required by FMFIA. This Circular indicates that "control weaknesses at a service organization could have a material impact on the controls of the customer organization. Therefore, management of cross-servicing agencies will need to provide an annual assurance statement to its customer agencies in advance to allow its customer agencies to rely upon that assurance statement. Management of cross-servicing agencies shall test the controls over the activities for which it performs for others on a yearly basis. These controls shall be highlighted in management's assurance statement that is provided to its customers. Cross-servicing and customer agencies will need to coordinate the timing of the assurance statements."

FFMIA Section 803(a) requires that each Agency to implement and maintain a system that complies substantially with Federal financial management system requirements as stipulated by OMB Circular No.A-127.

FEMA's SOP for *Processing Mission Assignment and Interagency Payments for Fund Code 06*, April 2005, establishes the process for Mission Assignment (MA) closeouts. The quarterly review of unliquidated obligations (ULO) lists all MA obligations with an available balance. The Financial Information Analyst (FIA) or Accountant reviews the MA report or Mission Assignment Financial Information Tool Report and other internal records to track activity against the obligation. If no activity has been recorded within the last 90 days, the Disaster Finance Branch (DFB) initiates the closeout process, by sending the quarterly ULO report to the Region or Headquarters MA Coordinator (MAC) for action.

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The FEMA Form 90-129, *Mission Assignment Agreement*, states in the description of work that the Other Federal Agency (OFA) is responsible for submitting a Mission Assignment Monthly Progress Report to FEMA to include cost data when MAs take more than 60 days to complete, including billing. The *Anti-deficiency Act* prohibits agencies from obligating or disbursing more than their appropriations and apportionments, has strict requirements for reporting violations, and includes penalties for violations. GAO *Standards* hold that transactions should be properly authorized, documented, and recorded accurately and timely.

*Recommendations:* We recommend that:

1. Coast Guard:

- a) Improve policies, procedures, and controls related to processing obligation transactions, including periodic review and validation of UDOs. Emphasize to all fund managers the need to perform effective reviews of open obligations, obtain proper approvals, and retain supporting documentation;
- b) Evaluate programming logic and transactions codes used to record advances for which an obligation was not previously recorded to ensure the obligation and UDO is properly recorded;
- c) Fully implement policies to ensure that contract awards are recorded in the general ledger in a timely manner;
- d) Improve segregation of duties for transactions related to the creation and approval of purchase requisitions, certification of funds availability, and the recording of the obligations, and record contracts timely;
- e) Revise controls and related policies and procedures to periodically review commitments, e.g., monitor aging, and determine the feasibility of modifying FPD to transmit all commitments, regardless of dollar amount, to the general ledger system, and to properly interface FPD with CAS;
- f) While no violations were noted, consider activating the electronic edit checks in FPD to prevent incurring commitments and obligations in excess of appropriations and apportionment and allotment levels; use of such a control is one method that would allow the Coast Guard to automatically flag and prevent the recording of commitments (a reservation of funds for future obligation) and obligations in excess of appropriations, apportionments, or allotments. In addition, the Coast Guard should establish procedures to effectively monitor unobligated commitment activity and make timely adjustments, e.g., cancel or update, to reflect the status of commitments;
- g) Reconcile FPD to CAS to ensure the completeness, existence, and accuracy of the year-end “pipeline” adjustment that is made to record obligations executed before year-end, but not recorded in the system prior to year-end close;
- h) Implement procedures to ensure that obligations related to PCS are recorded at the time orders are approved and issued, and supporting documentation is maintained; and
- i) Establish automated system controls to preclude the processing of procurement transactions if the contracting officer’s warrant authority had expired.

2. TSA:

- a) Develop system tools that improve the process of identifying, summarizing, and reporting accounting transactions to allow for the timely identification and research of procurement and expenditure documentation;

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**Exhibit I – Material Weaknesses in Internal Control**

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- b) Retain all procurement and intragovernmental expense supporting source documentation in a manner that facilitates timely document retrieval;
  - c) Review outstanding obligations for validity on a periodic basis, and document this review; and
  - d) Continue to work with its accounting services provider to fully implement programming logic in CAS to capture and report prior year recoveries at the transaction level.
3. FEMA:
- a) Require all regional offices to perform a complete UDO review, monitor timely completion of this review, and ensure that all identified mission assignment deobligations are processed in the general ledger promptly;
  - b) Ensure that personnel follow the established policy for quarterly obligation reviews prior to the end of each quarter to timely determine whether the remaining balance on a mission assignment is valid, or whether a deobligation of the remaining balance is necessary;
  - c) Seek assistance from other components within DHS and/or contractors when additional administrative staffing resources are needed because of disaster situations; and
  - d) Establish procedures to periodically communicate with its third-party service provider for grant disbursements to ascertain if control weaknesses exist and are reported timely.
4. ICE complete its validation and verification of FPS prior year obligations and verify the completeness, existence, and accuracy of FPS recorded obligations.
5. Management Directorate:
- a) Redesign the procurement process, as necessary, and follow established procedures and internal controls to ensure that all obligations are accurately entered into FFMS in a timely manner, in accordance with applicable accounting standards, e.g., OMB Circular No. A-11;
  - b) Policies and procedures be followed to ensure that all key attributes of an obligation and purchase are recorded in the financial accounting system; and
  - c) Improve policies and procedures to ensure that documentation, including contracting officer approvals, is maintained to support all obligations.
6. US-Visit should follow existing procedures to ensure that undelivered orders are periodically verified and validated and that the Open Document File is a reliable source to compute the accounts payable estimate. In addition, documentation supporting obligations and subsequent disbursements is filed and available for management and auditor review.

**J. Intragovernmental Balances**

*Background:* DHS conducts business with other Federal agencies resulting in intragovernmental receivables, payables, and the reporting of revenues, expenses and transfers from intragovernmental transactions. Federal accounting and reporting regulations require Federal agencies to routinely identify and reconcile intragovernmental balances and transactions with trading partners. These procedures help ensure that intragovernmental balances properly eliminate in the government-wide financial statements.

*Conditions:* In fiscal year 2005, we reported that DHS did not timely or completely reconcile intragovernmental balances with other Federal entities, particularly the DoD. Consequently, the

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### Exhibit I – Material Weaknesses in Internal Control

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DHS' *Material Difference/Status of Disposition Certification Report*, submitted to Treasury for September 30, 2005, showed material differences attributable to accounting/reporting errors in excess of \$1.6 billion. These conditions also impacted DHS' ability to accurately report transactions with Federal government trading partners in the financial statements and in the Required Supplementary Information section of the financial statements, as required.

During fiscal year 2006, we noted that DHS did not take action to correct the conditions reported in 2005. OFM has not been able to reconcile intragovernmental asset, liability, and revenue amounts with trading partners, as required by OMB Circular No. A-136, as follows:

- OFM did not coordinate a DHS-wide reconciliation throughout the year of all intragovernmental balances. We noted that DHS, in cooperation with its components, have not developed and adopted effective policies and procedures, or established systems, to completely track, confirm, and reconcile intra-governmental balances and/or transactions with trading partners in a timely manner, which contributed to the material differences, cited below in 2006.
- The *Material Differences Reports* submitted to Treasury identified accounting/reporting errors of approximately \$1.4 billion in both the first and second quarter 2006. These differences were primarily related to activity with the following trading partners: 96-U.S. Army Corps of Engineers and 97-Office of the Secretary of Defense-Defense Agencies. These differences were not fully reconciled/ resolved by the following quarter.
- The third quarter *Material Differences Reports* submitted to Treasury identified approximately \$25.4 billion in material differences with trading partners, of which DHS indicated \$25.3 billion related to accounting/reporting errors. Upon investigation, OFM indicated that incorrect data was transmitted to Treasury and resulted in a substantial amount of the errors in the report. OFM has not been able to determine the cause of this incorrect file submission. We also note that as the third quarter Treasury *Material Differences Report* was based on erroneous information, additional trading partner differences may have been identified if accurate information had been provided to Treasury.

*Cause/Effect:* A lack of resources, and decisions by management to defer corrective action, lead to the lack of reconciliation of intragovernmental differences. OFM's corrective action plan indicates that these conditions will not be fully remediated until fiscal year 2008. Reconciling trading partner activity and balances at least quarterly is necessary to identify material out-of-balance conditions between Federal entities and to support an accurate consolidation of DHS and the Government-wide financial statements.

*Criteria:* The *Treasury Federal Intragovernmental Transactions Accounting Policies Guide*, dated August 18, 2006 (TFITAPG) states that OMB Circular No. A-136, requires Federal CFO Act and non-CFO Act entities identified in the Treasury Financial Manual 2006, Vol. I, Part 2-Chapter 4700, *Agency Reporting Requirements for the Financial Report of the United States Government*, perform quarterly reconciliations of intragovernmental activity/balances.

Per the TFITAPG, each quarter of Federal agencies are responsible for:

- Establishing and maintaining a structure for intragovernmental transactions (initiating, executing, recording, reconciling, and reporting procedures).
- Documenting and supporting the information recorded in the accounting records related to intragovernmental transactions.
- Recording activity between Federal entities at the transaction level.



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- Providing intragovernmental balances (“F” transactions) for all proprietary USSGL accounts to FMS each quarter.
- Reconciling the intragovernmental data in the accounting records to the supporting documentation based on FMS IRAS Reports.
- Representing that all intragovernmental balances have been reconciled and that those balances are presented in the agency’s audited financial statements as instructed by OMB Circular No. A-136.
- Establishing a consistent relationship with their trading partners in order to identify and resolve differences.

The *Treasury Financial Management Service Memorandum M-03-01*, dated October 4, 2002, provides guidance to Federal agencies for standardizing the processing and recording of intragovernmental activities. The *Treasury Federal Intragovernmental Transactions Accounting Policies Guide*, dated October 23, 2002, requires quarterly reconciliation of intragovernmental asset, liability, and revenue amounts with trading partners. Further, the TFM, Section 4706, *Intragovernmental Activity/Balances*, requires reporting agencies to reconcile and confirm intragovernmental activity and balances quarterly for specific reciprocal groupings. It also requires agency financial statements to be presented on a consolidated basis, including the elimination of significant intradepartmental transactions and balances for reporting purposes.

*Recommendation:*

1. We recommend that DHS OFM:
  - a) Develop a Department-wide policy that requires the reconciliation of intragovernmental balances with trading partners in accordance with Treasury requirements;
  - b) Establish a formal documented review and approval process over reconciliation activities performed by OFM to ensure that all intragovernmental activity and balances are identified and differences are being resolved in a timely manner. Procedures should also include obtaining positive confirmation of balances with DHS trading partners;
  - c) Establish a relationship/point of contact with senior management of every trading partner to facilitate the resolution of differences on an on-going basis. For example, perform proactive reconciliation discussions with trading partners prior to the quarterly submissions of intragovernmental balances to Treasury;
  - d) Review the processes/logic used to generate the “F” transactions report and develop controls to ensure correct data is sent to FMS every quarter; and
  - e) Develop a correction action plan that will correct the conditions in fiscal year 2007.
2. We recommend that DHS OFM, develop and implement procedures to positively confirm and reconcile, at least on a quarterly basis, all intragovernmental activity and balances with their intragovernmental trading partners, including other DHS component entities, as prescribed by Treasury guidance.

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**Exhibit II – Other Reportable Conditions**

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**K. Environmental Liabilities**

*Background:* The Coast Guard's environmental liabilities consist of two main types: shore facilities and vessels. Shore facilities include any facilities or property other than ships and aircraft, e.g., buildings, fuel tanks, lighthouses, small arms firing ranges (SAFRs), batteries from aids to navigation, etc.

The Federal Law Enforcement Training Center (FLETC) maintains a number of SAFRs in at least four locations. FLETC also maintains facilities that contain lead-paint and asbestos.

*Conditions:* We noted the following internal control weaknesses related to DHS' environmental liabilities:

1 Coast Guard has not:

- Implemented effective policies, procedures and systems that will ensure that its environmental liabilities are accurately and completely estimated and recorded in its financial statements. We noted that:
  - Coast Guard could not support the completeness and existence of the population of shore facilities, including lighthouses and SAFRs used to estimate the related portions of the liability. Site visits were not performed to verify completeness of lists of assets requiring clean-up;
  - The process and modeling techniques used to estimate the liability are not reliable. Generalized cost parameters and assumptions in the lighthouse and SAFR models are used in the absence of site-specific inspection and data. Changes in methodology are not documented, and multiple assumptions and cost parameters are used in models without sufficient evidence to support the assumptions;
  - Estimates are not always subsequently validated against historical costs, and detailed cost data that reconciles to the general ledger is not maintained; and
- Implemented policies requiring quarterly procedures to determine if significant changes to the estimated liability are required for financial statement reporting.

2 FLETC has not:

- Implemented effective policies and procedures to accurately and completely estimate its liabilities. Consequently, FLETC's liability for lead contamination at its SAFRs was substantially understated and required an adjustment to the financial statements at year-end.
- Implemented a process to completely identify the existence of lead-paint and asbestos contamination, and to accurately estimate the cost of clean-up for financial statement purposes. The estimation process used in fiscal year 2006 was not supported by a detailed analysis that, among other things, considered the actual square footage of the contaminated area and the type of asbestos contamination.

*Cause/Effect:* Coast Guard has not developed consistent, written agency-wide policies to define the technical approach, cost estimation methodology, and overall financial management oversight of its environmental remediation projects, resulting in inconsistency in its estimates and possible misstatement of the liability in its financial statements. FLETC did not have policies and procedures in place whereby the Environmental and Safety Division would report the sites subject to clean-up, types of contamination, and the calculation of an estimated liability for asbestos-related clean-up costs.

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*Criteria:* SFFAS No. 6, paragraph 85, defines environmental cleanup costs as those costs for 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. Paragraph 88 states that these cleanup costs meet the definition of liability provided in SFFAS No. 5. In addition, SFFAS No. 6, paragraph 96, states that remediation estimates shall be revised periodically to account for material changes due to inflation or deflation and changes in regulations, plans and/or technology. New remediation cost estimates should be provided if there is evidence that material changes have occurred; otherwise estimates may be revised through indexing.

FASAB Technical Release No. 2, *Determining Probable and Reasonably Estimable for Environmental Liabilities in the Federal Government*, states that an agency is required to recognize a liability for environmental cleanup costs as a result of past transactions or events when a future outflow or other sacrifice of resources is probable and reasonably estimable. Probable is related to whether a future outflow will be required. Reasonably estimable relates to the ability to reliably quantify in monetary terms the outflow of resources that will be required.

The GAO *Standards* state that management is responsible for developing and documenting detailed policies, procedures, and practices that fit their agency's operations. As part of their monitoring of internal control, management must continue to maintain these policies and procedures and assess the quality of performance over time.

*Recommendations:* We recommend that:

1. Coast Guard:
  - a) Develop policies, procedures, processes and controls to ensure identification of and recording of all environmental liabilities, such as soil testing and remediation, lighthouses, small arms ranges, and vessels; and continue efforts to implement corrective action plans regarding small arms firing ranges and lighthouse/light station remediation projects. Perform a review of the population, historical and physical details, and regulatory requirements, to determine and document whether Coast Guard has an environmental liability associated with water-based firing ranges and ranges used by aircraft;
  - b) Implement policies and procedures to ensure the proper calculation and review of cost estimates for consistency and accuracy in financial reporting including the use of tested modeling techniques, use of verified cost parameters, and assumptions. The methodologies used should be documented with sufficient evidence maintained to support the assumptions used. Specifically, we recommend that the Coast Guard
    - i) Collect scope and cost data relating to actual/historical lighthouse and SAFR reviews and remediation, and improve, verify, and validate the cost model based on the data; and
    - ii) Conduct site visits to collect and document data related to the current lighthouses and SAFRs to determine that the input to the modeled estimates accurately reflects known conditions and to validate assumptions used in the estimates.
  - c) Estimates should be periodically validated against historical costs, and detailed cost data should be maintained and reconciled to the general ledger, in order to:
    - i) Identify and document the source data for all historical vessel cleanup costs used in the average cost per foot calculation for the vessels portion of the environmental liability, and reconcile the data to the Coast Guard general ledger(s); and

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**Exhibit II – Other Reportable Conditions**

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- ii) Perform an analysis of the disparities between the written vessel cleanup cost estimates and the calculated average cost-per-foot estimates in order to determine the cause and the appropriate estimates.
  - d) Document and implement an internal control program to install appropriate financial management oversight, segregation of duties and management review, as well as a training program for cost estimators and reviewers.
2. FLETC:
- a) Provide detailed training on the accounting requirements for environmental liabilities to personnel in the FLETC Facilities Management and Environmental and Safety Division; and
  - b) Establish policies and procedures to identify the type and extent of all potential environmental contamination develop an estimate of all environmental liabilities, and update the estimates quarterly. The estimate should be a product of a detailed analysis utilizing verifiable assumptions and cost data that are documented and available for review by the auditor.

**L. Custodial Revenue and Drawback**

*Background:* CBP collects approximately \$28 billion in annual import duties, taxes, and fees on merchandise arriving in the United States from foreign countries. Receipts of import duties and related refunds are presented in the statement of custodial activity in the DHS financial statements. CBP is the only DHS component with significant custodial responsibilities.

Drawback is a remittance, in whole or in part, of duties, taxes, or fees previously paid by an importer. Drawback typically occurs when the imported goods on which duties, taxes, or fees have been previously paid, are subsequently exported from the United States or destroyed prior to entering the commerce of the United States.

CBP employs a risk-based system of internal control over the collection of taxes, duties, and fees. By design, imports are subjected to various controls depending on a risk assessment associated with the importer, country of origin, merchandise being imported to the United States, and other factors. To measure the effectiveness of this risk-based control approach, CBP uses a technique known as the Compliance Measurement Program (CMP), which is essentially a control self-assessment. The CMP is also used to compute the “revenue gap” that is disclosed in DHS’ 2006 PAR, as described by SFFAS No. 7, *Accounting for Revenue and Other Financing Sources* and OMB Circular No. A-136.

Bonded Warehouses (BW) are facilities under the joint supervision of CBP and the Bonded Warehouse Proprietor used to store merchandise that has not made entry into the United States commerce. Foreign Trade Zones (FTZ) are secured areas under CBP supervision that are considered outside of the CBP territory, upon activation.

In-bond entries occur when merchandise is transported through one port; however, the merchandise does not officially enter U.S. commerce until it reaches the intended port of origin. An In-bond also allows foreign merchandise arriving at one U.S. port to be transported through the U.S. and be exported from another U.S. port without the payment of duty. In 1998, CBP implemented a tracking and audit system within the Automated Commercial System (ACS).

*Conditions:* We noted the following internal control weaknesses related to custodial activities at CBP:

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### Exhibit II – Other Reportable Conditions

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Related to drawback:

- The ACS lacked automated controls to detect and prevent excessive drawback claims and over-payments, necessitating inefficient manual processes that do not effectively compensate for these automated controls. ACS did not have the capability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries or export documentation upon which the drawback claim was based. Drawback review policies did not require drawback specialists to review all related drawback claims against the underlying consumption entries to determine whether, in the aggregate, an excessive amount was claimed.
- ACS lacked controls to prevent overpayment of drawback claims at the summary line level that were subject to the new deem liquidation process put in place during fiscal year 2006. Specifically, we noted approximately \$387K of overpayments. Also during fiscal year 2006, we noted a claim that was disbursed by accelerated payment in a prior year that was subsequently paid again during fiscal year 2006.
- CBP drawback review policy and procedures allowed drawback specialists, with supervisory approval, to judgmentally decrease the number of ACS selected underlying consumption entries randomly selected for review, thus decreasing the review's effectiveness.
- The initial period for document retention related to a drawback claim is only 3 years from the date of payment. However, there are several situations that could extend the life of the drawback claim well beyond those 3 years.

Related to the entry process – collection of taxes, duties and fees, and CMP:

- Policies, procedures, and general guidance provided to CMP coordinators related to sampling, review procedures, and documentation requirements for the monthly review of CM results are weak. Consequently, we noted a number of instances of non-compliance with CMP guidelines, inconsistencies in CMP review performance, and a lack of documentation to confirm performance of the monthly reviews. In addition, CBP policies allow the Import Specialist up to 120 days to input results of CMP reviews, which may interfere with CBP's timely review of CMP results.
- The National Analysis Specialist Division (NASD) port audits were no longer performed during FY 2006. Instead, CBP-HQ relies on the Self-Inspection program to determine how the ports are performing the CM examinations. We also noted that questions on the self-inspection program worksheets do not provide the equivalent information that the twenty-five point port audit review provided.
- CBP lacks formal policies and procedures to ensure the CM data used for analysis and to compute the revenue gap is accurately and completely input into the IT system.

Related to BW, FTZ, and In-bond:

- We noted inconsistencies in the performance of risk assessments and compliance reviews of BWs, and FTZs, and in-bond entries in various ports. In addition, HQ review of the assessment results can take up to 6 months to compile and analyze.
- CBP has not implemented a CMP to measure the revenue gap and effectiveness of controls over trade compliance related to the In-bond process.

*Cause/Effect:* CBP has been challenged to balance its commitment of limited resources to two important mission objectives – trade compliance, including the collection of taxes, duties and fees

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### Exhibit II – Other Reportable Conditions

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owed to the Federal government, and securing the U.S. borders from potential terrorist entry. While these mission objectives do overlap somewhat, there are differences in how resources are deployed. In fiscal year 2006, CBP made significant improvements in its custodial review controls and measurement processes, procedures and policies. For drawback, much of the process is manual until planned IT system functionality improvements are made, placing an added burden on limited resources. Policies and procedures have not been fully developed or implemented that will ensure reliable, timely reviews and tracking of the BWs, FTZ, and In-bond.

*Criteria:* Under FMFIA, management must implement cost-effective controls to safeguard assets and ensure reliable financial reporting. OMB's *Revised Implementation Guidance for FMFIA*, states that financial systems should "routinely provide reliable financial information consistently, accurately, and reported uniformly" to support management of current operations. JFMIP publications and OMB Circular No. A-127 outlines the requirements for Federal systems. JFMIP's *Core Financial System Requirements* states that the core financial system must maintain detailed information by account sufficient to provide audit trails and to support billing and research activities. OMB Circular No. A-127 requires that the design of financial systems should eliminate unnecessary duplication of a transaction entry. Wherever appropriate, data needed by the systems to support financial functions should be entered only once and other parts of the system should be updated through electronic means consistent with the timing requirements of normal business/transaction cycles.

The *Improper Payments Information Act of 2002*, effective in fiscal year 2004, requires agencies to assess the risk of erroneous payments and develop a plan to correct control weaknesses. In addition to the regulatory requirements stated above, CBP's *Drawback Handbook*, dated July 2004, states that management reviews are necessary to maintain a uniform national policy of supervisory review.

*Recommendations:* We recommend that CBP:

Related to drawback:

- a) Implement effective internal controls over drawback claims as part of any new systems initiatives, including the ability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries and export documentation for which the drawback claim is based, and identify duplicate or excessive drawback claims;
- b) Implement automated controls within ACS to prevent overpayment of a drawback claim that is subject to deem-liquidation as well as automated controls to prevent duplicate payments of refund claim;
- c) Evaluate the effectiveness of the sampling methodology implemented in FY 2006 related to underlying consumption entries;
- d) The updated sampling methodology should not allow for the drawback specialists, with supervisory approval, to judgmentally decrease the number of ACS selected underlying consumption entries randomly selected for review; and
- e) Continue to work with the U.S. Congress to lengthen the required document retention period for all supporting documentation so that it corresponds with the drawback claim life cycle.

Related to entry and CMP:

- a) Provide additional detail in the guidelines, specifying the sample size, procedures to perform, and documentation requirements for the CM Coordinator's review of Import

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- Specialists' review. The guidance should also readdress the timing requirements for the monitoring reports or data queries and documentation retention;
- a) Conduct periodic training to ensure that all port personnel have comprehensive knowledge of the CM program requirements;
  - b) Formalize and implement effective procedures for the port audit process performed by NASD, or readdress the self-inspection program to provide a more comprehensive and in-depth review of port activity (similar to what was accomplished under the previously performed port audits), including ensuring that the port is performing the reviews accurately;
  - c) Decrease the allowable time frame for final Import Specialist Discrepancy Adjustment (ISDA) remarks to allow for more timely analysis of the results; and
  - d) Establish an effective means of communication between the Office of Field Operations and Office of Strategic Trade to ensure data quality issues are timely addressed.

Related to BW, FTZ, and In-bond:

- a) Ensure adequate communication of the ports requirements related to the annual risk assessments and compliance reviews and provide effective training so that all responsible personnel are aware of and can consistently execute all of the requirements;
- b) Implement an electronic survey to be received and completed by the ports and sent back to HQs in order to ensure timely response and review by HQ personnel; and
- c) Consider the cost/effectiveness of implementing a CMP (such as a revenue gap calculation) over In-bond to assess the risk of revenue loss and violations of trade regulations by importers.

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**Exhibit III – Compliance and Other Matters**

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**(Findings A – J and K – L are presented in Exhibits I and II, respectively)**

All of the compliance and other matters described below are repeat conditions, except Comment T – *Debt Collection Improvement Act*, which is new finding in fiscal year 2006.

**M. Federal Managers' Financial Integrity Act of 1982 (FMFIA)**

OMB Circular No. A-123 requires agencies and Federal managers to (1) develop and implement management controls; (2) assess the adequacy of management controls; (3) identify needed improvements; (4) take corresponding corrective action; and (5) report annually on management controls (commonly known as management's FMFIA report). During fiscal year 2006, DHS OCFO significantly enhanced its FMFIA assessment policies and procedures to be conducted by the components, in part, to prepare for an audit of internal control over financial reporting as required by the *DHS Financial Accountability Act of 2004*. In addition, DHS launched and obtained OMB approval of a multi-year plan for implementation of OMB Circular No. A-123. The OCFO required the components to implement certain processes and undergo a self evaluation of some entity level controls and a review of the design of controls over Department-wide Financial Reporting, Fund Balance with Treasury and other select processes.

While we noted these positive steps toward full compliance with FMFIA and OMB Circular No. A-123, some components still have not established effective systems, processes, policies, and procedures to develop and implement internal accounting and administrative controls, and conformance of accounting systems.

*Recommendations:* We recommend that DHS components fully implement the FMFIA process, as prescribed by the OCFO, to ensure full compliance with FMFIA in accordance with its OMB approved plan. We also recommend that the OCFO consider additional training for its components, to ensure a thorough understanding of requirements.

**N. Federal Financial Management Improvement Act of 1996 (FFMIA)**

Passage of the *DHS Financial Accountability Act of 2004* made DHS subject to the FFMIA, in fiscal year 2005. In previous fiscal years – 2003 and 2004 – DHS was not subject to FFMIA. FFMIA Section 803(a) requires that agency Federal financial management systems comply with (1) Federal accounting standards, (2) Federal system requirements, and (3) the USSGL at the transaction level. FFMIA emphasizes the need for agencies to have systems that can generate timely, reliable, and useful information with which to make informed decisions to ensure ongoing accountability. We noted that DHS and each significant component did not fully comply with at least one of the requirements of FFMIA. The reasons for non-compliance are reported in Appendices I and II. The Secretary of DHS also has stated in the Secretary's Letter of Assurance dated November 15, 2006, listed in section I – MD&A of the accompanying 2006 PAR that the Department cannot provide assurance that its financial management systems are in substantial compliance with FFMIA. The Department's remedial actions and related timeframes are also presented in that section of the PAR.

*Recommendations:* We recommend that DHS improve its processes to ensure compliance with the FFMIA in fiscal year 2007.

**O. Federal Information Security Management Act of 2002 (FISMA)**

DHS is required to comply with the FISMA, which was enacted as part of the *Electronic Government Act of 2002*. FISMA requires the head of each agency to be responsible for (1) providing information security protections commensurate with the risk and magnitude of the harm resulting from unauthorized access, use, disclosure, disruption, modification, or destruction of (i) information



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**Exhibit III – Compliance and Other Matters**

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collected or maintained by or on behalf of the agency, and (ii) information systems used or operated by an agency or by a contractor of an agency or other organization on behalf of an agency; and (2) complying with the requirements of this subchapter and related policies, procedures, standards, and guidelines, including information security standards promulgated under section 11331 of Title 40. This particular section requires that Federal agencies provide minimum information security requirements as defined by the NIST. We noted instances of non-compliance with FISMA that have been reported by us in Appendix I within Comment C– *Financial Systems Security*.

*Recommendations:* We recommend that DHS follow the recommendations provided in Appendix I, Comment C – *Financial Systems Security*, and fully implement the requirements of FISMA in fiscal year 2007.

**P. Single Audit Act Amendments of 1996, and Laws and Regulations Supporting OMB Circular No. A-50, Audit Follow-up, as revised**

FEMA and TSA, are required to comply with certain provisions of OMB Circular No. A-133. This Circular requires agencies awarding grants to ensure they receive grantee reports timely and to follow-up on grantee Single Audit findings.

Additionally, OMB Circular No. A-50, as revised, provides policies and procedures for use by executive agencies when considering reports issued by Inspectors General, other executive branch audit organizations, the GAO, and non-Federal auditors, where follow up is necessary. Corrective action taken by management on findings and recommendations is essential to improve the effectiveness and efficiency of government operations.

Although certain procedures have been implemented to monitor grantees and their audit findings, we noted that DHS did not have procedures in place to fully comply with provisions in OMB Circular No. A-133 that require them to timely obtain and review grantee Single Audit reports and follow up on questioned costs and other matters identified in these reports. Because Single Audits typically are performed by other entities outside of DHS, procedures related to these reports are not always entirely within the control of DHS and its components.

DHS and its components did not fully develop and implement corrective action plans to address all material weaknesses and reportable conditions identified by previous financial statement audits within the time-frames established in OMB Circular No. A-50. We also noted that some corrective action plans lack sufficient detail, such as clearly defined roles and responsibilities, actions to be taken, time-table for completion of actions, and documented supervisory review and approval of completed actions.

*Recommendations:* We recommend that:

1. FEMA and TSA develop and implement department-wide policies and procedures to ensure compliance with OMB Circular No. A-133, including the identification of which components must comply. Until policy guidance is received from DHS management, grant-making components should perform the following in fiscal year 2007:
  - a) Develop and implement a tracking system to identify each grantee for which an OMB Circular No. A-133 Single Audit is required, and the date the audit report is due;
  - b) Strengthen communication with the cognizant agencies;
  - c) Use the tracking system to ensure audit and performance reports are received timely, or to follow-up when reports are overdue; and
  - d) Perform reviews of grantee audit reports, issue related management decisions, and ensure that the grantees take appropriate corrective action, on a timely basis.

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**Exhibit III – Compliance and Other Matters**

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2. DHS OFM should develop policies and procedures, including the adoption of Management Directive, and the development of a process to ensure that audit recommendations are resolved timely, and corrective action plans addressing all DHS audit findings are developed and implemented together with appropriate supervisory review in fiscal year 2007.

**Q. *Improper Payments Information Act of 2002 (IPIA)***

DHS is required to comply with the *Improper Payments Information Act of 2002* (the Act or IAIP). The Act requires agencies to review all programs and activities they administer annually and identify those that may be susceptible to significant erroneous payments. For all programs and activities where the risk of erroneous payments is significant, agencies must estimate the annual amounts of erroneous payments, and report the estimates to the President and Congress with a progress report on actions to reduce them. The agency must report a statistically valid error projection for susceptible programs in its annual PAR. To facilitate the implementation of the Act, OMB issued guidance in Memorandum M-03-13, *Implementation Guide for the Improper Payments Information Act of 2002*, which among other matters provided a recommended process to meet the disclosure requirements. We noted that DHS did not fully comply with the Act in fiscal year 2006.

We noted the following instances of non-compliance with the Act at DHS and its components.

- Not all programs subject to the Act were tested, and the population of disbursements tested for some programs was not complete.
- In some cases, the samples tested were not statistically derived, and thus, identified errors could not be statistically projected to the entire population of disbursements (including the untested portion).
- In some cases, the personnel performing the testwork were not knowledgeable or trained on the purpose or procedures to be performed.
- The time-period from which disbursements were selected for testwork was not always in compliance with IPIA requirements. For example, we noted that one component limited the time-period of disbursement samples to October 2005 to March 2006.
- Centralized monitoring was not performed over the IPIA results to ensure that IPIA testing was completed for all required programs in accordance with the Department's requirements.

*Recommendation:* We recommend that DHS follow the guidance provided in OMB M-03-13 in fiscal year 2007, including completing the necessary susceptibility assessments, performing testwork over all material programs, and instituting sampling techniques to allow for statistical projection of the results of its improper payments testing.

**R. *Chief Financial Officers Act of 1990***

The *DHS Financial Accountability Act of 2004* made DHS subject to the *Chief Financial Officers Act of 1990*, as amended, which requires DHS to submit to the Congress and OMB audited financial statements annually. DHS-OIG has engaged an independent auditor to audit the September 30, 2006, balance sheet and statement of custodial activity only. DHS must be able to represent that its balance sheet is fairly stated, and obtain at least a qualified opinion, before it is practical to extend the audit to other financial statements.

*Recommendation:* We recommend that DHS and its components continue to implement corrective action plans in order to remediate the fiscal year 2006 material weaknesses and reportable conditions, improve its policies, procedures, and processes, as necessary, to allow management to represent that

**Independent Auditors' Report**  
**Exhibit III – Compliance and Other Matters**

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its balance sheet is free of material error and ready for an independent audit of the balance sheet. This will enable DHS to extend its audit to all financial statements in future years.

**S. *Government Performance and Results Act of 1993 (GPRA)***

The *Government Performance and Results Act* requires each agency to prepare performance plans that include a description of the operational processes, skills and technology, and the resources required to meet the goals, and a description of the means used to verify and validate the measured results. In addition, the PAR should include performance indicators established in the annual performance plan, the actual performance achieved compared with the prior year goals, and an evaluation of the current year performance plan with respect to success in achieving the performance goals. The validation and verification section of the fiscal year 2006 DHS *Annual Performance Plan* was incomplete and included erroneous data. In addition, no performance goals or measures were established or aligned to two of the Department's strategic objectives in the *Annual Performance Plan*. GPRA states that an agency may not omit or minimize the significance of any program activity constituting a major function or operation for the agency. We also noted that management did not adequately review the PAR for accuracy and completeness.

*Recommendation:* We recommend that DHS develop policies and procedures to ensure full compliance with GPRA by aligning all strategic objectives to performance objectives in fiscal year 2007.

**T. *Debt Collection Improvement Act of 1996 (DCIA)***

The *Debt Collection Improvement Act of 1996 (DCIA)* is intended to significantly enhance the Federal Government's ability to service and collect debts. Under the DCIA, Treasury assumes a significant role for improving government-wide receivables management. The DCIA requires Federal agencies to refer eligible delinquent non-tax debts over 180 days to U.S. Treasury for the purpose of collection by cross-servicing or the offset program. Our tests of compliance disclosed instances where DHS was not in compliance with certain provisions of the DCIA. Specifically, we noted that due process is not performed in a timely manner to ensure that some eligible debts are forwarded to Treasury for cross-servicing or the offset program within the timeframes established by DCIA.

*Recommendation:* We recommend that DHS develop policies and procedures to ensure full compliance with the DCIA in fiscal year 2007.

**Independent Auditors' Report**  
**Exhibit IV – Status of Prior Year Findings**

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**Summary of Conditions**  
**As Reported in 2005 DHS Performance and Accountability Report**

**Fiscal Year 2006**  
**Status/Disposition**

***Material Weaknesses:***

**A. Financial Management and Oversight**

**A.1** ICE had not made sufficient, measurable progress in correcting its financial management oversight and weaknesses. All of the conditions we reported last year are repeated together with new findings. We noted that ICE did not have sufficient numbers of qualified financial managers and staff to perform its accounting responsibilities. ICE had difficulty; performing analysis of and record basic and routine accounting entries; correctly apply Federal accounting standards, in many instances, to ensure accurate and reliable financial reporting; develop and communicate accounting policies and procedures throughout ICE and the DHS-ICE components it serviced to ensure accuracy and consistency in financial reporting; timely and accurately respond to data requests from the OCFO during the year; and establishing adequate internal controls that reasonably ensured the integrity of financial data, and that adhered to Government Accountability Office (GAO) *Standards for Internal Control in the Federal Government (Standards)*. ICE lacked a comprehensive strategy to identify the root causes of its financial statement errors and to correct deficiencies in its accounting and financial reporting processes.

**Corrected**

**A.2** The Coast Guard had not fully implemented a financial management organizational structure that supports the development and implementation of effective policies, procedures, and internal controls to ensure data supporting financial statement assertions are complete and accurate. The Coast Guard had not established clear management oversight responsibilities and processes to review adjustments to account balances, identify the cause of abnormal balances, and account relationship discrepancies, e.g., budgetary to proprietary reconciliations, and investigate potential financial system concerns such as potential posting logic errors. The Coast Guard had not fully established management oversight functions to ensure that accounting principles are correctly applied, and to provide accounting operational guidance to other offices and facilities within the Coast Guard.

**Repeated**

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**Exhibit IV – Status of Prior Year Findings**

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<u>Summary of Conditions</u> <u>As Reported in 2005 DHS Performance and Accountability Report</u>	<u>Fiscal Year 2006</u> <u>Status/Disposition</u>
<p><b>A.3</b> The OCFO has not completed its plan to expand the OCFO with sufficient resources, including personnel with the requisite experience and skills to effectively manage the financial reporting and internal control infrastructure of a large Executive Branch agency. The OCFO had not provided effective management and oversight to ensure that; DHS component corrective action plans were developed, implemented, with progress tracked, and successfully completed, particularly at ICE and the Coast Guard, to support the elimination of material weaknesses and achieve consistent, timely, and reliable financial reporting from all DHS components, within the time-period requested by the Secretary; financial management, and reporting problems in DHS components were promptly and effectively addressed; workload among OCFO staff was separated to allow for proper supervisory reviews, and to provide appropriate back-up for key staff; and processes were implemented to draft an accurate and complete DHS <i>Performance and Accountability Report</i> (PAR), within a reasonable time-frame after year-end, and to prepare accurate monthly financial statements throughout the year, that did not require restatements to previously published financial statements.</p>	<b>Partially Repeated</b>
<p><b>B. Financial Reporting</b></p>	
<p><b>B.1</b> The OCFO was unable to prepare a balanced consolidated financial statement during fiscal year 2005 until November 2005. The OCFO had not fully documented policies and procedures for many critical activities necessary to adequately manage financial reporting processes, and monitoring controls to ensure monthly TIER submissions received from the components were prepared timely and accurately.</p>	<b>Repeated</b>
<p><b>B.2</b> The Coast Guard's financial reporting process was complex and labor-intensive, and required a significant number of "on-top" adjustments (adjustments made outside the core accounting system for presentation of financial information given to DHS for consolidation). Significant abnormal balances existed in its TIER submissions. The Coast Guard routinely used analytical comparisons to identify adjusting entries to the financial statements, without verifying that the ending balances were properly supported at the transaction level, e.g., budgetary accounts were adjusted to equal proprietary accounts, without verifying that the underlying transactional detail supported the ending balances. The processes that Finance Center personnel used for making year-end closing entries did not consistently include sufficient supporting documentation or internal controls at an appropriate level, such as effective management review, approval of individual adjusting entries, or procedures to determine that all necessary adjustments were identified.</p>	<b>Repeated</b>

**Independent Auditors' Report**  
**Exhibit IV – Status of Prior Year Findings**

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<p align="center"><u>Summary of Conditions</u>  <u>As Reported in 2005 DHS Performance and Accountability Report</u></p>	<p align="center"><u>Fiscal Year 2006</u>  <u>Status/Disposition</u></p>
<p><b>B.3</b> ICE had not established effective internal controls over the daily accounting and recording of transactions, supervisory review, reconciliation of accounts, and documentation of supporting information for auditor review. ICE routinely made “top-side” adjustments to financial information that was not adequately reviewed, supported by transactional data, or documented. ICE had inadequately designed the processes for some account reconciliations. Did not have documented policies and procedures that will ensure that financial information submitted monthly to the OCFO is in compliance with generally accepted accounting principles.</p>	<p align="center"><b>Corrected</b></p>
<p><b>B.4</b> TSA experienced difficulties in the monthly closing of its general ledger due, in part, to its change in accounting services providers. Specifically, we noted accrual amounts were not included in the initial financial data submission for year-end, numerous other on-top adjustments were made thereafter, account reconciliations were not performed timely throughout the year, material abnormal balances and analytical account variances were not resolved timely throughout the year, and detailed schedules to support financial statement amounts were not always provided timely.</p>	<p align="center"><b>Repeated</b></p>
<p><b>B.5</b> The Coast Guard and ICE did not have effective financial information systems, or sufficiently documented processes, to accumulate cost data by DHS strategic goal, as required by Statement of Financial Accounting Standard (SFFAS) No. 4, <i>Managerial Cost Accounting Concepts and Standards</i>. In addition, TSA and Emergency Preparedness and Response (EPR) did not have documentation to support their presentation of the full cost for each strategic goal, as included in the notes to the consolidated financial statements.</p>	<p align="center"><b>Partially Repeated</b></p>
<p><b>B.6</b> G&amp;T (formerly SLGCP) had not obtained a thorough understanding of control activities over the financial reporting processes performed by its accounting service provider on its behalf, to ensure services received are consistent with the intent of the parties.</p>	<p align="center"><b>Partially Repeated</b> (Comment G)</p>
<p><b>B.7</b> EPR was unable to make an accurate estimate of accounts payable related to the NFIP because EPR’s contractor for the National Flood Insurance Program (NFIP) did not provide final NFIP financial statements until after the time that final EPR fiscal year 2005 financial statement balances had been submitted to the OCFO.</p>	<p align="center"><b>Corrected</b></p>

**Independent Auditors' Report**  
**Exhibit IV – Status of Prior Year Findings**

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<u>Summary of Conditions</u> <u>As Reported in 2005 DHS Performance and Accountability Report</u>	<u>Fiscal Year 2006</u> <u>Status/Disposition</u>
<p><b>C. Financial Systems Functionality and Technology</b></p>	
<p>OCFO and DHS bureaus have IT and financial system control and functionality weaknesses in entity-wide security program planning and management, access controls, application software development and change controls, system software, segregation of duties, and service continuity.</p>	<b>Repeated</b>
<p><b>D. Fund Balance with Treasury (FBwT)</b></p>	
<p><b>D.1</b> ICE did not complete accurate and timely reconciliations of all of its FBwT accounts during the year, as required by the Treasury Financial Manual (TFM). ICE did not timely clear items carried in suspense clearing accounts during the year and the subsidiary ledger that contained detail listings of suspense transactions was not reconciled to the general ledger. ICE lacked written policies that clearly explain the correct reconciliation processes and internal controls that must be performed to ensure that monthly collection and disbursement activity is reported accurately and timely to the Treasury, and reflected in ICE and DHS-ICE components' general ledgers. ICE was unable to obtain document level information for financial transactions (both procurement and disbursement) of the DHS-ICE components that were processed by legacy agencies, which resulted in large unreconciled FBwT items.</p>	<b>Corrected</b>
<p><b>D.2</b> The Coast Guard did not effectively manage its suspense accounts to include accurately aging and clearing items carried in suspense clearing accounts in a timely manner during the year, and did not maintain adequate supporting documentation that validated the accuracy of the FBwT reconciliations and the clearing of suspense items.</p>	<b>Repeated</b>

**Independent Auditors' Report**  
**Exhibit IV – Status of Prior Year Findings**

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**Summary of Conditions**  
**As Reported in 2005 DHS Performance and Accountability Report**

**Fiscal Year 2006**  
**Status/Disposition**

**E. Property, Plant, and Equipment**

**E.1** The Coast Guard had not implemented appropriate controls and related processes to accurately, consistently, and timely record PP&E, to include additions, transfers from other agencies and disposals in its fixed asset system. The Coast Guard had not consistently applied policies and procedures to ensure appropriate documentation supporting PP&E acquisitions is maintained, and readily available for audit. The Coast Guard lacked methodologies and assumptions to support the value of PP&E that is not supported by original acquisition or other documentation. The Coast Guard needed an asset identification, system mapping, and tagging processes that included sufficient detail, e.g., serial number, to clearly differentiate and accurately track assets in the fixed asset system. The Coast Guard lacked an effective physical inventory process and appropriate support for the valuation method and classification of repairable PP&E to ensure accounting and reporting for PP&E is consistent with generally accepted accounting principles.

**Repeated**

**E.2** ICE (who provides accounting services for BTS), specifically the US-VISIT program, did not consistently apply procedures to identify and capitalize software development costs or to reclassify software placed into production from software in development.

**Partially Repeated**

**F. Operating Materials and Supplies**

**F.1** At the Coast Guard, internal controls over physical counts at field locations were not designed and implemented to remediate conditions identified during fiscal year 2003 and 2004. OM&S items were not always properly bar-coded or tagged, on-hand quantities frequently did not agree to the perpetual inventory records, and procedures did not sufficiently address whether all inventory on hand was properly recorded in the perpetual records or require discrepancies to be resolved timely. Processes and controls were not in place to fully support the calculated value of field-held and ICP OM&S to approximate historical cost. Policies, procedures and controls designed to remediate conditions related to conducting physical inventories of OM&S at the ICPs were not completely implemented.

**Repeated**



**Independent Auditors' Report**  
**Exhibit IV – Status of Prior Year Findings**

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<u>Summary of Conditions</u> <u>As Reported in 2005 DHS Performance and Accountability Report</u>	<u>Fiscal Year 2006</u> <u>Status/Disposition</u>
<b>G. Undelivered Orders, Accounts and Grants Payable, and Disbursements</b>	
<p><b>G.1</b> ICE had not established reliable internal controls to ensure that all invoices are paid timely, that all IPACs were cleared from suspense timely, that invoice payments and supporting documentation are matched with an originating obligation prior to disbursement, and that documentation supporting receipt of goods and services required from other Federal agencies for IPAC transactions are verified timely. ICE had not established sufficient controls to prevent duplicate payments to vendors related to prior year obligations or to prevent negative balances in certain Treasury accounts used by both ICE and the legacy agencies to make disbursements, or to ensure that open obligations were properly liquidated when corresponding accounts payable were recorded, and that liquidation was occurring at the proper detailed fund code level. ICE lacked policies related to verification and validation of obligations and completeness of all procurement and other obligations.</p>	<b>Corrected</b>
<p><b>G.2</b> At the Coast Guard periodic review and validation of UDOs was not properly designed, and was not effective to ensure that recorded obligations were valid, obligations incurred were recorded timely, and that proper approvals and supporting documentation existed. Programming logic and transaction codes used to record advances for which an obligation was not previously recorded are not operating effectively to ensure the obligation and UDOs were properly recorded. Policies were not fully implemented to ensure that contract awards were recorded in the general ledger in a timely manner. Policies and procedures related to Coast Guard's automated requisition and procurement process have not been consistently followed in all regions. The procurement Management Effectiveness Assessment (MEA), was not fully performed as planned in fiscal year 2005. The process used to estimate accounts payable was not fully documented as to the criteria used to develop the estimate for financial reporting.</p>	<b>Repeated</b>
<p><b>G.3</b> G&amp;T's accounting services provider was unable to resolve discrepancies identified in the data underlying the calculation of G&amp;T's grants payable liability at September 30, 2005.</p>	<b>Partially Repeated</b>
<p><b>G.4</b> TSA was unable to fully reconcile and support the accuracy and completeness of its accounts payable and UDOs, and did not have policies and procedures in place to validate TSA's grant accrual to ensure the methodology used provided a reasonable estimate of the actual amount owed.</p>	<b>Partially Repeated</b>

**Independent Auditors' Report**  
**Exhibit IV – Status of Prior Year Findings**

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<u>Summary of Conditions</u> <u>As Reported in 2005 DHS Performance and Accountability Report</u>	<u>Fiscal Year 2006</u> <u>Status/Disposition</u>
<p><b>G.5</b> EPR, G&amp;T, and TSA did not have sufficient policies and procedures in place to fully comply with the OMB Circular No. A-133, <i>Audits of States, Local Governments, and Non-profit Organizations</i>, and laws and regulations supporting OMB Circular No. A-50, <i>Audit Follow-up</i>, as revised.</p>	<b>Partially Repeated</b>
<p><b>H. Actuarial Liabilities</b></p>	
<p><b>H.1</b> The Coast Guard was unable to fully support its assertions relating to accuracy and completeness of the underlying participant data, medical cost data, and trend and experience data provided to, and used by, the actuary for the calculation of the MRS, and post employment travel benefits liabilities. The Coast Guard did not follow established policies and procedures to accumulate data for the actuary to compute post-employment travel benefits. The Coast Guard did not perform periodic reconciliations between the medical expenditures subsidiary ledger and the general ledger. The Coast Guard did not have effective policies, procedures, and controls to monitor the expenditures for medical services to ensure they were billed at proper rates and for valid participants only, e.g., service members and their families, and retiree/survivors.</p>	<b>Repeated</b>
<p><b>I. Budgetary Accounting</b></p>	
<p><b>I.1</b> At ICE obligations for ICE and the DHS-ICE components were not always recorded timely or accurately. Contracting officer approvals were not clearly documented on obligating documents. Weaknesses existed in controls over the preparation, submission and reconciliation to the general ledger of the SF-132, and the SF-133. Information reported on the SF-133 did not agree with the accounting records and was not reconciled timely resulting in inaccuracies in the June 2005 financial statements for ICE and the DHS-ICE components.</p>	<b>Partially Repeated</b>

**Independent Auditors' Report**  
**Exhibit IV – Status of Prior Year Findings**

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<u>Summary of Conditions</u> <u>As Reported in 2005 DHS Performance and Accountability Report</u>	<u>Fiscal Year 2006</u> <u>Status/Disposition</u>
<p><b>I.2</b> At the Coast Guard obligations related to post-employment permanent changes of station (PCS) were not recorded at the time orders were approved and issued. The electronic validation and edit checks within the FPD, a feeder system to the CAS, were not fully utilized. Obligations were recorded in FPD, but were not properly interfaced with the CAS, and were not supported by adequate documentation. Weaknesses existed in system capabilities and controls over the recording of budgetary authority. No automated system controls existed to preclude the processing of procurement transactions if the contracting officer's warrant authority had expired, and a manual check compensating control was not effective since listings of warranted contracting officers were outdated. Commitments were not routinely monitored for aging, or released timely, so that funds could be committed and obligated elsewhere.</p>	<b>Repeated</b>
<p><b>I.3</b> TSA's accounting service provider did not have the functionality to record amounts deobligated from prior year obligations at the transaction level, in accordance with the USSGL requirements.</p>	<b>Repeated</b>
<p><b>J. Intragovernmental and Intradepartmental Balances</b></p> <p>DHS did not timely or completely reconcile intragovernmental balances with other Federal entities, particularly the Department of Defense during fiscal year 2005. Consequently, the DHS' <i>Material Difference/Status of Disposition Certification Report</i>, submitted to Treasury for September 30, 2005, showed material differences attributable to accounting/reporting errors. Some components had not developed and adopted effective SOPs, or established systems to completely track, confirm, and reconcile intragovernmental balances and/or transactions with trading partners, in a timely manner, which contributed to the material differences. Intra-DHS transactions between ICE, CBP, CIS and other DHS components did not eliminate correctly at the consolidated level during the year. DHS was unable to completely reconcile out-of-balance intradepartmental transactions at year-end, resulting in the need for "on-top" adjustments, based primarily on estimates and analytical comparisons, to close the general ledger and prepare balanced consolidated financial statements.</p>	<b>Partially Repeated</b>

**Independent Auditors' Report**  
**Exhibit IV – Status of Prior Year Findings**

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<u>Summary of Conditions</u> <u>As Reported in 2005 DHS Performance and Accountability Report</u>	<u>Fiscal Year 2006</u> <u>Status/Disposition</u>
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***Other Reportable Conditions:***

**K. Environmental Liabilities**

- |  |                  |
|--|------------------|
| <b>K.1</b> At the Coast Guard consistent policies or procedures have not been developed for the identification, evaluation, and estimation of potential environmental remediation of Coast Guard sites, thereby resulting in different approaches by shore facility commands and ultimately varying liability estimates.   | <b>Repeated</b>  |
| <b>K.2</b> At S&T, policies and procedures have not been developed to determine if an environmental liability exists and if so, to accurately estimate and record an environmental liability for the cost of cleanup.  | <b>Corrected</b> |
| <b>K.3</b> CBP had not determined the environmental liabilities to be recorded in the September 30, 2005, financial statements, until a review was performed in response to our audit inquiry. No single program existed to manage CBP's environmental liabilities, resulting in the necessity for an ad hoc process to be implemented at year-end. A lack of communication existed throughout the organization, related to the requirements associated with environmental liabilities and weaknesses in documentation of data supporting the computation of liability for financial statement purposes. | <b>Corrected</b> |

**L. Custodial Revenue and Drawback**

CBP did not have a reliable process of monitoring the movement of in-bond shipments, adequate written SOPs, and consistent performance of a compliance measurement program to assess the risk and compute an estimate of underpayment of duties, taxes, and fees.

**Partially Repeated**

***Compliance and Other Matters:***

**M. Federal Managers' Financial Integrity Act of 1982**

DHS management's FMFIA report did not contain corrective action plans for all material weaknesses identified in the PAR. In addition, DHS and its components have not established effective systems, processes, policies and procedures to evaluate and report on FMFIA compliance.

**Partially Repeated**

**Independent Auditors' Report**  
**Exhibit IV – Status of Prior Year Findings**

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<p align="center"><u>Summary of Conditions</u>  <u>As Reported in 2005 DHS Performance and Accountability Report</u></p>	<p align="center"><u>Fiscal Year 2006</u>  <u>Status/Disposition</u></p>
<p><b>N. <i>Federal Financial Management Improvement Act of 1996</i></b>  DHS and each significant component – CBP, ICE and DHS-ICE components, EPR, SLGCP, TSA, and Coast Guard did not fully comply with at least one of the requirements of FFMIA.</p>	<p align="center"><b>Repeated</b></p>
<p><b>O. <i>Federal Information Security Management Act (Electronic Government Act of 2002)</i></b>  Instances of non-compliance with the FISMA were noted.</p>	<p align="center"><b>Partially Repeated</b></p>
<p><b>P. <i>Single Audit Act Amendments of 1996, and Laws and Regulations Supporting OMB Circular No. A-50, Audit Follow-up, as revised</i></b>  EPR, SLGCP, and TSA did not have procedures to monitor grantees and their audit findings.</p>	<p align="center"><b>Partially Repeated</b></p>
<p><b>Q. <i>Improper Payments Information Act of 2002</i></b>  DHS did not properly define programs and activities, institute a systematic method of reviewing all programs and identifying those at risk of significant erroneous payments, and properly sample or compute the estimated dollar amount of improper payments.</p>	<p align="center"><b>Repeated</b></p>
<p><b>R. <i>DHS Financial Accountability Act of 2004 (Chief Financial Officers Act of 1990)</i></b>  Section 3 of Public Law 108-330, <i>DHS Financial Accountability Act of 2004</i>, states that the President of the United States shall appoint a Chief Financial Officer of DHS not later than 180 days after the date of the enactment of this Act signed in October 2004, to be confirmed by the U.S. Senate. At September 30, 2005 DHS was operating with an Acting CFO, while no waiver or amendment to this law has been obtained by DHS management. The <i>DHS Financial Accountability Act of 2004</i> also made DHS subject to the <i>Chief Financial Officers Act of 1990</i>, as amended, which requires DHS to submit to the Congress and OMB audited financial statements annually. DHS engaged an independent auditor to audit the September 30, 2005, consolidated balance sheet only.</p>	<p align="center"><b>Partially Repeated</b></p>

**Independent Auditors' Report**  
**Exhibit IV – Status of Prior Year Findings**

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**S. *Government Performance and Results Act of 1993***

Also, DHS did not consistently present performance measures in the PAR as written in the annual performance plans, did not provide explanations of performance results, and did not have supporting documentation substantiating the changes in performance measure goals between the annual performance plan and the PAR.


**Repeated**



# Homeland Security

**November 15, 2006**

**MEMORANDUM FOR:** Richard L. Skinner, Inspector General

**FROM:** David L. Norquist, Chief Financial Officer 

**SUBJECT:** FY 2006 Financial Statement Audit

This memo is our response to the Independent Public Accountant's audit of our balance sheets as of September 30, 2006 and 2005, and the related statement of custodial activities for the year ended September 30, 2006. We agree with the Independent Public Accountant's conclusions.

I would like to personally acknowledge and commend the efforts and dedication by you, the OIG staff, and the Independent Public Accountant in working with the Department to improve financial management. The auditor's report on internal controls and compliance cites continued and serious challenges. As you know from our meetings on this subject, since my arrival at the Department I have made corrective actions my highest priority as Chief Financial Officer. I have redoubled the efforts of the Department and our staff to this end.

In early fiscal year 2007 we will publish DHS' unified corrective action plans in a document entitled, the *Internal Controls over Financial Reporting (ICOFR) Playbook*. The ICOFR Playbook will implement a single, comprehensive, and integrated plan to organize and focus corrective action efforts across the Department. This work will be another significant step in the maturation of the Department, and our ability to perform our critical mission as efficiently and effectively as possible. Thank you for your support.

## Introduction

The principal financial statements included in this report are prepared pursuant to the requirements of the *Chief Financial Officers Act of 1990*, as amended by the *Government Management Reform Act of 1994*. Other requirements include the Office of Management and Budget (OMB) Circular Number A-136, *Financial Reporting Requirements*. The responsibility for the integrity of the financial information included in these statements rests with the management of DHS. An independent certified public accounting firm, selected by the Department's Inspector General, was engaged to audit of the Balance Sheet and the Statement of Custodial Activity. The independent auditors' report accompanies the principal financial statements. These financial statements include the following:

- The **Balance Sheets** present as of September 30, 2006 and 2005, those resources owned or managed by DHS which represent future economic benefits (assets); amounts owed by DHS that will require payments from those resources or future resources (liabilities) and residual amounts retained by DHS comprising the difference (net position).
- The **Statements of Net Cost** present the net cost of DHS operations for the fiscal years ended September 30, 2006 and 2005. DHS net cost of operations is the gross cost incurred by DHS less any exchange revenue earned from DHS activities.
- The **Statements of Changes in Net Position** present the change in DHS' net position resulting from the net cost of DHS operations, budgetary financing sources, and other financing sources for the fiscal years ended September 30, 2006 and 2005.
- The **Statements of Budgetary Resources** present how and in what amounts budgetary resources were made available to DHS during fiscal years 2006 and 2005, the status of these resources at September 30, 2006 and 2005, the changes in the obligated balance, and outlays of budgetary resources for the fiscal years ended September 30, 2006 and 2005.
- The **Statements of Financing** present the reconciliation of the budgetary resources used to finance DHS operations with the net cost of operations for the fiscal years ended September 30, 2006 and 2005.
- The **Statements of Custodial Activity** present the disposition of custodial revenue collected and disbursed by DHS on behalf of other recipient entities for the fiscal years ended September 30, 2006 and 2005.

## Limitations of Financial Statements

The principal financial statements have been prepared to report the financial position and results of operations of the Department, pursuant to the requirements of Title 31, United States Code, Section 3515 (b) relating to financial statements of Federal agencies. While the statements have been prepared from the books and records of the agency in accordance with U.S. generally accepted accounting principles (GAAP) for Federal agencies and the formats prescribed by OMB, the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.



Department of Homeland Security Balance Sheets As of September 30, 2006 and 2005 (In Millions)		(Page 1 of 2)
	<u>2006</u> (Unaudited)	<u>2005</u> (Unaudited) (Restated)
<b>ASSETS (Note 2)</b>		
<b>Intragovernmental</b>		
Fund Balance with Treasury (Notes 2 and 3)	\$59,568	\$97,012
Investments, Net (Note 5)	634	738
Accounts Receivable (Note 6)	248	217
Other (Note 13)		
Advances and Prepayments	2,912	2,937
Due from Treasury (Note 2)	411	144
<b>Total Intragovernmental</b>	<b>63,773</b>	<b>101,048</b>
Cash and Other Monetary Assets (Notes 2 and 4)	99	78
Accounts Receivable, Net (Notes 2 and 6)	1,181	532
Taxes, Duties, and Fees Receivables, Net (Notes 2 and 7)	1,755	1,400
Direct Loans, Net (Note 8)	161	-
Inventory and Related Property, Net (Note 9)	677	498
General Property, Plant, and Equipment, Net (Notes 2 and 11)	11,036	10,460
Other (Note 13)		
Advances and Prepayments	551	480
<b>TOTAL ASSETS</b>	<b>\$79,233</b>	<b>\$114,496</b>
Stewardship PP&E (Note 12)		
<b>LIABILITIES (Note 14)</b>		
<b>Intragovernmental</b>		
Accounts Payable	\$1,900	\$865
Debt (Note 15)	17,446	226
Other (Note 18)		
Due to the General Fund	1,809	1,434
Accrued FECA Liability	323	358
Other	187	252
<b>Total Intragovernmental</b>	<b>21,665</b>	<b>3,135</b>
Accounts Payable	2,765	3,253
Federal Employee and Veterans' Benefits (Note 16)	32,278	30,050
Environmental and Disposal Liabilities (Note 17)	245	179
Other (Notes 18,19, 20, and 21)		
Accrued Payroll and Benefits	1,362	1,366
Deferred Revenue and Advances from Others	2,188	2,014
Deposit Liability	34	4,706
Insurance Liabilities	3,567	23,433

**Department of Homeland Security**  
**Balance Sheets**  
**As of September 30, 2006 and 2005**  
**(In Millions)**

	<u>2006</u> <u>(Unaudited)</u>	<u>2005</u> <u>(Unaudited)</u> <u>(Restated)</u>
Refunds and Drawbacks	5,593	118
Other	1,190	958
<b>Total Liabilities</b>	<b>\$70,887</b>	<b>\$69,212</b>
Commitments and contingencies (Notes 19, 20, and 21)		
<b>NET POSITION</b>		
Unexpended Appropriations		\$87,131
Unexpended Appropriations-Earmarked Funds (Note 22)	\$18	
Unexpended Appropriations-Other Funds	48,084	
Cumulative Results of Operations		(41,847)
Cumulative Results of Operations-Earmarked Funds (Note 22)	(19,328)	
Cumulative Results of Operations-Other Funds	(20,428)	
<b>Total Net Position</b>	<b>\$8,346</b>	<b>\$45,284</b>
<b>TOTAL LIABILITIES AND NET POSITION</b>	<b>\$79,233</b>	<b>\$114,496</b>

The accompanying notes are an integral part of these statements.

Department of Homeland Security		(Page 1 of 2)
Statements of Net Cost		
For the Years Ended September 30, 2006 and 2005		
(In Millions)		
	<u>2006</u> (Unaudited)	<u>2005</u> (Unaudited) (Restated)
<b>Directorates and Other Components (Note 24)</b>		
<b>United States VISIT</b>		
Gross Cost	\$263	\$172
Less Earned Revenue	(1)	-
<b>Net Cost</b>	<b>262</b>	<b>172</b>
<b>United States Customs and Border Protection</b>		
Gross Cost	7,135	7,059
Less Earned Revenue	(153)	(619)
<b>Net Cost</b>	<b>6,982</b>	<b>6,440</b>
<b>United States Coast Guard</b>		
Gross Cost	10,011	9,145
Less Earned Revenue	(424)	(220)
<b>Net Cost</b>	<b>9,587</b>	<b>8,925</b>
<b>United States Citizenship and Immigration Services</b>		
Gross Cost	1,609	1,275
Less Earned Revenue	(1,729)	(1,622)
<b>Net Cost</b>	<b>(120)</b>	<b>(347)</b>
<b>Federal Emergency Management Agency</b>		
Gross Cost	25,660	39,643
Less Earned Revenue	(2,443)	(2,159)
<b>Net Cost</b>	<b>23,217</b>	<b>37,484</b>
<b>Federal Law Enforcement Training Center</b>		
Gross Cost	312	257
Less Earned Revenue	(33)	(31)
<b>Net Cost</b>	<b>279</b>	<b>226</b>
<b>Preparedness Directorate</b>		
Gross Cost	3,795	2,701
Less Earned Revenue	(26)	(20)
<b>Net Cost</b>	<b>3,769</b>	<b>2,681</b>
<b>United States Immigration and Customs Enforcement</b>		
Gross Cost	4,487	3,814
Less Earned Revenue	(857)	(642)
<b>Net Cost</b>	<b>3,630</b>	<b>3,172</b>
<b>United States Secret Service</b>		
Gross Cost	1,471	1,505
Less Earned Revenue	(18)	(22)
<b>Net Cost</b>	<b>1,453</b>	<b>1,483</b>
<b>Science and Technology Directorate</b>		
Gross Cost	843	743
Less Earned Revenue	-	(12)
<b>Net Cost</b>	<b>843</b>	<b>731</b>

**Department of Homeland Security**  
**Statements of Net Cost**  
**For the Years Ended September 30, 2006 and 2005**  
**(In Millions)**

(Page 2 of 2)

<b>Directorates and Other Components (Note 24)</b>	<b><u>2006</u></b> <b>(Unaudited)</b>	<b><u>2005</u></b> <b>(Unaudited)</b> <b>(Restated)</b>
<b><i>Transportation Security Administration</i></b>		
Gross Cost	6,043	6,523
Less Earned Revenue	<u>(2,477)</u>	<u>(2,255)</u>
<b>Net Cost</b>	<b><u>3,566</u></b>	<b><u>4,268</u></b>
<b><i>Department Operations and Other</i></b>		
Gross Cost	852	642
Less Earned Revenue	<u>(2)</u>	<u>(11)</u>
<b>Net Cost</b>	<b><u>850</u></b>	<b><u>631</u></b>
<b>NET COST OF OPERATIONS (Note 24)</b>	<b><u>\$54,318</u></b>	<b><u>\$65,866</u></b>

The accompanying notes are an integral part of these statements.

**Department of Homeland Security**  
**Statements of Changes in Net Position**  
**For the Years Ended September 30, 2006 and 2005**  
(In Millions)

	<u>2006</u>		<u>2005</u>	
	(Unaudited)		(Unaudited) (Restated)	
	Earmarked Funds	All Other Funds	Consolidated Total	Consolidated Total
<b>Cumulative Results of Operations</b>				
Beginning Balances	\$(22,705)	\$(19,142)	\$(41,847)	\$(17,017)
Adjustments:				
Change in Accounting Principles (Note 34)	-	-	-	(8)
Corrections of Errors (Note 34)	-	-	-	(134)
Beginning Balance, as Adjusted	<b>(22,705)</b>	<b>(19,142)</b>	<b>(41,847)</b>	<b>(17,159)</b>
<b>Budgetary Financing Sources</b>				
Appropriations Used	13	52,882	52,895	38,068
Non-exchange Revenue	2,516	11	2,527	2,315
Donations and Forfeitures of Cash and Cash Equivalents	68	-	68	3
Transfers in/out without Reimbursement	(1,295)	1,657	362	265
Other	2	(183)	(181)	(143)
<b>Other Financing Sources (Non-Exchange)</b>				
Donations and Forfeitures of Property	-	6	6	8
Transfers in/out Reimbursement	-	30	30	11
Imputed Financing	2	700	702	651
Total Financing Sources	1,306	55,103	56,409	41,178
Net Cost of Operations	2,071	(56,389)	(54,318)	(65,866)
Net Change	3,377	(1,286)	2,091	(24,688)
<b>Cumulative Results of Operations</b>	<b>(19,328)</b>	<b>(20,428)</b>	<b>(39,756)</b>	<b>(41,847)</b>
<b>Unexpended Appropriations</b>				
Beginning Balance	29	87,102	87,131	25,504
Adjustments:				
Corrections of Errors (Note 34)	-	-	-	163
Beginning Balance, as Adjusted	<b>29</b>	<b>87,102</b>	<b>87,131</b>	<b>25,667</b>
<b>Budgetary Financing Sources</b>				
Appropriations Received (Note 31)	2	39,527	39,529	99,707
Appropriations Transferred in/out	-	(573)	(573)	158
Other Adjustments	-	(25,090)	(25,090)	(333)
Appropriations Used	(13)	(52,882)	(52,895)	(38,068)
Total Budgetary Financing Sources	(11)	(39,018)	(39,029)	61,464
Total Unexpended Appropriations	<b>18</b>	<b>48,084</b>	<b>48,102</b>	<b>87,131</b>
<b>NET POSITION</b>	<b>\$(19,310)</b>	<b>\$27,656</b>	<b>\$8,346</b>	<b>\$45,284</b>

The accompanying notes are an integral part of these statements.

**Department of Homeland Security**  
**Statements of Budgetary Resources**  
**For the Years Ended September 30, 2006 and 2005**  
(In Millions)

(Page 1 of 2)

	<u>2006</u>		<u>2005</u>	
	(Unaudited)		(Unaudited) (Restated)	
	<u>Budgetary</u>	<u>Non- Budgetary Credit Reform Financing Accounts</u>	<u>Budgetary</u>	<u>Non- Budgetary Credit Reform Financing Accounts</u>
<b>BUDGETARY RESOURCES</b>				
Unobligated Balance, Brought Forward, October 1	\$56,879	\$26	\$8,144	\$ -
Recoveries of Prior Year Unpaid Obligations	3,654	-	1,518	-
Budget Authority:				
Appropriations (Note 31)	45,748	-	105,147	-
Borrowing Authority	17,500	629	2,000	26
Spending Authority from Offsetting Collections:				
Earned:				
Collected	9,092	478	7,722	8
Change in Receivable from Federal Sources	39	-	(142)	-
Change in Unfilled Customer Orders:				
Advances Received	(541)	-	571	-
Without Advance From Federal Sources	186	481	569	-
Expenditure Transfers from Trust Funds	49	-	50	-
Subtotal	72,073	1,588	115,917	34
Non-expenditure Transfers, net; Anticipated and Actual	(228)	-	337	-
Temporarily Not Available Pursuant to Public Law	(29)	-	-	-
Permanently Not Available	(25,173)	(334)	(409)	(8)
<b>TOTAL BUDGETARY RESOURCES</b>	<b><u>\$107,176</u></b>	<b><u>\$1,280</u></b>	<b><u>\$125,507</u></b>	<b><u>\$26</u></b>
<b>STATUS OF BUDGETARY RESOURCES</b>				
Obligations Incurred: (Note 25)				
Direct	\$85,843	\$1,280	\$64,347	-
Reimbursable	4,289	-	4,281	-
Subtotal	90,132	1,280	68,628	-
Unobligated Balance:				
Apportioned	11,365	-	51,817	26
Exempt from Apportionment	80	-	45	-
Subtotal	11,445	-	51,862	26
Unobligated Balance Not Available	5,599	-	5,017	-
<b>TOTAL STATUS OF BUDGETARY RESOURCES</b>	<b><u>\$107,176</u></b>	<b><u>\$1,280</u></b>	<b><u>\$125,507</u></b>	<b><u>\$26</u></b>

**Department of Homeland Security**  
**Statements of Budgetary Resources**  
**For the Years Ended September 30, 2006 and 2005**  
(In Millions)

	<b>2006</b> (Unaudited)		<b>2005</b> (Unaudited) (Restated)	
	<b>Budgetary</b>	<b>Non- Budgetary Credit Reform Financing Accounts</b>	<b>Budgetary</b>	<b>Non- Budgetary Credit Reform Financing Accounts</b>
<b>CHANGE IN OBLIGATED BALANCE</b>				
Obligated Balance, Net				
Unpaid Obligations Brought Forward, October 1	\$40,456	-	\$26,432	-
Less: Uncollected Customer Payments from Federal Sources, Brought Forward, October 1	(1,845)	-	(1,418)	-
Total Unpaid Obligated Balance, net	38,611	-	25,014	-
Obligations Incurred, net	90,132	1,280	68,628	-
Less: Gross Outlays	(83,674)	(639)	(53,175)	-
Obligated Balance Transferred, net				
Actual Transfers, Unpaid Obligations	-	-	89	-
Total Unpaid Obligated Balance Transferred, net	-	-	89	-
Less: Recoveries of Prior Year Unpaid Obligations, Actual	(3,654)	-	(1,518)	-
Change in Uncollected Customer Payments from Federal Sources	(225)	(481)	(427)	-
Obligated Balance, net. End of Period				
Unpaid Obligations	43,260	642	40,456	-
Less: Uncollected Customer Payments from Federal Sources	(2,070)	(482)	(1,845)	-
Total, Unpaid Obligated Balance, net, End of Period	<u>\$41,190</u>	<u>\$160</u>	<u>\$38,611</u>	<u>\$-</u>
<b>NET OUTLAYS</b>				
Gross Outlays	\$83,674	\$639	\$53,175	\$-
Less: Offsetting Collections	(8,600)	(478)	(8,342)	(8)
Less: Distributed Offsetting Receipts	(4,821)	-	(4,548)	-
<b>NET OUTLAYS</b>	<u><b>\$70,253</b></u>	<u><b>\$161</b></u>	<u><b>\$40,285</b></u>	<u><b>(\$8)</b></u>

The accompanying notes are an integral part of these statements.

Department of Homeland Security		(page 1 of 2)
Statements of Financing		
For the Years Ended September 30, 2006 and 2005		
(In Millions)		
	<u>2006</u> (Unaudited)	<u>2005</u> (Unaudited) (Restated)
<b>Resources Used to Finance Activities</b>		
<b>Budgetary Resources Obligated</b>		
Obligations Incurred (Note 25)	\$91,412	\$68,628
Less: Spending Authority from Offsetting Collections and Recoveries	(13,438)	(10,296)
Obligations Net of Offsetting Collections and Recoveries	77,974	58,332
Less: Offsetting Receipts	(4,821)	(4,548)
Net Obligations	73,153	53,784
<b>Other Resources</b>		
Donations and Forfeiture of Property	6	8
Transfers in(out) Without Reimbursement	30	11
Imputed Financing from Costs Absorbed by Others	702	651
Net Other Resources Used to Finance Activities	738	670
<b>Total Resources Used to Finance Activities</b>	<b>\$73,891</b>	<b>\$54,454</b>
<b>Resources Used to Finance Items Not Part of the Net Cost of Operations</b>		
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but not yet Provided	2,159	12,863
Resources that Fund Expenses Recognized in Prior Periods	19,591	42
Budgetary Offsetting Collections and Receipts that do not Affect Net Cost of Operations:		
Credit program Collections that Increase Liabilities for Loan Guarantees or Allowances for Subsidy	(478)	(8)
Other	(2,433)	(741)
Resources that Finance the Acquisition of Assets	2,668	1,860
Other Resources or Adjustments to Net Obligated Resources that do not Affect Net Cost of Operations	1,677	501
<b>Total Resources Used to Finance Items Not Part of the Net Cost of Operations</b>	<b>23,184</b>	<b>14,517</b>
<b>TOTAL RESOURCES USED TO FINANCE THE NET COST OF OPERATIONS</b>	<b>\$50,707</b>	<b>\$39,937</b>



**Department of Homeland Security**  
**Statements of Financing**  
**For the Years Ended September 30, 2006 and 2005**  
**(In Millions)**

(page 2 of 2)

	<u>2006</u> <u>(Unaudited)</u>	<u>2005</u> <u>(Unaudited)</u> <u>(Restated)</u>
<b>Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period:</b>		
<b>Components Requiring or Generating Resources in Future Periods</b>		
Increase in Annual Leave Liability	\$140	\$67
Increase in Environmental and Disposal Liability	66	20
Increase in Exchange Revenue Receivable from the Public	(182)	(95)
Other		
Increase in Insurance Liabilities	-	21,651
Increase in Actuarial Pension Liability	1,721	1,691
Increase in USCG Military Post Employment Benefits	37	17
Increase in Actuarial Health Insurance Liability	658	367
Other	366	295
Total Components of Net Cost of Operations that will Require or Generate Resources in Future Periods	2,806	24,013
<b>Components not Requiring or Generating Resources</b>		
Depreciation and Amortization	1,152	1,121
Revaluation of Assets or Liabilities	25	552
Other	(372)	243
Total Components of Net Cost of Operations that will not Require or Generate Resources	805	1,916
<b>Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period</b>	<b>3,611</b>	<b>25,929</b>
<b>NET COST OF OPERATIONS</b>	<b>\$54,318</b>	<b>\$65,866</b>

The accompanying notes are an integral part of these statements.

**Department of Homeland Security**  
**Statements of Custodial Activity**  
**For the Years Ended September 30, 2006 and 2005**  
**(In Millions)**

	<u>2006</u>	<u>2005</u>
	<u>(Unaudited)</u>	<u>(Unaudited)</u>
<b>Revenue Activity</b>		
Sources of Cash Collections:		
Duties	\$24,730	\$23,198
User Fees	1,524	1,305
Excise Taxes	2,427	2,335
Fines and Penalties	64	63
Interest	12	9
Miscellaneous	178	417
<b>Total Cash Collections</b>	<b>28,935</b>	<b>27,327</b>
Accrual Adjustments (+/-)	(5,371)	253
<b>Total Custodial Revenue</b>	<b>23,564</b>	<b>27,580</b>
<b>Disposition of Collections</b>		
Transferred to Others:		
Federal Entities:		
U.S. Department of Agriculture	127	123
U.S. Department of Labor	189	142
U.S. Department of State	44	27
National Science Foundation	105	83
Treasury General Fund Accounts	27,206	25,688
Other Federal Agencies	17	16
Non-Federal Entities:		
Government of Puerto Rico	14	42
Government of the U.S. Virgin Islands	6	1
Other Non-Federal Entities	9	10
(Increase)/Decrease in Amounts Yet to be Transferred	(5,371)	250
Refunds and Drawbacks (Notes 18 and 33)	1,160	1,159
Retained by the Department	58	39
<b>Total Disposition of Custodial Revenue</b>	<b>23,564</b>	<b>27,580</b>
<b>Net Custodial Activity</b>	<b>\$ -</b>	<b>\$ -</b>

The accompanying notes are an integral part of these statements.

## Notes to the Financial Statements

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## Notes to the Financial Statements (Unaudited)

### 1. Summary of Significant Accounting Policies

#### A. Reporting Entity

The Department of Homeland Security (DHS or Department) was established by the *Homeland Security Act of 2002 (HSA)*, Public Law 107-296, dated March 25, 2002, as an executive department of the United States government. DHS' mission is to lead the national effort to secure America. This mission includes the prevention and deterrence of terrorist attacks and protection against, and response to, threats and hazards to the nation. Additionally, DHS' mission is to ensure the safety and security of borders, welcome lawful immigrants and visitors, and promote the free-flow of commerce. The Department is composed of the following reporting components:

**Federal Emergency Management Agency (FEMA)**

**Preparedness Directorate (PRE)**, including the Grants and Training (G&T), and U.S. Fire Administration (SPF)

**Science and Technology Directorate (S&T)**

**United States Citizenship and Immigration Services (USCIS)**

**United States Coast Guard (USCG)**

**United States Customs and Border Protection (CBP)**

**Federal Law Enforcement Training Center (FLETC)**

**United States Immigration and Customs Enforcement (ICE)**, including the Federal Protective Services (FPS)

**United States Secret Service (USSS)**

**Transportation Security Administration (TSA)**, including the Federal Air Marshals (FAM)

**United States VISIT (US VISIT)**

**Departmental Operations and Other**, including the Management Directorate (MGT), Headquarters, and the Office of the Inspector General (OIG)

On July 13, 2005, Secretary Michael Chertoff announced his agenda for the Department designed to ensure that the Department's policies, operations, and structures are aligned in the best way to address the potential threats – both present and future – that face the nation. This agenda reflects conclusions drawn as a result of the Second Stage Review (2SR or the Review). The Review examined the Department in order to recommend ways that the Department could better manage risks in terms of threats, vulnerability and consequences; prioritize policies and operational missions according to this risk based approach; and establish a series of steps that would increase security.

As a result of 2SR, which was formally approved on October 18, 2005, the Department underwent a realignment designed to increase its ability to prepare, prevent, and respond to terrorist attacks and other emergencies. Specific realignments that affect financial reporting include the establishment of four offices that are reported in the accompanying financial statements and footnote disclosures under Departmental Operations and Other.

- The Office of Policy was created to serve as the primary Department-wide coordinator for policies, regulations, and other initiatives. These functions were previously performed under the Border and Transportation Security Directorate.
- The Office of Intelligence and Analysis was created to gather, analyze, and report information from relevant field operations and information from other parts of the intelligence community. These functions were previously performed, in part, under the Information Analysis and Infrastructure Protection Directorate.
- The Office of Operations Coordination was established to conduct joint operations across the Department, coordinate incident management and the management of the Homeland Security Operations Center.
- The Office of Legislative and Intergovernmental Affairs was created to merge similar functions previously provided by the Office of Legislative Affairs and the Office of State and Local Government Coordination.

During fiscal year 2005, the Border and Transportation Security Directorate (BTS) consisted of CBP, ICE, FPS, FAM, TSA, and FLETC. The 2SR changes disassembled the BTS as a Directorate and established each component with direct reporting to the Secretary, with the exception of FAM which is reported as a component of TSA and FPS which is reported as a component of ICE. U.S. VISIT was also established as a separate reporting component.

The Emergency Preparedness and Response Directorate (EP&R) is no longer a separate component of the Department, as reported in fiscal year 2005. In fiscal year 2006, FEMA (formerly a component of EP&R) was established as a separate reporting component. Additionally, the Information Analysis and Infrastructure Protection Directorate was renamed the Preparedness Directorate (PRE). This Directorate was established to consolidate preparedness assets from across the Department, including the remaining EP&R functions, specifically the U.S. Fire Administration, that was previously reported with FEMA. Included in PRE is the Grants and Training component, formerly known as the Office of State and Local Government Coordination and Preparedness, which no longer exists as a separate office.

Based on the 2SR changes discussed above, the fiscal year 2005 financial statement balances were reclassified to conform with the fiscal year 2006 presentation. See Note 1.B, Basis of Presentation, for detailed information regarding the reporting effects of these changes.

## **B. Basis of Presentation**

These financial statements are prepared to report the consolidated financial position, net cost of operation, changes in net position, custodial activity, and financing, and the combined budgetary resources of the Department pursuant to the *Government Management Reform Act of 1994* (Public Law 103-356) and *Chief Financial Officers Act of 1990* (Public Law 101-576), as amended by the *Reports Consolidation Act of 2000* (Public Law 106-531).

The Department's financial statements have been prepared from the accounting records of the Department in conformity with U.S. generally accepted accounting principles (GAAP), and the Office of Management and Budget (OMB) Circular A-136, *Financial Reporting Requirements*. GAAP for Federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB), the official accounting standards-setting body of the Federal government.

The Department's financial statements reflect the reporting of Departmental activities including appropriations received to conduct operations and revenue generated from operations. The financial statements also reflect the reporting of certain non-entity (custodial) functions performed by the Department on behalf of the Federal government.

Intragovernmental assets and liabilities result from activity with other Federal entities. All other assets and liabilities result from activity with parties outside the Federal government, such as domestic and foreign persons, organizations, or governments. Intragovernmental earned revenues are collections or accruals of revenue from other Federal entities and intragovernmental costs are payments or accruals to other Federal entities. Transactions and balances among the Department's components have been eliminated in the consolidated presentation of the Balance Sheets, Statements of Net Cost, Statements of Changes in Net Position, and the Statements of Custodial Activity and certain lines of the Statements of Financing. The Statements of Budgetary Resources is reported on a combined basis; therefore, intradepartmental balances have not been eliminated.

While these financial statements have been prepared from the books and records of the Department in accordance with the formats prescribed by OMB, these financial statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records.

These financial statements should be read with the realization that they are for a component of the United States Government, a sovereign entity, that liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for

contracts can be abrogated by the sovereign entity.

**Reclassifications.** As a result of the 2SR changes affecting the definition of the Reporting Entity, OMB and other presentation changes, certain reclassifications were made to the fiscal year 2005 financial statements and associated footnotes to conform with the fiscal year 2006 presentation.

### **C. Basis of Accounting**

Transactions are recorded on an accrual and a budgetary basis of accounting. Under the accrual basis, revenues are recorded when earned and expenses are recognized when a liability is incurred, regardless of when cash is exchanged. Budgetary accounting facilitates compliance with legal constraints and the controls over the use of Federal funds. The balances and activity of budgetary accounting is used to prepare the Statements of Budgetary Resources. The Statements of Custodial Activity is reported using the modified cash basis. With this method, revenue from cash collections is reported separately from receivable accruals and cash disbursements are reported separately from payable accruals.

### **D. Use of Estimates**

Management has made certain estimates and assumptions in the reporting of assets, liabilities, revenues, expenses, obligations incurred, spending authority from offsetting collections and note disclosures in the financial statements. Actual results could differ from these estimates. Significant estimates include: the year-end accruals of accounts and grants payable, contingent legal and environmental liabilities, accrued workers' compensation, allowance for doubtful accounts receivable, allowances for obsolete inventory and operating supplies and materials (OM&S) balances, allocations of indirect common costs to construction-in-progress, depreciation, subsidy re-estimates, deferred revenues, National Flood Insurance Program (NFIP) insurance liability, actuarial workers compensation assumptions, military and other pension, retirement and post-retirement benefit assumptions, allowances for doubtful duties, fines, and penalties, and certain non-entity receivables and payables related to custodial activities.

### **E. Entity and Non-Entity Assets**

Entity assets are assets that the Department has the authority to use in its operations. The authority to use funds in an entity's operations means that Department management has the authority to decide how funds are used, or management is legally obligated to use funds to meet entity obligations, e.g. salaries and benefits.

Non-entity assets are assets held by the Department, but are not available for use by the Department. An example of a non-entity asset is Fund Balance with Treasury available to pay refunds and drawback claims of duties, taxes and fees, which the Department collects but has no authority to spend.

### **F. Fund Balance with Treasury**

Fund Balance with Treasury represents the aggregate amount of the Department's accounts with the Department of the Treasury (Treasury) available to pay current liabilities and finance authorized purchases, except as restricted by law. The Department's Fund Balance with Treasury balances are primarily appropriated, revolving, trust, deposit, receipt, and special fund amounts remaining as of the fiscal year-end.

The Department does not maintain cash in commercial bank accounts. For FEMA, certain receipts are received and processed by insurance companies. The remainder of the receipts and disbursements are processed by Treasury.

For additional information, see Note 3, Fund Balance with Treasury.

### **G. Cash and Other Monetary Assets**

The Department's cash and other monetary assets primarily consist of undeposited collections, imprest funds, cash used in undercover operations, cash held as evidence, cash held by insurance companies, and

seized cash and monetary instruments.

For additional information, see Note 4, Cash and Other Monetary Assets.

#### **H. Investments, Net**

Investments consist of United States government non-marketable par value and market based Treasury securities, and are reported at cost or amortized cost net of premiums or discounts. Premiums or discounts are amortized into interest income over the terms of the investment using the effective interest method or the straight line method, which approximates the interest method. No provision is made for unrealized gains or losses on these securities because it is the Department's intent to hold these investments to maturity.

For additional information, see Note 5, Investments, Net.

#### **I. Accounts Receivable, Net**

Accounts receivable represent amounts due to the Department by other Federal agencies and the public. Intragovernmental accounts receivable generally arise from the provision of goods and services to other Federal agencies and are expected to be fully collected.

Accounts receivable due from the public typically results from various immigration and user fees, premiums and restitution from insurance companies and policyholders, breached bonds, reimbursable services, and security fees. Public accounts receivable are presented net of an allowance for doubtful accounts, which is based on analyses of debtors' ability to pay, specific identification of probable losses, aging analysis of past due receivables, or historical collection experience. Interest due on past due receivables is fully reserved until collected.

For additional information, see Note 6, Accounts Receivable, Net.

#### **J. Advances and Prepayments**

Intragovernmental advances, presented as a component of other assets in the accompanying Balance Sheets, consist primarily of disaster recovery and assistance advances to other Federal agencies tasked with mission assignments.

Advances and prepayments to the public, presented as a component of other assets in the accompanying Balance Sheets, consist primarily of disaster recovery and assistance grants to states and other grant activity. Advances are expensed as they are used by the recipients. At year end, the amount, if any, of grant funding unexpended and a grant payable is estimated based on cash transactions reported by the grant administrator.

For additional information, see Note 13, Other Assets.

#### **K. Direct Loans, Net**

Direct loans are loans issued by the Department to local governments. FEMA, the only DHS component with loan activity, operates the Community Disaster Loan program to support any local government which has suffered a substantial loss of tax and other revenues as a result of a major disaster and which demonstrates a need for Federal financial assistance in order to perform its governmental functions. Under the program, FEMA transacts direct loans to local governments who meet statutorily set eligibility criteria. Loans are accounted for as receivables as funds are disbursed.

All of the Department's loans are post 1991 obligated direct loans, and the resulting receivables are governed by the *Federal Credit Reform Act of 1990 (FCRA)*. Under FCRA, for direct loans disbursed during a fiscal year, the corresponding receivable is adjusted for subsidy costs. Subsidy costs are an estimated long-term cost to the United States Government for its loan programs. The subsidy cost is equal to the

present value of the estimated cash outflows over the life of the loans minus the present value of the estimated cash inflows, discounted at the applicable Treasury interest rate. Administrative costs such as salaries and contractual fees are not included. Subsidy costs can arise from interest rate differentials, interest subsidies, delinquencies and defaults, and other cash flows. The Department calculates the subsidy costs based on a subsidy calculator model created by OMB.

Loans receivable are recorded at the present value of the estimated net cash flows. The difference between the outstanding principal of the loans and the present value of their net cash inflows is recorded in the allowance for subsidy, which is estimated and adjusted annually, as of year-end.

For additional information see Note 8, Direct Loans, net.

#### **L. Inventory and Related Property, Net**

Operating materials and supplies (OM&S) are tangible personal property consumed during normal operations. Department OM&S consists primarily of goods consumed during the service of vessels and aircraft. OM&S are valued based on an average unit cost, weighted moving average method or on actual prices paid. OM&S are expensed when consumed or issued for use. Excess, obsolete, and unserviceable OM&S are stated at net realizable value net of an allowance, which is based on the condition of various asset categories, as well as historical experience with using and disposing of such assets.

Inventory is tangible personal property that is held for sale, in the process of production for sale, or to be consumed in the production of goods for sale, or in the provision of services for fees. Department inventories consist primarily of USCG Supply Fund's uniform clothing, subsistence provisions, retail stores, general stores, technical material and fuel, and USCG Yard Fund's ship repair and general inventory. Inventories on hand at year-end are stated at cost using standard price/specific identification, last acquisition price, or weighted average cost methods, which approximates historical cost. Revenue on inventory sales and associated cost of goods sold are recorded when merchandise is sold to the end user. USCG's inventory is restricted to sales within the USCG, and is not available for sale to the public or other government agencies.

Stockpile materials are critical materials held due to statutory requirements for use in national emergencies. The Department's stockpile materials held by FEMA include goods that would be used to respond to national disasters, including water, meals, cots, and blankets. The goods are valued at historical cost.

For additional information see Note 9, Inventory and Related Property, Net

#### **M. Seized and Forfeited Property**

The Department's prohibited seized property results primarily from criminal investigations and passenger/cargo processing. Seized property falls into two categories, prohibited and non-prohibited. Prohibited seized property includes illegal drugs, contraband, and counterfeit items that cannot legally enter into the commerce of the United States; non-prohibited seized property includes items that are not inherently illegal to possess or own such as monetary instruments, real property, and tangible personal property of others.

Seized property is not considered an asset of the Department and is not reported as such in the Department's financial statements. However, the Department has a stewardship responsibility until the disposition of the seized items are determined, i.e., judicially or administratively forfeited or returned to the entity from which it was seized.

Forfeited property is seized property for which the title has passed to the United States government. Prohibited forfeited items such as counterfeit goods, narcotics, or firearms are held by the Department until disposed of or destroyed. Non-prohibited seized property is transferred to the Treasury Forfeiture Fund.

An analysis of changes in seized and forfeited property of prohibited items is presented in Note 10.



## N. General Property, Plant, and Equipment, Net

The Department's property, plant, and equipment (PP&E) consists of aircraft, vessels, vehicles, land, structures, facilities, capital leases, leasehold improvements, software, information technology and other equipment. PP&E is recorded at cost. The Department capitalizes PP&E acquisitions when the cost equals or exceeds an established threshold and has a useful life of two years or more.

Costs for construction projects are recorded as construction-in-progress until completed, and are valued at actual (direct) costs, plus applied overhead and other indirect costs. In cases where historical cost information was not maintained, PP&E is capitalized using an estimated cost based on the cost of similar assets at the time of acquisition or the current cost of similar assets discounted for inflation since the time of acquisition. The Department owns some of the buildings in which components operate. Other buildings are provided by the General Services Administration (GSA), which charges rent equivalent to the commercial rental rates for similar properties.

Internal use software includes purchased commercial off-the-shelf software (COTS), contractor developed software, and internally developed software. For COTS software, the capitalized costs include 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 cost (direct and indirect) incurred during the software development phase.

The schedule of capitalization thresholds shown below is a summary of the range of capitalization rules in place from the legacy agencies that comprised the Department at inception. In accordance with DHS policy, components were allowed to continue using their legacy thresholds and capitalization rules until a more comprehensive approach is developed that takes into account the vast differences in component size and asset usage.

The ranges of capitalization thresholds and service life used by components, by primary asset category, are as follows:

<b>Asset Description</b>	<b>Capitalization Threshold</b>	<b>Service Life</b>
Land and improvements	Regardless of cost to \$100,000	Not Applicable to 50 years
Buildings and improvement	\$25,000 to \$200,000	2 years to 50 years
Equipment and capital leases	\$5,000 to \$200,000	3 years to 65 years
Software	\$50,000 to \$750,000	2 years to 10 years

The Department begins to recognize depreciation expense once the asset has been placed in service. Depreciation is calculated on a straight-line method for all asset classes over their estimated useful lives. Land is not depreciated. Depreciation on buildings and equipment leased by GSA is not recognized by the Department. Leasehold improvements are depreciated over the shorter of the term of the remaining portion of the lease or the useful life of the improvement. Buildings and equipment acquired under capital leases are amortized over the lease term. Amortization of capitalized software is calculated using the straight-line method and begins on the date of acquisition if purchased, or when the module or component has been placed in use (i.e., successfully installed and tested) if contractor or internally developed. There are no restrictions on the use or convertibility of general PP&E.

For additional information see Note 11, General Property, Plant and Equipment, Net

## O. Stewardship Property, Plant and Equipment

Stewardship PP&E includes heritage assets and stewardship land which generally are not included in general PP&E presented on the balance sheet. Heritage assets are unique due to their historical or natural significance, cultural, educational, or artistic importance, or significant architectural characteristics. Heritage assets can serve two purposes, a heritage function and general government operational function. If a

heritage asset serves both purposes, but is predominantly used for general government operations, the heritage asset is considered a multi-use heritage asset, which is included in general PP&E on the Balance Sheet.

The Department's multi-use heritage assets consist primarily of buildings and structures owned by CBP and USCG. CBP depreciates its multi-use heritage assets. Due to their nature, heritage assets are not depreciated because matching costs with specific periods would not be meaningful.

For more information see Note 12, Stewardship Property, Plant and Equipment.

## **P. Liabilities**

Liabilities represent the probable and measurable future outflow or other sacrifice of resources as a result of past transactions or events. Liabilities covered by budgetary resources are those liabilities for which Congress has appropriated funds or funding is otherwise available to pay amounts due. Liabilities not covered by budgetary or other resources represent amounts owed in excess of available Congressionally appropriated funds or other amounts, and there is no certainty that the appropriations will be enacted. The United States Government, acting in its sovereign capacity, can abrogate liabilities of the Department arising from other than contracts.

## **Q. Contingent Liabilities**

Certain conditions exist as of the date of the financial statements, which may result in a loss to the government, but which will only be resolved when one or more future events occur or fail to occur. The Department recognizes a loss contingency when the future outflow or other sacrifice of resources is probable and reasonably estimable. The Department discloses a loss contingency in the notes to the financial statements when the conditions for liability recognition are not met or when a loss from the outcome of future events is more than remote. The uncertainty of loss should be resolved when one or more future events occur or fail to occur.

For more information see Note 21, Commitments and Contingent Liabilities.

**Environmental Cleanup Costs.** Environmental liabilities consist of environmental remediation, and cleanup and decommissioning. The liability for environmental remediation is an estimate of costs necessary to bring a known contaminated asset into compliance with applicable environmental standards. Accruals for environmental cleanup costs are the costs of removing, containing, and/or disposing of hazardous wastes or materials that, because of quantity, concentration, or physical or chemical characteristics may pose a substantial present or potential hazard to human health or the environment.

For all PP&E in service as of October 1, 1997, DHS recognizes the estimated total cleanup costs associated with the PP&E at the time the cleanup requirement is identified. DHS does not prorate a cleanup cost over the life of these PP&E. However, the estimate may be subsequently adjusted for material changes due to inflation/deflation or changes in regulations, plans, or technology. The applicable costs of decommissioning DHS' existing and future vessels are considered cleanup costs.

For more information see Note 17, Environmental and Disposal Liabilities.

## **R. Grants Liability**

The Department awards grants and cooperative agreements to Federal, state and local governments, universities, non-profit organizations, and private sector companies for the purpose of building the capacity to respond to disasters and emergencies, conduct research into preparedness, enhance and ensure the security of passenger and cargo transportation by air, land, or sea, and other Department-related activities. The Department estimates the year-end grant accrual for unreported grantee expenditures using historical disbursement data. Grants liabilities are combined with accounts payable to the public in the accompanying Balance Sheets.

For more information see Note 18, Other Liabilities.

## S. Insurance Liabilities

Insurance liabilities are the result of the Department's sale or continuation-in-force of flood insurance known as the National Flood Insurance Program (NFIP), which is managed by FEMA. The insurance liability represents an estimate of NFIP losses that are unpaid at the Balance Sheet date. Although the insurance underwriting operations believes the liability for unpaid losses and loss adjustment expenses is reasonable and adequate in the circumstances, actual incurred losses and loss adjustment expenses may not conform to the assumptions inherent in the estimation of the liability. Accordingly, the ultimate settlement of losses and the related loss adjustment expenses may vary from the estimate reported in the financial statements.

For more information see Note 18, Other Liabilities, and Note 20, Insurance Liabilities.

## T. Debt and Borrowing Authority

Debt is reported within Intragovernmental Liabilities and results from Treasury loans and related interest payable to fund NFIP and Disaster Assistance Direct Loan Program (DADLP) operations. The Department's obligations for NFIP and DADLP are financed by principal repayments, flood premiums, and map collection fees.

The Department has borrowing authority for NFIP and DADLP, and may obtain additional borrowing authority if needed.

For more information see Note 15, Debt.

## U. Accrued Payroll and Benefits

**Accrued Payroll.** Accrued Payroll is salaries, wages, and other compensation earned by the employees, but not disbursed as of September 30. The liability is estimated for reporting purposes based on historical pay information.

**Leave Program.** Earned annual and other vested compensatory leave is accrued as it is earned and reported on the Balance Sheet as an accrued payroll and benefits liability. The liability is reduced as leave is taken. Each year, the balances in the accrued leave accounts are adjusted to reflect the liability at current pay rates and leave balances. Sick leave and other types of non-vested leave are not earned benefits. Accordingly, non-vested leave is expensed when used.

**Federal Employees Compensation Act.** The *Federal Employees Compensation Act (FECA)* provides income and medical cost protection to covered Federal civilian employees injured on the job, to employees who have incurred work-related occupational diseases, and to beneficiaries of employees whose deaths are attributable to job-related injuries or occupational diseases. The FECA program is administered by the U.S. Department of Labor (Labor), which pays valid claims and subsequently seeks reimbursement from the Department for these paid claims.

The FECA liability consists of two components. The first component, accrued FECA liability, is based on actual claims paid by Labor but not yet reimbursed by the Department. The Department reimburses Labor for the amount of actual claims as funds are appropriated for this purpose. There is generally a two-to three-year time period between payment by Labor and reimbursement to Labor by the Department. As a result, the Department recognizes an intragovernmental liability for the actual claims paid by Labor and to be reimbursed by the Department.

The second component, actuarial FECA liability, is the estimated liability for future benefit payments and is recorded as a component of Federal Employee and Veterans' Benefits. This liability includes death, disability, medical, and miscellaneous costs. Labor determines this component annually, as of September 30, using an actuarial method that considers historical benefit payment patterns, wage inflation factors, medical inflation factors, and other variables. The projected annual benefit payments are discounted to present value using the OMB economic assumptions for 10-year Treasury notes and bonds. To provide for

the effects of inflation on the liability, wage inflation factors (i.e., cost of living adjustments), and medical inflation factors (i.e., consumer price index medical adjustments) are applied to the calculation of projected future benefit payments. These factors are also used to adjust historical benefit payments and to adjust future benefit payments to current year constant dollars. The actuarial FECA liability is not covered by budgetary resources and will require future funding.

For more information on the Actuarial FECA Liability see Note 16, Federal Employee and Veterans' Benefits. For more information on the Accrued FECA Liability, Accrued Payroll and Accrued Leave, see Note 18, Other Liabilities.

## V. Federal Employee and Veterans' Benefits

**Civilian Pension and Other Post Employment Benefits.** The Department recognizes the full annual cost of its civilian employees' pension benefits; however, the assets of the plan and liability associated with pension costs are recognized by Office of Personnel Management (OPM) rather than the Department.

Most U.S. Government employees of DHS hired prior to January 1, 1984, participate in the Civil Service Retirement System (CSRS), to which the Department contributes 7 percent of base pay for regular CSRS employees, and 7.5 percent of base pay for law enforcement agents. The majority of employees hired after December 31, 1983, are covered by the Federal Employees Retirement System (FERS) and Social Security. For the FERS basic annuity benefit the Department contributes 11.2 percent of base pay for regular FERS employees and 23.8 percent for law enforcement agents. A primary feature of FERS is that it also offers a defined contribution plan to which the Department automatically contributes 1 percent of base pay and matches employee contributions up to an additional 4 percent of base pay. The Department also contributes the employer's Social Security matching share for FERS participants.

Similar to CSRS and FERS, OPM rather than the Department reports the liability for future payments to retired employees who participate in the Federal Employees Health Benefits Program (FEHB) and Federal Employees Group Life Insurance Program (FGLI). The Department is required to report the full annual cost of providing these other retirement benefits (ORB) for its retired employees as well as reporting contributions made for active employees. In addition, the Department recognizes an expense and liability for other post employment benefits (OPEB), which includes all types of benefits provided to former or inactive (but not retired) employees, their beneficiaries, and covered dependents.

The difference between the full annual cost of CSRS and FERS retirement, ORB and OPEB and the amount paid by the Department is recorded as an imputed cost and offsetting imputed financing source in the accompanying financial statements.

**Military Retirement System Liability.** The USCG Military Retirement System (MRS) is a defined benefit plan that covers both retirement pay and health care benefits for all active duty and reserve military members of the USCG. The plan is funded through annual appropriations and, as such, is a pay-as-you-go system. The unfunded accrued liability reported on the accompanying Balance Sheet is actuarially determined by subtracting the present value of future employer/employee contributions, as well as any plan assets, from the present value of the future cost of benefits. Current period expense is computed using the aggregate entry age normal actuarial cost method.

A portion of the accrued MRS liability is for the health care of non-Medicare eligible retirees/survivors. The Department of Defense (DoD) is the administrative entity and in accordance with SFFAS No. 5, is required to recognize the liability on the Fund's financial statements. The USCG makes monthly payments to the Fund for current active duty members. Benefits for USCG members who retired prior to the establishment of the Fund are provided by payments from the Treasury to the Fund. The future cost and liability of the Fund is determined using claim factors and claims cost data developed by the DoD, adjusted for USCG retiree and actual claims experience. The USCG uses the current year actual costs to project costs for all future years.

**Post-employment Military Travel Benefit.** USCG uniformed service members are entitled to travel and transportation allowances for travel performed or to be performed under orders, without regard to the comparative costs of the various modes of transportation. These allowances, upon separation from the

service, include the temporary disability related list placement, release from active duty, retirement and entitlement for travel from the member's last duty station to home or the place from which the member was called or ordered to active duty, whether or not the member is or will be an active member of a uniformed service at the time of travel is or will be performed.

USCG recognizes an expense and a liability for this OPEB when a future outflow or other sacrifice of resources is probable and measurable on the basis of events occurring on or before the reporting date. The OPEB liability is measured at the present value of future payments, which requires the USCG to estimate the amount and timing of future payments, and to discount the future outflow using the Treasury borrowing rate for securities of similar maturity to the period over which the payments are made.

**Uniformed Division and Special Agent Pension Liability.** The District of Columbia Police and Fireman's Retirement System (the DC Pension Plan) is a defined benefit plan that covers USSS Uniformed Division and Special Agents. The DC Pension Plan makes benefit payments to retirees and/or their beneficiaries. The USSS receives permanent, indefinite appropriations each year to pay the excess of benefit payments over salary deductions. The DC Pension Plan is a pay-as-you-go system funded through annual appropriations. The unfunded accrued liability reported on the accompanying Balance Sheet is actuarially determined by subtracting the present value of future employer/employee contributions, as well as any plan assets, from the present value of future cost of benefits. Current period expense is computed using the aggregate cost method.

For more information on Civilian Pension and Other Post Employment Benefits, Military Retirement System Liability, Post-employment Military Travel Benefit and Uniformed Division and Special Agent Pension Liability see Note 16, Federal Employee and Veterans' Benefits.

## **W. Earmarked Funds and Adoption of a New Accounting Standard**

The Department adopted SFFAS No. 27, *Identifying and Reporting Earmarked Funds*. Earmarked funds are financed by specifically identified revenues, often supplemented by other financing sources, which remain available over time. These specifically identified revenues and other financing sources are required by statute to be used for designated activities, benefits or purposes, and must be accounted for separately from the Government's general revenues.

Earmarked non-exchange revenue and other financing sources, including appropriations, and net cost of operations are shown separately on the Statements 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.

For additional information see Note 22, Earmarked Funds, and Note 5, Investments, Net.

## **X. Revenue and Financing Sources**

**Appropriations.** The Department receives the majority of funding to support its programs through Congressional appropriations. The Department receives annual, multi-year, and no-year appropriations that may be used, within statutory limits, for operating and capital expenditures. Additional funding is obtained through exchange revenues, non-exchange revenues and transfers-in.

Appropriations are recognized as financing sources when related expenses are incurred or assets are purchased. Revenue from reimbursable agreements is recognized when the goods or services are provided by the Department. Prices for goods and services sold to the public are based on recovery of full cost or are set at a market price. Reimbursable work between Federal agencies is subject to the *Economy Act (31 United States Code (U.S.C.) 1535)* or other statutes authorizing reimbursement. Prices for goods and services sold to other Federal government agencies are generally limited to the recovery of direct cost.

**Exchange and Non-Exchange Revenue.** Exchange revenues are recognized when earned and are derived from transactions where both the government and the other party receive value; i.e., goods have been delivered or services have been rendered. Non-exchange revenues from user fees are recognized as earned in accordance with the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended.

Non-exchange revenues arise from transfers in with and without financing sources and donations from the public. Other financing sources, such as donations and transfers of assets without reimbursements, are recognized on the Statements of Changes in Net Position during the period in which the donations and transfers occurred.

- Fees for flood mitigation products and services, such as insurance provided through FEMA's NFIP, are established at rates necessary to sustain a self-supporting program. NFIP premium revenues are recognized ratably over the life of the policies. Deferred revenue relates to unearned premiums reserved to provide for the remaining period of insurance coverage.
- Exchange revenue for TSA consists of security fees assessed on the public and air carriers pursuant to PL 107-71, the Aviation and Transportation Security Act.
- USCIS requires advance payments of the fees for adjudication of applications or petitions for immigration and naturalization benefits. Revenue associated with the application fees received is deferred and not considered earned until the application is adjudicated.

Deferred revenue is recorded when the Department receives payment for goods or services which have not been fully rendered. Certain application fees are paid at the time of filing and are recognized as revenue when the requested benefits are adjudicated. Additionally, NFIP premium revenue is recognized over the life of the insurance policies. Deferred revenue is reported as a liability on the Balance Sheets.

**Imputed Financing Sources.** In certain instances, operating costs of DHS are paid out of funds appropriated to other Federal agencies. For example, the OPM, by law, pays certain costs of retirement programs, and certain legal judgments against DHS are paid from a Judgment Fund maintained by the Department of the Treasury. When costs that are identifiable to DHS and directly attributable to DHS operations are paid by other agencies, DHS recognizes these amounts as operating expenses. DHS also recognizes an imputed financing source on the Statements of Changes in Net Position to indicate the funding of DHS operations by other Federal agencies.

**Custodial Revenue.** Non-entity revenue and refunds are reported on the Statements of Custodial Activity using a modified cash basis. Non-entity revenue reported on the Department's Statement of Custodial Activity include duties, excise taxes, and various non-exchange fees collected by CBP and USCIS that are subsequently remitted to Treasury's General Fund or to other Federal agencies. Duties, user fees, fines and penalties are assessed pursuant to the provisions of Title 19 United States Code (U.S.C.); nonimmigrant petition fees under Title 8 U.S.C., and; excise taxes under Title 26 U.S.C. CBP also enforces over 400 laws and regulations some of which require the collection of fees or the imposition of fines and penalties pursuant to other Titles within the U.S.C. or Code of Federal Regulations (C.F.R.).

CBP assesses duties, taxes, and fees on goods and merchandise brought into the United States from foreign countries. Non-entity tax and trade accounts receivables are recognized when CBP is entitled to collect duties, user fees, fines and penalties, refunds and drawback overpayments, and interest associated with import/export activity on behalf of the Federal Government that have been established as a specifically identifiable, legally enforceable claim and remain uncollected as of year-end. The custodial revenue is recorded at the time of collection. These revenue collections primarily result from current fiscal year activities. Generally, CBP records an equal and offsetting liability due to the Treasury General Fund for amounts recognized as non-entity tax and trade receivable and custodial revenue. CBP accrues an estimate of duties, taxes and fees related to commerce released prior to year-end where receipt of payment is anticipated subsequent to year-end. Fees collected by USCIS for nonimmigrant petitions must be submitted with the petition. The portions of the fees that are subsequently remitted to other Federal agencies are recorded as custodial revenue at the time of collection.

Non-entity receivables are presented net of amounts deemed uncollectible. CBP tracks and enforces payment of estimated duties, taxes and fees receivable by establishing a liquidated damage case that generally results in fines and penalties receivable. A fine or penalty, including interest on past due balances, is established when a violation of import/export law is discovered. An allowance for doubtful collections is established for substantially all accrued fines and penalties and related interest. The amount is based on past experience in resolving disputed assessments, the debtor's payment record and willingness to pay, the probable recovery of amounts from secondary sources, such as sureties and an analysis of aged receivable activity. CBP regulations allow importers to dispute the assessment of duties,

taxes and fees. Receivables related to disputed assessments are not recorded until the protest period expires or a protest decision is rendered in CBP's favor.

Refunds and drawback of duties, taxes and fees are recognized when payment is made. A permanent, indefinite appropriation is used to fund the disbursement of refunds and drawbacks. Disbursements are recorded as a decrease in the amount Transferred to Federal Entities as reported on the Statement of Custodial Activity. An accrual adjustment is recorded on the Statements of Custodial Activity to adjust cash collections and refund disbursements with the net increase or decrease of accrued non-entity accounts receivables, net of uncollectible amounts and refunds payable at year-end.

For additional information see Note 7, Taxes, Duties, and Fees Receivables, Net, and Note 33, Custodial Revenues.

## **Y. Taxes**

The Department, as a Federal agency, is not subject to Federal, state or local income taxes and accordingly, no provision for income taxes has been recorded in the accompanying financial statements.

## **Z. Restatements**

In fiscal year 2006, the Department restated certain fiscal year 2005 balances. A brief explanation of the restatements follows, for additional information see Note 34, Restatements.

- TSA restated its fiscal year 2005 results to correct an error and to ensure its accounting practices for airline passenger and air carrier security fee collections are consistent with relevant legislation and government practice. This restatement did not change the net cost of the Department's operations and did not increase or decrease the amount of budgetary resources available to the Department. The restatement corrected the Statements of Budgetary Resources, Changes in Net Position, and related footnotes for fiscal year 2005.
- During fiscal year 2006, TSA became aware of obligations incurred but not recorded in prior years. As a result, the fiscal year 2005 Statement of Budgetary Resources was restated.
- The USCG restated its fiscal year 2005 results due to an error in the data used to determine the estimate for the Postretirement Medical liability. The restatement decreased the Federal Employee and Veterans' Benefits liability on the Balance Sheet as of September 30, 2005 which also resulted in an increase to the Cumulative Results of Operations. The restatement also resulted in decrease to gross cost of operations in fiscal year 2005 which also affect the Statements of Changes in Net Position and Financing.
- ICE, USCIS and PRE restated certain financial statement balances as a result of errors discovered during the implementation of corrective actions. These corrective actions primarily focused on Fund Balance with Treasury, Accounts Payable and Property, Plant, and Equipment and resulted in restatements to all principal statements except the Statement of Custodial Activity.
- FLETC restated certain 2005 financial statement balances due to accounting errors and accounting changes noted during fiscal year 2006. As a result, the Balance Sheet, the Statement of Changes in Net Position, and the Statement of Financing were restated.
- As a result of new or updated reporting requirements and the restatements completed based on errors noted by the components, the Department noted reporting errors that were not attributable to a single component. Therefore, the Department restated the Statement of Budgetary Resources and the Statement of Financing to correct errors based on improvements to the financial statement crosswalks.

## 2. Non-Entity Assets

Non-entity assets at September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited) (Restated)
Intragovernmental:		
Fund Balance with Treasury	\$ 5,949	\$5,067
Due From Treasury	411	144
Total Intragovernmental	<u>6,360</u>	<u>5,211</u>
Cash and Other Monetary Assets	46	44
Accounts Receivable, Net	19	19
Taxes, Duties, and Trade Receivables, Net	1,755	1,400
Property, Plant, and Equipment	3	6
Total Public	<u>1,823</u>	<u>1,469</u>
Total Non-Entity Assets	8,183	6,680
Total Entity Assets	71,050	107,816
<b>Total Assets</b>	<b><u>\$ 79,233</u></b>	<b><u>\$114,496</u></b>

Non-entity Fund Balance with Treasury consists of special and deposit funds, permanent and indefinite appropriations, and miscellaneous receipts that are available to pay non-entity liabilities presented on the Balance Sheet. Non-entity Fund Balance with Treasury at September 30, 2006, includes \$5.2 billion in unliquidated duties on imports of Canadian Softwood lumber collected by CBP. Non-entity Fund Balance with Treasury at September 30, 2005, includes (in deposit fund) approximately \$4.7 billion of unliquidated duties collected by CBP on imports of Canadian Softwood Lumber. All non-entity Fund Balance with Treasury is considered restricted cash. These assets offset accrued liabilities at September 30, 2006, and 2005 (see Notes 3 and 18).

Non-entity receivables due from Treasury represent an estimate of duty, tax and/or fee refunds and drawbacks that will be reimbursed by a permanent and indefinite appropriation account and will be used to pay estimated duty refunds and drawbacks payable. Duties and taxes receivable from the public represents amounts due from importers for goods and merchandise imported to the United States, and upon collection, will be available to pay the accrued intragovernmental liability due to the Treasury General Fund of \$1.8 billion and \$1.4 billion at September 30, 2006 and 2005, respectively (see Notes 7 and 18).



### 3. Fund Balance with Treasury

#### A. Fund Balance with Treasury

Fund Balance with Treasury at September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited) (Restated)
Appropriated Funds	\$50,898	\$89,508
Trust Funds	35	27
Revolving, Public Enterprise, and Working Capital Funds	216	108
Special Funds	2,909	2,457
Deposit Funds	5,510	4,912
<b>Total Fund Balance with Treasury</b>	<b>\$59,568</b>	<b>\$97,012</b>

Appropriated funds consist of amounts appropriated annually by Congress to fund the operations of the Department. Appropriated funds included clearing funds totaling \$110 million and \$105 million at September 30, 2006 and 2005, respectively, which represent reconciling differences with Treasury balances. The majority of the decrease in Appropriated funds is due to a FEMA rescission and an increase in payments to Hurricane Katrina recipients.

Trust funds include both receipt accounts and expenditure accounts that are designated by law as a trust fund. Trust fund receipts are used for specific purposes, generally to offset the cost of expanding border and port enforcement activities and oil spill related claims and activities.

Revolving funds are used for continuing cycles of business-like activity, in which the fund charges for the sale of products or services and uses the proceeds to finance its spending, usually without requirement for annual appropriations. The Working Capital Fund is a fee-for-service fund established to support operations of Department components. Also included are the financing funds for credit reform and the National Flood Insurance Fund.

Special funds include funds earmarked for specific purposes including the disbursement of non-entity monies received in connection with antidumping and countervailing duty orders due to qualifying Injured Domestic Industries (IDI). The Department also has special funds for immigration and naturalization user fees and CBP user fees; as well as inspection fees, flood map modernization subsidy, and off-set and refund transfers. For information related to earmarked funds see Note 22.

Deposit funds represent amounts received as an advance that are not accompanied by an order and include non-entity collections that do not belong to the Federal Government. The majority of the deposit fund balance relates to unliquidated antidumping and countervailing duties collected by CBP, mostly related to Canadian Softwood lumber.

**B. Status of Fund Balance with Treasury**

The status of Fund Balance with Treasury at September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited) (Restated)
Budgetary Status		
Unobligated Balances:		
Available	\$11,445	\$51,888
Unavailable	5,599	5,017
Obligated Balance Not Yet Disbursed	41,350	38,611
Total Budgetary Status	<u>58,394</u>	<u>95,516</u>
Reconciling Adjustments:		
Receipt, Clearing, and Deposit Funds	5,634	5,020
Borrowing Authority	(4,230)	(3,301)
Investments	(628)	(729)
Receivable Transfers and Imprest Fund	(97)	(79)
Receipt unavailable for obligation	495	585
<b>Total Fund Balance with Treasury</b>	<b><u>\$59,568</u></b>	<b><u>\$97,012</u></b>

Adjustments required to reconcile the budgetary status to non-budgetary Fund Balance with Treasury as reported in the accompanying Balance Sheets are as follows:

- Receipt, clearing, and deposit funds represent amounts on deposit with Treasury that have no budget status at September 30, 2006 and 2005. Included in adjustments for deposit funds are restricted balances for Canadian softwood lumber non-entity funds and receipts that are not available for obligation.
- Borrowing authority is in budgetary status for use by FEMA for disaster relief purposes and Community disaster loans.
- Budgetary resources have investments included; however, the money has been moved from the Fund Balance with Treasury asset account to Investments.
- Receivable transfers of currently invested balances increase the budget authority at the time the transfer is realized and obligations may be incurred before the actual transfer of funds.
- Imprest funds represent monies moved from Fund Balance with Treasury to Cash and Other Monetary Assets with no change in the budgetary status.
- Receipts immediately upon collection are unavailable for obligation. The receipts are not available for obligation until a specified time in the future.

Portions of the Unobligated Balances Available, Unavailable and Obligated Balance Not Yet Disbursed contain CBP's user fees of \$761 million and \$741 million at September 30, 2006 and 2005, respectively, which is restricted by law in its use to offset costs incurred by CBP.

Portions of the Unobligated Balance Unavailable include amounts appropriated in prior fiscal years that are not available to fund new obligations. However, it can be used for upward and downward adjustments for existing obligations in future years.

The Obligated Balance Not Yet Disbursed represents amounts designated for payment of goods and services ordered but not received or goods and services received but for which payment has not yet been made.

During September 2005, the Disaster Relief Fund received two supplemental appropriations totaling \$60 billion for Hurricane Katrina. During fiscal year 2006, \$23 billion was rescinded by the U.S. Congress, pursuant to Public Law 109-148. As of September 30, 2006 and 2005, this fund has an unobligated balance available of \$5.5 billion and \$46.4 billion, respectively.

#### 4. Cash and Other Monetary Assets

Cash and Other Monetary Assets at September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited)
Cash	\$62	\$42
Seized Monetary Instruments	37	36
<b>Total Cash and Other Monetary Assets</b>	<b>\$99</b>	<b>\$78</b>

DHS Cash includes cash held by others, including the net balance maintained by insurance companies for flood insurance premiums received from policyholders, less amounts paid for insured losses; undeposited cash, which represents fees collected but not yet deposited; and imprest funds. Seized Monetary Instruments are held until disposition and relate primarily to gold coins seized at the end of fiscal year 2004. As of September 30, 2006 and 2005, restricted cash and other monetary assets is \$46 and \$44 million, respectively.

#### 5. Investments, Net

Investments at September 30, 2006 consisted of the following (in millions):

Type of Investment:	Amortization Method	Cost	Amortized (Premium) Discount	Investments, Net (Unaudited)	Market Value Disclosure
<i>Intragovernmental Securities:</i>					
Oil Spill Liability Trust Fund	Effective interest method	\$610	(15)	\$595	N/A
<b>Total Non-Marketable</b>		<b>610</b>	<b>(15)</b>	<b>595</b>	<b>N/A</b>
Non-Marketable, Market-Based	Straight line method	39	-	39	39
<b>Total Investments, Net</b>		<b>\$ 649</b>	<b>(\$15)</b>	<b>\$ 634</b>	<b>N/A</b>

Investments at September 30, 2005 consisted of the following (in millions):

Type of Investment:	Amortization Method	Cost	Amortized (Premium) Discount	Investments, Net (Unaudited)	Market Value Disclosure
<i>Intragovernmental Securities:</i>					
Oil Spill Liability Trust Fund	Effective interest method	\$749	(\$14)	\$735	N/A
General Gift Fund	Straight line method	1	-	1	N/A
<b>Total Non-Marketable</b>		<b>750</b>	<b>(14)</b>	<b>736</b>	<b>N/A</b>
Non-Marketable, Market-Based	Straight line method	2	-	2	2
<b>Total Investments, Net</b>		<b>\$752</b>	<b>(\$14)</b>	<b>\$738</b>	<b>N/A</b>

The Federal Government does not set aside assets to pay future benefits or other expenditures associated with earmarked funds (Oil Spill Liability Trust Fund and General Gift Fund) for the USCG. The cash receipts collected from the public for an earmarked fund are deposited in the U.S. Treasury, which uses the cash for general Government purposes. Treasury securities are issued to the USCG as evidence of its receipts. Treasury securities associated with earmarked are an asset to USCG and a liability to the U.S. Treasury. Because DHS and the U.S. Treasury are all parts of the Government, these assets and liabilities offset each other from the standpoint of the Government as a whole. For this reason, these funds do not represent an asset or a liability in the U.S. Government-wide financial statements.

Treasury securities provide USCG with authority to draw upon the U.S. Treasury to make future benefit payments or other expenditures. When the USCG requires redemption of these securities to make expenditures, the Government finances those expenditures out of accumulated cash balances, by raising taxes or other receipts, by borrowing from the public or repaying less debt, or by curtailing other expenditures. This is the same way that the Government finances all other expenditures.

## 6. Accounts Receivable, Net

Accounts Receivable, net, at September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited)
Intragovernmental	\$248	\$217
With the Public:		
Accounts Receivable	1,639	929
Allowance for Doubtful Accounts	(458)	(397)
	<b>1,181</b>	<b>532</b>
<b>Accounts Receivable, Net</b>	<b>\$1,429</b>	<b>\$749</b>

Intragovernmental accounts receivable results from reimbursable work performed by the Department. Accounts receivable with the public consist of amounts due for reimbursable services and user fees. The increase in accounts receivable with the public is primarily caused by a change in how TSA calculates security fees due from airline companies, for FEMA's Other Needs Assistance program, and for the recovery of payments to disaster victims.

## 7. Tax, Duties, and Fees Receivables, Net

Tax, Duties, and Fees Receivables consisted of the following (in millions):

As of September 30, 2006 (Unaudited):

Receivables Category	Gross Receivables	Allowance	Total Net Receivables
Duties	\$1,601	(\$118)	\$1,483
Excise Taxes	99	(6)	93
User Fees	120	(13)	107
Fines/Penalties	1,243	(1,187)	56
Anti-Dumping/Countervailing Duties	259	(243)	16
<b>Total Tax, Duties, and Fees Receivables, Net</b>	<b>\$3,322</b>	<b>(1,567)</b>	<b>\$1,755</b>

As of September 30, 2005 (Unaudited):

Receivables Category	Gross Receivables	Allowance	Total Net Receivables
Duties	\$1,207	(\$97)	\$1,110
Excise Taxes	88	(6)	82
User Fees	84	(1)	83
Fines/Penalties	1,116	(1,032)	84
Anti-Dumping/Countervailing Duties	217	(176)	41
<b>Total Tax, Duties, and Fees Receivables, Net</b>	<b>\$2,712</b>	<b>(\$1,312)</b>	<b>\$1,400</b>

When a violation of import/export law is discovered, a fine or penalty is established. CBP assesses a liquidated damage or penalty for these cases to the maximum extent of the law. After receiving the notice

of assessment, the importer or surety has a period of time to either file a petition requesting a review of the assessment or pay the assessed amount. Once a petition is received, CBP investigates the circumstances as required by its mitigation guidelines and directives. Until this process has been completed, CBP records an allowance on fines and penalties of approximately 96 percent (93 percent at September 30, 2005) of the total assessment based on historical experience of fines and penalties mitigation and collection. Duties and taxes receivables are non-entity assets for which there is an offsetting liability due to the Treasury General Fund.

## 8. Direct Loans, Net

DHS's loan program consists of two types of direct loans, both administered by FEMA: (1) State Share Loans: FEMA may lend or advance to a State or an eligible applicant the portion of assistance for which the applicant is responsible under cost-sharing provisions of the Stafford Act. For 1992 and beyond, the State Share Loans are obligated from the Disaster Assistance Direct Loan Financing Account. (2) Community Disaster Loans (CDLs): Loans may be authorized to local governments that have suffered a substantial loss of tax and other revenues as a result of a major disaster, and have demonstrated a need for financial assistance in order to perform their municipal operating functions. The loans are made at the current Treasury rate for a term of 5 years and cannot exceed 25 percent of the annual operating budget of the local government for the fiscal year in which the major disaster occurred, with the exception of Hurricanes Katrina/Rita Special CDL. The rates for Katrina/Rita Special CDL are less than the Treasury rate and cannot exceed 50 percent of the annual operating budget of the local government for the fiscal year in which the major disaster occurred. In addition, in accordance with recent Stafford Act amendments (P.L. 109-88), CDLs may exceed \$5 million and shall not be canceled.

For FY 2006, subsidies totaling \$1 billion has been approved for up to \$1.4 billion in CDLs to local governments in the Gulf Region affected by the 2005 hurricane season. As of September 30, 2006, loans totaling \$1.3 billion had been approved. Disbursements are tracked by cohort as determined by the date of obligation rather than disbursement.

### A. Summary of Direct Loans to Non-Federal Borrowers at September 30 (in millions):

	2006 (Unaudited)	2005 (Unaudited)
	Loans Receivable, Net	Loans Receivable, Net
<b>Community Disaster Loans</b>	<b>\$161</b>	<b>\$.5</b>

An analysis of loans receivable and the nature and amounts of the subsidy and administrative costs associated with the direct loans is provided in the following sections.

### B. Direct Loans Obligated Prior to Fiscal Year 1992

All direct loans obligated prior to fiscal year 1992 have been collected and therefore, no balance remained as of September 30, 2006 and 2005.

### C. Direct Loans Obligated After Fiscal Year 1991 (in millions):

At September 30, 2006 (Unaudited):	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Value of Assets Related to Direct Loans
<b>Community Disaster Loans</b>	<b>\$631</b>	<b>\$9</b>	<b>(\$479)</b>	<b>\$161</b>

At September 30, 2005 (Unaudited):	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Value of Assets Related to Direct Loans
<b>Community Disaster Loans</b>	<b>\$2.3</b>	<b>\$1.4</b>	<b>(\$3.2)</b>	<b>\$ .5</b>

**D. Total Amount of Direct Loans Disbursed, Post-1991 (in millions):**

	2006 (Unaudited)	2005 (Unaudited)
Community Disaster Loans	<b>\$629</b>	<b>\$ -</b>

**E. Subsidy Expense for Direct Loans by Program and Component (in millions):**

**Subsidy Expense for New Direct Loans Disbursed as of September 30 (in millions):**

	Interest Differential	Defaults and Other	Total
Community Disaster Loans 2006 (Unaudited)	\$109	\$362	\$471
2005 (Unaudited)	-	-	-

For the Community Disaster Loan Program there were no re-estimates or modifications to the subsidy expense.

**Total Direct Loan Subsidy Expense**

	2006 (Unaudited)	2005 (Unaudited)
<b>Community Disaster Loans</b>	<b>\$471</b>	<b>\$-</b>

**F. Direct Loan Subsidy Rates at September 30 (in millions):**

The direct loan subsidy rates, by program, are as follows:

	2006 (Unaudited)		2005 (Unaudited)	
	Community Disaster Loans	State Share Loans	Community Disaster Loans	State Share Loans
Interest Subsidy Cost	17.4 %	(.55) %	3.72 %	(2.98) %
Default Costs	57.6 %	- %	- %	- %
Other	- %	0.36 %	89.72 %	0.38 %

**G. Schedule for Reconciling Subsidy Cost Allowance Balances at September 30 (in millions):**

	2006 (Unaudited)	2005 (Unaudited)
Beginning Balance of the Subsidy cost allowance	\$3.2	\$185.1
Add: subsidy expense for direct loans disbursed during the reporting years by component:		
(a) Interest rate differential costs	109.3	-
(b) Other subsidy costs	362.1	-
Adjustments:		
(a) Loans written off	-	(188.4)
(b) Subsidy allowance amortization	4.6	0.5
(c) Other	-	6.0
Ending balance of the subsidy cost allowance before reestimates	479.2	3.2
Add subsidy reestimate by component		
(a) Technical/default reestimate	-	-
<b>Ending balance of the subsidy cost allowance</b>	<b>\$479.2</b>	<b>\$3.2</b>

The amount of loans written off includes the cancellation of \$127 million (principal only) at September 30, 2005, in loans to the government of the Virgin Islands. No write-offs are reported as of September 30, 2006.

**H. Administrative Expenses at September 30 (in millions):**

	2006 (Unaudited)	2005 (Unaudited)
Community Disaster and State Share Loans	<b>\$1.6</b>	<b>\$ .4</b>

**9. Inventory and Related Property, Net**

Operating materials and supplies (OM&S) and inventory, net at September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited) (Restated)
OM&S		
Items Held for Use	\$337	\$354
Items Held for Future Use	28	86
Excess, Obsolete and Unserviceable Items	75	7
Less: Allowance for Losses	(75)	(7)
Total OM&S, Net	<b>365</b>	<b>440</b>



Inventory		
Inventory Purchased for Resale	69	59
Less: Allowance for Losses	(3)	(1)
Total Inventory, Net	66	58
Stockpile Materials Held in Reserve	246	-
<b>Total OM&amp;S and Inventory, Net</b>	<b>\$677</b>	<b>\$498</b>

## 10. Prohibited Seized Property

Prohibited seized property item counts as of September 30 and activity for the fiscal years then ended are as follows:

Seizure Activity						
Seized Property:	Fiscal Year Ended September 30, 2006 (Unaudited)					Seized Property:
Category	Balance October 1, 2005	New Seizures	Remissions	New Forfeitures	Adjustments	September 30 Weight/Items
Illegal Drugs (in kilograms):						
Cannabis (marijuana)	502	439,748	-	(439,597)	84	737
Cocaine	162	28,513	-	(28,289)	(33)	353
Heroin	26	1,345	-	(1,345)	(6)	20
Firearms and Explosives (in number of items)	2,021	1,362	(936)	(1,521)	(62)	864
Counterfeit Currency (US/Foreign, in number of items)	3,364,060	1,424,320	-	-	(560,949)	4,227,431
Pornography (in number of items)	141	158	-	(138)	(60)	101
Forfeiture Activity						
Forfeited Property:	Fiscal Year Ended September 30, 2006 (Unaudited)					Forfeited Property:
Category	Balance October 1, 2005	New Forfeitures	Transfers	Destroyed	Adjustments	September 30 Weight/Items
Illegal Drugs (in kilograms):						
Cannabis (marijuana)	92,834	439,597	(3,167)	(362,988)	(68,972)	97,304
Cocaine	21,513	28,289	(7)	(29,663)	(548)	19,584
Heroin	2,104	1,345	(1)	(1,242)	15	2,221
Firearms and Explosives (in number of items)	276	1,521	(1,551)	(4)	11	253

Pornography (in number of items)	39	138	-	(178)	33	32
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**Prohibited Seized Property, Continued**

<b>Seizure Activity</b>						
Seized Property:	Fiscal Year Ended September 30, 2005 (Unaudited)					Seized Property:
Category	Balance October 1, 2004	New Seizures	Remissions	New Forfeitures	Adjustments	September 30 Weight/Items
Illegal Drugs (in kilograms):						
Cannabis (marijuana)	2,176	444,751	-	(446,861)	436	502
Cocaine	144	31,818	-	(31,345)	(455)	162
Heroin	18	1,230	-	(1,225)	3	26
Firearms and Explosives (in number of items)	7,788	1,454	(5,798)	(1,364)	(59)	2,021
Counterfeit Currency (US/Foreign, in number of items)	2,887,743	804,946	-	-	(328,629)	3,364,060
Pornography (in number of items)	133	213	(5)	(182)	(18)	141
<b>Forfeiture Activity</b>						
Forfeited Property:	Fiscal Year Ended September 30, 2005 (Unaudited)					Forfeited Property:
Category	Balance October 1, 2004	New Forfeitures	Transfers	Destroyed	Adjustments	September 30 Weight/Items
Illegal Drugs (in kilograms):						
Cannabis (marijuana)	98,657	446,861	(641)	(419,668)	(32,375)	92,834
Cocaine	17,348	31,345	(58)	(26,576)	(546)	21,513
Heroin	2,545	1,225	(1)	(1,664)	(1)	2,104
Firearms and Explosives (in number of items)	297	1,364	(1,307)	(14)	(64)	276
Pornography (in number of items)	37	182	-	(189)	9	39

This schedule is presented for material prohibited (non-valued) seized and forfeited property only. These items are retained and ultimately destroyed by CBP and USSS and are not transferred to the Departments of Treasury or Justice Asset Forfeiture Funds or other Federal agencies. The ending balance for firearms includes only those seized items that can actually be used as firearms. Illegal drugs are presented in kilograms and a significant portion of the weight includes packaging, which often cannot be reasonably separated from the weight of the drugs since the packaging must be maintained for evidentiary purposes. Firearms, explosives and pornography are presented in number of items; and counterfeit currency is

presented in number of bills. The adjustments columns relates to prohibited property destroyed or adjustments made due to items incorrectly tagged or marked as to seized or forfeited.

USCG also seizes and takes temporary possession of small boats, equipment, contraband and other illegal drugs. USCG usually disposes of these properties within three days by transfer to CBP (who transfers non-prohibited seized property to the Treasury Forfeiture Fund), the Drug Enforcement Administration, or foreign governments, or by destroying it. Seized property in USCG possession at year-end is not considered material and therefore is not itemized and is not reported in the financial statements of the Department.

CBP will take into custody, without risk or expense, merchandise termed "general order property," which for various reasons cannot legally enter into the commerce of the United States. CBP's sole responsibility with general order property is to ensure the property does not enter the nation's commerce. If general order property remains in CBP custody for a prescribed period of time, without payment of all estimated duties, storage and other charges, the property is considered unclaimed and abandoned and can be sold by CBP at public auction or donated to charity (if not prohibited by law). Auction sales revenue in excess of charges associated with the sale or storage of the item is remitted to the Treasury General Fund. In some cases, CBP incurs charges prior to the sale and funds these costs from entity appropriations. Regulations permit CBP to offset these costs of sale before returning excess amounts to Treasury.

## 11. General Property, Plant, and Equipment, Net

General Property, Plant, and Equipment (PP&E) consisted of the following (in millions):

As of September 30, 2006 (Unaudited):	Service Life	Gross Cost	Accumulated Depreciation/ Amortization	Total Net Book Value
Land and Land Rights	N/A	\$75	N/A	\$75
Improvements to Land	3-50 yrs	64	29	35
Construction in Progress	N/A	2,914	N/A	2,914
Buildings, Other Structures and Facilities	2-50 yrs	3,876	1,902	1,974
Equipment:				
ADP Equipment	3-5 yrs	348	187	161
Aircraft	10-35 yrs	2,595	1,441	1,154
Vessels	5-65 yrs	4,233	2,152	2,081
Vehicles	3-8 yrs	502	380	122
Other Equipment	2-30 yrs	3,867	2,060	1,807
Assets Under Capital Lease	2-20 yrs	79	30	49
Leasehold Improvements	3-50 yrs	350	101	249
Internal Use Software	2-10 yrs	880	565	315
Internal Use Software- in Development	N/A	100	N/A	100
<b>Total General Property, Plant, and Equipment, Net</b>		<b>\$ 19,883</b>	<b>\$8,847</b>	<b>\$11,036</b>

As of September 30, 2005 (Unaudited) (Restated):	Service Life	Gross Cost	Accumulated Depreciation/ Amortization	Total Net Book Value
Land and Land Rights	N/A	\$63	N/A	\$63
Improvements to Land	3-50 yrs	50	22	28
Construction in Progress	N/A	2,403	N/A	2,403
Buildings, Other Structures and Facilities	2-50 yrs	3,702	1,803	1,899
Equipment:				
ADP Equipment	3-5 yrs	212	98	114
Aircraft	10-35 yrs	2,318	1,288	1,030
Vessels	5-45 yrs	4,131	2,009	2,122
Vehicles	3-8 yrs	501	348	153
Other Equipment	2-30 yrs	3,430	1,676	1,754
Assets Under Capital Lease	2-20 yrs	81	26	55
Leasehold Improvements	3-50 yrs	280	76	204
Internal Use Software	3-10 yrs	481	250	231
Internal Use Software- in Development	N/A	404	N/A	404
<b>Total General Property, Plant, and Equipment, Net</b>		<b>\$18,056</b>	<b>\$7,596</b>	<b>\$10,460</b>

## 12. Stewardship PP&E

DHS's Stewardship PP&E are primarily USCG's assets maintained to safeguard the remains of crew members who were lost at sea, to prevent the unauthorized handling of explosives or ordinance which may be aboard, and to preserve culturally valuable relics.

USCG does not acquire or retain heritage buildings and structures without an operational purpose. Most real property, even if designated as historical, is acquired for operational use and is transferred to other government agencies or public entities when no longer required for operations. Of the USCG buildings and structures designated as heritage, including memorials, recreational areas and other historical areas, over two-thirds are multi-use heritage. The remaining are historical lighthouses, which are no longer in use and awaiting disposal; their related assets; and a gravesite. CBP also has four multi-use heritage assets located in Puerto Rico.

### 13. Other Assets

Other Assets at September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited)
Intragovernmental:		
Advances and Prepayments	\$2,912	\$ 2,937
Due from Treasury	411	144
Total Intragovernmental	<u>3,323</u>	<u>3,081</u>
Public:		
Advances and Prepayments	551	480
Total Public	<u>551</u>	<u>480</u>
<b>Total Other Assets</b>	<b><u>\$3,874</u></b>	<b><u>\$3,561</u></b>

Intragovernmental Advances and Prepayments primarily consists of FEMA's Disaster Relief Fund (DRF) disaster assistance advances to other Federal agencies (principally the Department of Transportation) tasked with restoration efforts of the New York City region transportation system. Non-entity Receivable Due from Treasury represents an estimate of duty, tax and/or fee refunds and drawbacks that will be reimbursed by a permanent and indefinite appropriation account and will be used to pay estimated refunds and drawbacks of \$411 million and \$144 million, as of September 30, 2006 and 2005, respectively.

The Department provides advance funds to public grant recipients to incur expenses related to the approved grant. Advances are made within the amount of the total grant obligation.

## 14. Liabilities Not Covered by Budgetary Resources

Liabilities Not Covered by Budgetary Resources at September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited) Restated
Intragovernmental:		
Debt (Note 15)	\$17,092	\$ 226
Accrued FECA Liability (Note 18)	323	358
Other	55	(1)
<b>Total Intragovernmental</b>	<b>17,470</b>	<b>583</b>
Public:		
Federal Employee and Veterans' Benefits:		
Actuarial FECA Liability (Note 16)	1,520	1,473
Military Service and Other Retirement Benefits (Note 16)	30,758	28,577
Environmental and Disposal Liabilities (Note 17)	245	165
Other:		
Accrued Payroll and Benefits (Note 18)	824	834
Insurance Liabilities (Note 20)	3,557	22,679
Contingent Legal Liabilities (Note 21)	24	221
Capital Lease Liability (Note 19)	110	75
Other	-	9
<b>Total Public</b>	<b>37,038</b>	<b>54,033</b>
<b>Total Liabilities Not Covered by Budgetary Resources</b>	<b>\$54,508</b>	<b>\$54,616</b>
Liabilities Covered by Budgetary Resources or Non-Entity Assets	16,379	14,596
<b>Total Liabilities</b>	<b>\$70,887</b>	<b>\$69,212</b>

The Department anticipates that the liabilities listed above will be funded from future budgetary resources when required. Budgetary resources are generally provided for unfunded leave when it is used. Unfunded leave is included in accrued payroll and benefits. Intragovernmental Debt increased in fiscal year 2006 due to funds borrowed by FEMA from the Bureau of Public Debt to pay flood insurance claims, primarily related to Hurricanes Katrina and Rita.

## 15. Debt

Debt at September 30 consisted of the following (in millions):

Fiscal year ended September 30, 2006	Beginning Balance	Net Borrowing	Ending Balance (Unaudited)
<b>Other Debt:</b>			
Debt to the Treasury General Fund	\$226	\$17,220	\$17,446
<b>Total Debt</b>	<b>\$226</b>	<b>\$17,220</b>	<b>\$17,446</b>
<hr/>			
Fiscal year ended September 30, 2005	Beginning Balance	Net Borrowing	Ending Balance (Unaudited)
<b>Other Debt:</b>			
Debt to the Treasury General Fund	\$1	\$225	\$226
<b>Total Debt</b>	<b>\$1</b>	<b>\$225</b>	<b>\$226</b>

DHS' intragovernmental debt is owed to Treasury's Bureau of Public Debt and consists of borrowings to finance claims under NFIP and borrowings to finance the FEMA's credit reform programs (State Share Loans and Community Disaster Loans). The increase in fiscal year 2006 borrowings was the result of an increase to FEMA's borrowing authority to satisfy claims as a result of the 2005 hurricane season. FEMA did not utilize the total borrowing authority available of over \$18 billion.

NFIP loans are for a three-year term. Interest rates are obtained from the Bureau of Public Debt (BPD) and range by cohort year from 4.87% to 6.69% as of September 30, 2006 and from 6.20% and 6.69% as of September 30, 2005. Simple interest is calculated monthly – offset by an interest rebate, if applicable. The interest rebate is calculated at a rate equal to the weighted average of the interest rates of outstanding loans for the month multiplied by the "positive" daily account fund balance for the month. Interest is paid semi-annually, October 1 and April 1. Interest is accrued based on balances reported by BPD totaling \$275 as of September 30, 2006. The September 30, 2005 balance was zero. Principal repayments are required only at maturity, but are permitted any time during the term of the loan. All loan and interest payments are financed by the flood premiums and map collection fees.

Under Credit Reform, the unsubsidized portion of direct loans is borrowed from the Treasury. The repayment terms of FEMA's borrowing from Treasury are based on the life of each cohort of direct loans. Proceeds from collections of principal and interest from the borrowers are used to repay the Treasury. In addition, an annual reestimate is performed to determine any change from the original subsidy rate. If an upward reestimate is determined to be necessary, these funds are available through permanent indefinite authority which is to be approved by OMB. Once these funds are appropriated, the original borrowings are repaid to Treasury. The weighted average interest rates for FY 2006 and FY 2005 were 4.53% and 3.56%, respectively.

## 16. Federal Employee and Veterans' Benefits

Accrued liability for military service and other retirement benefits at September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited) (Restated)
USCG Military Retirement and Healthcare Benefits	\$27,105	\$25,024
USCG Post-Employment Military Travel Benefits	128	100
USSS DC Pension Plan Benefits	3,518	3,453
Actuarial FECA Liability	1,520	1,473
Other	7	-
<b>Total Federal Employee and Veterans' Benefits</b>	<b>\$32,278</b>	<b>\$30,050</b>

### A. USCG Military Retirement and Healthcare Benefits

The USCG Military Retirement System (MRS or the Plan) is a defined benefit plan that covers both retirement pay and health care benefits for all active duty and reserve military members of the USCG. The Plan is a pay-as-you-go system funded through annual appropriations. The unfunded accrued liability reported on the accompanying Balance Sheet is actuarially determined by subtracting the present value of future employer/employee contributions and any plan assets, from the present value of the future cost of benefits. Current period expense is computed using the aggregate entry age normal actuarial cost method.

The components of the MRS expense for the years ended September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited) (Restated)
Defined Benefit Plan:		
Normal cost	\$589	\$481
Interest on the liability	1,376	1,259
Actuarial losses/(gains)	(239)	617
Actuarial Assumption Change	902	103
<b>Total Defined Benefit Plan Expense</b>	<b>\$2,628</b>	<b>\$2,460</b>
Post-retirement Healthcare:		
Normal cost	\$180	\$137
Interest on the liability	249	226
Other Actuarial (gains)/losses	48	103
<b>Total Post-retirement Healthcare Expense</b>	<b>477</b>	<b>466</b>
<b>Total MRS Expense</b>	<b>\$3,105</b>	<b>\$2,926</b>

The USCG's military service members (both active duty and reservists) participate in the MRS. USCG



receives an annual "Retired Pay" appropriation to fund MRS benefits, thus the MRS is treated as a pay-as-you-go plan. The retirement system allows voluntary retirement for active members upon credit of at least 20 years of active service at any age. Reserve members may retire after 20 years of creditable service with benefits beginning at age 60. The USCG's MRS includes the USCG Military Health Services System (Health Services Plan). The Health Services Plan is a post-retirement medical benefit plan, which covers all active duty and reserve members of the USCG.

A portion of the accrued MRS liability is for the health care of non-Medicare eligible retirees/survivors. Effective October 1, 2002, USCG transferred its liability for the health care of Medicare eligible retirees/survivors to the Department of Defense (DoD) Medicare-Eligible Retiree Health Care Fund (the Fund), which was established in order to finance the health care benefits for the Medicare-eligible beneficiaries of all DoD and non-DoD uniformed services. DoD is the administrative entity and in accordance with SFFAS No. 5, is required to recognize the liability on the Fund's financial statements. The USCG makes monthly payments to the Fund for current active duty members. Benefits for USCG members who retired prior to the establishment of the Fund are provided by payments from the Treasury to the Fund. The future cost and liability of the Fund is determined using claim factors and claims cost data developed by the DoD, adjusted for USCG retiree and actual claims experience. The USCG uses the current year actual costs to project costs for all future years.

The unfunded accrued liability, presented as a component of the liability for military service and other retirement in the accompanying Balance Sheet, represents both retired pay and health care benefits for non-Medicare eligible retirees/survivors. Valuation of the plan's liability is based on the actuarial present value of accumulated plan benefits derived from the future payments that are attributable, under the retirement plan's provisions, to a participant's credited service as of the valuation date. Credited service is the years of service from active duty base date (or constructive date in the case of active duty reservists) to date of retirement measured in years and completed months. The present value of future benefits is then converted to an unfunded accrued liability by subtracting the present value of future employer/employee normal contributions. USCG plan participants may retire after 20 years of active service at any age with annual benefits equal to 2.5 percent of retired base pay for each year of credited service up to 75 percent of basic pay. Personnel who became members after August 1, 1986, may elect to receive a \$30,000 lump sum bonus after 15 years of service and reduced benefits prior to age 62. Annual disability is equal to the retired pay base multiplied by the larger of (1) 2.5 percent times years of service, or (2) percent disability. The benefit cannot be more than 75 percent of retired pay base. If a USCG member is disabled, the member is entitled to disability benefits, assuming the disability is at least 30 percent (under a standard schedule of rating disabilities by Veterans Affairs) and either: (1) the member has one month and one day of service, (2) the disability results from active duty, or (3) the disability occurred in the line of duty during a time of war or national emergency or certain other time periods.

The significant actuarial assumptions used to compute the MRS accrued liability are:

- (1) life expectancy is based upon the DoD death mortality table;
- (2) cost of living increases are 3.0 percent annually; and
- (3) annual rate of investment return is 6.25 percent.

## **B. District of Columbia Police and Fireman's Retirement System for U.S. Secret Service Employees**

Special agents and personnel in certain job series hired by USSS before January 1, 1984, are eligible to transfer to the District of Columbia Police and Fireman's Retirement System (DC Pension Plan) after completion of ten years of protection related experience. All uniformed USSS officers who were hired before January 1, 1984, are automatically covered under this retirement system. Participants in the DC Pension Plan make contributions of 7 percent of base pay with no matching contribution made by USSS. Annuitants of this plan receive benefit payments directly from the DC Pension Plan. The USSS reimburses the District of Columbia for the difference between benefits provided to the annuitants, and payroll contributions received from current employees. This liability is presented as a component of the liability for military service and other retirement benefits in the accompanying Balance Sheet. SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, requires the administrative entity (administrator) to report the actuarial liability. However, the USSS adopted the provisions of SFFAS No. 5 because the

administrator, the DC Pension Plan, is not a Federal entity and as such the liability for future funding would not otherwise be recorded in the United States government wide consolidated financial statements.

The liability and expense are computed using the aggregate cost method. The primary actuarial assumptions used to determine the liability at September 30, 2006, are:

- (1) life expectancy is based upon the *1994 Uninsured Pension (UP94)* tables;
- (2) cost of living increases are 3.5 percent annually;
- (3) rates of salary increases are 3.5 percent annually; and
- (4) annual rate of investment return is 7.25 percent.

Total expenses related to the DC Pension Plan for the fiscal years ended September 30, 2006 and 2005, were \$202 million and \$188 million, respectively.

### **C. Actuarial FECA Liability**

The actuarial Federal Employees' Compensation Act (FECA) liability represents the estimated liability for future workers' compensation and includes the expected liability for death, disability, medical, and miscellaneous costs for approved cases. Future workers' compensation estimates, generated from an application of actuarial procedures developed by the DOL, for the future cost of approved compensation cases were approximately \$1.5 billion at both September 30, 2006 and 2005.

## **17. Environmental and Disposal Liabilities**

Environmental and Disposal Liabilities at September 30, 2006 and 2005, are \$245 million and \$179 million, respectively. The Department is responsible to remediate its sites with environmental contamination, and is party to various administrative proceedings, legal actions and tort claims which may result in settlements or decisions adverse to the Federal government. The source of remediation requirements to determine the environmental liability is based on compliance with Federal and state or local environmental laws and regulations. The major Federal laws covering environmental response, cleanup and monitoring are the *Comprehensive Environmental Response, Compensation and Liability Act* and the *Resource Conservation and Recovery Act*.

The liabilities are primarily due to light houses, light stations, fuel storage tank program, buildings containing asbestos and/or lead based paint, firing ranges, fuels, solvents, industrial, chemicals and other environmental cleanup associated with normal operations of CBP, FLETC, and the USCG. For Plum Island Animal Disease Center, under S&T, potential environmental liabilities may exist in addition to the amounts accrued in the accompanying financial statements that are not presently estimable but could exist due to the facility's age, old building materials used and other materials associated with the facility's past use as a United States Army installation for coastline defense.

Cost estimates for environmental and disposal liabilities are subject to revision as a result of changes in technology, environmental laws and regulations, and plans for disposal.

## 18. Other Liabilities

Other Liabilities at September 30 consisted of the following (in millions):

	Current	Non-Current	2006 (Unaudited)	2005 (Unaudited) (Restated)
<b>Intragovernmental:</b>				
Accrued FECA Liability	\$143	\$180	\$323	\$358
Advances from Others	22	-	22	109
Employer Benefits Contributions and Payroll Taxes	150	3	153	96
Due to the General Fund (Note 2)	1,809	-	1,809	1,434
Other Intragovernmental Liabilities	4	8	12	47
<b>Total Intragovernmental Other Liabilities</b>	<b>\$2,128</b>	<b>\$191</b>	<b>\$2,319</b>	<b>\$2,044</b>
<b>Public:</b>				
Accrued Payroll and Benefits (See B. below)	\$1,173	\$189	\$1,362	\$1,366
Deferred Revenue and Advances from Others (See B. below)	1,200	988	2,188	2,014
Deposit Liability (Notes 2 and 3)	34	-	34	4,706
Injured Domestic Industries (Notes 2 and 3)	476	-	476	237
Insurance Liabilities (Note 20)	1,177	2,390	3,567	23,433
Contingent Legal Liabilities (Note 21)	-	71	71	247
Capital Lease Liability (Note 19)	16	94	110	129
Refunds and Drawbacks (Note 2) (See B. below)	5,593	-	5,593	118
Other Liabilities	466	67	533	345
<b>Total Other Liabilities with the Public</b>	<b>\$10,135</b>	<b>\$3,799</b>	<b>\$13,934</b>	<b>\$32,595</b>
<b>Total Other Liabilities</b>	<b>\$12,263</b>	<b>\$3,990</b>	<b>\$16,253</b>	<b>\$34,639</b>

### A. Intragovernmental Other Liabilities

**Workers' Compensation.** Claims incurred for the benefit of Department employees under FECA are administered by DOL and are ultimately paid by the Department. The accrued FECA liability represents money owed for current claims. Reimbursement to DOL on payments made occurs approximately two years subsequent to the actual disbursement. Budgetary resources for this intragovernmental liability are made available to the Department as part of its annual appropriation from Congress in the year in which the reimbursement takes place. Workers compensation expense was \$164 million and \$141 million, respectively, for the fiscal years ended September 30, 2006 and 2005.

**Due to the General Fund.** Amounts due to the Treasury General Fund represent duty, tax and fees collected by CBP to be remitted to various General Fund accounts maintained by Treasury.

### B. Other Liabilities with the Public

**Accrued Payroll and Benefits.** Accrued Payroll and Benefits at September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited)
Accrued Funded Payroll and Benefits	\$524	\$517
Accrued Unfunded Leave	767	729
Unfunded Employment Related Liabilities	57	105
Other	14	15
<b>Total Accrued Payroll and Benefits</b>	<b>\$1,362</b>	<b>\$1,366</b>

**Deferred Revenue and Advances from Others.** Deferred Revenue and Advances From Others for the periods ended September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited)
Total USCIS Application Fees	\$702	\$773
FEMA Unexpired NFIP premium	1,473	1,226
Advances from Others	13	14
Deferred Credits	-	1
<b>Total Deferred Revenue</b>	<b>\$2,188</b>	<b>\$2,014</b>

USCIS requires payments of fees for applications or petitions for immigration and naturalization benefits at the time of filing. FEMA's deferred revenue relates to unearned NFIP premiums that are recognized over the term of the period of insurance coverage.

**Injured Domestic Industries.** The *Continued Dumping and Subsidy Offset Act of 2000* calls for CBP to collect and disburse monies received in connection with antidumping and countervailing duty orders and findings to qualifying Injured Domestic Industries (IDI). Antidumping duties are collected when it is determined that a class or kind of foreign merchandise is being released into the U.S. economy at less than its fair value to the detriment of a U.S. industry. Countervailing duties are collected when it is determined that a foreign government is providing a subsidy to its local industries to manufacture, produce, or export a class or kind of merchandise for import into the U.S. commerce to the detriment of a U.S. industry. The duties will eventually be distributed, pursuant to rulings by the Department of Commerce.

**Refunds and Drawbacks.** The liability for refunds and drawbacks for the fiscal years ended September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited)
Canadian Softwood Lumber Duties and Accrued Interest	\$5,504	\$ -
Other Refunds and Drawbacks	89	118
<b>Total</b>	<b>\$ 5,593</b>	<b>\$118</b>

CBP has collected duties on the import of Canadian Softwood Lumber which are included in non-entity fund balance with Treasury. These amounts were reported as a refund payable as of September 30, 2006 and a deposit fund liability as of September 30, 2005. During fiscal year 2006, an agreement was reached related to the litigation for duties related to the import of Canadian softwood lumber. As a result of this agreement, the Canadian Softwood Lumber duties previously collected and accrued interest totaling \$590

million will be refunded. The refunds will be distributed during fiscal year 2007.

**Other Liabilities.** Other public liabilities consist primarily of NFIP payable to insurance companies and the liability for deposit and suspense funds.

## 19. Leases

### A. Operating Leases

The Department leases various facilities and equipment under leases accounted for as operating leases. Leased items consist of offices, warehouses, vehicles and other equipment. The majority of office space occupied by the Department is either owned by the Federal government or is leased by GSA from commercial sources. The Department is not committed to continue to pay rent to GSA beyond the period occupied providing proper advance notice to GSA is made and unless the space occupied is designated as unique to Department operations. However, it is expected the Department will continue to occupy and lease office space from GSA in future years and lease charges will be adjusted annually to reflect operating costs incurred by GSA.

As of September 30, 2006, estimated future minimum lease commitments under operating leases for equipment and GSA controlled leases were as follows (in millions) (unaudited):

	GSA	Non-GSA	Total
FY 2007	\$869	\$137	\$1,006
FY 2008	887	126	1,013
FY 2009	903	124	1,027
FY 2010	925	124	1,049
FY 2011	955	127	1,082
After FY 2011	2,595	372	2,967
<b>Total Future Minimum Lease Payments</b>	<b>\$7,134</b>	<b>\$1,010</b>	<b>\$8,144</b>

The estimated future lease payments for GSA controlled leases are based on payments made during the year ended September 30, 2006.

### B. Capital Leases

The Department maintains capital leases for buildings and commercial software license agreements. The liabilities associated with capital leases and software license agreements are presented as other liabilities in the accompanying financial statements based upon the present value of the future minimum lease payments.

Certain license agreements are cancelable depending on future funding. Substantially all of the net present value of capital lease obligations and software license agreements may be funded from future sources.

As of September 30, 2006, estimated future minimum lease payments under capital leases for equipment were as follows (in millions) (unaudited):

	GSA	Non-GSA	Total
FY 2007	\$6	\$18	\$24
FY 2008	6	18	24
FY 2009	6	18	24

FY 2010	6	18	24
FY 2011	6	-	6
After FY 2011	70	-	70
<b>Total Future Minimum Lease Payments</b>	<b>100</b>	<b>72</b>	<b>172</b>
Less: Imputed interest and Executory costs	(52)	(10)	(62)
<b>Total Capital Lease Liability</b>	<b>\$48</b>	<b>\$62</b>	<b>\$110</b>

## 20. Insurance Liabilities

Insurance Liabilities at September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited)
National Flood Insurance Program	\$3,557	\$23,406
<i>Cerro Grande Fire Assistance Act</i>	10	27
<b>Total Insurance Liabilities</b>	<b>\$3,567</b>	<b>\$23,433</b>

### A. National Flood Insurance Program (NFIP)

The NFIP liability for unpaid losses and related loss adjustment expenses and amounts paid for the year ended September 30 consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited)
Beginning Balance	\$23,406	\$1,357
Change in incurred losses	(2,281)	25,407
Less: Amounts paid during current period	(17,568)	(3,358)
<b>Total NFIP Liability at September 30</b>	<b>\$3,557</b>	<b>\$23,406</b>

The NFIP insurance liability represents an estimate of NFIP based on the loss and loss adjustment expense factors inherent in the NFIP insurance underwriting operations experience and expectations. Estimation factors used by the insurance underwriting operations reflect current case basis estimates and give effect to estimates of trends in claim severity and frequency. These estimates are continually reviewed, and adjustments, reflected in current operations, are made as deemed necessary. As of September 30, 2005, the increase in incurred losses was primarily due to Hurricane Katrina which impacted the Gulf Coast in August 2005. The decrease in incurred losses recognized in fiscal year 2006 is the result of fewer loss events during the period resulting in a lower liability for unpaid losses and related loss adjustment expenses.

NFIP premium rates are generally established for actuarially rated policies with the intent of generating sufficient premiums to cover losses and loss adjustment expenses of a historical average loss year and to provide a surplus to compensate the Insurance Underwriting Operations for the loss potential of an unusually severe loss year due to catastrophic flooding.

Notwithstanding the foregoing, subsidized rates have historically been charged on a countrywide basis for certain classifications of insured. These subsidized rates produce a premium less than the loss and loss adjustment expenses expected to be incurred in a historical average loss year. The subsidized rates do not

include a provision for losses from catastrophic flooding. Subsidized rates are used to provide affordable insurance on construction or substantial improvements started on or before December 31, 1974, or before the effective date of the initial Flood Insurance Rate Map (i.e., an official map of a community on which NFIP has delineated both the special hazard areas and the non-subsidized premium zones applicable to the community).

### **B. Cerro Grande Fire Assistance Act**

The U.S. Department of Interior, National Park Service, initiated a prescribed burn that resulted in the loss of Federal, state, local, Indian tribal and private property. In July 2000, Congress passed the *Cerro Grande Fire Assistance Act* (CGFAA) to compensate as fully as possible those parties who suffered damages from the Cerro Grande Fire.

At September 30, 2006 and 2005, the liability for unpaid insurance expenses represents an estimate of the known probable and estimable losses that are unpaid as of September 30, 2006 and 2005, based on the Final Rules dated March 21, 2001, entitled, the Disaster Assistance: Cerro Grande Fire Assistance, Final Rule, published in the *Federal Register Part II* at 44 Code of Federal Regulations Chapter I, Part 295.

## **21. Commitments and Contingent Liabilities**

### **A. Legal Contingent Liabilities**

The estimated contingent liability recorded in the accompanying financial statements included with other liabilities for all probable and estimable litigation related claims at September 30, 2006, was \$71 million, of which \$47 million is funded. The range of probable and estimable litigation is \$71 million to \$100 million. (At September 30, 2005, was \$247 million, of which \$26 million is funded). Asserted and pending legal claims for which loss is reasonably possible is estimated to range from \$68 million to \$2.7 billion at September 30, 2006, and \$319 million to \$2.5 billion, at September 30, 2005. The Department is subject to various other legal proceedings and claims. In management's opinion, the ultimate resolution of other actions will not materially affect the Department's financial position or net costs. The nature of probable and reasonably possible claims is litigation related to the Federal Tort Claims Act (FTCA), Oil Spill Liability Trust Fund, and various customs laws and regulations.

DHS management and general legal counsel assess such contingent liabilities, and such assessment inherently involves an exercise of judgment. In assessing contingencies related to legal proceedings that are pending against DHS, or unasserted claims that may result in such proceedings, general legal counsel evaluates the perceived merits of any legal proceedings or unasserted claims as well as the perceived merits of the amounts of relief sought or expected to be brought therein.

If the assessment of the loss contingency indicates that it is probable that a material liability has been incurred and the amount of the liability can be estimated, then the estimated liability is accrued in the financial statements regardless of the source of funding used to pay the liability. If the assessment indicates that a potentially material contingent liability is not probable but is reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss if determinable and material is disclosed.

Contingent liabilities considered remote are generally not disclosed unless they involve guarantees, in which case the nature of the guarantee are disclosed.

### **B. Duty and Trade Refunds**

There are various trade related matters that fall under the jurisdiction of other Federal agencies, such as the Department of Commerce, which may result in refunds of duties, taxes and fees collected by CBP. Until a decision is reached by the other Federal agencies, CBP does not have sufficient information to estimate a contingent liability amount, if any, for trade related refunds under jurisdiction of other Federal agencies in

addition to the amount accrued on the accompanying financial statements. All known refunds as of September 30, 2006, and 2005, have been recorded.

### **C. Loaned Aircraft and Equipment**

The Department is generally liable to the DoD for damage or loss to aircraft on loan to CBP. As of September 30, 2006 and September 30, 2005, CBP had 16 aircraft loaned from DoD with an acquisition value of \$94 million (unaudited). No damage or aircraft losses were accrued as of September 30, 2006 and September 30, 2005.

### **D. Other Contractual Arrangements**

In addition to future lease commitments disclosed in Note 19, the Department is committed under contractual agreements for goods and services that have been ordered but not yet received (undelivered orders) at fiscal year-end. Aggregate undelivered orders for all Department activities are disclosed in Note 30. For fiscal year 2006, DHS estimates \$67 million (unaudited) in obligations related to cancelled appropriations for which the Department has a contractual obligation for payment as well as an estimated \$41 million (unaudited) for contractual arrangements which may require future funding. For fiscal year 2005, DHS estimated \$26 million (unaudited) in obligations related to cancelled appropriations, for which the Department has a contractual obligation which may require future financial obligations.

TSA entered into a number of *Letters of Intent for Modifications to Airport Facilities* with eight major airports in which TSA may reimburse the airports for 75% (estimated total of \$957 million) of the cost to modify the facilities for security purposes. These Letters of Intent would not obligate TSA until funds have been appropriated and obligated. TSA has received appropriations of \$240 million (unaudited) in fiscal year 2006 and \$269 million (unaudited) in fiscal year 2005 under this program, which is available for payment to the airports upon submission to TSA of an invoice for the modification costs incurred. As of September 30, 2006, TSA has received invoices or documentation for costs incurred totaling \$335 million (unaudited) related to these agreements. In addition to invoices or documentation received, TSA has accrued costs of \$28 million (unaudited) and \$267 million (unaudited) as of September 30, 2006 and 2005, respectfully.



## 22. Earmarked Funds

Earmarked funds are financed by specifically identified revenues, often supplemented by other financing sources, which remain available over time. These specifically identified revenues and other financing sources are required by statute to be used for designated activities or purposes. SSFAS No. 27 defines the following three criteria for determining an earmarked fund: 1) A statute committing the Federal Government to use specifically identified revenues and other financing sources not used in the current period for future use to finance the designated activities, benefits, or purposes; 2) Explicit authority for the earmarked fund to retain revenues and other financing sources not used in the current period for future use to finance the designated activities, benefits, or purposes; and 3) A requirement to account for and report on the receipt, use, and retention of the revenues and other financing sources that distinguished the earmarked fund from the Government's general revenues.

Earmarked Funds consisted of the following (in millions) (unaudited):

	<b>Customs User Fees</b>	<b>Immigration Examination Fees</b>	<b>National Flood Insurance Program</b>	<b>All Other Earmarked Funds</b>	<b>Total Earmarked Funds</b>
<b>Balance Sheet as of September 30, 2006</b>					
<b>ASSETS</b>					
Fund Balance with Treasury	\$761	\$819	\$138	\$843	\$ 2,561
Investments, Net	-	-	-	634	634
Accounts Receivable, Net	72	4	19	217	312
Cash and Other Monetary Assets	-	19	24	3	46
Taxes Receivables	61	-	-	-	61
Inventory and Related Property, Net	-	-	8	-	8
General Property, Plant, and Equipment, Net	-	6	34	-	40
Other	-	-	422	-	422
<b>Total Assets</b>	<b>\$894</b>	<b>\$848</b>	<b>\$645</b>	<b>\$1,697</b>	<b>\$4,084</b>
<b>LIABILITIES</b>					
Other Liabilities	96	840	22,370	88	23,394
<b>Total Liabilities</b>	<b>\$96</b>	<b>\$840</b>	<b>\$22,370</b>	<b>\$88</b>	<b>\$23,394</b>
<b>NET POSITION</b>					
Unexpended Appropriations	\$ -	\$ -	\$ -	\$18	\$18
Cumulative Results of Operations	798	8	(21,725)	1,591	(19,328)
<b>Total Liabilities and Net Position</b>	<b>\$894</b>	<b>\$848</b>	<b>\$645</b>	<b>\$1,697</b>	<b>\$4,084</b>
<b>Statement of Net Cost for the Year Ended September 30, 2006</b>					
Gross Program Costs	\$ -	\$1,590	\$(716)	\$1,474	\$2,348
Less: Earned Revenues	(1)	(1,721)	(2,321)	(376)	(4,419)
<b>Net Cost of Operations</b>	<b>\$(1)</b>	<b>\$(131)</b>	<b>\$(3,037)</b>	<b>\$1,098</b>	<b>\$(2,071)</b>

	<b>Customs User Fees</b>	<b>Immigration Examination Fees</b>	<b>National Flood Insurance Program</b>	<b>All Other Earmarked Funds</b>	<b>Total Earmarked Funds</b>
<b>Statement of Changes in Net Position for the Year Ended September 30, 2006</b>					
<b>Net Position Beginning of Period</b>	\$797	\$(123)	\$(24,764)	\$1,414	\$(22,676)
Net Cost of Operations	1	131	3,037	(1,098)	2,071
Appropriation Used	-	-	-	13	13
Non-exchange Revenue	-	-	-	2,516	2,516
Other	-	-	2	(1,236)	(1,234)
Change in Net Position	1	131	3,039	206	3,377
<b>Net Position, End of Period</b>	<b>\$798</b>	<b>\$8</b>	<b>\$(21,725)</b>	<b>\$1,609</b>	<b>\$(19,310)</b>

### Customs User Fees

In April 1986, the President signed the Consolidated Omnibus Budget Reconciliation Act (COBRA) of 1985, which authorized the CBP to collect user fees for certain services. The law initially established processing fees for air and sea passengers, commercial trucks, rail cars, private vessels and aircraft, commercial vessels, dutiable mail packages, and CBP broker permits. An additional fee category, contained in tax reform legislation, for processing barges and bulk carriers for Canada and Mexico, was added later that year. The collection of the COBRA fees for CBP services began on July 7, 1986.

In addition to the collection of user fees, other changes in CBP procedures were enacted due to the COBRA statute. Most importantly, provisions were included for providing non-reimbursable inspectional overtime services and paying for excess pre-clearance costs from COBRA user fee collections.

The Customs and Trade Act of 1990 amended the COBRA legislation to provide for the hiring of inspectional personnel, the purchasing of equipment, and the covering of related expenses with any surplus monies available, after overtime and excess pre-clearance costs are satisfied. Expenditures from the surplus can only be used to enhance the service provided to those functions for which fees are collected. This legislation took effect on October 1, 1990.

19 USC Section 58c contains the fees for certain customs services. The authority to use these funds is contained in the annual Department of Homeland Security Appropriations Act.

Access to COBRA surplus funds provides CBP with additional resources to assist in the accomplishment of CBP's mission. Increased staffing and equipment have enhanced the manager's flexibility in dealing with the ever-increasing demands of the trade and travel communities. At the same time, the responsibilities of CBP have also increased.

User fees are legislatively set as are the restrictions on the use of collections; all of which prevent CBP from adequately funding the associated services provided. Based on the statute, fee collections may be used to pay for inspectional overtime, excess pre-clearance costs, the hiring of inspectional personnel, purchasing of equipment, foreign language proficiency awards, and payment of related expenses using surplus monies available after overtime and pre-clearance costs are satisfied. The Customs User Fees are paid by the public.

### Immigration Examination Fees

In 1988, Congress established the Immigration Examination Fee Account (IEFA) and the fees deposited into the IEFA have been the primary source of funding for providing immigration and naturalization benefits,

and other benefits as directed by Congress. The Immigration and Nationality Act (INA) provides for the collection of fees at a level that will ensure recovery of the full costs of providing adjudication and naturalization services, including the costs of providing similar services without charge to asylum applicants and other immigrants. The INA also states that the fees may recover administrative costs. This revenue remains available to provide immigration and naturalization benefits and the collection, safeguarding, and accounting for fees. The authority provided by section 286(m) of the INA permits USCIS to recover the full costs of providing all immigration adjudication and naturalization services, including those services provided to individuals other than those paying fees.

The primary sources of revenue are the application and petition fees that are collected during the course of the fiscal year and deposited into the Immigration Examinations Fee Account (TAFS 70X5088). In addition, the USCIS provides specific services to other federal agencies, such as production of Border Crossing Cards for the Department of State (DOS), that result in the collection of other revenues that are the result of intragovernmental flows.

In 1999, Congress authorized USCIS to collect a specific fee for petitions under a nonimmigrant temporary worker program and to retain a portion of the fee for cost related to the processing of these petitions. In 2005, Congress increased the total fee amount and set the portion that US Citizenship retains at five percent. The portion of the fees collected and retained by the USCIS during the fiscal year, are deposited into the H-1B Nonimmigrant Petitioner Account (TAFS 70X5016).

In 2005, Congress authorized an additional fraud detection and prevention fee on applications filed by employees to obtain visa for nonimmigrant workers. U.S. Citizenship and Immigration Service retains one-third of the fraud prevention and detections fee to cover cost associated with an expanded fraud detection program. The portion of the fees, collected and retained by the USCIS during the fiscal year are deposited into the H-1B and L Fraud Prevention and Detection Account (TAFS 70X5389).

There has been no change in legislation during or subsequent to the reporting period and before the issuance of financial statements that significantly changes the purpose of the fund or redirects a material portion of the accumulated balance.

### **National Flood Insurance Program**

The National Flood Insurance Program (NFIP) was established by the National Flood Insurance Act of 1968. The purpose of NFIP is to better indemnify individuals for flood losses through insurance, reduce future flood damages through State and community floodplain management regulations, and reduce Federal expenditures for disaster assistance and flood control.

The Flood Disaster Protection Act of 1973 expanded the authority of FEMA and its use of the NFIP to grant premium subsidies as an additional incentive to encourage widespread state, community, and property owner acceptance of the program requirements.

The National Flood Insurance Reform Act of 1994 reinforced the objective of using insurance as the preferred mechanism for disaster assistance by expanding mandatory flood insurance purchase requirements and by effecting a prohibition on further flood disaster assistance for any property where flood insurance, after having been mandated as a condition for receiving disaster assistance, is not mandated.

The Bunning-Bereuter-Blumenauer Flood Insurance Reform Act (FIRA) of 2004 provides additional tools for addressing the impact of repetitive loss properties on the National Flood Insurance Fund. It introduced a pilot project through fiscal year 2009 that defines severe repetitive loss properties, authorizes additional funds for mitigation projects, and mandates a 50% increase of premiums for property owners who decline a mitigation offer, along with an appeal process. It also modifies the Flood Mitigation Assistance (FMA) Program by doubling the annual authorized funding level to \$40 million and directing it to give priority to those properties that are in the best interest of the National Flood Insurance Fund.

The NFIP requires all partners (Write Your Own (WYO) Companies) in the program to submit financial statements and statistical data to the Bureau & Statistical Agent (B&SA) on a monthly basis. This information is reconciled and the WYO companies are required to correct any variances.

Since this program is an insurance program for which the Department pays claims to policyholders whose houses have been flooded. The WYO companies that participate in the program have authority to use Departmental funds (revenue and other financing sources) to respond to the obligations of the policyholders. Congress has mandated that the NFIP funds are to only be used to pay claims caused by flooding.

The NFIP sources of revenue and other financing comes from premiums collected to insure policyholders homes and the borrowing authority provided to our program from Congress. The resources are inflows to the Government and are not the result of intragovernmental flows.

### **All Other Earmarked Funds**

The balances and activity reported for all other earmarked funds result from the funds listed below. Information related to these earmarked funds can be located in the Department's appropriations legislation or the statutes referenced.

- 70X0200 Office of the Inspector General, Department of Homeland Security
- 70 6/7 0200 Office of the Inspector General, Department of Homeland Security
- 70X0715 Radiological Emergency Preparedness Program, Emergency Preparedness and Response, Department of Homeland Security
- 70X5089 Customs and Border Protection, Land Border Inspection Fees, Border and Transportation Security, Department of Homeland Security; 116 Stat. 2135
- 70X5087 Customs and Border Protection, Immigration User Fees, Border and Transportation Security, Department of Homeland Security; 116 Stat. 2135
- 70X5126 Breach Bond/Detention Fund, Border and Transportation Security, Department of Homeland Security; 116 Stat. 2135
- 70X5378 Student and Exchange Visitor Program, Border and Transportation Security, Department of Homeland Security; 110 Stat. 3009-706, Sec. (e)(4)(B)
- 70X5382 Immigration User Fee Account, BICE, Department of Homeland Security; 116 Stat. 2135
- 70X5385 Aviation Security Capital Fund, Transportation Security Administration, Department of Homeland Security; 117 Stat. 2567(h)(1)
- 70X5436 Radiological Emergency Preparedness Fund, Department of Homeland Security; 116 Stat. 2135
- 70X5451 Immigration Enforcement Account, Border and Transportation Security, Department of Homeland Security; 116 Stat. 2135
- 70X5464 Flood Map Modernization Fund, Emergency Preparedness and Response, Department of Homeland Security; 116 Stat. 2135
- 70X5694 User Fees, Small Airports, U.S. Customs Service, Department of Homeland Security; 116 Stat. 2135
- 70X8149 Boat Safety, Coast Guard, Department of Homeland Security; 116 Stat. 2135
- 70X8244 Gifts and Donations, Department Management, Department of Homeland Security; 116 Stat. 2135 (FEMA REPORTED)
- 70X8312 Oil Spill Liability Trust Fund, Coast Guard, Department of Homeland Security; 116 Stat. 2135
- 70 8314 Trust Fund Share of Expenses, Coast Guard, Department of Homeland Security; 116 Stat. 2135
- 70X8349 Oil Spill Recovery, Coast Guard, Department of Homeland Security; 116 Stat. 2135
- 70X8533 General Gift Fund, Coast Guard, Department of Homeland Security; 116 Stat. 2135
- 70X8597 Salaries and Expenses, Violent Crime Reduction Program, Immigration Services, Department of Homeland Security; 116 Stat. 2135
- 70X8598 Violent Crime Reduction Program, Immigration Services, Department of Homeland Security; 116 Stat. 2135
- 70X8870 Harbor Maintenance Fee Collection, U.S. Customs Service, Department of Homeland Security; 116 Stat. 2135

- 20X8185 Oil Spill Liability Trust Fund; 103 Stat. 2363, 2364

## 23. Intragovernmental Costs and Exchange Revenue

For the year ended September 30, 2006 (in millions) (Unaudited)

Directorates and Other Components	Intragovernmental Consolidated	With the Public	Total
<b>United States VISIT</b>			
Gross Cost	\$44	\$219	\$263
Less Earned Revenue	(1)	-	(1)
<b>Net Cost</b>	<b>43</b>	<b>219</b>	<b>262</b>
<b>United States Customs and Border Protection</b>			
Gross Cost	1,787	5,348	7,135
Less Earned Revenue	(47)	(106)	(153)
<b>Net Cost</b>	<b>1,740</b>	<b>5,242</b>	<b>6,982</b>
<b>United States Coast Guard</b>			
Gross Cost	1,105	8,906	10,011
Less Earned Revenue	(332)	(92)	(424)
<b>Net Cost</b>	<b>773</b>	<b>8,814</b>	<b>9,587</b>
<b>United States Citizenship and Immigration Services</b>			
Gross Cost	487	1,122	1,609
Less Earned Revenue	(15)	(1,714)	(1,729)
<b>Net Cost</b>	<b>472</b>	<b>(592)</b>	<b>(120)</b>
<b>Federal Emergency Management Agency</b>			
Gross Cost	6,039	19,621	25,660
Less Earned Revenue	(117)	(2,326)	(2,443)
<b>Net Cost</b>	<b>5,922</b>	<b>17,295</b>	<b>23,217</b>
<b>Federal Law Enforcement Training Center</b>			
Gross Cost	26	286	312
Less Earned Revenue	(31)	(2)	(33)
<b>Net Cost</b>	<b>(5)</b>	<b>284</b>	<b>279</b>
<b>Preparedness Directorate</b>			
Gross Cost	589	3,206	3,795
Less Earned Revenue	(3)	(23)	(26)
<b>Net Cost</b>	<b>586</b>	<b>3,183</b>	<b>3,769</b>
<b>United States Immigration and Customs Enforcement</b>			
Gross Cost	1,169	3,318	4,487
Less Earned Revenue	(757)	(100)	(857)
<b>Net Cost</b>	<b>412</b>	<b>3,218</b>	<b>3,630</b>
<b>United States Secret Service</b>			
Gross Cost	403	1,068	1,471
Less Earned Revenue	(18)	-	(18)
<b>Net Cost</b>	<b>385</b>	<b>1,068</b>	<b>1,453</b>

Directorates and Other Components	Intragovernmental Consolidated	With the Public	Total
<b>Science and Technology Directorate</b>			
Gross Cost	467	376	843
Less Earned Revenue	-	-	-
<b>Net Cost</b>	<b>467</b>	<b>376</b>	<b>843</b>
<b>Transportation Security Administration</b>			
Gross Cost	1,194	4,849	6,043
Less Earned Revenue	(5)	(2,472)	(2,477)
<b>Net Cost</b>	<b>1,189</b>	<b>2,377</b>	<b>3,566</b>
<b>Department Operations and Other</b>			
Gross Cost	288	564	852
Less Earned Revenue	(2)	-	(2)
<b>Net Cost</b>	<b>286</b>	<b>564</b>	<b>850</b>
<b>Total Department of Homeland Security</b>			
Gross Cost	\$13,598	\$48,883	\$62,481
Less Earned Revenue	(1,328)	(6,835)	(8,163)
<b>Net Cost</b>	<b>\$12,270</b>	<b>\$42,048</b>	<b>\$54,318</b>

## For the year ended September 30, 2005 (in millions) (Unaudited) (Restated)

Directorates and Other Components	Intragovernmental Consolidated	With the Public	Total
<b>United States VISIT</b>			
Gross Cost	\$18	\$154	\$172
Less Earned Revenue	-	-	-
<b>Net Cost</b>	<b>18</b>	<b>154</b>	<b>172</b>
<b>United States Customs and Border Protection</b>			
Gross Cost	1,188	5,871	7,059
Less Earned Revenue	(33)	(586)	(619)
<b>Net Cost</b>	<b>1,155</b>	<b>5,285</b>	<b>6,440</b>
<b>United States Coast Guard</b>			
Gross Cost	980	8,165	9,145
Less Earned Revenue	(133)	(87)	(220)
<b>Net Cost</b>	<b>847</b>	<b>8,078</b>	<b>8,925</b>
<b>United States Citizenship and Immigration Services</b>			
Gross Cost	525	750	1,275
Less Earned Revenue	(14)	(1,608)	(1,622)
<b>Net Cost</b>	<b>511</b>	<b>(858)</b>	<b>(347)</b>
<b>Federal Emergency Management Agency</b>			
Gross Cost	1,695	37,948	39,643
Less Earned Revenue	(106)	(2,053)	(2,159)
<b>Net Cost</b>	<b>1,589</b>	<b>35,895</b>	<b>37,484</b>
<b>Federal Law Enforcement Training Center</b>			
Gross Cost	27	230	257
Less Earned Revenue	(30)	(1)	(31)
<b>Net Cost</b>	<b>(3)</b>	<b>229</b>	<b>226</b>
<b>Preparedness Directorate</b>			
Gross Cost	762	1,939	2,701
Less Earned Revenue	(2)	(18)	(20)
<b>Net Cost</b>	<b>760</b>	<b>1,921</b>	<b>2,681</b>
<b>United States Immigration and Customs Enforcement</b>			
Gross Cost	1,137	2,677	3,814
Less Earned Revenue	(557)	(85)	(642)
<b>Net Cost</b>	<b>580</b>	<b>2,592</b>	<b>3,172</b>
<b>United States Secret Service</b>			
Gross Cost	361	1,144	1,505
Less Earned Revenue	(22)	-	(22)
<b>Net Cost</b>	<b>339</b>	<b>1,144</b>	<b>1,483</b>
<b>Science and Technology Directorate</b>			
Gross Cost	484	259	743
Less Earned Revenue	(12)	-	(12)
<b>Net Cost</b>	<b>472</b>	<b>259</b>	<b>731</b>
<b>Transportation Security Administration</b>			
Gross Cost	1,307	5,216	6,523
Less Earned Revenue	(20)	(2,235)	(2,255)
<b>Net Cost</b>	<b>1,287</b>	<b>2,981</b>	<b>4,268</b>



Directorates and Other Components	Intragovernmental Consolidated	With the Public	Total
<b>Department Operations and Other</b>			
Gross Cost	273	369	642
Less Earned Revenue	(11)	-	(11)
<b>Net Cost</b>	<b>262</b>	<b>369</b>	<b>631</b>
<b>Total Department of Homeland Security</b>			
Gross Cost	\$8,757	\$64,722	\$73,479
Less Earned Revenue	(940)	(6,673)	(7,613)
<b>Net Cost</b>	<b>\$7,817</b>	<b>\$58,049</b>	<b>\$65,866</b>

Intragovernmental costs represent exchange transactions made between two reporting entities within the Federal government and are presented separately from costs with the public (exchange transactions made between the reporting entity and a non-Federal entity). Intragovernmental exchange revenue is disclosed separately from exchange revenue with the public. The criteria used for this classification requires that the intragovernmental expenses relate to the source of goods and services purchased by the reporting entity and not to the classification of related revenue. For example, with “exchange revenue with the public,” the buyer of the goods or services is a non-Federal entity. With “intragovernmental costs,” the buyer and seller are both Federal entities. If a Federal entity purchases goods or services from another Federal entity and sells them to the public, the exchange revenue would be classified as “with the public,” but the related costs would be classified as “intragovernmental.” The purpose of this classification is to enable the Federal government to provide consolidated financial statements, and not to match public and intragovernmental revenue with costs that are incurred to produce public and intragovernmental revenue. Non-exchange revenues consist primarily of user fees collected by CBP to off-set certain costs of operations.

## 24. Suborganization Costs by DHS Strategic Goals

Operating costs are summarized in the Statement of Net Cost by responsibility segment, as applicable to the reporting period. The net cost of operations is the gross (i.e., total) cost incurred by the Department, less any exchange (i.e., earned) revenue. A responsibility segment is the component that carries out a mission or major line of activity, and whose managers report directly to Departmental Management.

To integrate performance and financial information, as required by the *President's Management Agenda* and the *Government Performance and Results Act*, a supplemental schedule of net cost is included in this note, in which costs by component are allocated to Departmental strategic goals.

**Net Costs of Department Sub-organizations by Strategic Goals (in millions)**  
**For the year ended September 30, 2006 (Unaudited)**

	Awareness	Prevention	Protection	Response	Recovery	Service	Organizational Excellence	TOTAL
US VISIT	\$ -	\$144	\$ -	\$ -	\$ -	\$118	\$ -	<b>\$262</b>
US Customs and Border Protection	-	6,535	-	-	-	447	-	<b>6,982</b>
US Coast Guard	1,055	4,184	1,552	1,231	57	1,508	-	<b>9,587</b>
US Citizenship and Immigration Services	-	(34)	-	-	-	(86)	-	<b>(120)</b>
Federal Emergency Management Agency	-	-	13,462	4,509	5,246	-	-	<b>23,217</b>
Federal Law Enforcement Training Center	-	279	-	-	-	-	-	<b>279</b>
Preparedness Directorate	214	-	3,555	-	-	-	-	<b>3,769</b>
US Immigration and Customs Enforcement	-	3,313	317	-	-	-	-	<b>3,630</b>
US Secret Service	-	-	1,453	-	-	-	-	<b>1,453</b>
Science and Technology Directorate	133	460	78	136	36	-	-	<b>843</b>
Transportation Security Administration	4	3,370	192	-	-	-	-	<b>3,566</b>
Departmental Operations and Other	86	-	-	-	-	-	764	<b>850</b>
<b>TOTAL Department</b>	<b>\$1,492</b>	<b>\$18,251</b>	<b>\$20,609</b>	<b>\$5,876</b>	<b>\$5,339</b>	<b>\$1,987</b>	<b>\$764</b>	<b>\$54,318</b>

**Net Costs of Department Sub-organizations by Strategic Goals (in millions)**  
**For the year ended September 30, 2005 (Unaudited) (Restated)**

	Awareness	Prevention	Protection	Response	Recovery	Service	Organizational Excellence	TOTAL
US VISIT	\$ -	\$100	\$ -	\$ -	\$ -	\$72	\$ -	\$172
US Customs and Border Protection	-	5,939	-	-	-	501	-	6,440
US Coast Guard	893	3,437	1,914	1,199	60	1,422	-	8,925
US Citizenship and Immigration Services	-	(97)	-	-	-	(250)	-	(347)
Federal Emergency Management Administration	-	-	25,790	2,272	9,422	-	-	37,484
Federal Law Enforcement Training Center	-	226	-	-	-	-	-	226
Preparedness Directorate	263	-	2,418	-	-	-	-	2,681
US Immigration and Customs Enforcement	-	2,958	214	-	-	-	-	3,172
US Secret Service	-	-	1,483	-	-	-	-	1,483
Science and Technology Directorate	114	417	174	26	-	-	-	731
Transportation Security Administration	7	3,929	332	-	-	-	-	4,268
Departmental Operations and Other	-	-	-	-	-	-	631	631
<b>TOTAL Department</b>	<b>\$1,277</b>	<b>\$16,909</b>	<b>\$32,325</b>	<b>\$3,497</b>	<b>\$9,482</b>	<b>\$1,745</b>	<b>\$631</b>	<b>\$65,866</b>

## 25. Apportionment Categories of Obligations Incurred: Direct vs. Reimbursable Obligations

Apportionment categories are determined in accordance with the guidance provided in OMB Circular A-11, *Preparation, Submission and Execution of the Budget*. Category A represents resources apportioned for calendar quarters. Category B represents resources apportioned for other time periods; for activities, projects, or objectives; or for any combination thereof (in millions).

<b>Year Ended September 30, 2006 (Unaudited):</b>	<b>Apportionment Category A</b>	<b>Apportionment Category B</b>	<b>Exempt from Apportionment</b>	<b>Total</b>
Obligations Incurred - Direct	\$28,126	\$58,004	\$993	\$87,123
Obligations Incurred - Reimbursable	3,492	788	9	4,289
<b>Total Obligations Incurred</b>	<b>\$31,618</b>	<b>\$58,792</b>	<b>\$1,002</b>	<b>\$91,412</b>

<b>Year Ended September 30, 2005 (Unaudited) (Restated):</b>	<b>Apportionment Category A</b>	<b>Apportionment Category B</b>	<b>Exempt from Apportionment</b>	<b>Total</b>
Obligations Incurred - Direct	\$27,071	\$36,423	\$853	\$64,347
Obligations Incurred - Reimbursable	3,740	542	(1)	4,281
<b>Total Obligations Incurred</b>	<b>\$30,811</b>	<b>\$36,965</b>	<b>\$852</b>	<b>\$68,628</b>

The increase in payments of Apportionment Category B, Obligations Incurred - Direct of \$36,423 million in fiscal year 2005 to \$58,004 million in fiscal year 2006 is due to FEMA's approved claims from Hurricane Katrina which were obligated and paid during fiscal year 2006.

## 26. Available Borrowing Authority

The Department, through FEMA's NFIP, has total borrowing authority of \$21 billion (unaudited), as of September 30, 2006, available for disaster relief purposes. The \$21 billion borrowing authority includes \$18 billion in current year borrowing authority and \$3 billion in borrowing authority carried forward from fiscal year 2005. At the end of the fiscal year, borrowing authority is reduced by the amount of any unused portion. As of September 30, 2006, FEMA exercised \$16.8 billion in borrowing authority, the remaining balance of \$4.2 billion represents the total unused portion. DADLP annually requests borrowing authority to cover the principal amount of direct loans not to exceed \$25 million less the subsidy due from the program account.

## 27. Permanent Indefinite Appropriations

Permanent indefinite appropriations refer to the appropriations that result from permanent public laws, which authorize the Department to retain certain receipts. The amount appropriated depends upon the amount of the receipts rather than on a specific amount. The Department has two permanent indefinite appropriations as follows:

- CBP has a permanent and indefinite appropriation, which is used to disburse tax and duty refunds, and duty drawbacks. Although funded through appropriations, refund and drawback activity is, in most instances, reported as a custodial activity of the Department. Refunds are custodial revenue-related activity in that refunds are a direct result of overpayments of taxes, duties, and fees. Federal tax revenue received from taxpayers is not available for use in the operation of the Department and is not reported on the Statement of Net Cost. Likewise, the refunds of overpayments are not available for use by the Department in its operations.
- USSS has a permanent and indefinite appropriation, which is used to reimburse the District of Columbia Police and Fireman's Retirement System (DC Pension Plan) for the difference between

benefits to participants in the DC Pension Plan (see Note 16), and payroll contributions received from current employees.

These appropriations are not subject to budgetary ceilings established by Congress. CBP's refunds payable at year-end are not subject to funding restrictions.

## **28. Legal Arrangements Affecting Use of Unobligated Balances**

Unobligated balances, whose period of availability has expired, are not available to fund new obligations. Expired unobligated balances are available to pay for current period adjustments to obligations incurred prior to expiration. For a fixed appropriation account, the balance can be carried forward for five fiscal years after the period of availability ends. At the end of the fifth fiscal year, the account is closed and any remaining balance is canceled and returned to Treasury. For a no-year account, the unobligated balance is carried forward indefinitely until (1) specifically rescinded by law; or (2) the head of the agency concerned or the President determines that the purposes for which the appropriation was made have been carried out and disbursements have not been made against the appropriation for two consecutive years.

Included in the cumulative results of operations for special funds is \$1.2 billion (unaudited) and \$760 million (unaudited) at September 30, 2006 and 2005, respectively, that represents the Department's authority to assess and collect user fees relating to merchandise and passenger processing, to assess and collect fees associated with services performed at certain small airports or other facilities, retain amounts needed to offset costs associated with collecting duties, and taxes and fees for the government of Puerto Rico. These special fund balances are restricted by law in their use to offset specific costs incurred by the Department. Part of the passenger fees in the User Fees Account, totaling approximately \$761 million (unaudited) and \$741 million (unaudited) at September 30, 2006 and 2005, respectively, is restricted by law in its use to offset specific costs incurred by the Department and are available to the extent provided in Department Appropriation Acts.

The entity trust fund balances result from the Department's authority to use the proceeds from general order items sold at auction to offset specific costs incurred by the Department relating to their sale, to use available funds in the Salaries and Expense Trust Fund to offset specific costs for expanding border and port enforcement activities, and to use available funds from the Harbor Maintenance Fee Trust Fund to offset administrative expenses related to the collection of the Harbor Maintenance Fee.

## 29. Explanation of Differences between the Statement of Budgetary Resources and the Budget of the U.S. Government

The table below documents the material differences between the 2005 Statement of Budgetary Resources and the actual amounts reported for 2005 in the Budget of the United States Government. Since the fiscal year 2006 financial statements will be reported prior to the release of the Budget of the United States Government, DHS is reporting for 2005 only. Typically, the Budget of the United States Government with the 2006 actual data is published in the February of the subsequent year. Once published the 2006 actual data will be available that OMB website, [www.whitehouse.gov/omb](http://www.whitehouse.gov/omb).

(in millions)	Budgetary Resources	Obligations Incurred	Distributed Offsetting Receipts	Net Outlays
<b>2005 Actual Balances per the 2007 President's Budget</b>	\$121,856	\$66,065	\$4,427	\$43,727
<b>Reconciling Items:</b>				
Accounts that are expired that are not included in Budget of the United States.	1,069	413	-	-
Fund Symbols Not Included in the Budget of the United States.	1,754	1,117	26	(3,039)
Resources Permanently Not Available	(12)	-	-	-
Adjustment for the overestimate of Hurricane Katrina obligations recorded in the Statement of Budgetary Resources, but not the Budget of the United States	1,019	1,021	-	-
Fiscal year 2005 Revenue Recognition/Cash Collection Timing Differences	-	-	98	-
Miscellaneous Differences	(153)	12	(3)	(411)
<b>Per the 2005 SBR (Unaudited)</b>	<b>\$125,533</b>	<b>\$68,628</b>	<b>\$4,548</b>	<b>\$40,277</b>

## 30. Undelivered Orders, End of Period

An undelivered order exists when a valid obligation has occurred and funds have been reserved, but the goods or services have not been delivered. Undelivered orders for the periods ended September 30, 2006 and 2005 were \$37,312 million (unaudited) and \$34,611 million (unaudited), respectively.

## 31. Explanation for the Difference Between the Appropriations Received reported on the Statement of Budgetary Resources and on the Statement of Changes in Net Position

The Statement of Budgetary Resources reported \$45,748 million (unaudited) for appropriations received for fiscal year 2006. This balance does not agree to the balance reported on the Statement of Changes in Net Position of \$39,529 (unaudited) for fiscal year 2006. The difference is primarily related to 1) \$5,177 million

in trust and special fund receipts not reflected in the unexpended appropriations section of the Statement of Changes in Net Position, 2) \$42 million for the decrease in amounts appropriated from specific Treasury-managed trust funds, 3) \$974 million related to refunds and drawbacks, and 4) \$110 million for receipts unavailable for obligations upon collection.

In fiscal year 2005, appropriations received on the SBR of \$105,147 million (unaudited) did not equal the amounts reported on the Statement of Changes in Net Position of \$99,707 million (unaudited) due to: 1) \$4,544 million of trust and special receipts that are not reflected in the unexpended appropriation section of the SCNP; 2) \$33 million of the change in amounts appropriated from specific Treasury managed trust funds; 3) \$845 million of refunds and drawbacks; and 4) \$18 million of receipts unavailable for obligations upon collections.

### 32. Explanation of Relationship Between Liabilities Not Covered by Budgetary Resources and Components Requiring or Generating Resources in Future Periods

In fiscal year 2006, the differences between the amounts reported as liabilities not covered by budgetary resources on the balance sheet and amounts reported as components requiring or generating resources in future periods on the Statement of Financing were primarily due to an increase in Debt by approximately \$16.9 billion (unaudited) and a decrease in several uncovered liabilities by approximately \$19.4 billion (unaudited), primarily related to the Insurance Liabilities. In both instances, these changes do not affect the amounts reported as Components Requiring or Generating Resources in Future Periods on the Statement of Financing but do effect the change in the uncovered liabilities. In fiscal year 2005, the differences were primarily due to the increase in the insurance liability for claims and claims settlement of \$21.6 billion, and the change in the USCG actuarial pension liability of \$1.7 billion and other USCG military post employment liability of \$1 billion, which do not generate net cost of operations or require the use of budgetary resources.

### 33. Custodial Revenues

The Department collects revenue from variety of duties, excise taxes and various other fees, some of which are refunded. Refunds and drawbacks by entry year for the fiscal years ended September 30 (in millions):

Entry Year	2006 (Unaudited)	2005 (Unaudited)
2005	\$596	\$684
2004	142	139
2003	90	42
2002	40	21
Prior Years	292	273
<b>Total Refunds and Drawbacks</b>	<b>\$1,160</b>	<b>\$1,159</b>

Non-entity revenue reported on the Department's Statement of Custodial Activity include duties, excise taxes, and various non-exchange fees collected by CBP and USCIS that are subsequently remitted to Treasury's General Fund or to other Federal agencies. CBP assesses duties, taxes, and fees on goods and merchandise brought into the United States from foreign countries. At the time an importer's merchandise is brought into the United States, the importer is required to file entry documents. Generally, within ten working days after release of the merchandise into the United States commerce, the importer is to submit an entry document with payment of estimated duties, taxes, and fees. Non-entity tax and trade accounts receivables are recognized when CBP is entitled to collect duties, user fees, fines and penalties, refunds and drawback overpayments, and interest associated with import/export activity on behalf of the Federal Government that have been established as a specifically identifiable, legally enforceable claim and remain uncollected as of year-end. Revenues are reported at the time of collection. These revenue collections primarily result from current fiscal year activities. Generally, CBP records an equal and offsetting liability due to the Treasury General Fund for amounts recognized as non-entity tax and trade receivable and custodial revenue. CBP accrues an estimate of duties, taxes and fees related to commerce released

prior to year-end where receipt of payment is anticipated subsequent to year-end. Fees collected by USCIS for nonimmigrant petitions must be submitted with the petition. The portion of fees that are subsequently remitted to other Federal agencies are recorded as custodial revenue at the time of collection.

The significant types of non-entity accounts receivable (custodial revenues as presented in the Statement of Custodial Activity) are described below.

- **Duties:** amounts collected on imported goods collected on behalf of the Federal government.
- **Excise taxes:** amounts collected on imported distilled spirits, wines and tobacco products.
- **User fees:** amounts designed to maintain United States harbors and to defray the cost of other miscellaneous service programs. User fees include application fees collected from employers sponsoring nonimmigrant petitions.
- **Fines and penalties:** amounts collected for violations of laws and regulations.
- **Refunds:** amounts of duties, taxes and fees previously paid by an importer/exporter. Refunds include drawback remittance paid when imported merchandise, for which duty was previously paid, is exported from the United States.

Duties, user fees, fines and penalties are assessed pursuant to the provisions of Title 19 United States Code (U.S.C.); Immigration fees under Title 8 U.S.C., and; Excise taxes under Title 26 U.S.C. CBP also enforces over 400 laws and regulations some of which require the collection of fees or the imposition of fines and penalties pursuant to other Titles within the U.S.C. or Code of Federal Regulations (C.F.R.).

Non-entity receivables are presented net of amounts deemed uncollectible. CBP tracks and enforces payment of estimated duties, taxes and fees receivable by establishing a liquidated damage case that generally results in fines and penalties receivable. A fine or penalty, including interest on past due balances, is established when a violation of import/export law is discovered. An allowance for doubtful collections is established for substantially all accrued fines and penalties and related interest. The amount is based on past experience in resolving disputed assessments, the debtor's payment record and willingness to pay, the probable recovery of amounts from secondary sources, such as sureties and an analysis of aged receivable activity. CBP regulations allow importers to dispute the assessment of duties, taxes and fees. Receivables related to disputed assessments are not recorded until the protest period expires or a protest decision is rendered in CBP's favor.

Refunds and drawback of duties, taxes and fees are recognized when payment is made. A permanent, indefinite appropriation is used to fund the disbursement of refunds and drawbacks. Disbursements are recorded as a decrease in the amount Transferred to Federal Entities as reported on the Statement of Custodial Activity. An accrual adjustment is recorded on the Statement of Custodial Activity to adjust cash collections and refund disbursements with the net increase or decrease of accrued non-entity accounts receivables, net of uncollectible amounts and refunds payable at year-end. Disbursements from the refunds and drawback account for the fiscal years ended September 30, 2006 and 2005, consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited)
Refunds	\$646	\$729
Drawback	514	430
<b>Total Refunds and Drawbacks</b>	<b>\$1,160</b>	<b>\$1,159</b>

The disbursements include interest payments of \$111 million and \$33 million, for the fiscal years ended September 30, 2006 and 2005, respectively. Refunds and other payments funded from collections rather than the refunds and drawback account totaled \$269 million and \$354 million for the fiscal years ended



September 30, 2006 and 2005, respectively.

The disbursement totals for refunds include antidumping and countervailing duties collected that are refunded pursuant to rulings by the DOC. These duties are refunded when the DOC issues a decision in favor of the foreign industry.

The total amounts of antidumping and countervailing duties vary from year to year depending on decisions from DOC. Antidumping and countervailing duty refunds (included in total refunds presented above) and associated interest refunded for the fiscal year ended September 30, 2006 and 2005, consisted of the following (in millions):

	2006 (Unaudited)	2005 (Unaudited)
Antidumping and countervailing duty refunds	\$381	\$124
Interest	86	14
<b>Total Antidumping and Countervailing Duty Refunds</b>	<b>\$467</b>	<b>\$138</b>

### 34. Restatements

#### A. TSA Restatement (Unaudited)

**Security Fee Reporting.** The Department has restated the fiscal year 2005 Statements of Budgetary Resources and the Changes in Net Position and related footnotes as a result of an error in the accounting for passenger and air carrier aviation security fees. In prior years the security fees collected to provide aviation security were recorded as revenue. At the end of each fiscal year the TSA recorded a rescission in an amount equal to the security fees and appropriated funds were returned to the Treasury General Fund and a negative warrant was received from Treasury. The Statement of Budgetary Resources presented a reduction of the appropriation, but the general ledger showed fees being reduced by the negative warrant received from Treasury. New procedures in accordance with Public Law 108-90 will show a reduction of the appropriation received instead of showing a rescission of the appropriation. The fiscal year 2005 financial statements have been restated to comply with the *Department of Homeland Security Appropriations Act for Fiscal Year 2004*, which requires that the sum appropriated from the General Fund will be reduced on a dollar for dollar basis as offsetting receipts are received during the fiscal year.

**Unrecorded Obligations Resulting in a Potential Anti-Deficiency.** TSA identified \$248 million of unrecorded obligations resulting in an adjustment to the fiscal year 2004 Statement of Budgetary Resources, which carries forward to the beginning balances to the fiscal year 2005 Statement of Budgetary Resources. The effect of the restatement is a decrease to the unobligated balance carried forward from fiscal year 2004 and an increase to the beginning obligated balance carried forward from fiscal year 2004. As a result of the unrecorded obligations, a potential violation of the *Anti-Deficiency Act* may have occurred.

#### B. USCG Restatement (Unaudited)

**Postretirement Medical Liability.** The Department has restated the fiscal year 2005 Balance Sheet and Statements of Net Cost, Changes in Net Position and Financing as a result of a correction of an error of the actuarial determined medical liability. The USCG initiated a follow-up review of its prior medical expense reports. The review indicated that a substantial amount of prior expenditures were not accurately reported to the actuary firm which led to a re-calculation of their FY 2005 Postretirement Medical liability. The revaluation of the FY 2005 medical liability was \$444 million. The Balance Sheet presented a reduction of this amount to the Federal Employee and Veteran Benefits line and a corresponding increase to the Cumulative Results of Operations for FY 2005. This restatement also resulted in a decrease to the USCG Gross Cost which affected the Statements of Changes in Net Position and Financing.

### **C. USCIS, PRE, and ICE Restatement (Unaudited)**

During 2006, several components began implementation of corrective action plans to address certain control deficiencies. As a result of these corrective actions three Components, ICE, USCIS, and PRE, restated their fiscal year 2005 financial statements to correct errors in accounting. The restatement affected FBWT, accounts payable, PP&E, and the associated budgetary balances. These restatements affected each of the principal financial statements, except for the Statement of Custodial Activity.

### **D. FLETC Restatement (Unaudited)**

The Department restated their fiscal year 2005 financial statements due to errors discovered in FLETC's reporting of the environmental liabilities and accounting changes of operating materials and supplies balances. During 2006, FLETC determined that the environmental liabilities were understated by approximately \$7 million, while the accounting treatment of the operating materials and supplies valued at approximately \$8 million was changes to the consumption method to purchase method due to improper valuation. These restatements affected the Balance Sheet, the Statement of Changes in Net Position, and the Statement of Financing.

### **E. Other Restatements (Unaudited)**

As a result of new or updated reporting requirements, including OMB Circular A-136, and the restatements completed based on errors noted by the components, the Department reviewed the fiscal year 2005 financial statements and noted errors that were not attributable to a single component, but rather were related to the reporting of component information. As a result, the Department processed a \$396 million restatement to the Distributed Offsetting Receipts reported on the Statement of Budgetary Resources and the Statement of Financing.

The effects of the restatement on the fiscal year 2005 financial statements are presented below for all principles financial statement, except for the Statement of Custodial Activity.

<b>BALANCE SHEET, in millions</b>	<b>Original 2005</b>	<b>Effects of Restatements</b>	<b>Restated 2005</b>	<b>Description Reference</b>
<b>ASSETS</b>				
<b>Intragovernmental</b>				
Fund Balance With Treasury	\$97,004	\$8	\$97,012	C
Investments, Net	738	-	738	
Accounts Receivable	217	-	217	
Other				
Advances and Prepayments	2,937	-	2,937	
Due from Treasury	144	-	144	
<b>Total Intragovernmental</b>	<b>\$101,040</b>	<b>\$8</b>	<b>\$101,048</b>	
Cash and Other Monetary Assets	\$78	\$ -	\$78	
Accounts Receivable, Net	532	-	532	
Taxes, Duties, and Trade Receivables, Net	1,400	-	1,400	
Direct Loans, Net	-	-	-	
Inventory and Related Property, Net	506	(8)	498	D
General Property, Plant, and Equipment, Net	10,470	(10)	10,460	C
Other				
Advances and Prepayments	480	-	480	
<b>TOTAL ASSETS</b>	<b>\$114,506</b>	<b>\$(10)</b>	<b>\$114,496</b>	
<b>LIABILITIES</b>				
<b>Intragovernmental</b>				
Accounts Payable	\$870	\$(5)	\$865	C
Debt	226	-	226	
Other				
Due to the General Fund	1,434	-	1,434	
Accrued FECA Liability	358	-	358	
Other	270	(18)	252	C
<b>Total Intragovernmental</b>	<b>\$3,158</b>	<b>\$(23)</b>	<b>\$3,135</b>	
Accounts Payable	\$3,329	\$(76)	\$3,253	C
Federal Employee and Veteran Benefits	30,494	(444)	30,050	B
Environmental and Disposal Liabilities	172	7	179	D
Other				
Accrued Payroll	1,372	(6)	1,366	C
Deferred Revenue and Advances from Others	2,014	-	2,014	
Deposit Liability for Canadian Softwood Lumber	4,706	-	4,706	

<b>BALANCE SHEET, in millions</b>	<b>Original 2005</b>	<b>Effects of Restatements</b>	<b>Restated 2005</b>	<b>Description Reference</b>
Insurance Liabilities	23,433	-	23,433	
Refunds and Drawbacks	118	-	118	
Other	949	9	958	C
<b>Total Liabilities</b>	<b>\$69,745</b>	<b>\$(533)</b>	<b>\$69,212</b>	
<b>Net Position</b>				
Unexpended Appropriations	\$87,166	\$(35)	\$87,131	C
Cumulative Results of Operations-Other Funds	(42,405)	558	(41,847)	B, C, D
<b>Total Net Position</b>	<b>44,761</b>	<b>523</b>	<b>45,284</b>	
<b>TOTAL LIABILITIES AND NET POSITION</b>	<b>\$114,506</b>	<b>\$(10)</b>	<b>\$114,496</b>	

<b>STATEMENT OF NET COST, in millions</b>	<b>Original 2005</b>	<b>Effects of Restatements</b>	<b>Restated 2005</b>	<b>Description Reference</b>
<b>Directorates and Other Components</b>				
<b>United States VISIT</b>				
Gross Cost	\$172	\$-	\$172	
Less Earned Revenue	-	-	-	
<b>Net Cost</b>	<b>172</b>	<b>-</b>	<b>172</b>	
<b>United States Customs and Border Protection</b>				
Gross Cost	7,059	-	7,059	
Less Earned Revenue	(619)	-	(619)	
<b>Net Cost</b>	<b>6,440</b>	<b>-</b>	<b>6,440</b>	
<b>United States Coast Guard</b>				
Gross Cost	9,589	(444)	9,145	B
Less Earned Revenue	(220)	-	(220)	
<b>Net Cost</b>	<b>9,369</b>	<b>(444)</b>	<b>8,925</b>	
<b>United States Citizenship and Immigration Services</b>				
Gross Cost	1,291	(16)	1,275	C
Less Earned Revenue	(1,622)	-	(1,622)	
<b>Net Cost</b>	<b>(331)</b>	<b>(16)</b>	<b>(347)</b>	
<b>Federal Emergency Management Agency</b>				
Gross Cost	39,643	-	39,643	
Less Earned Revenue	(2,159)	-	(2,159)	
<b>Net Cost</b>	<b>37,484</b>	<b>-</b>	<b>37,484</b>	
<b>Federal Law Enforcement Training Center</b>				
Gross Cost	257	-	257	
Less Earned Revenue	(31)	-	(31)	
<b>Net Cost</b>	<b>226</b>	<b>-</b>	<b>226</b>	
<b>Preparedness Directorate</b>				
Gross Cost	2,701	-	2,701	
Less Earned Revenue	(20)	-	(20)	
<b>Net Cost</b>	<b>2,681</b>	<b>-</b>	<b>2,681</b>	
<b>United States Immigration and Customs Enforcement</b>				
Gross Cost	3,893	(79)	3,814	C
Less Earned Revenue	(642)	-	(642)	
<b>Net Cost</b>	<b>3,251</b>	<b>(79)</b>	<b>3,172</b>	

<b>STATEMENT OF NET COST, in millions</b>	<b>Original 2005</b>	<b>Effects of Restatements</b>	<b>Restated 2005</b>	<b>Description Reference</b>
<b><i>United States Secret Service</i></b>				
Gross Cost	1,505	-	1,505	
Less Earned Revenue	(22)	-	(22)	
<b>Net Cost</b>	<b>1,483</b>	<b>-</b>	<b>1,483</b>	
<b><i>Science and Technology Directorate</i></b>				
Gross Cost	743	-	743	
Less Earned Revenue	(12)	-	(12)	
<b>Net Cost</b>	<b>731</b>	<b>-</b>	<b>731</b>	
<b><i>Transportation and Security Administration</i></b>				
Gross Cost	6,523	-	6,523	
Less Earned Revenue	(2,255)	-	(2,255)	
<b>Net Cost</b>	<b>4,268</b>	<b>-</b>	<b>4,268</b>	
<b><i>Department Operations and Other</i></b>				
Gross Cost	642	-	642	
Less Earned Revenue	(11)	-	(11)	
<b>Net Cost</b>	<b>631</b>	<b>-</b>	<b>631</b>	
<b>NET COST OF OPERATIONS</b>	<b>\$66,405</b>	<b>\$(539)</b>	<b>\$65,866</b>	

<b>STATEMENT OF CHANGES IN NET POSITION, in millions</b>	<b>Original 2005</b>	<b>Effects of Restatements</b>	<b>Restated 2005</b>	<b>Description Reference</b>
<b>Cumulative Results of Operations</b>				
Beginning Balances	\$(17,017)	\$ -	\$(17,017)	
Adjustments:				
Changes in accounting principles	-	(8)	(8)	D
Corrections of Errors	(127)	(7)	(134)	D
Beginning balance, as adjusted	<b>\$(17,144)</b>	<b>\$(15)</b>	<b>\$(17,159)</b>	
<b>Budgetary Financing Sources:</b>				
Appropriations Used	\$38,034	\$34	\$38,068	C
Non-Exchange Revenue	2,315	-	2,315	
Donations and Forfeitures of Cash and Cash Equivalents	3	-	3	
Transfers in/out without Reimbursement	265	-	265	
Other	(143)	-	(143)	
<b>Other Financing Sources (Non-Exchange):</b>				
Donations and Forfeitures of Property	8	-	8	
Transfers in/out reimbursement	11	-	11	
Imputed Financing	651	-	651	
Total Financing Sources	41,144	34	41,178	
Net Cost of Operations	(66,405)	539	(65,866)	B, C
Net Change	<b>(25,261)</b>	<b>573</b>	<b>(24,688)</b>	
<b>Cumulative Results of Operations</b>				
	<b>\$(42,405)</b>	<b>\$558</b>	<b>\$(41,847)</b>	
<b>Unexpended Appropriations:</b>				
Beginning Balance	\$25,504	\$-	\$25,504	
Adjustments:				
Corrections of errors	163	-	163	
Beginning Balance, as adjusted	<b>\$25,667</b>	<b>\$ -</b>	<b>\$25,667</b>	
<b>Budgetary Financing Sources:</b>				
Appropriations Received	\$101,251	\$(1,544)	\$99,707	A
Appropriations transferred in/out	158	-	158	
Other Adjustments	(1,876)	1,543	(333)	A
Appropriations Used	(38,034)	(34)	(38,068)	C
Total Budgetary Financing Sources	61,499	(35)	61,464	
Total Unexpended Appropriations	<b>87,166</b>	<b>(35)</b>	<b>87,131</b>	
<b>NET POSITION</b>	<b>\$44,761</b>	<b>\$523</b>	<b>\$45,284</b>	

STATEMENT OF BUDGETARY RESOURCES, in millions	Original 2005		Effects of Restatements		Restated 2005		Description Reference
	Budgetary	Non-Budgetary Credit Reform Financing Accounts	Budgetary	Non-Budgetary Credit Reform Financing Accounts	Budgetary	Non-Budgetary Credit Reform Financing Accounts	
<b>BUDGETARY RESOURCES</b>							
Unobligated Balance, brought forward October 1	\$8,392	\$ -	\$(248)	\$ -	\$8,144	\$ -	A
Recoveries of Prior Year Unpaid Obligations	1,431	-	87	-	1,518	-	C
Budget Authority:							
Appropriations	106,691	-	(1,544)	-	105,147	-	A
Borrowing Authority	2,000	26	-	-	2,000	26	A
Earned/Collected	7,708	8	14	-	7,722	8	C
Change in Receivable from Federal Sources	(142)	-	-	-	(142)	-	
Change in Unfilled Customer Orders:							
Advance Received	571	-	-	-	571	-	
Without Advance From Federal Sources	569	-	-	-	569	-	
Expenditure transfers from trust funds	50	-	-	-	50	-	
Subtotal	117,447	34	(1,530)	-	115,917	34	
Non-expenditure transfers, net; anticipated and actual	337	-	-	-	337	-	
Permanently Not Available	(1,953)	(8)	1,544	-	(409)	(8)	A
<b>TOTAL BUDGETARY RESOURCES</b>	<b>\$125,654</b>	<b>\$26</b>	<b>\$(147)</b>	<b>\$ -</b>	<b>\$125,507</b>	<b>\$26</b>	



STATEMENT OF BUDGETARY RESOURCES, in millions	Original 2005		Effects of Restatements		Restated 2005		Description Reference
	Budgetary	Non-Budgetary Credit Reform Financing Accounts	Budgetary	Non-Budgetary Credit Reform Financing Accounts	Budgetary	Non-Budgetary Credit Reform Financing Accounts	
<b>STATUS OF BUDGETARY RESOURCES</b>							
Obligations Incurred:							
Direct	\$64,227	\$ -	\$120	\$ -	\$64,347	\$ -	A, C
Reimbursable	4,394	-	(113)	-	4,281	-	A
	<b>68,621</b>	<b>-</b>	<b>7</b>	<b>-</b>	<b>68,628</b>	<b>-</b>	
Subtotal:							
Apportioned	51,811	26	6	-	51,817	26	C
Exempt from Apportionment	45	-	-	-	45	-	
	<b>51,856</b>	<b>26</b>	<b>6</b>	<b>-</b>	<b>51,862</b>	<b>26</b>	
Subtotal:							
Subtotal Balance Not Available	5,177	-	(160)	-	5,017	-	A, C
<b>TOTAL STATUS OF BUDGETARY RESOURCES</b>	<b>\$125,654</b>	<b>\$26</b>	<b>\$(147)</b>	<b>\$ -</b>	<b>\$125,507</b>	<b>\$26</b>	

STATEMENT OF BUDGETARY RESOURCES, in millions	Original 2005		Effects of Restatements		Restated 2005		Description Reference
	Budgetary	Non-Budgetary Credit Reform Financing Accounts	Budgetary	Non-Budgetary Credit Reform Financing Accounts	Budgetary	Non-Budgetary Credit Reform Financing Accounts	
<b>CHANGE IN OBLIGATED BALANCE</b>							
Obligated Balance, Net							
Unpaid obligations brought forward, October 1	\$26,184	\$ -	\$248	\$ -	\$26,432	\$ -	A
Less: Uncollected customer payments from Federal Sources, brought forward, October 1	(1,418)	-	-	-	(1,418)	-	
Total unpaid obligated balance, net	24,766	-	248	-	25,014	-	
Obligations incurred, net	68,621	-	7	-	68,628	-	C
Less: Gross Outlays	(53,175)	-	-	-	(53,175)	-	
Obligated balance transferred, net							
Actual transfers, unpaid obligations	89	-	-	-	89	-	
Total unpaid obligated balance transferred, net	89	-	-	-	89	-	
Recoveries of Prior Year Unpaid Obligations, Actual	(1,431)	-	(87)	-	(1,518)	-	C
Change in uncollected customer payments from Federal Sources	(427)	-	-	-	(427)	-	
Obligated balance, net end of period							
Unpaid obligations	40,288	-	168	-	40,456	-	A, C
Less: Uncollected customer payments from Federal Sources	(1,845)	-	-	-	(1,845)	-	
Total, unpaid obligated balance, net end of period	38,443	-	168	-	38,611	-	
Net Outlays							
Gross Outlays	53,175	-	-	-	53,175	-	
Less: Offsetting Collections	(8,328)	(8)	(14)	-	(8,342)	(8)	C
Less: Distributed Offsetting Receipts	(4,152)	-	(396)	-	(4,548)	-	E
<b>NET OUTLAYS</b>	<b>\$40,695</b>	<b>\$(8)</b>	<b>\$(410)</b>	<b>\$ -</b>	<b>\$40,285</b>	<b>\$(8)</b>	

<b>STATEMENT OF FINANCING, in millions</b>	<b>Original 2005</b>	<b>Effects of Restatements</b>	<b>Restated 2005</b>	<b>Description Reference</b>
<b>Resources Used to Finance Activities:</b>				
<b>Budgetary Resources Obligated</b>				
Obligations Incurred	\$68,621	\$7	\$68,628	C
Less: Spending Authority from Offsetting Collections and Recoveries	(10,195)	(101)	(10,296)	C
Obligations Net of Offsetting Collections and Recoveries	58,426	(94)	58,332	
Less: Offsetting Receipts	(4,152)	(396)	(4,548)	E
Net Obligations	54,274	(490)	53,784	
<b>Other Resources</b>				
Donations and Forfeiture of Property Transfers in(out) Without Reimbursement (+/-)	8	-	8	
Imputed Financing from costs Absorbed by Others	11	-	11	
Net Other Resources Used to Finance Activities	651	-	651	
	670	-	670	
<b>Total Resources Used to Finance Activities</b>	<b>\$54,944</b>	<b>\$(490)</b>	<b>\$54,454</b>	
<b>Resource Used to Finance Items Not Part of the Net Cost of Operations</b>				
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but not yet Provided (+/-)	\$12,866	\$(3)	\$12,863	C
Resources that Fund Expenses Recognized in Prior Periods	26	16	42	C
Budgetary Offsetting Collections and Receipts that do not Affect Net Cost of Operations:				
Credit Program Collections that Increase Liabilities for Loan Guarantees or Allowances for Subsidy	(8)	-	(8)	
Other	(345)	(396)	(741)	E
Resources that Finance the Acquisition of Assets	1,860	-	1,860	
Other Resource or Adjustments to Net Obligated Resources that do not Affect Net Cost of Operations (+/-)	499	2	501	C
<b>Total Resources Used to Finance Items Not Part of the Net Cost of Operations</b>	<b>14,898</b>	<b>(381)</b>	<b>14,517</b>	
<b>TOTAL RESOURCES USED TO FINANCE THE NET COST OF OPERATIONS</b>	<b>\$40,046</b>	<b>\$(109)</b>	<b>\$39,937</b>	

<b>STATEMENT OF FINANCING, in millions</b>	<b>Original 2005</b>	<b>Effects of Restatements</b>	<b>Restated 2005</b>	<b>Description Reference</b>
<b>Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period: Components Requiring or Generating Resources in Future Periods:</b>				
Increase in Annual Leave Liability	\$67	\$ -	\$67	
Increase in Environmental and Disposal Liability	13	7	20	D
Increase in Exchange Revenue Receivable from the Public	(95)	-	(95)	
Other				
Increase in Unfunded Claims and Claims Settlement Liabilities	21,651	-	21,651	
Increase in Actuarial Pension Liability	1,691	-	1,691	
Increase in USCG Military Post Employment Benefits	17	-	17	
Increase in Actuarial Health Insurance Liability	811	(444)	367	B
Other	311	(16)	295	C, D, E
Total Components of Net Cost of Operations that will Require or Generate Resources in Future Periods	24,466	(453)	24,013	
<b>Components not Requiring or Generating Resources:</b>				
Depreciation and Amortization	1,108	13	1,121	C
Revaluation of Assets or Liabilities (+/-)	543	9	552	C
Other (+/-)	243	-	243	
Total Components of Net Cost of Operations That Will Not Require or Generate Resources	1,894	22	1,916	
<b>Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period</b>	<b>26,360</b>	<b>(431)</b>	<b>25,929</b>	
<b>NET COST OF OPERATIONS</b>	<b>\$66,406</b>	<b>\$(540)</b>	<b>\$65,866</b>	

## Required Supplementary Information (unaudited, see Auditors' Report)

### 1. Stewardship PP&E

#### A. Heritage Assets

USCG and CBP maintain Heritage Assets, located in the United States, including the Commonwealth of Puerto Rico. Heritage Assets are property, plant and equipment that have historical or national significance; cultural, educational, or artistic importance; or significant architectural characteristics. Heritage Assets are generally expected to be preserved indefinitely. Multi-use Heritage Assets have more than one purpose such as an operational purpose and historical purpose.

The following table summarizes activity related to Heritage Assets for the fiscal years ended September 30 (in number of units).

	2006 (Unaudited)			2005 (Unaudited)		
	USCG	CBP	Total	USCG	CBP	Total
Beginning Balance	20,254	4	20,258	19,930	4	19,934
Additions	349	-	349	599	-	599
Withdrawals	(178)	-	(178)	(275)	-	(275)
<b>Ending Balance</b>	<b>20,425</b>	<b>4</b>	<b>20,429</b>	<b>20,254</b>	<b>4</b>	<b>20,258</b>

USCG possesses artifacts that can be divided into four general areas: ship's equipment, lighthouse and other aids-to-navigation items, military uniforms and display models. The addition of artifacts is the result of gifts to USCG. Withdrawals are made when items have deteriorated through inappropriate display, damage due to moving and transportation, or environmental degradation.

- Ship's equipment is generally acquired when the ship is decommissioned and includes small items such as sextants, ship's clocks, wall plaques, steering wheels, bells, binnacles, engine order telegraphs and ship's name boards. Conditions will vary based upon use and age.
- Aids-to-navigation items include fog and buoy bells, lanterns, lamp changing apparatus and lighthouse lenses. Buoy equipment is usually acquired when new technology renders the equipment obsolete. Classical lighthouse lenses can vary in condition. The condition is normally dependent on how long the item has been out of service. The lenses go to local museums or USCG bases as display items.
- Military uniforms are generally donated by retired USCG members and include clothing as well as insignia and accessories. Most clothing is in fair to good condition, particularly full dress items.
- Display models are mostly of USCG vessels and aircraft. These are often builders' models. Display models are generally in very good condition. Builders' models are acquired by USCG as part of the contracts with the ship or aircraft builders. The withdrawal of display models normally results from excessive wear.

The USCG also has non-collection type heritage assets, such as sunken vessels and aircraft under the property clause of the *U.S. Constitution*, Articles 95 and 96 of the *International Law of the Sea Convention* and the sovereign immunity provisions of *Admiralty* law. Despite the passage of time or the physical condition of these assets, they remain Government-owned until the Congress of the United States formally declares them abandoned. The USCG desires to retain custody of these assets to safeguard the remains of crew members who were lost at sea, to prevent the unauthorized handling of explosives or ordnance which may be aboard and to preserve culturally valuable relics of the USCG's long and rich tradition of service to our Nation in harm's way.

Buildings and Structures - USCG does not acquire or retain heritage buildings and structures without an operational use. Most real property, even if designated as historical, is acquired for operational use and is transferred to other government agencies or public entities when no longer required for operations. Of the USCG buildings and structures designated as heritage, including memorials, recreational areas and other historical areas, over two-thirds are multi-use heritage. The remaining are historical lighthouses, which are no longer in use and awaiting disposal; their related assets; and a gravesite.

CBP also has four multi-use heritage assets located in Puerto Rico. All multi-use heritage assets are reflected on the Balance Sheet. Financial information for multi-use heritage assets is presented in the principal statements and notes. Deferred maintenance information for heritage assets and general PP&E is presented in the required supplementary information.

## 2. Deferred Maintenance

The Department components use condition assessment as the method for determining the deferred maintenance for each class of asset. The procedure includes reviewing equipment, building and other structure logistic reports. Component logistic personnel identify maintenance not performed as scheduled and establish future performance dates. Logistic personnel use a condition assessment survey to determine the status of referenced assets according to the range of conditions shown below:

**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. There is no deferred maintenance on buildings or equipment in good condition.

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

**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. Based on periodic condition assessments, an indicator of condition is the percent of facilities and item of equipment in each of the good, fair, or poor categories.

Deferred maintenance as of September 30, 2006 was estimated to range from \$771 million to \$967 million on general property, plant and equipment and heritage assets. In fiscal year 2005, the Department reported estimated deferred maintenance of \$734 million to \$890 million with a range of poor to fair. These amounts represent maintenance on vehicles, vessels and buildings and structures owned by the Department that was not performed when it should have been or was scheduled to be and which is delayed for a future period.

A summary of deferred maintenance at September 30, 2006 is presented below (in millions):

	Low estimate	High estimate	Asset Condition
Building & Structures	\$ 514	\$ 645	Poor to Good
Equipment (vehicles and vessels)	256	321	Poor to Fair
Heritage assets	1	1	Poor to Good
<b>Total</b>	<b>\$ 771</b>	<b>\$ 967</b>	

### 3. Statement of Budgetary Resources

#### Schedule of FY 2006 Budgetary Resources by Responsibility Segments (in millions) (page 1 of 2)

	VISIT	CBP	USCG	USCIS	FEMA	FLE	ICE	Dept	PRE	SS	ST	TSA	TOTAL
<b>BUDGETARY RESOURCES</b>													
Unobligated balance, brought forward, Oct 1	\$80	\$1,724	\$1,254	\$318	\$49,241	\$76	\$405	\$164	\$2,569	\$79	\$276	\$719	<b>\$56,905</b>
Recoveries of Prior Year Obligations	17	217	-	155	2,561	55	273	44	29	-	169	134	<b>3,654</b>
Budget Authority:													
Appropriations	340	9,254	8,762	1,813	9,101	308	3,744	960	4,097	1,435	1,502	4,432	<b>45,748</b>
Borrowing Authority	-	-	-	-	18,129	-	-	-	-	-	-	-	<b>18,129</b>
Spending Authority from Offsetting Collections:													
Earned:	1	1,291	561	25	3,866	87	1,270	426	54	19	10	1,960	<b>9,570</b>
Change in Receivable from Federal Collected Sources	-	10	18	1	2	2	3	(2)	-	3	2	-	<b>39</b>
Change in Unfilled Customer Orders:													
Advance Received	-	1	30	(5)	(531)	1	(14)	-	6	(2)	(18)	(9)	<b>(541)</b>
Without Advance From Federal Sources	-	43	33	13	424	109	(3)	(6)	12	9	32	1	<b>667</b>
U.S. Expenditure transfers from trust funds	-	3	46	-	-	-	-	-	-	-	-	-	<b>49</b>
U.S. Subtotal	341	10,602	9,450	1,847	30,991	507	5,000	1,378	4,169	1,464	1,528	6,384	<b>73,661</b>
Non-expenditure transfers, net; anticipated and actual	-	243	281	-	(750)	-	16	(4)	-	-	(14)	-	<b>(228)</b>
Temporarily Not Available Pursuant to Public Law	-	-	-	-	(24)	-	(5)	-	-	-	-	-	<b>(29)</b>
Permanently Not Available	(3)	(163)	(485)	(11)	(23,828)	(7)	(39)	(35)	(56)	(49)	(36)	(795)	<b>(25,507)</b>
<b>TOTAL BUDGETARY RESOURCES</b>	<b>\$435</b>	<b>\$12,623</b>	<b>\$10,500</b>	<b>\$2,309</b>	<b>\$58,191</b>	<b>\$631</b>	<b>\$5,650</b>	<b>\$1,547</b>	<b>\$6,711</b>	<b>\$1,494</b>	<b>\$1,923</b>	<b>\$6,442</b>	<b>\$108,456</b>
<b>STATUS OF BUDGETARY RESOURCES</b>													
Obligations Incurred:													
	236	9,032	8,028	2,066	48,663	308	3,767	903	4,994	1,409	1,450	6,267	<b>87,123</b>
Direct	1	1,295	590	(176)	493	233	1,275	428	44	29	35	42	<b>4,289</b>
Reimbursable	237	10,327	8,618	1,890	49,156	541	5,042	1,331	5,038	1,438	1,485	6,309	<b>91,412</b>
Subtotal	198	294	1,272	107	6,888	73	278	164	1,628	5	404	54	<b>11,365</b>
Appropriated	-	-	66	-	14	-	-	-	-	-	-	-	<b>80</b>
Exempt from Apportionment	198	294	1,338	107	6,902	73	278	164	1,628	5	404	54	<b>11,445</b>
Subtotal	-	2,002	544	312	2,133	17	330	52	45	51	34	79	<b>5,599</b>
Unobligated Balance Not Available	-	2,002	544	312	2,133	17	330	52	45	51	34	79	<b>5,599</b>
<b>TOTAL STATUS OF BUDGETARY RESOURCES</b>	<b>\$435</b>	<b>\$12,623</b>	<b>\$10,500</b>	<b>\$2,309</b>	<b>\$58,191</b>	<b>\$631</b>	<b>\$5,650</b>	<b>\$1,547</b>	<b>\$6,711</b>	<b>\$1,494</b>	<b>\$1,923</b>	<b>\$6,442</b>	<b>\$108,456</b>

Schedule of FY 2006 Budgetary Resources by Responsibility Segments (in millions) (page 2 of 2)

	U.S. VISIT	CBP	USCG	USCIS	FEMA	FLE	ICE	Dept	PRE	SS	ST	TSA	TOTAL
<b>CHANGE IN OBLIGATED BALANCES</b>													
Obligated Balance, Net													
Unpaid obligations brought forward, Oct 1	\$345	\$2,398	\$3,061	\$636	\$20,287	\$114	\$1,293	\$557	\$8,291	243	952	2,279	<b>40,456</b>
Uncollected customer payments from federal sources, brought forward, Oct 1	-	(323)	(182)	(11)	(539)	(42)	(483)	(182)	(5)	(9)	-	(69)	<b>(1,845)</b>
Total unpaid obligated balance, net	345	2,075	2,879	625	19,748	72	810	375	8,286	234	952	2,210	<b>38,611</b>
Obligations incurred, net	237	10,328	8,618	1,889	49,156	541	5,042	1,331	5,039	1,438	1,485	6,308	<b>91,412</b>
Gross Outlays	(359)	(9,441)	(8,535)	(1,731)	(46,198)	(335)	(4,372)	(1,083)	(3,975)	(1,374)	(1,044)	(5,866)	<b>(84,313)</b>
Recoveries of Prior Year Unpaid Obligations	(17)	(217)	-	(155)	(2,561)	(55)	(272)	(44)	(30)	-	(168)	(135)	<b>(3,654)</b>
Change in uncollected customer payments from Federal Sources	-	(52)	(51)	(14)	(425)	(111)	(1)	7	(13)	(12)	(34)	-	<b>(706)</b>
Obligated balance, net end of Period													
Unpaid Obligations	206	3,067	3,144	639	20,685	265	1,690	761	9,326	307	1,225	2,587	<b>43,902</b>
Uncollected customer payments from Federal Sources	-	(374)	(233)	(25)	(965)	(153)	(483)	(175)	(19)	(21)	(34)	(70)	<b>(2,552)</b>
Total, unpaid obligated balance, net, end of period	206	2,693	2,911	614	19,720	112	1,207	586	9,307	286	1,191	2,517	<b>41,350</b>
<b>NET OUTLAYS</b>													
Net Outlays													
Gross Outlays	359	9,441	8,535	1,731	46,198	335	4,372	1,083	3,975	1,374	1,044	5,866	<b>84,313</b>
Offsetting collections	(1)	(1,295)	(637)	(20)	(3,335)	(87)	(1,256)	(427)	(60)	(17)	8	(1,951)	<b>(9,078)</b>
Offsetting collections	-	(2,348)	(33)	(2,041)	(7)	(6)	(110)	1	-	(1)	-	(276)	<b>(4,821)</b>
<b>Net Outlays</b>	<b>\$358</b>	<b>\$5,798</b>	<b>\$7,865</b>	<b>\$(330)</b>	<b>\$42,856</b>	<b>\$242</b>	<b>\$3,006</b>	<b>\$657</b>	<b>\$3,915</b>	<b>\$1,356</b>	<b>\$1,052</b>	<b>\$3,639</b>	<b>\$70,414</b>



**Schedule of FY 2005 Budgetary Resources by Responsibility Segments (in millions) (page 1 of 2)**

	U.S. VISIT	CBP	USCG	USCIS	FEMA	FLE	ICE	Dept	PRE	SS	ST	TSA	TOTAL
<b>BUDGETARY RESOURCES</b>													
Unobligated balance, brought forward, October 1	\$136	\$1,915	\$1,077	\$317	\$3,147	\$67	\$209	\$161	\$373	\$55	\$381	\$306	<b>\$8,144</b>
Recoveries of Prior Year Obligations	-	146	77	56	609	29	245	12	150	-	64	130	<b>1,518</b>
Budget Authority:													
Appropriations	350	7,572	7,648	1,702	69,487	227	3,188	614	7,406	1,386	1,115	4,452	<b>105,147</b>
Borrowing Authority	-	-	-	-	2,026	-	-	-	-	-	-	-	<b>2,026</b>
Contract Authority	-	-	-	-	-	-	-	-	-	-	-	-	<b>-</b>
Spending Authority from Offsetting Collections:													
Earned:	-	1,207	422	67	2,692	64	1,003	209	30	23	24	1,989	<b>7,730</b>
Change in Receivable from Federal Sources	-	33	(65)	(67)	(7)	3	(59)	12	-	5	-	3	<b>(142)</b>
Collection:													
Change in Unfilled Customer Orders:													
Advance Received	-	-	(7)	(7)	534	-	3	-	84	(12)	(4)	(20)	<b>571</b>
Without Advance From Federal Sources	-	63	30	7	188	12	205	95	4	(5)	(1)	(29)	<b>569</b>
Anticipated for Rest of Year, Without Advances	-	-	-	-	-	-	-	-	-	-	-	-	<b>-</b>
Previously unavailable	-	-	-	-	-	-	-	-	-	-	-	-	<b>-</b>
Expenditure transfers from trust funds	-	3	47	-	-	-	-	-	-	-	-	-	<b>50</b>
Subtotal	350	8,878	8,075	1,702	74,920	306	4,340	930	7,524	1,397	1,134	6,395	<b>115,951</b>
Non-expenditure transfers, net; anticipated and actual	-	136	198	-	(14)	-	4	22	(6)	-	(5)	2	<b>337</b>
Temporarily Not Available Pursuant to Public Law	-	-	-	-	-	-	-	-	-	-	-	-	<b>-</b>
Permanently Not Available	-	(197)	(52)	-	(18)	(2)	(86)	(24)	(25)	(13)	-	-	<b>(417)</b>
<b>TOTAL BUDGETARY RESOURCES</b>	<b>486</b>	<b>10,878</b>	<b>9,375</b>	<b>2,075</b>	<b>78,644</b>	<b>400</b>	<b>4,712</b>	<b>1,101</b>	<b>8,016</b>	<b>1,439</b>	<b>1,574</b>	<b>6,833</b>	<b>125,533</b>
<b>STATUS OF BUDGETARY RESOURCES</b>													
Obligations Incurred:													
	405	7,881	7,747	1,822	28,333	235	3,244	627	5,349	1,317	1,283	6,104	<b>64,347</b>
Direct	-	1,273	374	(65)	1,069	88	1,060	311	100	43	14	14	<b>4,281</b>
Reimbursable	405	9,154	8,121	1,757	29,402	323	4,304	938	5,449	1,360	1,297	6,118	<b>68,628</b>
Subtotal	81	203	830	67	46,961	63	283	121	2,548	2	277	407	<b>51,843</b>
Unobligated Balance:													
Expenditure from Apportionment	-	-	33	-	12	-	-	-	-	-	-	-	<b>45</b>
Subtotal	81	203	863	67	46,973	63	283	121	2,548	2	277	407	<b>51,888</b>
Unobligated Balance Not Available	-	1,521	391	251	2,269	14	125	42	19	77	-	308	<b>5,017</b>
<b>TOTAL STATUS OF BUDGETARY RESOURCES</b>	<b>486</b>	<b>10,878</b>	<b>9,375</b>	<b>2,075</b>	<b>78,644</b>	<b>400</b>	<b>4,712</b>	<b>1,101</b>	<b>8,016</b>	<b>1,439</b>	<b>1,574</b>	<b>6,833</b>	<b>125,533</b>

**Schedule of FY 2005 Budgetary Resources by Responsibility Segments (in millions) (page 2 of 2)**

	VISIT	CBP	USCG	USCIS	FEMA	FLE	ICE	Dept	PRE	SS	ST	TSA	TOTAL
<b>CHANGE IN OBLIGATED BALANCES</b>													
Obligated Balance, Net													
Unpaid obligations brought forward, October 1	188	2,160	2,794	603	8,507	79	1,146	487	7,286	299	573	2,310	<b>26,432</b>
Uncollected customer payments from federal	-	(227)	(216)	(71)	(357)	(27)	(337)	(76)	(3)	(8)	(1)	(95)	<b>(1,418)</b>
Total unaid obligated balance net	188	1,933	2,578	532	8,150	52	809	411	7,283	291	572	2,215	<b>25,014</b>
Obligations incurred, net	396	9,153	8,121	1,757	29,402	323	4,304	946	5,448	1,361	1,298	6,119	<b>68,628</b>
Gross Outlays	(239)	(8,773)	(7,778)	(1,670)	(17,014)	(259)	(3,999)	(864)	(4,291)	(1,417)	(855)	(6,016)	<b>(53,175)</b>
Obligated balance transferred, net:													
Actual transfers, unpaid obligations	-	3	-	2	-	-	84	-	-	-	-	-	<b>89</b>
Actual transfers, uncollected customer	-	-	-	-	-	-	-	-	-	-	-	-	<b>-</b>
Total unaid obligated balance transferred net	-	3	-	2	-	-	84	-	-	-	-	-	<b>89</b>
Recoveries of Prior Year Unpaid Obligations	-	(146)	(77)	(57)	(608)	(29)	(245)	(13)	(150)	-	(64)	(129)	<b>(1,518)</b>
Change in uncollected customer payments from Federal Sources	-	(96)	34	60	(181)	(15)	(146)	(106)	(5)	-	1	27	<b>(427)</b>
Obligated balance, net end of Period													
Unpaid Obligations	345	2,397	3,060	635	20,287	114	1,290	556	8,291	244	952	2,285	<b>40,456</b>
Uncollected customer payments from Federal Sources	-	(323)	(182)	(11)	(538)	(42)	(483)	(182)	(6)	(9)	-	(69)	<b>(1,845)</b>
<b>Total unaid obligated balance net end of period</b>	<b>345</b>	<b>2,074</b>	<b>2,878</b>	<b>624</b>	<b>19,749</b>	<b>72</b>	<b>807</b>	<b>374</b>	<b>8,285</b>	<b>235</b>	<b>952</b>	<b>2,216</b>	<b>38,611</b>
<b>NET OUTLAYS</b>													
Net Outlays													
Gross outlays	239	8,773	7,778	1,670	17,014	259	3,999	864	4,291	1,417	855	6,016	<b>53,175</b>
Offsetting collections	-	(1,210)	(461)	(61)	(3,226)	(64)	(1,006)	(208)	(114)	(11)	(20)	(1,969)	<b>(8,350)</b>
Distributed offsetting receipts	-	(2,247)	(25)	(1,891)	-	-	(135)	-	-	-	-	(250)	<b>(4,548)</b>
<b>Net Outlays</b>	<b>239</b>	<b>5,316</b>	<b>7,292</b>	<b>(282)</b>	<b>13,788</b>	<b>195</b>	<b>2,858</b>	<b>656</b>	<b>4,177</b>	<b>1,406</b>	<b>835</b>	<b>3,797</b>	<b>40,277</b>

#### 4. Statement of Custodial Activity

Substantially all duty, tax and fee revenues collected by CBP are remitted to various General Fund accounts maintained by Treasury. Treasury further distributes these revenues to other Federal agencies in accordance with various laws and regulations. CBP transfers the remaining revenue (generally less than two percent of revenues collected) directly to other Federal agencies, the Governments of Puerto Rico and the U.S. Virgin Islands, or retains funds as authorized by law or regulations. Refunds of revenues collected from import/export activities are recorded in separate accounts established for this purpose and are funded through permanent indefinite appropriations. These activities reflect the non-entity, or custodial, responsibilities that CBP, as an agency of the Federal government, has been authorized by law to enforce.

CBP reviews selected documents to ensure all duties, taxes and fees owed to the Federal government are paid and to ensure regulations are followed. If CBP believes duties, taxes, fees, fines, or penalties are due in addition to estimated amounts previously paid by the importer/violator, the importer/violator is notified of the additional amount due. CBP regulations allow the importer/violator to file a protest on the additional amount due for review by the Port Director. A protest allows the importer/violator the opportunity to submit additional documentation supporting their claim of a lower amount due or to cancel the additional amount due in its entirety. Work in progress will continue until all protest options have expired or an agreement is reached. During this protest period, CBP does not have a legal right to the importer/violator's assets, and consequently CBP recognizes accounts receivable only when the protest period has expired or an agreement is reached. For fiscal years 2006 and 2005, CBP had legal right to collect \$1.8 billion and \$1.4 billion of receivables respectively. In addition, there was an additional \$2.4 billion and \$1.9 billion representing records still in the protest phase for fiscal years 2006 and 2005 respectively. CBP recognized as write-offs \$204 million and \$134 million respectively, of assessments that the Department has statutory authority to collect at September 30, 2006 and 2005, but has no future collection potential. Most of this amount represents fines, penalties and interest.

USCG collects various fines, penalties and miscellaneous user fees from the public that are deposited to the General Fund miscellaneous receipts of the U.S. Treasury. USCG does not collect taxes or duties. As of September 30, 2006 and 2005, USCG had outstanding general fund receipt receivables due to the Treasury General Fund of \$10 million and \$15 million, respectively.

USCIS collects user fees from employers for nonimmigrant petitions under two Congressionally mandated programs. All user fees are collected when the petition is submitted. USCIS retains a portion of the fees to fund specific program expenses and transfers the remaining balance to other Federal agencies.

## 5. Risk Assumed Information

The Department has performed an analysis of the contingencies associated with the unearned premium reserve for the National Flood Insurance Program (NFIP). That analysis shows unearned premium reserve is less than the combined values of (i) the estimated present value of unpaid expected losses and (ii) other operating expenses associated with existing policy contracts. Therefore, the Department can state the unearned premium reserve will be adequate to pay future losses and other operating expenses associated with existing policy contracts. However, there is a remote chance that the volume of flood losses in the next year could exceed the unearned premium reserve.

Our estimate of the present value of unpaid expected losses is based on a loss ratio (losses to premium), which is then multiplied by the current unearned premium reserve. This loss ratio is derived from the NFIP actual historical premium, historical losses and historical mix of business, each adjusted to today's level. More specifically, historical premiums have been adjusted to reflect the premium levels of the present by making adjustments for historical rate changes and historical changes in coverage amounts. Historical losses have been adjusted for inflation, using inflation indexes such as the Consumer Price Index as well as chain price indexes, to reflect the values that historical losses would settle as if they were settled today. In addition, the historical mix of business is adjusted to reflect today's mix of business. Examples of how the historical mix of business includes proportionately fewer pre-firm policies versus post-firm policies are in force today. Also, there are proportionately more preferred risk policies in force than in past years.

## Required Supplementary Stewardship Information (unaudited, see Auditors' Report)

### 1. Stewardship Investments

Due to changes in the DHS organization as a result of the Second Stage Review stewardship investments information is presented only for fiscal year 2006. Stewardship investments are substantial investments made by the Federal government for the benefit of the Nation. When incurred, stewardship investments are treated as expenses in calculating net cost, but they are separately reported as Required Supplementary Stewardship Information (RSSI) to highlight the extent of investments that are made for long-term benefit. Fiscal year 2006, investment amounts reported below are an allocation of gross cost based on program outlays.

#### Summary of Stewardship Investments (in millions)

Programs	Human Capital	Research and Development
G&T – First Responders Programs	\$6	\$494
S&T – Research and Development Programs	-	1,225
<b>Total</b>	<b>\$6</b>	<b>\$1,719</b>

### 2. Investments in Human Capital

These investments include expenses incurred for programs for education and training of the public that are intended to increase or maintain national productive capacity and that produce outputs and outcomes that provide evidence of maintaining or increasing national productive capacity. Based on a review of the Department's programs, PRE has made significant investments in Human Capital.

#### PRE

**First Responders Training Programs:** In fiscal year 2006, PRE provided various training initiatives to improve the knowledge, skills, and abilities of first responders for prevention, response, and recovery. Highlights of performance information include:

Program	Performance Measure	FY 2006 Target	FY 2006 Results
Grants, Training, & Exercises	Percent of jurisdictions demonstrating acceptable performance on applicable critical tasks in exercises using G&T approved scenarios.	60%	35%
Grants, Training, & Exercises	Percent of state and local homeland security agency grant recipients reporting measurable progress towards identified goals and objectives to prevent and respond to terrorist attacks.	90%	61.8%
Grants, Training, & Exercises	Percent of participating urban area grant recipients reporting measurable progress made towards identified goals and objectives to prevent and respond to terrorist attacks.	90%	64.8%
Grants, Training, &	Average percentage increase in	38%	27%

Program	Performance Measure	FY 2006 Target	FY 2006 Results
Exercises	Weapons of Mass Destruction (WMD) and other knowledge, skills, and abilities of state and local homeland security preparedness professionals receiving training from pre and post assessments.		

### 3. Investments in Research and Development

These investments represent expenses incurred to support the search for new or refined knowledge and ideas and for the application or use of such knowledge and ideas for the development of new or improved products and processes with the expectation of maintaining or increasing national productive capacity or yielding other future benefits. Based on a review of the Department's programs, S&T has made significant investments in Research and Development.

#### S&T

**Research and Development Programs:** In fiscal year 2006, S&T sponsored several research and development programs to advance the science and intellectual capacity needed to support the Department's mission. Highlights of performance information include:

Program	Performance Measure	FY 2006 Target	FY 2006 Results
Threat Awareness Portfolio	Average of expert reviews of improvement in the national capability to assess threats of terrorist attacks.	7	7
Explosives Countermeasures	Cumulative number of air cargo and rail passenger explosives screening pilots initiated.	4	5
Rapid Prototyping	Number of prototypes delivered through DHS funded projects through Technical Support Working Group (TSWG), Rapid Technology Application Program (RTAP) and Small Business Innovation Research (SBIR) program.	4	17
Standards	Number of Department of Homeland Security official technical standards introduced.	15	15
Standards	Percent of standards introduced that are adopted by Department of Homeland Security and partner agencies.	67%	92%
Biological Countermeasures	Number of bioaerosol collectors deployed in the top threat cities.	223	198
Counter Man-Portable Air Defense System (MANPADS)	Increase in Mean Flight Hours Between Failure (MFHBF) from Phase II to Phase III.	1,100	0
Counter Man-Portable Air Defense System (MANPADS)	Number of operational flight hours of Counter-MANPADS system conducted in a commercial aviation	300	0

<b>Program</b>	<b>Performance Measure</b>	<b>FY 2006 Target</b>	<b>FY 2006 Results</b>
	environment.		
University Programs	Percent of peer review adjectival ratings on University Programs' management and research and education programs that are very good or excellent.	78%	54.3%
Chemical Countermeasures	Percent completion of an effective restoration capability to restore key infrastructure to normal operation after a chemical attack.	25%	25%
Interoperability & Compatibility	Percent of grant programs for public safety wireless communications that include "SAFECOM" Federal standards-approved grant guidance.	100%	100%
Interoperability & Compatibility	Percent of states that have initiated or completed a statewide interoperability plan, such as the Statewide Communications Interoperability Plan (SCIP).	26%	26%

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