

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

**Independent Auditor's Report on TSA's  
FY 2006 Balance Sheet**



**OIG-08-05**

**October 2007**



Homeland  
Security

October 16, 2007

Preface

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

This report presents the results of the audit of the Transportation Security Administration's (TSA) consolidated balance sheet as of September 30, 2006. We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the audit. The contract required that KPMG perform its audit according to generally accepted government auditing standards and guidance from the Office of Management and Budget and the Government Accountability Office. KPMG issued a disclaimer of opinion on TSA's financial statements for fiscal year 2006. KPMG's report identified seven material weaknesses related to financial reporting, financial systems security, undelivered orders and contract file maintenance, property and equipment, journal voucher preparation and approval, grant accrual methodology and monitoring, and accrued leave. It also identified instances of non-compliance with six laws and regulations, including one violation of the *Anti-deficiency Act* that affected certain previously issued financial statements. KPMG is responsible for the attached auditor's report dated December 21, 2006, and the conclusions expressed in the report. We do not express opinions on TSA's financial statements or internal control or conclusions on compliance with laws and regulations.

The recommendations herein have been developed to the best knowledge available to our office, and 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



KPMG LLP  
2001 M Street, NW  
Washington, DC 20036

## Independent Auditors' Report

Assistant Secretary for the Department of Homeland Security,  
Transportation Security Administration, and Inspector General,  
Department of Homeland Security

We were engaged to audit the accompanying consolidated balance sheet of the Department of Homeland Security (DHS) Transportation Security Administration (TSA) as of September 30, 2006. We were also engaged to consider TSA's internal controls over financial reporting, Required Supplementary Stewardship Information (RSSI), and performance measures, and to test TSA's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on this consolidated balance sheet.

### SUMMARY

As discussed in our report on the consolidated balance sheet, the scope of our work was not sufficient to express an opinion on TSA's consolidated balance sheet as of September 30, 2006. Also as discussed in our report on the consolidated balance sheet, TSA adopted new reporting requirements for earmarked funds and included the Federal Air Marshal Service as part of the TSA reporting entity, effective October 1, 2005. In addition, as discussed in our report on the consolidated balance sheet, during 2006 TSA identified and communicated an *Anti-deficiency Act* violation as required by the United States Code; the error that caused this violation affects certain previously issued consolidated financial statements.

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

- A. Financial Reporting
- B. Financial Systems Security
- C. Undelivered Orders and Contract File Maintenance
- D. Property and Equipment
- E. Journal Voucher Preparation and Approval
- F. Grant Accrual Methodology and Grant Monitoring
- G. Accrued Leave

We consider all the reportable conditions 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*.

- H. *Federal Financial Management Improvement Act of 1996*
- I. *Federal Information Security Management Act (Electronic Government Act of 2002)*



- J. *Single Audit Act Amendments of 1996*, and Laws and Regulations Supporting OMB Circular No. A-50, *Audit Follow-up*, as revised
- K. *Debt Collection Improvement Act of 1996*
- L. *Improper Payments Information Act of 2002*
- M. *Anti-deficiency Act*

As discussed in our report on the consolidated balance sheet, the scope of our work was not sufficient to express an opinion on the consolidated balance sheet as of September 30, 2006. Accordingly, other internal control matters and other instances of noncompliance may have been identified and reported had we been able to perform all procedures necessary to express an opinion on TSA's consolidated balance sheet as of September 30, 2006.

The following sections discuss the reasons why we are unable to express an opinion on TSA's consolidated balance sheet; our consideration of TSA's internal controls over financial reporting, RSSI, and performance measures; our tests of the TSA's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements; and management's and our responsibilities.

## **REPORT ON THE CONSOLIDATED BALANCE SHEET**

We were engaged to audit the accompanying consolidated balance sheet of TSA as of September 30, 2006. Prior to the completion of TSA's *FY 2006 Annual Financial Report*, TSA was unable to provide sufficient evidential matter or make knowledgeable representations of facts and circumstances that support the following account balances of TSA as presented in TSA's consolidated balance sheet at September 30, 2006: property and equipment, intragovernmental accounts payable, accounts payable, accrued leave, and the components of net position.

Because of the matters discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying TSA consolidated balance sheet as of September 30, 2006.

As discussed in Note 1(t) to the consolidated balance sheet, TSA changed its method of reporting earmarked funds to adopt the provisions of the Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards No. 27, *Identifying and Reporting Earmarked Funds*, effective October 1, 2005. In addition, as discussed in Note 1(a), the Federal Air Marshal Service became part of the TSA reporting entity, effective October 1, 2005.

As discussed in Note 11 to the consolidated balance sheet, during 2006 TSA reported a violation of the *Anti-deficiency Act*. The primary cause of this violation was an erroneous budgetary accounting entry that TSA recorded in fiscal year 2003. This error caused misstatements in TSA's previously issued combined statement of budgetary resources and consolidated statement of financing for the seven month period ended September 30, 2003 and the combined statement of budgetary resources and consolidated statement of financing for the year ended September 30, 2004. In our reports dated January 19, 2004 and November 5, 2004 (except as to notes 10 and 13, which were dated as of December 21, 2004), we expressed opinions that the 2003 and 2004 financial statements, respectively, presented fairly, in all material respects, TSA's financial position, net costs, changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations in conformity with U.S. generally accepted accounting principles. Because of the subsequent discovery of the facts discussed in Note 11, our opinion on the consolidated financial statements for the seven month period ended September 30, 2003 and the consolidated financial statements for the year ended September 30, 2004 should not be relied upon.



The information in Management's Discussion and Analysis (MD&A) and RSSI is not a required part of the consolidated balance sheet, 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 the MD&A and RSSI 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. We did not audit the information in the MD&A and RSSI 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 TSA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the consolidated balance sheet.

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

We noted certain matters, described in Exhibit I, involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that all reportable conditions presented in Exhibit I are material weaknesses. As discussed in our report on the consolidated balance sheet, the scope of our work was not sufficient to express an opinion on the consolidated balance sheet as of 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 the consolidated balance sheet as of September 30, 2006.

## **INTERNAL CONTROLS OVER REQUIRED SUPPLEMENTARY STEWARDSHIP INFORMATION AND PERFORMANCE MEASURES**

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 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 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.

In our fiscal year 2006 audit engagement, we noted a material weakness, as defined above, in internal control over Required Supplementary Stewardship Information as described in Exhibit I within Finding A.

Further, in our fiscal year 2006 audit engagement, we noted no matters involving the design and operation of the internal control over the existence and completeness assertions related to key performance measures that we considered to be material weaknesses as defined above.

As discussed in our report on the consolidated balance sheet, the scope of our work was not sufficient to express an opinion on the consolidated balance sheet as of 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 the consolidated balance sheet as of September 30, 2006.

## **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 *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed five instances of noncompliance that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 06-03, and are described in Exhibit II.

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

The results of our tests of FFMIA disclosed instances, described in Exhibit II, where TSA's financial management systems did not 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.

As discussed in our report on the consolidated balance sheet, the scope of our work was not sufficient to express an opinion on the consolidated balance sheet as of September 30, 2006, and accordingly, other instances of noncompliance 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 consolidated balances sheet as of September 30, 2006.

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

TSA management has indicated in a separate letter immediately following this report that it concurs with the findings presented in Exhibits I and II of our report. Further, they have responded that they will take corrective action to implement the recommendations presented herein.

\* \* \* \* \*



## RESPONSIBILITIES

### Management's Responsibilities.

Management is responsible for the consolidated balance sheet, including:

- Preparing the consolidated balance sheet in conformity with U.S. generally accepted accounting principles;
- Preparing the Management's Discussion and Analysis (including the performance measures) and Required Supplementary Stewardship Information;
- Establishing and maintaining effective internal control; and
- Complying with laws, regulations, contracts, and grant agreements applicable to TSA, 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 our report on the consolidated balance sheet, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on TSA's consolidated balance sheet as of September 30, 2006.

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

OMB Bulletin No. 06-03 requires auditors, with respect to internal control over RSSI, to obtain an understanding of management's internal control, determine whether these internal controls had been placed in operation, assess control risk, and perform tests of controls. Our procedures were not designed to provide an opinion on internal control over RSSI and, accordingly, we do not provide an opinion thereon. As discussed in our report on the consolidated balance sheet, we were unable to complete procedures over RSSI presented in TSA's *FY 2006 Annual Financial Report*.

OMB Bulletin No. 06-03 further requires auditors, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis, to obtain an understanding of the design of internal controls relating to the existence and completeness assertions and determine whether these internal controls had been placed in operation. Our procedures were not designed to provide an opinion on internal control



over reported performance measures and, accordingly, we do not provide an opinion thereon. As discussed in our report on the consolidated balance sheet, we were unable to complete procedures over the MD&A and performance measures presented in TSA's *FY 2006 Annual Financial Report*.

In connection with our fiscal year 2006 engagement, we performed tests of TSA's 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 consolidated balance sheet amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 06-03, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to TSA. However, providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our audit 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 TSA's consolidated balance sheet as of September 30, 2006.

Under OMB Bulletin No. 06-03 and FFMIA, we are required to report whether TSA's financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements. However, as discussed in our report on the consolidated balance sheet, the scope of our work was not sufficient to express an opinion on the consolidated balance sheet as of September 30, 2006, and accordingly, other instances of noncompliance may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the consolidated balance sheet as of September 30, 2006.

#### **RESTRICTED USE**

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

**KPMG LLP**

December 21, 2006, except as to note 11, which is as of February 6, 2007, and except as to note 12, which is as of May 15, 2007



## Exhibit I –Material Weaknesses

Discussed below are reportable conditions that we believe are material weaknesses.

### A. Financial Reporting

*Background:* Beginning in fiscal year (FY) 2005, the Transportation Security Administration (TSA) contracted with the United States Coast Guard's Finance Center (FINCEN) to provide accounting services. As such, the FINCEN maintains TSA's general ledger and processes accounting transactions as directed by TSA. At the end of each accounting period, TSA submits adjusting journal entries to FINCEN as part of the closing process.

All bureaus within the Department of Homeland Security (DHS) are required to submit financial data monthly to the DHS Office of the Chief Financial Officer (OCFO) via the Treasury Information Executive Repository (TIER).

*Condition:* During FY 2006, TSA experienced difficulties completing a timely analysis of security fees previously recorded and associated financial statement effects, meeting the requirements of the DHS June 30 hard close and the September year-end close, and timely and adequately supporting financial transactions.

As part of our FY 2005 audit engagement, we raised certain questions about the accounting and reporting of aviation security fees collected from passengers and air carriers. In a legal opinion obtained on March 7, 2006, the DHS Office of General Counsel concluded that TSA misinterpreted the applicable Public Law when it deemed that the fees were not available for use. This misinterpretation and the ambiguity of the accounting impact were the primary reasons why we were unable to reach a conclusion regarding the accounting treatment of the fees for FY 2005. Additionally, abnormal and analytical tests performed in FY 2005 indicated that TSA may have misstated the components of its net position (cumulative results of operations and unexpended appropriations). Audit procedures related to TSA's draft FY 2005 financial statements formally ended on March 14, 2006, and we did not issue an audit report. Although TSA corrected its accounting for fees collected to be in compliance with this legal interpretation of its enabling legislation in FY 2006, TSA did not complete an historical analysis of fee amounts collected in previous fiscal years until April 2007. Because this analysis identified material adjustments to net position as of September 30, 2006, TSA posted the on-top adjustment resulting from this analysis to its September 30, 2006 balance sheet in May 2007, as described in note 12 to the balance sheet.

TSA did not fully comply with the requirements of the DHS June 30, 2006 hard close guidance and did not identify all relevant qualifications in its certification to the DHS OCFO. Specifically, we noted accruals had not been posted for all accounts, certain account balances had not been updated to reflect activity for the current year, certain account reconciliations were not performed timely throughout the year, and material abnormal balances and analytical account variances, including several related to the 3100 general ledger account series (unexpended appropriations), were not resolved.

With regards to TSA's interim financial statements and accompanying Management's Discussion and Analysis (MD&A), we noted TSA had not performed a thorough review of the footnotes and MD&A to ensure the footnotes reflected the current scope (balance sheet only) and MD&A contained the requirements outlined in Office of Management and Budget (OMB) Circular No. A-136, *Financial Reporting Requirements*.

## Exhibit I –Material Weaknesses

At year end, we noted TSA posted adjustments to several accounts because reconciliations were not performed during the year. Specifically, TSA recorded on-top adjustments to correct the \$230 million overstatement of the unfunded Federal Employees Compensation Act (FECA) liability. TSA also recorded an adjustment for approximately \$130 million to reflect activity posted by FINCEN to a property holding account. Several year end confirmations, required to determine year end accruals, were not received and appropriate measures to ensure receipt were not performed. In addition, material abnormal balances and analytical account variances, including several related to the 3100 general ledger account series (unexpended appropriations), continued to be unresolved. We also noted that TSA's FY 2006 Required Supplementary Stewardship Information (RSSI), specifically investments in human capital and research and development, did not report outcomes and outputs as required by OMB Circular No. A-136.

Lastly, TSA has not established policies and procedures to ensure that financial transaction supporting documentation is readily available in accordance with OMB Circular No. A-123. At the end of July, we noted approximately 50% of our requests (provided in early July) for financial transaction supporting documentation were received late or were overdue. In mid-September, this percentage increased to 53%. We also requested documentation from both TSA and its accounting services provider to support our review of the information technology (IT) systems during the same period; at the end of July, 100% of these requests were late or overdue, and this percentage decreased to 65% by mid-September. In addition, TSA did not effectively communicate delays in submission as they occurred and/or waited to request an extension once the item was overdue.

*Cause/Effect:* Related to the accounting for fees collected and used, TSA's initial focus was on the current and prospective accounting treatment of these fees and related scenarios, including the impact on the statements of changes in net position and statements of budgetary resources. This initial focus excluded an analysis of the analytical and abnormal balance questions initially raised by us as of June 30, 2005.

The relatively new reporting process caused by the change in accounting services providers, accelerated reporting deadlines necessitated by DHS's reporting timeline, and the lack of specific policies and procedures for preparing the financial statements created delays in the preparation of accurate and complete TIER financial data, financial statements and related footnotes.

TSA did not provide an explanation regarding the omitted accruals for specific payable types, the omitted adjustment to accrued leave, the lack of updated property balances, and the lack of reconciliations over property balances as of June 30, 2006. An adjustment for trading partner eliminations was not recorded because the adjustment was not ready until after the TIER file had been submitted to DHS. Research and any related adjustments/explanations for material abnormal balances and analytical variances were not made because of time constraints. As of June 30, 2006, TSA did not prepare accurate, full accrual financial statements and did not comply with all Departmental requirements in order to allow for the timely completion of interim audit procedures.

Because of the movement of various grant programs within DHS, TSA has not been able to establish meaningful outcomes and outputs for its RSSI disclosures.

To facilitate the audit, TSA assigns an audit liaison to coordinate auditor requests from the various TSA offices. The TSA audit liaison has not been consistently provided the required PBC

## Exhibit I –Material Weaknesses

items from the responsible TSA offices in a timely manner. Further, delayed PBC items have not consistently been communicated to the auditors. The inability to provide both high quality and timely requested PBC documentation impacted our audit plan and timeline.

*Criteria:* According to the *Standards for Internal Control in the Federal Government* (the Standards) issued by the Government Accountability Office (GAO), “Control activities occur at all levels and functions of the entity. They include a wide range of diverse activities such as approvals, authorizations, verifications, reconciliations, performance reviews, maintenance of security, and the creation and maintenance of related records which provide evidence of execution of these activities as well as appropriate documentation. Control activities may be applied in a computerized information system environment or through manual processes.”

The Standards define internal control as “an integral component of an organization’s management that provides reasonable assurance that the following control objectives are being achieved: ...Reliability of financial reporting....” The Standards also state, “Internal control should provide reasonable assurance that the objectives of the agency are being achieved in the following categories...Reliability of financial reporting, including reports on budget execution, financial statements, and other reports for internal and external use...” The Standards list certain internal control activities, which include “top-level reviews of actual performance, reviews by management at the functional or activity level.”

Per the U.S. Government Standard General Ledger’s (USSGL) Accounts and Definitions (dated October 2005), account 3100 (Unexpended Appropriations – Cumulative) has a normal credit balance and represents “the amount of unexpended appropriations after fiscal yearend closing. The balance in this account remains the same during the fiscal year. Activity to increase or decrease unexpended appropriations is reflected in other USSGL accounts in the 3100 series. At yearend, the nominal USSGL accounts in the 3100 series are closed to this USSGL account. During the fiscal year, the net of debit and credit balances in the 3100 series accounts reflects the total remaining balance of unused appropriations.”

The FY 2006 DHS June Hard Close memorandum outlined the requirements that each DHS component was required to follow and meet.

OMB Circular No. A-123 states, “Management is responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. The documentation for internal control, all transactions, and other significant events should be readily available for examination.”

*Recommendation:* We recommend that TSA:

1. Work with DHS personnel to ensure that the prior period adjustment at the DHS level resulting from the analysis completed in April 2007 is properly presented and disclosed in DHS’ FY 2007 *Performance and Accountability Report*.
2. Implement formal, documented policies and procedures for the monthly and year-end closing processes to ensure complete and accurate TIER financial data, financial statements, and RSSI can be prepared, and adequately disclose all TIER deficiencies on its certification statement to DHS. These procedures should identify the responsibilities of the accounting services provider and TSA; allow for adequate time for TSA to review financial information provided; provide for the timely resolution of abnormal balances, analytical variances and

## Exhibit I –Material Weaknesses

intra-DHS elimination differences; and allow adequate time to reconcile and adjust balances to reflect actual line item amounts. Ensure key financial management personnel are aware of their roles and responsibilities in performing a hard close in compliance with DHS standards. Develop and implement a process to identify a complete listing of post-closing adjustments to be provided to the accounting services provider and DHS.

3. Increase communications with the responsible TSA offices preparing / providing financial statement supporting documentation, implement a quality control system to review financial statement supporting documentation prior to recording the transactions and prior to submission to the auditors, require the audit liaison to communicate audit request delays as soon as they are known, and provide an acceptable alternative receipt date based on consultation with the auditors.

### B. Financial Systems Security

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

The FINCEN hosts the financial processing of key TSA financial applications. As such, our audit procedures over IT controls for TSA included a review of FINCEN procedures, policies, and practices. We noted several actions taken by FINCEN to improve its IT general controls environment and to address many prior year IT general control issues. During the year, TSA and FINCEN were able to close out seven previously issued IT findings in the area of access controls and entity-wide security. Despite these improvements, several significant IT general control weaknesses were identified this year, and many findings were re-issued again this fiscal year. These issues collectively limit TSA's ability to ensure that critical financial and operational data is maintained in a manner to ensure confidentiality, integrity, and availability.

*Condition:* The following IT and financial system control weaknesses identified at FINCEN in FY 2006 impact TSA:

1. Regarding entity-wide security program planning and management, we noted:
  - Background investigations of FINCEN civilian and contractors employed to operate, manage and provide security over IT systems were not properly conducted.
  - Policies and procedures associated with FINCEN computer incident response capabilities are incomplete.
  - Initial and/or annual refresher training for TSA security awareness was not completed for 9,821 of 52,106, approximately 19%, of the TSA personnel and contractors with access to TSA information systems.
  - The paperwork for TSA employees was not consistently completed for terminated personnel. Specifically, we noted the required form was unavailable for 38 of 60 terminated employees selected for testing. Additionally, 8 of the 22 remaining forms received were incomplete.

## Exhibit I –Material Weaknesses

2. Regarding access controls, we noted:
  - Missing or weak user passwords were identified on key servers and databases.
  - Certain workstations, servers, and network devices were not configured with the necessary security patches, or were not configured in the most secure manner.
  - Policies and procedures requiring local security administrators to periodically revalidate user profiles for financial systems were not implemented.
  - Reviews of financial system user accounts for the removal of accounts for separated personnel were not conducted.
  - Procedures for the authorization, regular review, and removal of certain system access were not formalized and were inconsistent.
  - TSA Computer Access Agreements were not complete for 9,627 of 55,335, approximately 17%, of users with access to certain information systems. Additionally, 30,835 of 55,335 personnel, approximately 56%, had agreements on file that were over a year old.
  - Audit logging has not been enabled with in certain application. Additionally, audit trails of appropriate user actions, including changes to security profiles, are not generated and maintained for certain applications.
3. Regarding application software development and change control, we noted:
  - Several weaknesses exist in change control processes for certain applications. Specifically, change control procedures were not properly developed, formal change request forms were not in use, and test plans and results were not documented.
4. Regarding system software, we noted:
  - In some cases, the desktop's anti-virus could be disabled, screen-saver password settings could be disabled, and the ability existed to significantly increase the time period for the screen saver activation.
5. Regarding service continuity, we noted:
  - Backup tapes testing procedures for certain systems have not been properly documented.
  - One of the business continuity plans is in draft form and has not been tested.
6. Regarding application controls, we noted:
  - Weak access controls are associated with a certain financial application that has been outsourced to another entity. This weakness included excessive access privileges related to authorization, review and certification of payments.

*Cause/Effect:* While FINCEN has developed and begun to implement planned corrective actions to address weaknesses in its financial processing environment, some of the actions are multi-phased and will take multiple years to complete. This is particularly applicable to weaknesses in the change control process of key financial applications and business continuity/disaster recovery planning efforts. Additionally, several weaknesses, such as those related to account management, configuration management, and monitoring of system software require the implementation and enforcement of consistent policies and procedures.

FINCEN reported the correction of weaknesses identified by periodic scans of its network for security weaknesses. However, system configurations and the application of required patches are

## Exhibit I –Material Weaknesses

not consistently monitored as application changes are implemented to ensure that they remain in compliance with DHS and Federal guidance. In addition, financial system functionality weaknesses in various processes can be attributed to non-integrated legacy financial systems that do not have the embedded functionality called for by OMB Circular No. A-127, *Financial Management Systems*. Further, FINCEN and the DHS Chief Information Officer do not consistently test and monitor IT controls to identify and mitigate weaknesses.

*Criteria:* DHS' Sensitive Systems Policy Directive 4300A, Information Technology Security Program, was utilized during the audit engagement. 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.

*Recommendation:* Unless specifically noted where TSA needs to take specific correction action, we recommend that TSA ensure and verify that the FINCEN complete the following corrective actions:

1. For entity-wide security program planning and management:
  - Enforce DHS policy to ensure that all contractors go through the appropriate background/suitability check.
  - Develop an incident response capability that includes:
    - Designation of response team members and
    - Training for team members.
  - Procedures for incident handling, including preparation, containment, eradication, recovery and follow-up activities.
  - Approve and implement the incident response capability at the FINCEN.
  - Enforce the DHS policy by having all new and existing users and contractors complete the security awareness training.
  - Ensure that TSA employees consistently complete the required paperwork for terminated personnel (*TSA needs to take this action*).
2. For access control:
  - Enforce password controls that meet DHS password requirements on all key financial systems.
  - Develop and implement a process for performing scans of the network environment, including the financial processing environment, for the identification and correction of vulnerabilities in accordance with DHS and Federal guidance. These scans should occur on a regular basis, especially after the implementation of a software release.
  - Develop and implement formal entity-wide procedures for controlling the processes associated with the granting, monitoring, and terminating user accounts that require the periodic revalidation of user profiles by local security administrators that comply with existing policies.
  - Develop and implement formal entity-wide procedures for controlling the processes associated with the granting, monitoring, and terminating of user accounts that require the

## Exhibit I –Material Weaknesses

periodic revalidation of user profiles by local security administrators that comply with existing policies.

- Ensure that computer access agreements are completed for all TSA federal employees and contractors with access to financial applications (*TSA needs to take this action*).
  - Establish detailed procedures for audit trail generation, review and management. The procedures should discuss the conditions under which the audit trails should be generated and reviewed, the frequency of the reviews, and the basis for determining when suspicious activity should be investigated. In addition, sufficient resources should be allocated to ensure the proper implementation and monitoring of these procedures.
3. For application software development and change control:
- Develop and enforce one standard set of configuration management procedures for developing and documenting test plans, documenting test results, delivering and implementing software, and management approving system changes for normal and emergency upgrade situations.
4. For system software:
- Develop and implement a configuration checklist for the anti-virus server.
  - Perform periodic audits of the anti-virus and workstation security settings to ensure appropriate configurations are maintained.
5. For service continuity:
- Develop and document comprehensive backup procedures, which include testing the backup tapes on a regular basis.
  - Enforce the tape rotation procedures to ensure that tape transfer logs are completed, and perform a weekly review to ensure that the logs are completed in their entirety before the tapes are sent offsite.
  - Include all backup tapes in the weekly offsite tape rotation.
  - Periodically test the business continuity plan and evaluate the results so that the plan can be adjusted to correct any deficiencies identified during testing.
6. For application controls:
- Develop and implement access control procedures for the periodic access reviews. These procedures should include, at a minimum, steps for reviewing the system user listings to ensure that all terminated individuals no longer have active accounts, that inactive accounts are locked, and that privileges associated with each individual are still authorized and necessary.

**C. Undelivered Orders and Contract File Maintenance**

*Background:* In accordance with Federal appropriations law, entities in the Federal government are required to reserve funds for goods and services ordered but not yet delivered; this reserved amount is commonly referred to as an undelivered order (UDO). The UDO balance is the difference between the total order placed and the goods or services received to date. Larger UDO balances are typically associated with larger purchases, where the period of performance / terms of delivery span multiple accounting periods. TSA's Office of Acquisition and Office of Financial Management (OFM) are required to provide sufficient evidence in order to support expense and procurement transactions in the general ledger. These divisions are also responsible for supporting the validity of outstanding UDOs and unbilled goods and services.

As part of the financial reporting process, TSA uses the UDO balance at the end of each quarter to calculate an accrual estimate for goods and services received for which an invoice has not been received. This estimate is based on a percentage of the outstanding UDO balance.

*Condition:* During the course of our June 30 UDO compliance, control and substantive testwork, we were unable to obtain in a timely manner sufficient audit evidence to substantiate amounts recorded in TSA's general ledger related to the UDO balance, which totaled \$1.5 billion. Of our statistical sample of 154 items, we noted the following:

- 17 files were not provided;
- Questions pertaining to 16 files tested were not addressed in a timely manner;
- Sufficient documentation was not provided timely for 43 files; and
- 20 outstanding balances were no longer valid and should have been deobligated.

As a result of these errors, we were unable to examine sufficient audit evidence to properly support the recorded June 30, 2006 UDO balance.

Additionally, while progress has been made, the accounting system does not have the ability to process amounts deobligated from prior year obligations (i.e., recoveries) at the transaction level in accordance with Federal financial management system requirements. Accordingly, prior year recoveries were manually tracked and recorded.

*Cause/Effect:* TSA managers use an Open Document File (ODF) to determine what activity has posted against an obligation (e.g., contract modifications and expenditures). This report is extracted from the general ledger, provides the detail in order to reconcile back to originating source documentation, and provides a basis for TSA managers to research transactions or differences. The ODF often contains many lines of accounting including reversal transactions and other adjustments, making it difficult to effectively research and locate procurement and expenditure documentation to resolve related questions in a timely manner. Further, fund managers do not appear to periodically reconcile and monitor outstanding obligation balances to determine their validity. We also noted numerous employees in the Office of Acquisition have separated from their positions, and the procurement contact database is not kept current, which makes the task of locating contracting officers time consuming.

We ended audit work over the June 30<sup>th</sup> UDO balance on October 13, 2006. At that time, the results of our June 30, 2006 testing produced an error rate in our sample exceeding our acceptable limit to reach a conclusion. We calculated our error rate under the assumption that unsupported items or unanswered audit questions were 100% errors and were extrapolated as such to the



## Exhibit I –Material Weaknesses

population. Because TSA would not be able to provide sufficient documentation to support a full sample of UDOs as of September 30, 2006 in the time remaining before completion of TSA's *FY 2006 Annual Financial Report*, all work over UDOs concluded on October 13, 2006. As such, we were unable to determine if the \$1.6 billion balance of UDOs as of September 30, 2006 was fairly stated.

Additionally, TSA applies a percentage estimate on certain populations to UDOs to calculate an accrual for received but unbilled goods and services. Based on our conclusion related to the UDO balance, a key input for the estimate, we were also unable to determine if the intragovernmental and public general accounts payable accruals, approximately \$40 million and \$395 million, respectively, at September 30, 2006, were fairly stated.

The programming necessary to record obligations recovered at the transaction level was not fully developed and functional during FY 2006. The accounting system, used by TSA's accounting services provider, does not comply with Federal financial management system requirements (recording amounts at the transaction level). This system deficiency may prevent TSA from correctly capturing and reporting amounts recovered from prior year obligations.

*Criteria:* United States Code (U.S.C.) Title 31 Chapter 15, Section 1501, Documentary Evidence Requirement for Government Obligations states, "An amount shall be recorded as an obligation of the United States Government only when supported by documentary evidence of a binding agreement between an agency and another person (including an agency) that is in writing, in a way and form, and for a purpose authorized by law."

U.S.C. Title 31 Chapter 15, Section 1554, Audit, Control, and Reporting states, "The head of each agency shall establish internal controls to assure that an adequate review of obligated balances is performed to support the certification required by section 1108(c) of this title."

The Standards state that, "Internal controls and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination. The documentation should appear in management directives, administrative policies, or operating manuals and may be in paper or electronic form. All documentation and records should be properly managed and maintained." Additionally, with regard to accountability for records and resources, "Periodic comparison of resources with the recorded accountability should be made to help reduce the risk of errors, fraud, misuse, or unauthorized alteration."

Section 803(a) of the *Federal Financial Management Improvement Act of 1999* (FFMIA) requires that Federal financial management systems comply with (1) Federal accounting standards, (2) Federal system requirements, and (3) the United States Government Standard General Ledger 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.

*Recommendation:* We recommend that TSA:

1. Work with its accounting services provider to (a) develop or refine existing system tools that simplify the process of identifying, summarizing, and reporting accounting transactions to allow for the timely identification and research of procurement and expenditure

## Exhibit I –Material Weaknesses

- documentation, and (b) fully implement programming logic in the accounting system to capture and report prior year recoveries at the transaction level.
2. Retain all procurement and expense (Federal) supporting source documentation in a manner that facilitates timely document retrieval.
  3. Develop and implement procedures to review outstanding obligations for validity on a periodic basis, and document this review.

### D. Property and Equipment

*Background:* In executing its mission to prevent terrorist attacks and to protect the U.S. transportation network, TSA maintains property and equipment to aid in the screening of both passengers and baggage. During the current year, as part of its property management process, all TSA locations conducted a physical inventory. Based on the results of the inventory, certain locations made updates to the property management system, Sunflower. Through an interface, Sunflower and the Fixed Asset Module of the general ledger update one another depending on the information being populated and / or updated.

*Condition:* We reviewed the June 30 interim subsidiary data provided by TSA and noted that the totals presented did not reconcile to the trial balance. Subsequent to investigation by TSA, the data provided was deemed unreliable and TSA requested that we use July 31<sup>st</sup> as the sample selection date instead. The July data was not provided timely, but we were provided with an August reconciliation and subsidiary file on September 19, 2006, from which to sample.

Subsequent to our sample selection, management was unable to provide adequate supporting documentation for approximately 30% of the selected sample items. The results of this testing produced an error rate in our sample exceeding our acceptable limit to reach a conclusion. We calculated our error rate under the assumption that unsupported items were 100% errors and were extrapolated as such to the population. Therefore, we were unable to determine if the net \$1.1 billion balance of property and equipment as of September 30, 2006 was fairly stated.

TSA's investigation also found the Fixed Assets Module of the general ledger had not been updated since FY 2004 for activity related to a unique organizational segment of the fixed asset balance, including depreciation, additions, and disposals. In addition, TSA identified an unsupported journal voucher that had been posted in excess of \$14 million (85% of the unique organizational segment's fixed asset balance as of June 30<sup>th</sup>).

In performing other property procedures, we determined that TSA maintains idle property in a warehouse. These idle property items are currently in the Fixed Assets Module and continue to be depreciated. A majority of the idle items were placed in the warehouse in November 2004; as of August 31, 2006, the acquisition value of these items totaled approximately \$74 million, and the net book value was \$35.7 million. TSA indicated these assets are being held in the warehouse until an approved disposal plan is in place.

Lastly, at year-end TSA recorded an adjustment for approximately \$130 million to remove activity posted to a U.S. Standard General Ledger (USSGL) account which is improperly used as a property holding account by its accounting services provider.

*Cause/Effect:* It is likely that updates as a result of the physical inventory, a change in the property accountant, and interface timing matters contributed to this condition. Net property and

## Exhibit I –Material Weaknesses

equipment in the general ledger and the financial statements was misstated as of June 30, 2006. These conditions led to the delay in performing audit procedures over property and equipment until late September 2006. In addition, the older nature of many sample items selected for testing prevented TSA from providing the corresponding invoices in a timely manner to support the acquisition value recorded in the general ledger.

*Criteria:* OMB Circular No. A-123, *Management's Responsibility for Internal Control*, states “Management is responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations...The documentation for internal control, all transactions, and other significant events is readily available for examination.”

The Standards state that “Transactions and other significant events should be authorized and executed only by persons acting within the scope of their authority. This is the principal means of assuring that only valid transactions to exchange, use, or commit resources and other events are initiated or entered into. Authorizations should be clearly communicated to managers and employees.” The Standards further state that “Internal controls and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination.”

Statement of Federal Financial Account Standards Number 6, *Accounting for Property, Plant and Equipment*, paragraph 39 states: “General PP&E shall be removed from general property, plant and equipment (PP&E) accounts along with associated accumulated depreciation/amortization, if prior to disposal, retirement or removal from service, it no longer provides service in the operations of the entity. This could be either because it has suffered damage, becomes obsolete in advance of expectations, or is identified as excess. It shall be recorded in an appropriate asset account at its expected net realizable value. Any difference in the book value of the PP&E and its expected net realizable value shall be recognized as a gain or a loss in the period of adjustment. The expected net realizable value shall be adjusted at the end of each accounting period and any further adjustments in value recognized as a gain or a loss. However, no additional depreciation/amortization shall be taken once such assets are removed from general PP&E in anticipation of disposal, retirement, or removal from service.”

*Recommendation:* We recommend that TSA:

1. 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 property holding account.
2. Ensure physical inventories are performed periodically and related ledgers are updated timely based on the results of the periodic inventories.
3. Ensure the property and equipment of the unique organizational segment are entered in Sunflower and the Fixed Assets Module and remain updated.
4. Perform and document, to include supervisory reviews, timely reconciliations between Sunflower, the Fixed Asset Module (i.e., subsidiary ledger) and general ledger.
5. Investigate those items identified as idle located in the warehouse, determine the appropriate accounting treatment and related rationale, and post any related adjustments.
6. Ensure adequate supporting documentation exists and is readily available to support the acquisition cost and date of property and equipment items.

**E. Journal Voucher Preparation and Approval**

*Background:* As part of the monthly general ledger closing process, TSA prepares journal vouchers to process various end-of-month transactions. In most cases, the detailed transactions are posted in the subsequent month. Additionally, journal vouchers are processed to correct various balances, correct system-generated accounting discrepancies, adjust accruals and process activity as a result of TSA’s accounting services provider closing 5 to 7 days prior to month end.

A requester completes the journal voucher form and submits it to the appropriate approver. Once approved, the journal voucher is sent to FINCEN to be recorded in the general ledger. Upon recordation in the general ledger, a confirmation email is sent by FINCEN personnel to the appropriate approver to notify them that the journal voucher has been recorded.

*Condition:* We selected a sample of 87 journal vouchers (JVs) from October 2005 to July 2006, and noted the following conditions:

- TSA was unable to provide supporting documentation for 6 of the requested JVs.
- Thirty-two (32) of our sample items, largely attributed to a single branch within the Office of Financial Management, were supported by emails only and no specific approvals were required (i.e., no ‘journal voucher form’ was used). Twenty-eight (28) of these items were not reviewed prior to being posted.
- For 15 sample items, TSA was only able to provide partial supporting documentation.
- For 8 sample items, documentation (e.g., analysis spreadsheet or the like) to support the journal voucher form did not exist.
- For the remaining 25 sample items, we noted emails existed to communicate the adjustment within TSA and between TSA and its accounting services provider. However, for these sample items, we found extent of completion of the ‘journal voucher form’ varied and cases where the JV Preparer, Reviewer, Branch Chief, and associated dates were not completed at all.

*Cause/Effect:* Formally documented policies and procedures do not exist over the preparation and approval of journal vouchers. Without appropriate supporting documentation to substantiate adjustments posted via journal vouchers and adequate controls over the approval of journal vouchers, TSA increases the risks that material error or fraud would not be prevented or detected and corrected on a timely basis.

*Criteria:* The Standards state “Key duties and responsibilities need to be divided or segregated among different people to reduce the risk of error or fraud. This should include separating the responsibilities for authorizing transactions, processing and recording them, reviewing the transactions, and handling any related assets. No one individual should control all key aspects of a transaction or event.”

OMB Circular No. A-123 states, “Management is responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. The documentation for internal control, all transactions, and other significant events should be readily available for examination.”

*Recommendation:* We recommend TSA formally 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.

**F. Grants Accrual Methodology and Grant Monitoring**

*Background:* Because of audit findings in FY 2005, TSA revised its grant accrual methodology in FY 2006. This new methodology uses the change in grant expenditures over various periods of time as its base; the resulting percentages are applied against UDOs at a point in time to estimate the related grant accrual.

*Condition:* Based on the results of the procedures performed related to port security grants rounds 2, 3 and 4, we noted there were approximately 210 grants with a related UDO balance of \$81.7 million which had no activity reported for the nine months ended June 30, 2006. Based on conversations held with TSA personnel, these grants are valid; however, the grantees have not submitted a request for reimbursement for various reasons (e.g., loss of grant expertise, forgotten password to log into the grant website and submit “Request for Reimbursement”, or lack of need of large public companies to submit for reimbursement timely). However, a thorough analysis of the expenditures of non-reporters has not yet been completed.

While we recognize the grant accrual methodology is an estimate, the FY 2006 methodology developed by TSA does 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. The UDO amount for non-reporters is material to TSA’s financial statements.

Further, TSA has not developed policies and procedures to properly monitor grantees’ compliance with OMB Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Specifically, procedures are not in place at TSA:

- To ensure that OMB Circular No. A-133 audit reports from grantees are received from the grantees or the DHS Office of Inspector General (OIG).
- To ensure that any findings on TSA grants in such audit reports are resolved and closed in a timely manner.
- For TSA management to issue management decisions on grantee audit findings within the six month timeframe required by OMB Circular No. A-133.

*Cause/Effect:* During FY 2005, the majority of TSA’s grant functions transferred to another DHS component, and TSA currently issues very few new grants. As 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.

TSA has not gained assurance that the grant accrual methodology reasonably estimates the amounts owed to all grantees at year-end. An inappropriate methodology could result in materially misstated grant expenses and liabilities.

If grants are not appropriately monitored by TSA, it is possible that funding will not be used for its intended purpose. Additionally, questioned costs may have been reported for TSA programs of which TSA is not aware.

## Exhibit I –Material Weaknesses

*Criteria:* Per the Statement on Auditing Standards (SAS) No. 57 (AU 342.06), “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 No. A-133, Subpart D(c)(1-6) states that Federal awarding agencies shall perform the following for the Federal awards it makes:

- Ensure that audits are completed and reports are received in a timely manner and in accordance with the requirements of this circular.
- Provide technical advice and counsel to auditees and auditors as requested.
- Issue a management decision on audit findings within six months after receipt of the audit report and ensure that the recipient takes appropriate and timely corrective action.
- Assign a person responsible for providing annual updates of the compliance supplement to OMB.

*Recommendation:* We recommend that TSA:

1. For all grant awards made prior to FY 2006, review the remaining UDOs to determine if the obligations are valid or should be deobligated due to expiration of the period of performance, inability of the grantee to expend all funds, or other reasons.
2. In coordination with the DHS component responsible for managing most of the grant programs funded by TSA, implement monitoring procedures to ensure that grantees submit requests for reimbursement and related reports in a timely manner.
3. In coordination with the DHS component responsible for managing most of the grant programs funded by TSA, continue to refine its grant accrual methodology to properly consider grantees that do not submit requests for reimbursement in a timely manner (non-reporters).
4. Develop and implement a tracking system to identify each grantee for which an OMB Circular No. A-133 audit is required and the date that the audit report is due. TSA should then use this system to track the receipt of all completed audit reports, the issuance of TSA's management decision on TSA-related findings (if any), and the completion of appropriate corrective action by the grantee.
5. Establish sufficient and ongoing communication with the DHS OIG to verify the receipt and status of all OMB Circular No. A-133 reports for TSA grantees, and place higher emphasis on following up with grantees and the DHS OIG for the audit reports that identify questioned costs or other significant findings and ensure that timely resolution is documented.

### **G. Accrued Leave**

*Background:* Federal employees earn leave each pay period based on years of government service. Employees accumulate this balance, more commonly referred to as accrued leave, which can be used at a later time when needed. At TSA, accrued leave is comprised of annual, restored and compensatory leave amounts. Federal agencies are required to report this total leave amount (in dollars) on their financial statements as a liability.

*Condition:* As part of our procedures to test the FY 2006 accrued leave balance, we had planned to select an interim sample from the July 31, 2006 balance. Accordingly, we requested a detail file containing the leave balance by category and associated dollar amount by employee. TSA's

## Exhibit I –Material Weaknesses

accounting services provider was unable to provide the requested file with amounts which agreed to the general ledger in a timely manner.

The requested file was provided by TSA's Financial Systems Branch based on payroll files obtained from the U.S. Department of Agriculture's National Finance Center (NFC), TSA's third-party payroll services provider. However, we noted that the file's balance differed from the general ledger balance by approximately \$165 million. Once received, we selected a sample from the accrued leave file, but TSA was unable to provide supporting documentation for the selected items prior to the end of our field work. Therefore, we were unable to determine if the \$129.6 million balance of accrued leave as of September 30, 2006 was fairly stated.

*Cause/Effect:* TSA personnel indicated that a deficiency in the accounting system exists which prevented the payroll files, received from NFC, from being accurately summarized in the required format. As such, accrued leave amounts reported may not be correctly summarized in the accounting system, and the balance recorded in the general ledger and the amount reported in the financial statement may be misstated. Additionally, we could not complete audit procedures related to the accrued leave balance prior to completion of TSA's *FY 2006 Annual Financial Report* as a result of TSA's decentralized time and attendance recordkeeping.

*Criteria:* OMB Circular No. A-123 states, "Management is responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. The documentation for internal control, all transactions, and other significant events should be readily available for examination."

*Recommendation:* We recommend that TSA's accounting services provider, in coordination with TSA, investigate the programming logic which summarizes accrued leave information for recordation in the general ledger and make corrections where required to properly report the annual leave balance in the general ledger each pay period.

## Exhibit II – Compliance and Other Matters

### H. *Federal Financial Management Improvement Act of 1996*

Passage of the *DHS Financial Accountability Act of 2004* made DHS and its components subject to the FFMIA. Prior to FY 2005, DHS and TSA were not subject to FFMIA. Section 803(a) of FFMIA requires that agency Federal financial management systems comply with (1) Federal financial management system requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger (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 TSA was not in full compliance with the requirements of FFMIA. Specifically:

- TSA's financial management systems do not comply substantially with Federal financial management system requirements because of certain weaknesses in general computer access controls discussed in Finding B of Exhibit I.
- TSA's financial management systems do not comply substantially with applicable Federal accounting standards because of the issues noted related to net position and property and equipment discussed in Findings A and D, respectively, of Exhibit I.
- TSA's financial management systems do not permit use of the USSGL at the transaction level for certain activities discussed in Finding C of Exhibit I.

*Recommendation:* We recommend that TSA implement the recommendations identified in Findings A, B, C and D of Exhibit I to address its FFMIA noncompliance.

### I. *Federal Information Security Management Act (Electronic Government Act of 2002)*

TSA is required to comply with the FISMA, which was enacted as part of the *Electronic Government Act of 2002*. FISMA requires agencies to: (1) provide information security for the systems that support the operations under their control; (2) develop, document and implement an organization-wide information security program; (3) develop and maintain information security policies, procedures and control techniques; (4) provide security training and oversee personnel with significant responsibilities for information security; (5) assist senior officials concerning their security responsibilities; and (6) ensure the organization has sufficient trained personnel to comply with FISMA requirements. We noted instances of noncompliance with FISMA that have been reported by us in Exhibit I within Finding B.

*Recommendation:* We recommend that TSA implement the recommendations identified in Finding B of Exhibit I and fully implement the requirements of FISMA.

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

As a grant-making agency, TSA is required to comply with certain provisions of OMB Circular No. A-133 and OMB Circular No. A-50, as revised. These circulars require agencies awarding grants to ensure they receive grantee reports timely and to follow-up on grantee single audit findings.

Although certain procedures have been implemented to monitor grantees and their audit findings, we noted that TSA did not have procedures in place to fully comply with provisions in OMB



## Exhibit II – Compliance and Other Matters

Circular Nos. A-133 and A-50 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.

*Recommendation:* We recommend that TSA implement recommendations (4) and (5) identified in Finding F of Exhibit I.

### **K. Debt Collection Improvement Act of 1996**

As a Federal entity, TSA is required to aggressively service and collect debts in accordance with the requirements established by the Debt Collection Improvement Act of 1996 (DCIA). The DCIA centralized the governmentwide collection of debt with U.S. Department of the Treasury (Treasury). Treasury's Financial Management Services (FMS) uses a variety of collection tools to encourage debtors to repay the federal government. Federal agencies are required to refer eligible delinquent non-tax debts to Treasury for debt collection action, if they have not been successful in collecting those debts.

Our procedures identified that policies and procedures were not in place throughout the entire year to ensure Dunning Notices were promptly sent to debtors in accordance with Treasury guidelines. Dunning Notices are the first step before debt can be referred to Treasury's FMS.

*Recommendation:* We recommend that TSA review the full requirements of the DCIA and establish policies and procedures to ensure Dunning Notices are sent to debtors in a timely manner with interest, penalties and administrative charges properly assessed.

### **L. Improper Payments Information Act of 2002**

TSA is required to comply with the Improper Payments Information Act of 2002 (IPIA). The IPIA requires agencies to review all programs and activities they administer annually and identify those that may be susceptible to erroneous payments. Where the risk of erroneous payments is significant, agencies must estimate the annual amounts of erroneous payments and report on the estimates.

DHS has delegated these responsibilities to each of its primary components. In FY 2006, we noted that TSA did not assess one unique organizational segment's programs and activities for susceptibility to erroneous payments.

*Recommendation:* We recommend that TSA adhere to the IPIA guidance and ensure all programs and activities are assessed for susceptibility to erroneous payments.

### **M. Anti-deficiency Act**

TSA management notified us of an *Anti-deficiency Act* violation that occurred in the TSA, Expenses Account, Treasury Symbol – 70X0508 in an amount up to \$195,000,000. As discussed below, the violation was an over-obligation of this appropriation. The DHS Secretary has reported the violation to the President of the United States, the President of the Senate, the Speaker of the House of Representatives, and the Comptroller General, as required by 31 U.S.C. section 1351.

TSA was created as an operating unit of the Department of Transportation (DOT) in fiscal year 2002. TSA's funding and operations were subsequently transferred to DHS in March 2003,

## Exhibit II – Compliance and Other Matters

pursuant to the *Homeland Security Act of 2002*. During this period of entity start-up, TSA was in the process of building its financial and other key management staff.

After establishing certain budgetary authority within its DHS general ledger through a journal entry, the related individual purchase orders were then recorded and the journal entry reversed in March 2003. A subsequent transaction in May 2003 erroneously reversed the initial journal entry amount again. This second journal entry reversal, which led to the *Anti-deficiency Act* violation, overstated TSA's budget authority by underreporting its existing obligations.

In fiscal year 2003, we selected a sample for test work, from the population of undelivered orders and related journal entries recorded in the general ledger as of September 30, 2003. The erroneous May 2003 journal entry was not a part of this sample.

In 2006, TSA posted a correcting journal entry to its general ledger to record the remaining balance of the erroneously-reversed obligations. TSA has begun efforts to (a) transfer funding from existing sources and (b) identify the responsible party to determine whether disciplinary measures are warranted. A separate notification of the final determination is still required under 31 U.S.C. section 1351.

*Recommendation:* We recommend that TSA continue to implement the remedial actions resulting from its internal investigation of this matter.



Transportation  
Security  
Administration

MAR - 9 2007

Richard L. Skinner  
Inspector General  
Department of Homeland Security  
245 Murray Drive, Building 410  
Washington, DC 20528

Dear Mr. Skinner:

This letter is our response to KPMG's audit of the Transportation Security Administration (TSA) balance sheet as of September 30, 2006. We fully concur with KPMG's findings and are taking action to implement all of the recommendations contained in the report.

The auditor's report has cited a number of serious material internal control weaknesses. In accordance with the direction provided by Secretary Chertoff and the Department of Homeland Security's Chief Financial Officer, TSA has developed comprehensive Corrective Action Plans (CAPs) to remediate these weaknesses in the years ahead. In developing the CAPs, TSA conducted a thorough analysis of each weakness to identify the root cause in the context of systems, process, people, and policy. We report our CAP progress to the Department on a quarterly basis and will be glad to discuss our progress with your auditors upon request.

On behalf of the Assistant Secretary, I would like to acknowledge the efforts by your staff and the KPMG team in completing this audit. While we continue to face serious financial management and accounting challenges, your report has highlighted the most critical issues and helped to focus our corrective action efforts for FY 2007 and later.

Sincerely,

A handwritten signature in blue ink, appearing to read "David R. Nicholson".

David R. Nicholson  
Assistant Administrator and Chief Financial Officer  
Finance and Administration

**UNITED STATES DEPARTMENT OF HOMELAND SECURITY  
TRANSPORTATION SECURITY ADMINISTRATION**

Management's Discussion and Analysis

(Unaudited)

September 30, 2006

**INTRODUCTION**

The United States Department of Homeland Security (DHS or Department) Transportation Security Administration (TSA or Administration), presents to the American public, Congress, the Office of Management and Budget (OMB), and the transportation industry the current performance of TSA's major programs and a brief description of how the public benefits from them.

The major developments in our program and financial activities and the progress and commitment we have made to meet our strategic goals are described in the following sections of this report.

*Management's Discussion and Analysis* consists of four sections:

- *Mission and Organization Structure* provides an overview of the Administration's mission, organization, and major program activities.
- *Performance Goals, Objectives, and Results* are designed to ensure that America's transportation security excels in efficiency in protecting the American people.
- *Financial Analysis* highlights TSA's FY 2006 budgetary funding sources, discusses TSA's efforts to improve its financial management systems and procedures, and provides an analysis of TSA's Balance Sheet and stewardship information.
- *Analysis of Systems, Controls, and Compliance* summarizes TSA's FY 2006 Federal Managers' Financial Integrity Act Statement of Assurance. TSA's efforts to comply with the Federal Financial Management Improvement Act and the Improper Payments Information Act are also discussed.

The *Balance Sheet and Related Footnotes* are an important tool in promoting and improving accountability and stewardship over the public resources entrusted to the Administration. Statement preparation provides accurate and reliable information used in assessing performance and allocating resources.

*Required Supplementary Stewardship Information* relates to areas of Federal Government accountability over certain resources entrusted to TSA, and to certain responsibilities assumed by TSA, which are not measured in traditional financial reports. This information focuses on assets and investments made by the government for the benefit of the Nation.

Readers who would like to know more about TSA's programs and organization may access the TSA Internet website at <http://www.tsa.gov>.

**UNITED STATES DEPARTMENT OF HOMELAND SECURITY  
TRANSPORTATION SECURITY ADMINISTRATION**

Management's Discussion and Analysis

(Unaudited)

September 30, 2006

**MISSION AND ORGANIZATION STRUCTURE**

On November 19, 2001, Congress enacted the Aviation and Transportation Security Act (ATSA) which established the Transportation Security Administration. The mission of TSA is to prevent terrorist attacks and to protect the U.S. transportation network. In carrying out this mission, TSA strives always to be vigilant, effective and efficient. The organization is led by the Assistant Secretary of Homeland Security for TSA. Field operations, which consist primarily of aviation security activities, report to the headquarters program offices.

Effective at the beginning of FY 2006, the Federal Air Marshal Service (FAMS) was realigned within DHS from U.S. Immigration and Customs Enforcement to TSA. During FY 2006, the FAMS was fully integrated into TSA's organizational structure and is now a component of TSA's Law Enforcement / FAMS program.

Transportation systems move billions of people and trillions of dollars worth of goods each year and are vital to the Nation's economic prosperity, global competitiveness, and national security. TSA recognizes that terrorism risks are asymmetric, and traditional linear thinking can not address the uncertainty and complexity of risks of terrorist attacks on a large, interconnected, and adaptive network like the U.S. transportation system. As a result, TSA's security strategy focuses on implementing unpredictable, flexible and layered security measures. Within the U.S. aviation system, TSA has strengthened aviation security by deploying thousands of explosive detection systems (EDS), checkpoint x-ray devices, enhanced metal detectors, and explosive trace detection systems devices. However, the checkpoints constitute only one security layer among many others in place to protect the U.S. aviation system. Other layers include intelligence gathering and analysis, checking passenger manifests against watch lists, canine team at airports, federal air marshals, federal flight deck officers, flight crew self-defense training and more security measures both visible and invisible to the public.

TSA is also actively strengthening security in other modes of transportation. TSA is building security networks with its partners in other Federal agencies, state and local governments, and the private sector. Through its Transportation Security Network Management (TSNM) organization, TSA has a "one-stop shop" and networking hub for stakeholder outreach and policy coordination within and across the transportation modes. TSNM has created a seamless connection with those who have a stake in transportation security. General Managers have been appointed in TSNM for each critical transportation area – airlines, airports, business management, cargo, general aviation, highways, international, maritime, mass transit, network integration, pipelines, and rail.

**MAJOR PROGRAM ACTIVITIES**

The following gives a general overview of how TSA endeavors to strengthen the security of, and reduce the risk associated with, the nation's transportation systems.

The Aviation Security program allows TSA to develop and deploy systems and programs to ensure air passengers and air cargo traveling through and entering in the United States are protected through a multi-layered security system. TSA improved collaborative efforts designed to provide an ever tightening security focus at our aviation nodes. Deployment of technology, increased regulatory inspections and effective use of local law enforcement within the airport environment are ongoing efforts, continuing to receive aggressive attention.

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Improving our ability to detect and deter the use of Improvised Explosive Devices through technology, training and operational testing is a key goal of this program. Increased and innovative use of canine units, Behavior Detection Officers and Bomb Appraisal Officers will also greatly enhance security and deterrence efforts.

The Law Enforcement / Federal Air Marshal Service (LE/FAMS) program promotes public confidence in our Nation's aviation and civil transportation systems through the effective risk-based strategic deployment of highly trained federal air marshals and other LE/FAMS law enforcement resources in both air and land-based mission related assignments. TSA continues to engage in an integrated global strategy to help deter terrorism worldwide, encourage the emergence of air marshal programs in other countries, and develop operational and training relationships with our international partners. TSA continued its participation in the Crew Member Self Defense Training and the Federal Flight Deck Officer programs. In addition, TSA continues to enhance cargo security operations in the aviation sector and train canine teams for use in the commercial passenger aviation, air cargo and mass transit modes, and is implementing the Force Multiplier Program (FMP) to leverage other Federal law enforcement officers flying armed on commercial air carriers.

Surface Transportation Security efforts include resources for TSA's security operations in all non-aviation modes of transportation. To enhance security in all modes of transportation, TSA initiated Multi-Modal Security Enhancement Teams (MMSET). MMSETs are used to enhance information management among Federal, state and local partners and the private sector. The current surge capability of the MMSET program is to deploy 250 FAMs, 500 Transportation Security Officers (TSO) and 30 canines within a 24 hour period. The mission of the MMSET is to protect the traveling public, deter criminal and terrorist activity, provide surveillance, and report and/or respond to suspicious activity. Different configurations of an MMSET are used to deter criminal and terrorist activity, provide surveillance, and build regional surge capability to the response of threats. The function of the MMSETs will be expanded to check immigration status. TSA will further enhance and expand its MMSET capability to support TSA's four concentric rings of security – securing infrastructure perimeter; enforcing security and surveillance detection; screening passengers, baggage, and cargo; and securing assets.

Transportation Threat Assessment and Credentialing serves as the lead for all name based terrorist threat assessments, background check and credentialing issues surrounding transportation industry workers, and domestic passengers. Key initiatives include Secure Flight, Registered Traveler (RT), and the Transportation Worker Identification Card (TWIC).

Transportation Security Support supports the operational needs of TSA's extensive airport/field and headquarters personnel and infrastructure. One recent initiative that is increasing utilization and effectiveness is the conversion of the Transportation Security Screener position to TSO. This conversion allows TSA to provide a more progressive career path and to better retain and strengthen the TSO workforce.

## **PERFORMANCE GOALS, OBJECTIVES, AND RESULTS**

The performance information contained within this report is reliable and complete in accordance with OMB standards:

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**DHS Strategic Goal = AWARENESS**

<b>Transportation Security Support Performance Goal:</b>	100 percent distribution of sensitive threat information relative to Department of Homeland Security / Transportation Security Administration components, field elements and stakeholders.					
<b>Performance Measure:</b>	Number of successful attacks resulting from mishandling or misinterpreting intelligence information received by TSA intelligence service.					
<b>Fiscal Year:</b>	<b>FY 2003 Actual</b>	<b>FY 2004 Actual</b>	<b>FY 2005 Actual</b>	<b>FY 2006 Target</b>	<b>FY 2006 Actual</b>	<b>FY 2006 Results</b>
<b>Actual:</b>	0	0	0	0	0	Met
<b>Description:</b>	This measure refers to any attack on the U.S. transportation system, which could have been prevented given viable resources, and was a result of TSA's intelligence program mishandling or misinterpreting intelligence information.					
<b>Explanation of Results:</b>	The results of this measure are indicators of how successful TSA is performing its mission by minimizing analytical errors and maximizing intelligence provisioning to customers and stakeholders. The measure greatly reflects on the partnership with the DHS Office of Intelligence and Analysis and the ability of the agency to communicate and operate within the Department. The public is well-served by preventing loss of life, property, and the financial burden otherwise incurred from failure.					

**DHS Strategic Goal = AWARENESS**

<b>Transportation Threat Assessment and Credentialing Performance Goal:</b>	Prevent known or suspected terrorist from gaining access to sensitive areas of the transportation system.					
<b>Performance Measure:</b>	Number of successful attacks to the transportation system that should have been prevented by the program.					
<b>Fiscal Year:</b>	<b>FY 2003 Actual</b>	<b>FY 2004 Actual</b>	<b>FY 2005 Actual</b>	<b>FY 2006 Target</b>	<b>FY 2006 Actual</b>	<b>FY 2006 Results</b>
<b>Actual:</b>	N/A	N/A	0	0	0	Met
<b>Description:</b>	This performance measure was developed in FY 2005; therefore data prior to FY 2005 is not applicable. This measure refers to any successful attack that could have been prevented, given current resources, by the sub-programs within Transportation Vetting and Credentialing (Secure Flight, Crew Vetting, Transportation Worker Identification Credential ("TWIC"), Registered Traveler, HAZMAT Trucker Background Checks, and Alien Flight School Checks).					
<b>Explanation of Results:</b>	In FY 2006, there were zero reported attacks on our national transportation system. TSA consistently performed effective vetting and credentialing requirements that prevented acts on terrorism on our national transportation system. The programs and processes associated with vetting and credentialing met the requirements and objectives of ensuring that those individuals using our Nation's transportation system did not endanger it or cause damage.					

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<b>DHS Strategic Goal = PREVENT and PROTECT</b>						
<b>Aviation Security Performance Goal:</b>	Reduce the probability of a successful terrorist or other criminal attack to the air transportation system by improved passenger and baggage screening processes.					
<b>Performance Measure:</b>	Level of the Customer Satisfaction Index (CSI - A) for Aviation Operations					
<b>Fiscal Year:</b>	<b>FY 2003 Actual</b>	<b>FY 2004 Actual</b>	<b>FY 2005 Actual</b>	<b>FY 2006 Target</b>	<b>FY 2006 Actual</b>	<b>FY 2006 Results</b>
<b>Actual:</b>	N/A	N/A	78%	81%	81%	Met
<b>Description:</b>	This performance measure was developed in FY 2005; therefore data prior to FY 2005 is not available. The CSI - A is a composite index incorporating data on security confidence, passenger surveys, and compliments/complaint data on screener performance.					
<b>Explanation of Results:</b>	In FY 2006, the score on the Customer Satisfaction Index for Aviation (CSI-A) reached 81 percent, a new level for customer satisfaction with screening operations at the Nation's security checkpoints. This score, when considered with other performance measures, indicates that TSA was able to perform necessary checkpoint screening operations preventing and protecting against adverse actions, while maintaining a high level of customer satisfaction. The FY 2006 target was set at 81% and TSA achieved that target.					

<b>DHS Strategic Goal = PREVENT and PROTECT</b>						
<b>Federal Air Marshals Performance Goal:</b>	Promote confidence in our nation's civil aviation system through the effective deployment of Federal Air Marshals to detect, deter, and defeat hostile acts targeting U.S. air carriers, airports, passengers, and crews.					
<b>Performance Measure:</b>	Number of successful terrorist and other criminal attacks initiated from commercial passenger aircraft cabins with Federal Air Marshal Service (FAMS) coverage.					
<b>Fiscal Year:</b>	<b>FY 2003 Actual</b>	<b>FY 2004 Actual</b>	<b>FY 2005 Actual</b>	<b>FY 2006 Target</b>	<b>FY 2006 Actual</b>	<b>FY 2006 Results</b>
<b>Actual:</b>	0	0	0	0	0	Met
<b>Description:</b>	This measure describes how many criminal attacks were initiated from commercial passenger aircraft cabins while at least one Federal Air Marshal was aboard. By meeting current targets, the FAMS program has promoted confidence in the civil aviation system and has helped to deter terrorists and criminals from committing hostile acts on the U.S. aviation system.					
<b>Explanation of Results:</b>	During FY 2006, there were no successful terrorist/criminal attacks initiated from commercial passenger aircraft cabins while at least one Federal Air Marshal was aboard. The presence of Federal Air Marshals within the aviation domain, specifically on commercial aircraft, has proven to be an effective deterrent that mitigates the threat of criminal attacks originating from passenger aircraft cabins. There is a reasonable expectation that the continued deployment of Federal Air Marshals will successfully defeat future terrorist and other criminal in-air attacks on commercial aircraft. This presence on commercial aircraft has also promoted general confidence in the civil aviation system as evidenced by the reported increases of passengers in scheduled daily U.S. carrier commercial flights which have reached or exceeded pre-9/11 levels.					



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<b>DHS Strategic Goal = PREVENT and PROTECT</b>						
<b>Surface Transportation Security Performance Goal:</b>	Reduce the probability of a successful terrorist or other criminal attack on surface transportation systems through the issuing of standards, compliance inspections, and vulnerability assessments.					
<b>Performance Measure:</b>	Percentage of nationally critical surface transportation assets or systems that have been assessed and have mitigation strategies developed based on those assessments.					
<b>Fiscal Year:</b>	<b>FY 2003 Actual</b>	<b>FY 2004 Actual</b>	<b>FY 2005 Actual</b>	<b>FY 2006 Target</b>	<b>FY 2006 Actual</b>	<b>FY 2006 Results</b>
<b>Actual:</b>	N/A	N/A	N/A	<b>Baseline</b>	31%	N/A
<b>Description:</b>	This measure was established and baselined in FY 2006; therefore data prior to FY 2006 is not applicable. This measure refers to the percentage of nationally critical surface transportation assets or systems that have been assessed and have mitigation strategies developed based on those assessments. TSA tracks these assessments through participation in the Federal Risk Assessment Working Group (FRAWG).					
<b>Explanation of Results:</b>	In previous years the results focused only on the number of assessments performed by TSA; in FY 2006 the results included assessments performed by other Federal agencies. The measure was revised this year to include data that is collected, and assessments made, by multiple Federal agencies to provide a more complete picture of the assets or systems assessed. Through participation in the FRAWG and direct communication with our Federal partners, TSA has visibility into the assessments conducted by other Federal agencies. With this enhancement, TSA has improved the management of the surface transportation assessment efforts conducted at the nationally critical surface transportation assets and systems.					

**PERFORMANCE RESULTS**

TSA's ability to achieve its mission, fulfill its performance goals, devise effective strategies, and allocate resources appropriately is enhanced by its understanding of historical trends and performance results. The following are some of the Administration's accomplishments during FY 2006 as they relate to the above-mentioned performance goals:

- **DHS Goals: Awareness, Prevent and Protect.** *Closed Circuit Cameras Benefit TSA and the Airport Community.* Portland, Oregon's airport is pursuing a plan with TSA regulatory staff to dramatically increase security monitoring capabilities of the airport environment. Portland's plan will allow TSA to share in the feed of the airport's camera system and permit TSA to expand coverage to effectively handle potential security situations, including security breaches. Sharing the system will allow TSA to meet its mission requirements without having to build a separate system.

In this example of partnership, better security service and a sound investment result from the well-developed working relationship between TSA, local airport security staff members and airport management team members. Under this type of plan, TSA envisions other airports installing systems like this with TSA

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financing. TSA will obtain the access and coverage it needs to do its job, with other TSA functions such as screening and compliance directly benefiting from having a real-time picture of overall airport operations. With that comes the immediate ability to recall incident data in very short order.

Public benefits result from overall airport closed circuit television security coverage being increased by this partnership with airports. Also, fiscally sound practices are instituted, thereby eliminating potential duplication and waste.

- **DHS Goals: Prevent and Protect.** *High Threat Urban Area Corridor Initiative.* Beginning in 2004, DHS and Department of Transportation partnered with freight railroad stakeholders to conduct security assessments of high threat urban area rail corridors. In addition, the Federal Railroad Administration (FRA) conducted security plan reviews on all hazardous material rail carriers. As a result of this collaborative effort, TSA and FRA developed a list of security action items based on the lessons-learned from the assessments and plan reviews. The agencies believed the security action items would have a high security impact and could be implemented quickly. Implementation would raise the security baseline for the transportation of toxic inhalation hazard (TIH) materials across the industry.

The draft action items were provided to industry for comment on March 30, 2006. Subsequently, a task force was formed under the aegis of the Critical Infrastructure Partnership Advisory Council (CIPAC) to refine the action items. Task force participants included Federal members of the Freight Rail Government Coordinating Council and private sector representatives of the freight rail industry, including the Association of American Railroads, the American Short Line and Regional Railroad Association, and the Class I railroads. As of September 2006, this initiative is ongoing.

On June 23, 2006 by joint letter, TSA and FRA formally issued a list of security action items intended to provide security recommendations to the TIH rail carrier industry. The action items are voluntary guidance that are expected to be implemented in varying degrees based on multiple factors—including the size of the operation and materials transported. The CIPAC task force will continue its work on remaining items from the initial list that need additional discussion to determine more specific operating parameters.

- **DHS Goals: Prevent and Protect.** *Mobile Security Checkpoint Pilot Program.* TSA, in partnership with the Maryland Transit Administration (MTA), conducted a Mobile Security Checkpoint (MSC) pilot program to screen Maryland Rail Commuter (MARC) passengers and their bags for explosive material. Passenger screening was conducted at the Dorsey Road MARC commuter rail station, weekdays from April 4-28, 2006 between 5 a.m. and 9 a.m. The MSC pilot was designed to determine the operational feasibility, effectiveness, and cost of commercially available screening technology installed in a mobile container. The results from the pilot will be used to determine in which environments this containerized checkpoint is suitable.

Every passenger had his or her baggage screened and then entered an Explosives Trace Portal (puffer) machine and a metal detector. This pilot program focused on searching for explosives; as a result, unlike airport screening, passengers were allowed to retain cell phones, keys, change and other small metal objects during the screening process. Special screening accommodations were made for persons with disabilities.

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TSOs from TSA's National Screening Force performed screening for the pilot, and a MARC Customer Service representative was available during the screening process to address any passengers concerns.

A Sentinel II Portal and a CEIA-brand Metal Detector were used during the pilot. A HI-SCAN 6046si (an X-ray explosives detector) and an Ionscan 400B (a trace explosives detector currently used in airports) were used to screen baggage.

- **DHS Goals: Prevent and Protect.** *Cooperative Relationship Leads to Increased Airport Security.* TSA's airport security oversight activities are not limited to inspection and monitoring of program rules and requirements. A substantial amount of effort is expended in outreach and in fostering improved security practices and procedures. At one airport, the shared concerns of TSA inspectors and airport officials for enhanced system security led to the implementation of several initiatives that exceed basic regulatory requirements. This airport's cooperative working relationship between airport officials and TSA inspectors has brought about key improvements including the installation of new security access controls and an enhanced security identification badge system.

Officials also determined that better security would result from a reduction in the number of access gates and in the installation of automated controls at several points. In another upgrade that exceeds regulatory minimums, secured areas of the airport are now monitored electronically by newly installed closed circuit television cameras that augment airport patrols and TSA inspections. In addition, perimeter security fencing has been upgraded and previously unprotected natural areas are secured by barbed wire fencing.

Moreover, the airport has expanded communications about airport security by publishing security and safety bulletins that focus on local issues of concern. These bulletins are published in non-technical terms to facilitate greater understanding. These efforts also extend to the travelers in the terminal who hear automated announcements informing the public about their security responsibilities concerning control of baggage and the reporting of suspicious activity.

## **FINANCIAL ANALYSIS**

### **PROGRAM BUDGET OVERVIEW**

TSA's budget authority is composed of appropriated and fee resources. The fee resources include two broad categories – aviation security fees from airline passengers and air carriers that offset TSA's appropriations, and direct fee-based programs, such as the credentialing fees. More than half of TSA's FY 2006 funding was realized from appropriations. TSA's budget for 2006 (net of rescissions) is listed below:

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**Transportation Security Administration Budget**

(Amounts in millions)

	<u><b>2006</b></u>
Appropriation, net of fees	\$ 4,182.0
Offsetting aviation security fee collections	1,921.3
Program fees and federal sources	<u>280.9</u>
Total	<u><u>\$ 6,384.2</u></u>

Most of TSA's funding is devoted to achieving overall security in the nation's airports. Other funding is devoted to transportation security for other transportation modes. TSA continues to implement a comprehensive aviation security program by continuing efforts to improve security at airport screening locations and speed the flow of passengers at these checkpoints.

**FINANCIAL MANAGEMENT**

During 2006, TSA continued to build and improve its financial management operations and controls. Significant progress was made in 2006 in the areas of:

- Management/Internal Control - TSA continues to improve our Internal Control Program implemented in FY 2005. This action supports compliance with the new requirement in the Department of Homeland Security Financial Accountability Act for an audit opinion on internal controls. The program assists leaders and managers throughout TSA in establishing effective management control systems to provide reasonable assurance that program objectives are met and public laws are complied with.
- Financial Analysis – TSA continues to increase the quality and visibility of financial data to support management decision making. Periodic review of internal reports for abnormal and unusual balances and improved communication with our accounting services provider has resulted in increased data reliability.
- FAMS Financial Integration – During FY 2006, TSA began integrating the budget and financial management functions of the FAMS with the rest of the agency. Effective October 1, 2006, TSA and FAMS accounting is performed using a single, integrated general ledger.

**ANALYSIS OF THE BALANCE SHEET**

To facilitate a reasonable comparison between FY 2005 and FY 2006, the FAMS FY 2006 financial data was excluded from the calculations for the following analysis. As of September 30, 2006, total assets decreased by about \$244 million as compared to the total assets as of September 30, 2005. TSA's assets mostly consist of its Fund Balance with Treasury (cash), capitalized property and equipment, and accounts receivable from the public. The decrease in total assets results from multiple factors, the most significant being depreciation of property and equipment and the return of appropriations offset by fee collections prior to fiscal year-end, as opposed to after year-end in the past, which reduces the Fund Balance with Treasury. The decrease also impacts the Net Position accounts.

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As of September 30, 2006, total liabilities decreased by about \$280 million as compared to the total liabilities as of September 30, 2005. TSA's liabilities mostly consist of accounts payable with the public, accrued payroll, accrued leave, and actuarial and payable amounts due to the Department of Labor for the Federal Employee Compensation Act (FECA). Reductions in accounts payable were partially offset by increases in the FECA-related liabilities. Accounts payable to the public decreased in part due to revised methodology for grants payable accruals.

## **ANALYSIS OF SYSTEMS, CONTROLS, AND COMPLIANCE**

### **FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT (FMFIA)**

TSA identified the following weaknesses and system non-conformances in its FY 2006 Federal Managers' Financial Integrity Act Assurance Statement.

During FY 2006, DHS, including TSA was required to assess two areas (Fund Balance with Treasury and Financial Reporting) in accordance with the OMB approved A-123 implementation plan for DHS.

#### **FMFIA Section 2 Material Weaknesses**

- **Performance Based Management throughout the TSA.** Improvements are required throughout TSA to improve processes for measuring performance and reporting on the Government Performance and Results Act.
  - Repeat finding from FY 2005. TSA continues to make progress in correcting this weakness with resolution anticipated by September 30, 2007.
- **Timely Payment of Vendor Invoices.** TSA processes to ensure vendor invoices are paid timely, in accordance with the Prompt Payment Act, require improvement. Inadequate system and business process controls resulted in TSA paying approximately \$1.5 million in late payment interest penalties during FY 2005.
  - Repeat finding from FY 2005. Internal controls initiated during FY 2006 have reduced interest penalties by over 75% from FY 2005 levels. Continued improvement will enable us to close this weakness in FY 2007.
- **Prior Year Financial Data Integrity.** Internal control processes to ensure TSA financial system data is reviewed, analyzed, and reconciled requires improvement.

#### **FMFIA Section 4 Systems Non-Conformances**

- **Automated controls to verify funds availability are required.** Current Financial System does not have the capability to electronically verify funds availability for all program managers and field users.

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- Repeat finding from FY 2005. This capability has been developed and is currently undergoing final testing and pilot implementation in the 1<sup>st</sup> quarter of FY 2007. Closeout of this weakness is anticipated in FY 2007.
- **United States Coast Guard (USCG) Finance Center (FINCEN) System weaknesses identified during prior audit impact TSA.** TSA receives Core Accounting and Financial System support from the USCG FINCEN. Open audit issues identified for USCG FINCEN directly impact TSA conformance with Government-wide financial system requirements. USCG reported Statement of No Assurance in FY 2006.
  - Repeat finding from FY 2005. This weakness is impacted by the multi-year USCG Financial Management Transformation Project initiated this year. TSA will monitor USCG remediation activities and implement compensating controls where possible.
- **Core Accounting System compliance with the US Standard General ledger.** Certain accounting processes in the USCG-owned Core Accounting System, used by TSA, do not comply with the U.S. Standard General Ledger at the transaction level. Areas of specific non-compliance include recording the purchase of property, plant, and equipment, and recording prior year adjustments.
  - Repeat finding from FY 2005. Funding constraints have delayed corrective action on this weakness. Development of the functional requirements to remediate this issue to be completed 3<sup>rd</sup> quarter FY 2007 with issue resolved by March 31, 2008.

The aforementioned financial systems non-conformances also prevent TSA from achieving full compliance with the Federal Financial Management Improvement Act of 1996 at this time.

#### **IMPROPER PAYMENTS INFORMATION ACT REPORTING**

During fiscal year 2006, TSA sampled payments made during fiscal year 2005 to determine the percentage of improper payments. For testing purposes, payments were categorized into the following programs: contractual non-grants, grants, travel, purchase card, and overnight delivery payments. In the area of contractual non-grants payments, 1.38% of the sample was determined to be improper. The error rate for grant payments was 1.21%. Automated payment processes and daily reconciliation for travel and purchase card payments and automated payment processes and weekly reconciliation for overnight delivery payments minimize risks of improper payments in these areas. Per Section 4.02 of DHS FY 2006 Performance and Accountability Report Guidance (Improper Payments Information Act Compliance Guidance), TSA is not required to test these types of payments.

Payments made during fiscal year 2006 will be tested during fiscal year 2007, utilizing the same statistical sampling processes conducted during fiscal year 2006. This process will be repeated during fiscal years 2008 and 2009. Results should continue to improve during this time period due to maturation of payment center processes and further refinement of internal controls.

#### **LIMITATIONS OF THE BALANCE SHEET**

The balance sheet should be read with the realization that it is for a component of the United States Government, a sovereign entity. It has been prepared to report the financial position for TSA, pursuant to the requirements of

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31. U.S.C. 3515(b). While the balance sheet has been prepared from the books and records of TSA in accordance with U.S. Generally Accepted Accounting Principles (GAAP) for Federal entities and in the format prescribed by OMB, the balance sheet is in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records.

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Consolidated Balance Sheet

As of September 30, 2006

(Dollars in thousands)

<b>ASSETS</b>	<b>2006 (unaudited)</b>
Intragovernmental	
Fund Balance with Treasury (Note 2)	\$ 2,633,251
Accounts Receivable, Net (Note 4)	4,470
Advances and Prepayments	3,173
Total Intragovernmental	2,640,894
Accounts Receivable, Net (Note 4)	371,749
General Property and Equipment, Net (Note 3)	1,106,814
Advances and Prepayments	1,128
<b>Total Assets</b>	\$ 4,120,585
<b>LIABILITIES</b>	
Intragovernmental:	
Accounts Payable	\$ 42,581
Other (Notes 5 and 6)	227,153
Total Intragovernmental	269,734
Accounts Payable	564,644
Advances from Others	750
Actuarial FECA Liabilities (Note 5)	598,078
Accrued Payroll and Leave	117,937
Accrued Unfunded Leave (Note 5)	129,586
Other (Notes 5 and 6)	4,925
<b>Total Liabilities</b>	1,685,654
Commitments and Contingencies (Notes 7 and 9)	—
<b>NET POSITION</b>	
Unexpended Appropriations (Note 12)	1,647,395
Cumulative Results of Operations-Earmarked Funds (Note 8)	267,810
Cumulative Results of Operations-Other Funds (Note 12)	519,726
<b>Total Net Position</b>	2,434,931
<b>Total Liabilities and Net Position</b>	\$ 4,120,585

See accompanying notes to Consolidated Balance Sheet.



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Notes to the Consolidated Balance Sheet

(Unaudited)

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**(1) Summary of Significant Accounting Policies**

**(a) Reporting Entity**

TSA was created by the *Aviation and Transportation Security Act*, Public Law (PL) 107-71, (the Act), enacted on November 19, 2001, as an agency within the Department of Transportation (DOT). The Act transferred the Civil Aviation Security functions and responsibilities of the Federal Aviation Administration (FAA) to TSA not later than 3 months after the date of enactment. TSA assumed responsibility for the Civil Aviation Security functions from the FAA on February 13, 2002. TSA's mission is to develop transportation security policies and programs that contribute to providing secure transportation for the American public. Effective March 1, 2003, TSA transferred to the newly created Department of Homeland Security (DHS), as mandated by the *Homeland Security Act of 2002, PL 107-296*. On October 1, 2005, the Federal Air Marshal Service (FAMS) transferred to TSA from the Immigration and Customs Enforcement bureau of DHS. As a program within TSA, the FAMS financial data is included in the consolidated balance sheet.

**(b) Basis of Presentation**

The consolidated balance sheet has been prepared from the accounting records of TSA in accordance with U.S. generally accepted accounting principles and the DHS accounting policies, which are summarized in this note.

Intragovernmental activities result from activity with other Federal agencies. All other accounts result from activity with parties outside the Federal government.

The TSA consolidated balance sheet is reported using the accrual basis of accounting. In accordance with OMB Circular No. A-136, intra-entity transactions and balances have been eliminated from the consolidated balance sheet.

**(c) Budgets and Budgetary Accounting**

TSA incurs obligations for specified purposes. TSA recognizes budgetary resources as assets when cash (funds held by the Department of the Treasury (Treasury)) is made available through Treasury's General Fund warrants or as authorized by Congress through Continuing Resolution.

**(d) Basis of Accounting**

Transactions are recorded on both the accrual basis of accounting and on a budgetary basis. Under the accrual method, revenues are recognized when earned, and expenses are recognized when incurred, without regard to receipt or payment of cash. Budgetary accounting facilitates compliance with legal constraints and controls over the use of Federal funds.

**(e) Revenues and Other Financing Sources**

Congress enacted one-year, multi-year, and no-year appropriations to be used, within statutory limits, for operating and capital expenditures. Additional amounts are obtained from security fees

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assessed on the public and air carriers pursuant to PL 107-71 and from other federal agencies for services performed by TSA and on their behalf.

**(f) *Fund Balance with Treasury***

TSA does not maintain cash in commercial bank accounts or foreign currency balances. Treasury processes cash receipts and disbursements. Fund Balance with Treasury represents amounts remaining as of September 30, 2006 and is available to pay current liabilities and finance authorized purchases.

**(g) *Accounts Receivable***

Accounts receivable with the public consists of amounts owed to TSA that arise from security fees assessed on the public and air carriers pursuant to PL 107-71. An allowance for doubtful accounts is based on specific identification and analysis of outstanding balances for reporting purposes. The allowance is adjusted accordingly at the time of collection or write off during the fiscal year. Accounts receivable is reported net of allowance amounts.

Intragovernmental accounts receivable represent amounts due from other Federal agencies for reimbursable work such as investigative services. All intragovernmental receivables are considered fully collectible.

**(h) *General Property and Equipment, Net***

Effective March 1, 2003, the capitalization threshold for property and equipment, with an estimated useful life of two years or more was raised to \$50,000. Prior to that date, the capitalization threshold was \$25,000 and property and equipment was depreciated over a seven year useful life. DHS instructed TSA that capitalized property and equipment prior to March 1, 2003, will continue to be recorded using the \$25,000 threshold and depreciated over a 7 year period. Property and equipment with an acquisition cost of less than \$50,000 is expensed when purchased.

Personal property is depreciated using the straight-line method over a useful life, determined for each general asset category, which is generally five years to seven years. Depreciation and amortization commences the first month after the asset is placed in service.

Progress payments made pursuant to firm contracts for the purchase of a capital asset are recorded in a capital asset account. However, the asset is not subject to depreciation until such time as TSA takes delivery of the asset and the asset is placed in service.

**(i) *Advances and Prepayments***

Payments made in advance of the receipt of goods and services are recorded as advances or prepayments at the time of prepayment and recognized as expenses or capitalized when the related goods and services are received.

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**(j) Liabilities**

Liabilities represent amounts to be paid by TSA as a result of a transaction or event that has already occurred. However, no liability can be liquidated by TSA absent an appropriation or offsetting collection. Liabilities for which an appropriation has not yet been enacted are, therefore, classified as unfunded liabilities.

TSA awards grants and cooperative agreements to State and local governments, universities, nonprofit organizations and private sector companies to enhance and ensure the security of passenger and cargo transportation by air, land, or sea. The related grant liability accrual is estimated using a change of expended percentage applied to the undelivered order amount.

**(k) Commitments and Contingencies**

TSA recognizes losses for contingent liabilities when such losses are probable and estimable.

**(l) Annual, Sick, and Other Leave**

Annual leave is accrued as it is earned, and the accrual is reduced as leave is taken. At each bi-weekly pay period, the balance in the accrued annual leave account reflects the latest pay rates and unused hours of leave. To the extent that appropriations are not available to fund annual leave earned but not taken, funding will be obtained from future financing sources. Sick leave and other types of nonvested leave are expensed as used.

**(m) Benefit Plans**

Employees who participate in the Civil Service Retirement System (CSRS) are beneficiaries of TSA's matching contribution equal to 8.51% of pay to their annuity account in the Civil Service Retirement and Disability Fund.

On January 1, 1987, the Federal Employees' Retirement System (FERS) went into effect pursuant to PL 99-335. Most Federal employees hired after December 31, 1983 are automatically covered by FERS and Social Security. Employees hired prior to January 1, 1984 could elect either to join FERS and Social Security or to remain in CSRS. A primary feature of FERS is that it offers a savings plan to which TSA automatically contributes 1% of pay and matches any employee contribution up to an additional 4%. For FERS participants, TSA also contributes the employer's matching share for Social Security.

TSA does not report CSRS or FERS assets, accumulated plan benefits, or unfunded liabilities, if any, applicable to its employees. Reporting such amounts is the responsibility of Office of Personnel Management (OPM).

The majority of TSA employees are authorized to participate in the Federal Employees Health Benefits (FEHB) program and the Federal Employees' Group Life Insurance (FEGLI) program, which are administered by OPM.

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**(n) *Imputed Financing Sources and Costs***

TSA recognizes as imputed financing sources and costs the amount of accrued pension and post retirement benefit expense for current employees, insurance payments, and judgment fund payments. The assets and liabilities associated with such payments are the responsibility of OPM, Department of Labor (DOL), and Department of Justice (DOJ).

**(o) *Net Position***

Net position is the difference between assets and liabilities and comprises unexpended appropriations and cumulative results of operations.

Unexpended appropriations represent the amount of unobligated and unexpended budget authority. Unexpended appropriations are reduced for appropriations used and adjusted for other changes in budgetary resources, such as transfers and rescissions.

Cumulative results of operations represent the net results of operations since inception plus the cumulative amount of prior period adjustments. This includes the cumulative amount of donations and transfers of assets in and out without reimbursement.

**(p) *Use of Estimates***

TSA has made certain estimates and assumptions relating to the reporting of assets and liabilities and the note disclosures of the consolidated balance sheet. Actual results could differ from these estimated amounts. Significant estimates include the allowance for uncollectible accounts receivable and accounts payable.

**(q) *Tax Exempt Status***

As an agency of the Federal Government, TSA is exempt from all income taxes imposed by any governing body whether it is a Federal, state, commonwealth, local, or foreign government.

**(r) *Federal Employee Compensation Benefits***

The Federal Employees Compensation Act (FECA) authorizes income and medical cost protection to covered federal civilian employees who are injured on the job or who have incurred a work-related occupational disease, and to beneficiaries of deceased employees whose death is attributable to a job-related injury or occupational disease. FECA benefit claims for TSA employees are initially paid by DOL and subsequently reimbursed by TSA.

TSA's FECA liability consists of two components: (1) accrued FECA liabilities and (2) actuarial FECA liabilities. Accrued FECA liabilities are claims paid by the DOL but not yet billed to or paid by TSA. Estimated future costs are determined by applying actuarial procedures to anticipated future costs. The DOL is responsible for calculating the actuarial FECA liability of future compensation benefits for all federal agencies. These benefits include the liability for death, disability, medical, and miscellaneous costs for approved compensation cases. This liability is determined using a paid-losses extrapolation method calculated over a 37-year period. This method

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utilizes historical benefit payment patterns that relate to a specific period. Projected annual benefit payments are discounted to present value. The resulting liability is then distributed by DOL to each benefiting agency. The DHS calculates and distributes each bureau's respective portion of the total DHS actuarial liability.

The actuarial FECA liability is recorded for financial reporting purposes only and is an extended future estimate of costs which will not be obligated against budgetary resources until the year in which the cost is actually billed to the TSA.

**(s) *Non-Entity Assets***

Non-entity assets consist of the funds assessed and collected from interest, fines, and penalties. TSA has no authority to use these funds. The funds are deposited and maintained in the General Fund Receipt Accounts. Sections 31-Code of Federal Regulations (CFR)-900 and 49-CFR-89 provide TSA the authority to impose interest, fines, and penalties. The custodial amounts collected are incidental to TSA's operations.

**(t) *Earmarked Funds***

In 2006, TSA has reported the net position for earmarked funds separately from other funds on the consolidated balance sheet and disclosed certain balances of these funds in the notes. This new method was adopted in accordance with the provisions of the Federal Accounting Standards Advisory Board's Statement of Federal Financial Accounting Standards (SFFAS) No. 27, *Identifying and Reporting Earmarked Funds*, which became effective October 1, 2005. This new standard amended SFFAS No.7, *Revenue and Other Financing Sources*, by:

- elaborating the special accountability needs associated with dedicated collections;
- separating dedicated collections into two categories – earmarked funds and fiduciary activity; and
- defining and providing accounting and reporting guidance for earmarked funds.

See Note 8 for specific required disclosures related to TSA's earmarked funds.

**(u) *Other Assets and Liabilities***

The consolidated balance sheet has been prepared using the guidance provided in the Office of Management and Budget (OMB) Circular A-136, "Financial Reporting Requirements". In OMB Circular A-136, Other Assets includes Advances and Prepayments. Other Liabilities consists of Accrued FECA Liabilities, Custodial Liabilities, Accrued Payroll and Benefits, Contingent Liabilities, Accrued Annual and Compensatory Leave Liabilities, Deferred Revenue, and Seized Cash and Investments. To enhance reporting consistency and properly reflect the materiality of certain items, TSA disaggregated Other Assets and Other Liabilities on the balance sheet. Note 6 shows the detail of items that have been reported as Other Liabilities on the balance sheet, and Note 10 provides a Balance Sheet Crosswalk to OMB Circular A-136 classifications.

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**(2) Fund Balance with Treasury**

Fund Balance with Treasury as of September 30, 2006 consists of the following (dollars in thousands):

	<b>2006 (unaudited)</b>
Fund Balances:	
Appropriated Funds	\$ 2,344,322
Other Fund Types	288,929
Total	\$ 2,633,251
Status of Fund Balance with Treasury:	
Unobligated Balance Available	\$ 303,535
Unobligated Balance Not Available	73,975
Obligated Balance Not Yet Disbursed	2,274,140
Non-Budgetary	(18,399)
Total	\$ 2,633,251

The Fund Balance with Treasury is comprised of the aggregate amounts of the entity's accounts with Treasury for which TSA is authorized to make expenditures and pay liabilities. Other fund types include Suspense Accounts, which temporarily hold collections pending clearance to the applicable account, and Deposit Funds, which are established to record amounts held until ownership is determined. It also includes \$4.892 million in General Fund Receipt accounts which are non-entity assets.

**(3) General Property and Equipment, Net**

General Property and equipment balances as of September 30, 2006 consists of the following (dollars in thousands):

Major classes	Useful lives	Acquisition value	Accumulated depreciation	Net book value
Equipment	5 - 7	\$ 2,119,076	\$ (1,018,694)	\$ 1,100,382
Construction in progress	N/A	1,393	0	1,393
Leasehold improvements	9	5,039	0	5,039
Total		\$ 2,125,508	\$ (1,018,694)	\$ 1,106,814

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**(4) Accounts Receivable, Net**

Accounts receivable balances as of September 30, 2006 consists of the following (dollars in thousands):

	<b><u>2006 (unaudited)</u></b>
Intragovernmental:	
Accounts receivable	\$ <u>4,470</u>
Total intragovernmental accounts receivable	<u><u>4,470</u></u>
With the public:	
Accounts receivable	535,390
Allowance for uncollectible accounts	(170,296)
Interest and penalties	<u>6,655</u>
Total accounts receivable with the public	<u><u>371,749</u></u>
Total accounts receivable	\$ <u><u>376,219</u></u>

The intragovernmental accounts receivable balance consists of reimbursable agreement activity with other DHS bureaus, Immigration and Customs Enforcement (ICE) and Science and Technology (S&T), owed to TSA.

Interest and penalties of approximately \$6.655 million represents non-entity assets.

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**(5) Liabilities not Covered by Budgetary Resources**

TSA's liabilities not covered by budgetary resources as of September 30, 2006 consist of the following (dollars in thousands):

	<u><b>2006 (unaudited)</b></u>
Intragovernmental:	
Accrued FECA liabilities	\$ 140,977
Other employment related liability	67,015
Total intragovernmental liabilities	<u>207,992</u>
Accrued unfunded leave	129,586
Actuarial FECA liabilities	598,078
Other employment related liability	201
Total public liabilities	<u>727,865</u>
Total liabilities not covered by budgetary resources	935,857
Total liabilities covered by budgetary resources	<u>749,797</u>
Total liabilities	\$ <u>1,685,654</u>



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**(6) Other Liabilities**

TSA's other liabilities as of September 30, 2006 consist of the following (dollars in thousands):

	<b>Noncurrent liabilities (unaudited)</b>	<b>Current liabilities (unaudited)</b>	<b>Total (unaudited)</b>
Intragovernmental:			
Advances from others	\$ 0	\$ 88	\$ 88
Accrued FECA liabilities	83,471	57,506	140,977
Employer contributions and payroll taxes payable	0	19,073	19,073
Other employment related liability	0	67,015	67,015
Total other intragovernmental liabilities	83,471	143,682	227,153
With the public:			
Custodial liability	0	11,922	11,922
Liability for deposit and clearing funds	0	(10,506)	(10,506)
Other employment related liability	0	3,509	3,509
Total other liabilities with public	0	4,925	4,925
Total other liabilities	\$ 83,471	\$ 148,607	\$ 232,078

Other Employment Related Liabilities consist of Unfunded Employment Related Liabilities such as benefits.

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**(7) Commitments and Contingencies**

There are several claims, which may be asserted against TSA regarding contractual agreements. There is currently one case where an unfavorable outcome is reasonably possible for which an amount cannot be estimated. For all other cases where an unfavorable outcome is reasonably possible the potential loss is between \$1.1 million and \$16 million. However, the government anticipates a favorable outcome.

As of September 30, 2006, TSA has the following types of agreements that have potential contingent liabilities:

- 1) *Letters of Intent for Modifications to Airport Facilities* – TSA entered into Letters of Intent 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. In addition, each airport shall have title to any improvements to its facilities. During fiscal year 2006, \$240 million was appropriated and 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 received invoices or documentation for costs incurred and paid in a total of \$335.4 million related to these agreements.

The amounts requested under these letters of intent may differ significantly from the original estimates and, therefore, TSA could ultimately pay substantially more than originally estimated.

- 2) *Contract options with vendors* – TSA entered into contracts with options in FY 2004 that provide TSA with the unilateral right to purchase additional services and or equipment or to extend the contract terms. Exercising these rights would require the obligation of funds in future years.

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**(8) Earmarked Funds**

TSA has the following two special fund receipt accounts that are earmarked funds.

**Aviation Security Capital Fund**

Fund Description. In FY 2005, P.L. 108-176 established the Aviation Security Capital Fund to finance projects to integrate explosive detection equipment into airport baggage handling systems. In accordance with P.L. 108-76, the first \$250 million in aviation security fees collected by TSA is transferred into this fund. These collections, and the associated expenditures made against them, are tracked through a Special Fund account.

Sources of Revenue. Amounts in this fund are collected as fees from the traveling public and the airline industry. They represent an inflow of resources to the government. In FY 2006, a total of \$250 million was collected in this fund.

Changes. There has been no change in legislation related to this fund during or subsequent to the reporting period and before the issuance of the financial statements.

**Unclaimed Money Fund**

Fund Description. Unclaimed money is money that passengers inadvertently leave behind at airport screening checkpoints during screening. In most cases, the monies are coins that passengers empty from their pockets so the metal detectors do not sound. Prior to FY 2005, receipts of unclaimed money were deposited into Treasury's miscellaneous receipt account. In the FY 2005 DHS Appropriation Act (P.L. 108-334), TSA received statutory budget authority to expend the funding for purposes of providing Civil Aviation Security. Accordingly, beginning in FY 2005, the receipts of unclaimed money were deposited into a Special Fund account so that the resources could be easily tracked and subsequently expended.

Sources of Revenue. Amounts in this fund are collected as involuntary donations from the traveling public. They represent an inflow of resources to the government. In FY 2006, a total of \$359 thousand was collected in this fund.

Changes. There has been no change in legislation related to this fund during or subsequent to the reporting period and before the issuance of the financial statements.

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(Unaudited)

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Condensed Information for Earmarked Funds (Unaudited)

TSA's Earmarked Funds as of September 30, 2006 consist of the following (dollars in thousands):

<b>Balance Sheet</b>	<u>Aviation Security Capital Fund</u>	<u>Unclaimed Money Fund</u>	<u>Combined</u>
<b>Assets</b>			
Fund Balance with Treasury	\$ 306,657	\$ 670	\$ 307,327
<b>Total Assets</b>	<u>306,657</u>	<u>670</u>	<u>307,327</u>
<b>Liabilities and Net Position</b>			
<b>Liabilities</b>			
Accounts Payable	\$ 39,517	-	\$ 39,517
Total Liabilities	<u>39,517</u>	<u>-</u>	<u>39,517</u>
<b>Net Position</b>			
Cumulative Results of Operations	<u>267,140</u>	<u>670</u>	<u>267,810</u>
<b>Total Liabilities and Net Position</b>	<u>\$ 306,657</u>	<u>\$ 670</u>	<u>\$ 307,327</u>

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**(9) Leases**

TSA has a total of 607 occupancy agreements with the General Services Administration for space in airports or surrounding areas. In addition, TSA has seven lease agreements with the public; they are TSA Headquarters, Cabot Tech, Clark County Department of Aviation, Gerald R. Ford International Airport, Airport Corporate Center, Airport Mini-Storage LLC, and Massport Administrative Office as well as 21 FAMS lease agreements with the public consisting of the FAMS Headquarters lease in Reston, VA and 20 field offices. Lease expenses were \$110 million in FY 2006.

Operating Leases:

Future payments consist of the following (dollars in thousands):

Fiscal year:	
2007	\$ 113,607
2008	80,160
2009	63,167
2010	53,498
2011	48,051
After 2011	<u>103,127</u>
Total	\$ <u><u>461,610</u></u>

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(Unaudited)

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**(10) Balance Sheet Crosswalk to OMB Circular A-136 Classifications**

TSA's balance sheet is presented in a format which varies from the format prescribed by OMB Circular A-136. The following table shows reclassification adjustments needed to present the Balance Sheet in the OMB Circular A-136 format (dollars in thousands):

As of September 30, 2006	As Presented	Reclassification		OMB A-136
		Debit	Credit	
<b>ASSETS</b>				
Intragovernmental				
Fund Balance with Treasury	\$2,633,251	\$ -	\$ -	\$2,633,251
Accounts Receivable, Net	4,470	-	-	4,470
Advances and Prepayments	3,173	-	3,173	-
Other	-	3,173	-	3,173
<b>Total Intragovernmental</b>	<b>2,640,894</b>	<b>3,173</b>	<b>3,173</b>	<b>2,640,894</b>
Accounts Receivable, Net	371,749	-	-	371,749
General Property and Equipment, Net	1,106,814	-	-	1,106,814
Advances and Prepayments	1,128	-	1,128	-
Other	-	1,128	-	1,128
<b>Total Assets</b>	<b>4,120,585</b>	<b>4,301</b>	<b>4,301</b>	<b>4,120,585</b>
<b>LIABILITIES</b>				
Intragovernmental:				
Accounts Payable	42,581	-	-	42,581
Other	227,153	-	-	227,153
<b>Total Intragovernmental</b>	<b>269,734</b>	<b>-</b>	<b>-</b>	<b>269,734</b>
Accounts Payable	564,644	-	-	564,644
Advances from Others	750	750	-	-
Actuarial FECA Liabilities	598,078	598,078	-	-
Federal Employee and Veteran Benefits	-	-	598,078	598,078
Accrued Payroll and Leave	117,937	117,937	-	-
Accrued Unfunded Leave	129,586	129,586	-	-
Other	4,925	-	248,273	253,198
<b>Total Liabilities</b>	<b>1,685,654</b>	<b>846,351</b>	<b>846,351</b>	<b>1,685,654</b>
Commitments and Contingencies	-	-	-	-
<b>NET POSITION</b>				
Unexpended Appropriations	1,647,395	-	-	1,647,395
Cumulative Results of Operations-Earmarked Funds	267,810	-	-	267,810
Cumulative Results of Operations-Other Funds	519,726	-	-	519,726
<b>Total Net Position</b>	<b>2,434,931</b>	<b>-</b>	<b>-</b>	<b>2,434,931</b>
<b>Total Liabilities and Net Position</b>	<b>4,120,585</b>	<b>846,351</b>	<b>846,351</b>	<b>4,120,585</b>

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**(11) Anti-Deficiency Act Violation**

In August 2006, TSA identified a potential violation of the Anti-Deficiency Act (ADA) (31 USC 1341(a)) in its FY 2002-2003 Expenses Account, Treasury Appropriation Fund Symbol 70X0508. TSA immediately reported the matter to the DHS Chief Financial Officer and was directed to complete a preliminary review within 90 days. As a result of the review, TSA found that legal obligations in the 70X0508 account had been underreported, resulting in actual obligations exceeding available budget authority in this account in an amount of approximately \$195 million as of September 30, 2006. This situation was caused by an erroneous journal entry recorded during the migration of TSA's financial data from the Department of Transportation to DHS in FY 2003. This erroneous journal entry resulted in the underreporting of obligations, allowing the ADA violation to occur in FY 2004. DHS provided formal notification of the violation to the President of the United States, Congressional Leadership, and the Comptroller General in December 2006.

In order to accurately reflect the financial implications of the legal obligations that had been underreported in prior years, TSA recorded a year-end budgetary entry to increase obligations by \$248.1 million and decrease budget authority by an identical amount in the Expenses Account (70X0508), resulting in a final FY 2006 year-end account balance of \$(195) million. This entry had no effect on TSA's Consolidated Balance Sheet as of September 30, 2006.

In order to ensure that adequate resources are available to meet anticipated expenditures from existing obligations for contracts and grants, TSA has requested legislative authority to transfer unobligated balances from TSA's Aviation Security and Transportation Security Support Accounts to its Expenses Account. This request is fully offset through transfers of unobligated balances currently available to TSA and will not increase overall federal spending or the federal deficit. In February 2007, this authority was enacted into law. TSA will utilize this authority by September 30, 2007 to ensure the account has sufficient resources to meet anticipated expenditures.

Because the erroneous journal entry that led to this violation was made in FY 2003 and was not discovered and corrected until FY 2006, TSA's FY 2003 and FY 2004 Consolidated Financial Statements should not be relied upon. In addition, TSA will not issue restated consolidated financial statements for FY 2003 and FY 2004, and TSA did not issue stand-alone financial statements in FY 2005.

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(Unaudited)

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**(12) Prior Period Adjustment due to an Error**

In April 2007, TSA completed a review and reconciliation of its Aviation Security appropriations. As a result of this process, TSA identified an error in recording Aviation Security fees from FY 2002 through 2005 and an error in recording a transfer at the inception of DHS that caused the Unexpended Appropriations (Cumulative) account to be understated by \$588 million and the Cumulative Results of Operations account to be overstated by \$588 million. In addition, smaller adjustments were made to correct invalid data in Accounts Receivable and Accounts Payable. These additional adjustments decreased the Cumulative Results of Operations by \$1.3 million.

The fee related error was the result of TSA's understanding that the Aviation Security fee collections were to be returned to the U.S. Treasury and TSA was to retain the entire amount of its Aviation Security appropriation, rather than reducing it by the amount of Aviation Security fees collected. This understanding resulted in understated balances in the Unexpended Appropriations (Cumulative) account and overstated balances in the Cumulative Results of Operations account. As a result of the misstated balances, TSA sought guidance in 2006 from OMB, the U.S. Treasury and the DHS General Counsel to re-interpret legislative language and derive the proper accounting treatment for recording its Aviation Security fees. In March 2007, OMB issued a memorandum which confirmed and clarified earlier guidance that TSA was to return to the U.S. Treasury unexpended appropriations equal to the amount of Aviation Security fees collected. This process is treated as offsetting collections.

Implementing the new guidance and incorporating the adjustments discussed above, returns the Net Position accounts to their correct balances and rectifies the cumulative effects of the erroneous accounting treatment. The effects of these changes to the Net Position accounts are shown below:

Changes in the Net Position at September 30, 2006  
(Amounts in Thousands)

	<u>Unexpended Appropriations</u>	<u>Cumulative Results of Operations</u>		<u>Total</u>
		<u>Others</u>	<u>Earmarked</u>	
Pre Adjusted Balance:	\$ 1,059,329	\$ 1,106,519	\$ 267,810	\$ 2,433,658
Adjustments:	<u>588,066</u>	<u>(586,793)</u>	<u>-</u>	<u>1,273</u>
Adjusted Balance:	<u>\$ 1,647,395</u>	<u>\$ 519,726</u>	<u>\$ 267,810</u>	<u>\$ 2,434,931</u>



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Required Supplementary Stewardship Information

(Unaudited)

September 30, 2006

	<u>2003</u> <u>(unaudited)</u>	<u>2004</u> <u>(unaudited)</u>	<u>2005</u> <u>(unaudited)</u>	<u>2006</u> <u>(unaudited)</u>
Nonfederal property:				
Airport improvement program	\$ 241,732	\$ 259,437	\$ 211,447	\$ (107,132)
Airport renovation program	29,298	0	95,910	(13,998)
Port security program	0	217,745	77,906	5,904
Intercity bus program	0	18,340	8,324	(3,609)
Total	<u>\$ 271,030</u>	<u>\$ 495,523</u>	<u>\$ 393,587</u>	<u>\$ (118,835)</u>
Human capital:				
Highway watch cooperative agreement	\$ 0	\$ 7,532	\$ 21,020	\$ 12,211
Total	<u>\$ 0</u>	<u>\$ 7,532</u>	<u>\$ 21,020</u>	<u>\$ 12,211</u>
Research and development:				
Applied research projects	\$ 0	\$ 30,138	\$ 22,979	\$ 18,452
Operation safe commerce	0	50,236	8,276	3,484
Total	<u>\$ 0</u>	<u>\$ 80,374</u>	<u>\$ 31,255</u>	<u>\$ 21,936</u>

**Stewardship Investments**

DHS TSA did not exist prior to FY 2002; stewardship investment data is limited to its years of existence. Stewardship investments are the costs incurred by the Federal Government for the benefit of the United States. These investments represent federally financed (but not federally owned) purchases, construction, or major renovations of physical property owned by state and local governments, including major additions, alterations, replacements, and the purchase of major equipment; and the purchase or improvement of other physical assets. Though the cost is treated as expenses to determine TSA's net cost of operations, these items merit special treatment so that users of Federal financial reports know the extent of investments that are made for the long-term benefit of the United States.

During FY 2004, the grant award functions of the TSA Maritime and Land Security programs were transferred to another DHS bureau. The transfer was accomplished in two phases. Program development and program management functions associated with the programs transitioning from TSA were integrated with the other bureau's existing program development and program management operations. The staffers associated with those functions were detailed to the other bureau, with permanent transfer at the end of FY 2004. Financial management functions for all grants issued prior to FY 2005 remain with TSA.

In FY 2006, it was determined that the accrual methodology related to stewardship investments used in FY 2005 resulted in an over-accrual. Therefore, TSA changed its method for calculating an accrual related to stewardship investments in FY 2006. This new methodology resulted in a much smaller calculated accrual. Since the

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FY 2006 actual expenses and calculated accrual were smaller than the reversal of the over-accrual in FY 2005, negative numbers are presented for certain nonfederal property investments.

**Investments in Nonfederal Property**

*Airport Improvement Program* – TSA purchases and installs in-line explosive detection systems (EDS) equipment through a variety of funding mechanisms, including Congressionally authorized Letters of Intent (LOIs). LOIs provide partial reimbursement to airports for facility modifications required to install in-line EDS solutions. TSA has issued eight LOIs for eight agreements to provide for the facility modifications necessary to accommodate in-line EDS screening solutions for these agreements.

In-line systems also allow TSA to achieve maximum baggage throughput capacity. For example, a stand-alone EDS can screen 180 bags per hour, while an in-line unit can screen 450 bags per hour. An added benefit is that installation of an in-line EDS system removes checked baggage screening operations from the airport lobby. However, in-line EDS systems are considerably more costly than stand-alone EDS, and many airports are not configured to accommodate installation of EDS technology in-line without extensive facility modifications. These funds are available only for physical modification of commercial service airports for the purpose of installing checked baggage EDS.

*Airport Renovation Program* – TSA entered into Other Transaction Agreements with 17 airports. These other transaction agreements are to establish the respective cost-sharing obligations and other responsibilities of the TSA and the specific entity (Board, Port, or Authority) relating not only to the installation of integrated and non-integrated EDS and Explosives Trace Detection (ETD) equipment, but also to the improvements to be made to the existing systems, in the baggage handling area. All work will be completed in order to achieve compliance with the Aviation and Transportation Security Act (ATSA) Public Law 107-71, November 19, 2001.

*Port Security Grant Program* – This program provided grants to critical national seaports to support the security efforts at the port through enhanced facility and operational security. These grants contribute to important security upgrades such as surveillance equipment, access controls to restricted areas, communications equipment, and the construction of new command and control facilities.

*Intercity Bus Security Program* – This program provides funds to improve security for intercity bus operators and passengers. TSA awards grants based on the following program categories:

- Vehicle specific security enhancements to protect or isolate the driver, such as alarms and security mirrors.
- Monitoring, tracking, and communication technologies for over-the-road buses.
- Implementation and operation of passenger and baggage screening programs at terminals and over-the road buses.
- Development of an effective security assessment/security plan that identifies critical security needs and vulnerabilities.

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- Training for drivers, dispatchers, ticket agents, and other personnel in recognizing and responding to criminal attacks and terrorist threats, evacuation procedures, passenger screening procedures, and baggage inspection.
- Facility security enhancements (alteration/renovation) to terminals, garages and facilities, including but not limited to: fencing, lighting, secured access, locking down of vehicles, and securing of bus yards/depots.

**Investments in Human Capital**

*Highway Watch Cooperative Agreement* – This cooperative agreement between TSA and the American Trucking Association (ATA) expands ATA’s Highway Watch program, which educates highway professionals to identify and report safety and security situations on our Nation’s roads. The program provides training and communications infrastructure to prepare 400,000 transportation professionals to respond in the event they or their cargo are the target of a terrorist attack and to share valuable intelligence with TSA if they witness potential threats. The intelligence allows Federal agencies and industry stakeholders to quickly move to prevent an attack or to immediately respond if an attack occurs.

**Investments in Research and Development**

*Applied Research Projects* – TSA funds applied research projects and grants to develop advance security technology equipment and systems. Projects include partnerships with George Mason University, the Regional Maritime Security Coalition, and the Federal Aviation Administration. These applied research projects include human factors research intended to enhance screener capabilities, improve person-machine performance, and increase human system effectiveness; ongoing certification testing of EDS and ETD technology; and infrastructure protection research related to using biometrics for passenger access controls and tracking.

*Operation Safe Commerce* – Operation Safe Commerce is a pilot program that brings together private business, ports, local, state, and federal representatives to analyze current security procedures for cargo entering the country. The ports of Seattle and Tacoma, Los Angeles and Long Beach, and the Port Authority of New York/New Jersey are participating in the pilot program. The program functions like a venture capital fund to utilize existing technology to monitor the movement and integrity of containers through the supply chain. Selected ports test new technologies and initiatives in selected supply chains. The new technologies look at improving security during the process of stuffing and deconsolidating containers, physically securing and monitoring containers as they are transported through the supply chain, and exchanging timely and reliable communication.

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