

DEPARTMENT OF HOMELAND SECURITY
Office of Inspector General

**INDEPENDENT AUDITORS' REPORT
ON DHS' FY 2004 FINANCIAL
STATEMENTS**



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

Office of Audits

OIG-05-05

December 2004

U.S. DEPARTMENT OF HOMELAND SECURITY

**Performance and Accountability Report
Excerpts of Appendices & Financial Information Part II
Ended September 30, 2004
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Appendix B – Independent Auditor’s Report

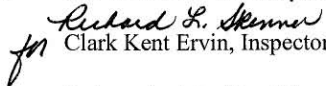
Office of Inspector General

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



**Homeland
Security**

November 19, 2004

MEMORANDUM FOR: The Honorable Tom Ridge, Secretary
FROM:  Richard L. Skemer
Clark Kent Ervin, Inspector General
SUBJECT: *Independent Auditors’ Report on DHS’ FY 2004 Financial Statements*
Audit Report No. OIG-05-05

The attached report presents the results of the Department of Homeland Security’s (the Department) financial statement audits for fiscal year (FY) 2004 and the seven months ended September 30, 2003. These audits were required by the *Accountability of Tax Dollars Act of 2002*. This report is incorporated into the Department’s FY 2004 *Performance and Accountability Report*. We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the audits.

The Department experienced a setback in its financial reporting this year. For 2003, KPMG issued a qualified opinion on the Department’s balance sheet and statement of custodial activity, meaning that these statements were presented fairly in all material respects, except for matters identified in the 2003 audit report. KPMG was unable to issue an opinion on any of the Department’s FY 2004 financial statements, and the number of material weaknesses increased from 7 to 10 this year. Although this was a disappointment, it was not entirely a surprise given the number of material weaknesses at the Department and the accelerated reporting deadline. The conditions at Immigration and Customs Enforcement (ICE) are the most critical and, as discussed below, need immediate attention. In addition, the Office of the Chief Financial Officer (OCFO) needs additional resources if it is going to provide reliable financial reporting and leadership and technical support to the bureaus.

We hope that the Department can address these weaknesses in a timely fashion. If so, this year’s results will represent only a temporary setback. My office will do all it can to assist the Department in this effort.

Summary of Auditors’ Report

KPMG was unable to provide an opinion as to whether the Department’s FY 2004 statements were presented fairly in all material respects. This disclaimer of opinion was due specifically to the circumstances at ICE, the inability to complete audit procedures over certain costs and budgetary transactions at the Coast Guard, the lack of reconciliations for intra-governmental balances, and the accelerated reporting deadline of November 15 that prevented an extension of audit procedures.

ICE did not adequately maintain its accounting records during FY 2004 and was unable to provide support for certain transactions. ICE’ financial reporting environment underwent significant change

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in FY 2004. Its legacy agency, the Immigration and Naturalization Service, and the former U.S. Customs Service, were reorganized into three new bureaus: ICE, Customs and Border Protection (CBP) and Citizenship and Immigration Services (CIS). ICE experienced significant budget difficulties during the year due at least in part to the late preparation of agreements to reimburse it for costs incurred on others' behalf. In FY 2004 ICE became the accounting services provider for several other Department components, as well as supporting its own and CIS' accounting needs. ICE also experienced significant staff turnover. As a result, ICE fell seriously behind in basic accounting functions, such as account reconciliations, analysis of material abnormal balances, and proper budgetary accounting. A void exists in the financial management infrastructure at ICE that likely will continue to jeopardize the integrity of DHS financial reporting until the fundamental issues of internal control, which includes human capital practices and oversight, have been addressed.

KPMG was unable to complete audit procedures over certain costs and budgetary transactions at the Coast Guard. The Coast Guard contributes significantly to many of the material weaknesses identified in the auditors' report, and the accelerated reporting deadline left insufficient time for the auditors to overcome the difficulties these weaknesses presented.

The Department had significant out-of-balance conditions with other federal entities that were not reconciled; therefore, it could not support certain balances on its own books. The most significant out-of-balance conditions existed at ICE. A lack of resources in the OCFO prevented the accountant responsible for intra-governmental reconciliations from researching and reconciling these differences in a timely manner during the year and at year-end.

The financial statement audit had to be completed three months earlier than it was last year due to the accelerated reporting deadline of November 15. The Department had little time to focus on correcting deficiencies from KPMG's last report before being subjected to another financial statement audit. To have a high likelihood of meeting an accelerated reporting deadline, the Department's internal controls needed to be much better. The Department entered this audit with seven material weaknesses and seven other reportable conditions related to financial reporting.

For 2003, KPMG issued a qualified opinion on the Department's balance sheet and statement of custodial activity, meaning that these statements were presented fairly in all material respects, except for matters identified in the audit report. The qualification on the balance sheet was related to lack of certain documentation for \$2.9 billion in property, plant, and equipment (PP&E) at the Coast Guard; KPMG's inability to observe physical count procedures or otherwise verify the recorded balance of \$497 million in operating materials and supplies (OM&S) at the Coast Guard; and lack of certain documentation related to \$3.3 billion in retirement benefits at the Secret Service and \$201 million in post-employment benefits at the Coast Guard. As described in the auditors' report, PP&E and OM&S remain material weaknesses at DHS, primarily due to conditions at the Coast Guard. The Secret Service corrected its documentation problem for its recorded retirement benefits.

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Summary of Reports on Internal Control and Compliance with Laws and Regulations

The FY 2004 auditors' report discusses 10 material weaknesses, three other reportable conditions in internal control, and four instances of non-compliance with laws and regulations, as follows:

Material Weaknesses

- A. Financial Management Structure
- B. Financial Management and Oversight at Immigration and Customs Enforcement
- C. Financial Reporting in the Office of the Chief Financial Officer and DHS Components
- D. Financial Systems Functionality and Technology
- E. Fund Balance with Treasury
- F. Property, Plant, and Equipment
- G. Operating Materials and Supplies, and Seized Property
- H. Undelivered Orders, Accounts and Grants Payable, and Disbursements
- I. Budgetary Accounting
- J. Intra-governmental and Intra-departmental Balances

Other Reportable Conditions

- K. Deferred Revenue on Immigration and Naturalization Applications
- L. Environmental Liabilities
- M. Custodial Activity Performed by Customs and Border Protection

Non-compliance with Laws and Regulations

- N. *Federal Managers' Financial Integrity Act of 1982*
- O. *Federal Information Security Management Act*
- P. *Single Audit Act Amendments of 1996*, Laws and Regulations Supporting OMB Circular No. A-50, *Audit Follow-up*, as revised, and the *Robert T. Stafford Disaster Relief and Emergency Assistance Act*, as amended October 2000
- Q. *Improper Payments Information Act of 2002*

The auditors' report provides extensive information on the conditions creating the 10 material weaknesses identified in FY 2004, explains their causes, and provides recommendations. The most critical material weaknesses are described in the auditors' comment A, *Financial Management Structure*, and comment B, *Financial Management and Oversight at Immigration and Customs Enforcement*. The Department must address the OCFO's serious need for additional personnel with the specialized financial reporting experience and general ledger skills needed to ensure accurate, reliable, and timely financial reporting and to provide leadership, coordination, and technical support to the bureaus. The Department will have a much more difficult time correcting its material weaknesses and other reportable conditions without the addition of technical resources at the OCFO.

The Department must address the void in ICE' financial management infrastructure immediately to restore confidence its financial reporting. The auditors identified weaknesses in controls that might

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have allowed ICE to become anti-deficient or prevented management from knowing whether ICE was anti-deficient. This condition is very serious for ICE and for the Department.

The 10 material weaknesses represent a net increase of three over last year. Five remain from last year; two are new; and three moved from reportable condition to material weakness this year. There are three reportable conditions: one remains from last year; one is new; and one is a consolidation of two reportable conditions from last year. The auditors' report provides a summary of the status of 2003 findings. The Department must reduce the number of these material weaknesses if it is to increase the likelihood of meeting the accelerated reporting deadlines.

The auditors also tested the Department's compliance with certain provisions of laws, regulations, contracts, and grant agreements materially relevant to its financial statements. KPMG identified four areas of non-compliance, as listed above. Two areas remain from last year; one is new; and one has been expanded.

KPMG is responsible for the attached auditor's report dated November 8, 2004 and the conclusions expressed in the report. We do not express opinions on the financial statements or internal control or conclusions on compliance with laws and regulations.

We request that a corrective action plan be provided to us within 90 days of the date of this letter. If you or your staff have questions, you may contact me, or a member of your staff may contact J. Richard Berman, Assistant Inspector General for Audits, at 202-254-4100.

Attachment

Appendices



KPMG LLP
2001 M Street, NW
Washington, DC 20036

INDEPENDENT AUDITORS' REPORT

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

We were engaged to audit the accompanying consolidated balance sheet of the U.S. Department of Homeland Security (DHS) as of September 30, 2004, and the related consolidated statements of net cost, changes in net position, financing, and custodial activity, and combined statement of budgetary resources (hereinafter referred to as "financial statements"), for the year then ended. We have audited the accompanying consolidated balance sheet of DHS as of September 30, 2003, and the related statement of custodial activity for the seven months then ended. In accordance with instructions received from the Office of Management and Budget (OMB), only the accompanying consolidated balance sheet and related statement of custodial activity are presented in comparative form with the prior period financial statements.

In connection with our fiscal year 2004 engagement, we were also engaged to consider DHS' internal control over financial reporting and to test DHS' compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on these financial statements.

Summary

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the financial statements as of, and for the year ended, September 30, 2004. Regarding the 2003 financial statements presented herein, as discussed in our report on the financial statements, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence related to certain financial statement balances, the accompanying consolidated balance sheet and statement of custodial activity, present fairly, in all material respects, the financial position of DHS as of September 30, 2003 and the related custodial activity for the seven months then ended, in conformity with accounting principles generally accepted in the United States of America.

As further described in Note 1 of the consolidated financial statements, DHS was established by the *Homeland Security Act of 2002* on November 19, 2002, as an Executive Branch Department of the United States government, and began operations on March 1, 2003.

Our consideration of internal control over financial reporting resulted in the following conditions being identified as reportable conditions:

Reportable Conditions That Are Considered To Be Material Weaknesses

- A. Financial Management Structure
- B. Financial Management and Oversight at Immigration and Customs Enforcement
- C. Financial Reporting in the Office of Chief Financial Officer and DHS Components
- D. Financial Systems Functionality and Technology
- E. Fund Balance with Treasury
- F. Property, Plant, and Equipment
- G. Operating Materials and Supplies, and Seized Property

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- H. Undelivered Orders, Accounts and Grants Payable, and Disbursements
- I. Budgetary Accounting
- J. Intragovernmental and Intradepartmental Balances

Other Reportable Conditions

- K. Deferred Revenue on Immigration and Naturalization Applications
- L. Environmental Liabilities
- M. Custodial Activity Performed by Customs and Border Protection

The results of our tests of compliance with certain provisions of the following laws, regulations, contracts, and grant agreements disclosed 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 OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*:

- *Federal Managers' Financial Integrity Act of 1982 (FMFIA)*
- *Federal Information Security Management Act (Electronic Government Act of 2002)*
- *Single Audit Act Amendments of 1996*, laws and regulations supporting OMB Circular No. A-50, *Audit Follow-up*, as revised, and the *Robert T. Stafford Disaster Relief and Emergency Assistance Act*, as amended October 2000
- *Improper Payments Information Act of 2002*

As discussed in our report on the financial statements the scope of our work was not sufficient to express an opinion on the financial statements as of and for the year ended September 30, 2004, and accordingly, other internal control matters and other instances of non-compliance may have been identified and reported had we been able to perform all procedures necessary to express an opinion.

DHS was not subject to the requirements of the *Chief Financial Officers Act of 1990* (CFO Act) during fiscal year 2004 and, consequently, was not required to comply with the *Federal Financial Management Improvement Act of 1996* (FFMIA). Therefore, we are not reporting herein on DHS's compliance with FFMIA. However, our testwork disclosed deficiencies in financial management information systems, the application of federal accounting standards, and recording of financial transactions, related to FFMIA that are presented within our report on internal control over financial reporting.

The following sections discuss the reasons why we are unable to express an opinion on the accompanying DHS financial statements as of and for the year ended September 30, 2004; our report on the consolidated balance sheet and statement of custodial activity as of and for the seven months ended September 30, 2003; our consideration of DHS's internal control over financial reporting; our tests of DHS's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements; and management's and our responsibilities.

Report on the Financial Statements

We were engaged to audit the accompanying consolidated balance sheet of the U.S. Department of Homeland Security (DHS) as of September 30, 2004, and the related consolidated statements of net cost, changes in net position, financing, and custodial activity, and combined statement of budgetary resources, for the year then ended.

Immigration and Customs Enforcement (ICE), a significant component of DHS, did not adequately maintain its accounting records during fiscal year 2004, particularly with respect to balances transferred in from legacy agencies, intradepartmental and intragovernmental agreements and transactions, suspense accounts, costs and budgetary transactions, thus requiring extensive reconciliation and adjustment of these and other accounts at

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year end, which ICE was unable to complete. Also, ICE management was unable to provide evidential matter or was not able to make knowledgeable representation of facts and circumstances, regarding certain transactions occurring in fiscal year 2004. DHS was unable to complete and review the accompanying financial statements, or reconcile its intragovernmental balances, prior to the completion of our procedures. In addition, we were unable to complete audit procedures over certain costs and budgetary transactions of the U.S. Coast Guard (Coast Guard) for the year ended September 30, 2004. For fiscal year 2004, OMB required that federal agencies submit audited financial statements by November 15, 2004. It was impracticable to extend the time period and procedures of our audit sufficiently to determine the extent to which the financial statements as of and for the year ended September 30, 2004, may have been affected by these conditions.

Because of the matters discussed in the previous paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying financial statements of DHS as of and for the year ended September 30, 2004.

Regarding the 2003 financial statements, we audited the consolidated balance sheet of DHS as of September 30, 2003, and the related consolidated statement of custodial activity for the seven months then ended. Further, we were engaged to audit the related consolidated statements of net cost, changes in net position, and financing, and the related combined statement of budgetary resources for the seven months ended September 30, 2003. In accordance with instructions received from the OMB, only the 2003 consolidated balance sheet and related statement of custodial activity are presented in comparative form with the fiscal year 2004 financial statements.

The Coast Guard, a component entity of DHS, was unable to provide sufficient documentation, prior to the completion of our audit procedures, to support the acquisition value and existence of property, plant, and equipment (PP&E), amounting to \$2.9 billion that is included within the \$9.1 billion net PP&E balance stated in the accompanying consolidated balance sheet as of September 30, 2003. We were unable to observe a sufficient number of the physical counts of operating materials and supplies (OM&S) conducted by the Coast Guard, and we were unable to satisfy ourselves by other means as to the fairness of the quantities used in the valuation of OM&S, that amounted to \$497 million included within the \$1.2 billion net OM&S, inventory, and stockpile balance stated in the accompanying consolidated balance sheet as of September 30, 2003. The U.S. Secret Service, another component of DHS, and the Coast Guard were unable to provide sufficient documentation, prior to the completion of our audit procedures, to support retirement and post-employment benefits amounting to \$3.3 billion and \$201 million, respectively, included within the \$25.3 billion military and other retirement balance stated in the accompanying consolidated balance sheet as of September 30, 2003.

Statement of Federal Financial Accounting Standard No. 3, *Accounting for Inventory and Related Property*, requires financial statement note disclosure of an analysis of prohibited seized property, including weight or item counts on-hand at the beginning of the year, seizures and disposals during the period, and on-hand weight or item counts at the end of the year (see Note 9). Because we were not engaged as auditors until after March 1, 2003, we were not present to observe the physical count of the prohibited seized property in DHS' possession on March 1, 2003, and we were unable to satisfy ourselves through other audit procedures as to beginning inventory quantities or seizures and disposals that occurred during the seven month period ended September 30, 2003.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence related to certain PP&E, OM&S, and retirement and post-employment benefits, as discussed in the fifth paragraph of this section, the accompanying consolidated balance sheet and statement of custodial activity present fairly, in all material respects, the financial position of DHS as of September 30, 2003, and the related custodial activity for the seven months then ended, in conformity with accounting principles generally accepted in the United States of America. The scope of our work was not sufficient to enable us to express, and we did not express, an opinion on the consolidated statements of net cost, changes in net position, and financing, and combined statement of budgetary resources for the seven months ended September 30, 2003.

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In addition, because of the matters discussed in the sixth paragraph of this section, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying disclosure in Note 9 of the weight and/or item counts of prohibited seized property transferred to DHS from legacy agencies on March 1, 2003, and seizures and disposals that occurred during the seven months ended September 30, 2003.

As further described in Note 1 of the consolidated financial statements, DHS was established by the *Homeland Security Act of 2002* on November 19, 2002, as an Executive Branch Department of the United States government, and began operations on March 1, 2003.

The information in the Management's Discussion and Analysis (MD&A), Required Supplementary Stewardship Information (RSSI), and Required Supplementary Information (RSI) sections is not a required part of the financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We did not audit the MD&A, RSSI, and RSI and, accordingly, we express no opinion on it. Certain information presented in the RSSI and RSI is based on net cost and budgetary data from the consolidated statements of net cost and changes in net position, combined statement of budgetary resources, and consolidated statement of financing for the year ended September 30, 2004 and the seven months ended September 30, 2003, on which we have not expressed an opinion. Furthermore, pursuant to OMB instructions, in certain cases, DHS has presented annualized information in the MD&A and RSSI disclosures for the twelve months ended September 30, 2003, which includes the five months preceding March 1, 2003, the effective date of DHS' operations as an entity. We were unable to apply to the information certain procedures prescribed by professional standards within the timeframe established by OMB, because of the limitations on the scope of our audit, as described in the previous paragraphs of this section or our report. However, in fiscal year 2004, we noted that DHS did not present as RSI a schedule of budgetary resources by major budgetary account, as required, and DHS did not reconcile nonfiduciary accounts with its trading partners, as specified by OMB requirements, which could affect the intragovernmental information presented as RSI.

The information in the Performance Information and Other Accompanying Information sections of the DHS *Fiscal Year 2004 Performance and Accountability Report* are presented for purposes of additional analysis, and is not a required part of the financial statements. The Performance Information and Other Accompanying Information sections have not been subjected to auditing procedures, and accordingly, we express no opinion on this information.

Internal Control over Financial Reporting

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

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

We noted certain matters, described in Appendices I and II involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that reportable conditions A through J presented in Appendix I are material weaknesses. Appendix II represents other reportable conditions K through M.

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We noted weaknesses in the DHS' FMFIA reporting process that are reported in Appendix I within Comment C – *Financial Reporting within the Office of Chief Financial Officer and DHS Components*.

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the financial statements of DHS as of and for the year ended September 30, 2004, and accordingly, other matters involving internal control over financial reporting may have been identified and reported had we been able to perform all procedures necessary to express an opinion.

* * * * *

A summary of the status of 2003 reportable conditions is included as Appendix IV.

We also noted other matters involving internal control over financial reporting and its operation that we will report to the management of DHS and certain component entities.

Internal Controls over Required Supplementary Stewardship Information

We noted certain significant deficiencies in internal control over Required Supplementary Stewardship Information, discussed in Appendix I, that in our judgment, could adversely affect DHS's ability to collect, process, record, and summarize Required Supplementary Stewardship Information.

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the financial statements of DHS as of and for the year ended September 30, 2004, and accordingly, other matters involving internal control over Required Supplementary Stewardship Information may have been identified and reported had we been able to perform all procedures necessary to express an opinion.

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, disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, and are described in Appendix III.

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the financial statements of DHS as of and for the year ended September 30, 2004, and accordingly, other instances of non-compliance may have been identified and reported had we been able to perform all procedures necessary to express an opinion.

DHS was not subject to the requirements of the CFO Act during fiscal year 2004 and, consequently, was not required to comply with the FFMA. Therefore, we are not reporting herein on DHS's compliance with FFMA. However, our testwork disclosed deficiencies in financial management information systems (e.g., OMB Circulars A-127, *Financial Management Systems*, and A-130, *Management of Federal Information Resources*), the application of federal accounting standards, and recording of financial transactions, related to FFMA, that are presented in Appendices I and II.

Management's Response to Internal Control and Compliance Findings

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

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Responsibilities

Management's Responsibilities. The *Accountability of Tax Dollars Act of 2002* requires DHS to obtain annual financial statement audits.

DHS management is responsible for the financial statements, including:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal controls over financial reporting, and preparing Management's Discussion and Analysis (including the performance measures), Required Supplementary Information, and Required Supplementary Stewardship Information; and
- Complying with laws, regulations, contracts, and grant agreements.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements, due to error or fraud, may nevertheless occur and not be detected.

Auditors' Responsibilities. As discussed in our report on the financial statements, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying financial statements of DHS as of and for the year ended September 30, 2004. We considered the limitations on the scope of our work in forming our conclusions.

Relating to the 2003 financial statements presented herein, our responsibility is to express an opinion on the consolidated balance sheet of DHS as of September 30, 2003, and the related statement of custodial activity for the seven months ended September 30, 2003, based on our audit. Except as discussed in our report on the financial statements, we conducted our 2003 audit in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated balance sheet and statement of custodial activity are free of material misstatement.

An audit includes:

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

We believe that our 2003 audit provides a reasonable basis for our report on the consolidated balance sheet and the related statement of custodial activity as of and for the seven months ended September 30, 2003.

In connection with our fiscal year 2004 engagement, we considered DHS's internal control over financial reporting by obtaining an understanding of DHS's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02 and *Government Auditing Standards*. 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 assurance on internal control over financial reporting. Consequently, we do not provide an opinion thereon. Further, other matters involving internal control over financial reporting may have been identified and reported had we been able to perform

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all procedures necessary to express an opinion on the financial statements of DHS as of and for the year ended September 30, 2004.

As required by OMB Bulletin No. 01-02, in fiscal year 2004, we considered DHS's internal control over Required Supplementary Stewardship Information by obtaining an understanding of DHS's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. Our procedures were not designed to provide assurance on internal control over Required Supplementary Stewardship Information and, accordingly, we do not provide an opinion thereon. Further, other matters involving internal control over Required Supplementary Stewardship Information may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the financial statements of DHS as of and for the year ended September 30, 2004.

OMB Bulletin No. 01-02 requires auditors, with respect to internal control related to performance measures determined by management to be key and reported in the MD&A, to obtain an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal controls over performance measures and, accordingly, we do not provide an opinion thereon. As discussed in our report on the financial statements, we did not apply procedures to the MD&A and performance measures presented in the *DHS Fiscal Year 2004 Performance and Accountability Report*.

In connection with our fiscal year 2004 engagement, we performed tests of DHS'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 financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to the DHS. We also note that while OMB Bulletin No. 01-02 requires certain testing and reporting on the compliance requirements of FFMIA, DHS is not subject to those requirements, and as a result, testing for compliance with FFMIA requirements was not an objective of our engagement. Further, other matters involving compliance with laws, regulations, contracts, and grant agreements may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the financial statements of DHS as of and for the year ended September 30, 2004. Providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our engagement and, accordingly, we do not express such an opinion.

Distribution

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

KPMG LLP

November 8, 2004

Appendices

Independent Auditors' Report Appendix I – Material Weaknesses in Internal Control

A. Financial Management Structure

Background: The Chief Financial Officer (CFO) and his staff have been challenged by a myriad of issues since the inception of the Department of Homeland Security (DHS), many of which are one-time, unique matters, related to the set-up of the consolidated financial processes of DHS as a single operating entity. Management has taken several positive steps toward financial integration of a diverse group of operating components. However, despite the achievements and progress made in fiscal year (FY) 2004, the CFO has acknowledged that much work remains to complete a fully integrated financial management and reporting structure to accommodate all transferred agencies and programs and to fully support the DHS mission.

Conditions: The conditions described below are structural in nature and rise to the level of a material weakness because they affect the process that controls the overall integrity of DHS' consolidated financial statements, at a time when DHS has a number of other material weaknesses and reportable conditions that affect financial reporting. Under the current financial reporting structure, the Office of the Chief Financial Officer (OCFO) prepares financial statements only at the DHS consolidated level, from trial balances submitted by the bureaus to the OCFO. The bureaus are not required to prepare complete financial statements with footnotes and supplementary data that comply with generally accepted accounting principles (GAAP). The OCFO has minimal staff to consolidate the data received directly from the bureaus, ensure consistent accounting treatment for similar transactions among the bureaus, develop consolidated footnote and supplementary data and perform quality control procedures. The vast majority of DHS' financial reporting resources have remained decentralized at the bureau level.

During FY 2004 we noted the following conditions that affected the OCFO's ability to effectively manage the consolidated financial reporting process. The OCFO has not:

- Fully developed processes that bridge the gap between where DHS' consolidated reporting responsibilities lie (at the OCFO), and where most accounting resources and detailed bureau accounting knowledge needed to ensure accurate financial statements reside (at the bureaus);
- Hired or contracted a sufficient number of personnel with the experience and skills to properly perform and supervise financial reporting functions of an Executive Branch department. This condition also has been an impediment to the adoption of effective management and oversight practices, including the ability to separate workload among OCFO staff to allow for proper supervisory reviews and to provide appropriate back-up for key staff;
- Provided the DHS bureaus with sufficient management oversight and timely policy guidance to address accounting and reporting issues that cross multiple bureaus and affect the efficiency of bureau financial accounting and reporting operations; and
- Established sufficient internal controls over financial management and reporting processes to ensure that the five essential elements of internal control over financial reporting, as defined by the Comptroller General, are designed and operating effectively, as discussed below under *Criteria*.

Other conditions that affect the quality of financial reporting that exist in the DHS bureaus and OCFO are described in Comment C - *Financial Reporting in the Office of Chief Financial Officer and DHS Components*.

Cause/Effect: In 2004, DHS has been challenged with continuing the standing-up of a large, new, and complex Executive Branch department. The OCFO has had little time to focus on correcting deficiencies

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from our FY 2003 audit before being subjected to the FY 2004 audit process. Nevertheless, there remains a significant gap between the CFO's responsibility for financial management and reporting at DHS, and the sufficiency of resources to accomplish this objective.

As a result, the conditions described above continue to prevent DHS from timely preparation of accurate consolidated financial information and reports and have contributed to the conditions reported in Comment C of this Appendix. Lack of adequate processes and sufficient qualified staff or contractors at the DHS consolidated level have led management to place excessive reliance on the financial statement audit process to identify errors in accounts and deficiencies in processes and controls. DHS will continue to have difficulty complying with Federal accounting standards and requirements, and implementing appropriate internal control as defined by the Comptroller General, until the structure of the financial reporting process is fully assessed and adequate resources are provided to the OCFO.

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

Recommendations: We recommend that the OCFO:

- a) Assess the structure and resourcing of the DHS financial reporting process and make appropriate improvements. These improvements could include establishing much stronger quality control processes at the OCFO, improving the policy guidance provided to DHS bureaus, and considering the benefits of requiring individual bureaus to prepare financial statements according to GAAP;
- b) Hire or contract additional accounting personnel that possess complementary technical skills to perform and supervise reporting and quality control functions, including monitoring of bureau reporting processes;
- c) Continue the hiring process for a Deputy CFO who possesses the knowledge to assist the CFO in driving internal controls and best practices into department and bureau financial management operations. In addition, the Deputy CFO should have extensive knowledge of GAAP, as it applies to Federal entities, and the GAO's *Standards*;
- d) Be more active in identifying and promptly addressing intra-bureau financial management and reporting issues, especially where bureau financial managers do not have sufficient authority or jurisdiction to resolve matters; and
- e) Perform an evaluation of the consolidated financial reporting process, using the criteria defined by the Comptroller General, to ensure that financial processes are designed and implemented with proper internal control, including the five essential control elements (i.e., control environment, risk assessment, control activities, information and communication, and monitoring). Further, consolidated and bureau level financial statement audits cannot be relied upon as an internal control.

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B. Financial Management and Oversight at Immigration and Customs Enforcement

Background: Immigration and Customs Enforcement (ICE) is a significant bureau of DHS with over \$2.8 billion in annual funding. ICE was created when DHS reorganized the legacy Immigration and Naturalization Service (INS) and U.S. Customs Service into three new bureaus: ICE, Customs and Border Protection (CBP) and Citizenship and Immigration Services (CIS). ICE inherited its financial organization and systems from the former INS. ICE also serves as the accounting services provider for a significant number of DHS directorates and components, including: CIS, Science and Technology (S&T), Information Analysis and Infrastructure Protection (IAIP), DHS Management, and Border Transportation and Security (BTS) Headquarters. Together, these operations represent approximately 10 of the former 22 legacy agencies and programs that transferred to and formed DHS on March 1, 2003, and represent approximately \$6.7 billion or 20 percent of the total DHS FY 2004 budget authority.

During FY 2004, ICE, CBP and CIS, referred to as the Tri-bureaus, entered into significant agreements to reorganize and exchange certain operations. For example, Border Patrol operations, and Immigration Inspection activities, including its assets and approximately 20,000 employees, were transferred to CBP from ICE. In addition, during FY 2004, ICE entered into more than 30 shared services and reconciliation agreements with various entities inside and outside DHS, for reimbursement of costs incurred on their behalf. As a result, ICE's financial reporting environment underwent significant change in FY 2004. Further, ICE experienced significant turnover in its financial personnel starting in the summer of 2003, resulting in the loss of key individuals who had important day-to-day knowledge of ICE's accounting operations and financial reporting processes.

Conditions: The conditions described below are organizational weaknesses specific to ICE's financial management. Other conditions that affect the quality of ICE's financial reporting are described in Comment C in this Appendix. We noted that during FY 2004, ICE did not have:

- A thorough, well-designed plan for transition of the accounting operations of major DHS directorates and components to its accounting systems. The transition of accounting responsibility for S&T, IAIP, and other DHS components to ICE during FY 2004 was flawed, and resulted in material errors, irregularities, and abnormal balances in the DHS consolidated financial statements that existed for most of FY 2004. The pervasiveness of the errors, in both proprietary and budgetary accounts, prevented us from completing our audit procedures for ICE and the components it serviced in FY 2004.
- In conjunction with the OCFO, a process to establish and maintain more than 30 important shared services agreements with trading partners, particularly those agreements dealing with the Tri-bureaus. The preparation of these agreements late in the fiscal year delayed ICE's receipt of cost reimbursements and contributed to significant budget difficulties. Further, the delay in preparing the agreements left little time to determine whether the allocation of expenses between the Tri-bureaus was appropriate and equitable. Many of these agreements were not executed until well into the fourth quarter of FY 2004.
- A blueprint for identifying and fixing deficiencies in its accounting and financial reporting processes, including control weaknesses, human capital needs, and information technology requirements. ICE financial systems, processes, and control activities were inadequate to provide accounting services for itself and five other major DHS operating units. Responsibility for financial reporting was fragmented among multiple organizations and offices, leading to a lack of communication and coordination within ICE.

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- Sufficient leadership and guidance, both from the OCFO and within its own management ranks, particularly given FY 2004 changes and difficult circumstances, and it lacked sufficient numbers of qualified financial managers and staff to fulfill its accounting responsibilities. ICE fell seriously behind in performance of even basic accounting functions, such as account reconciliations, analysis of material abnormal balances, and proper budgetary accounting, which prevented it from submitting timely and accurate periodic financial reports to DHS during FY 2004. Specifically, during FY 2004 ICE financial managers and staff did not:
 - Correctly apply Federal accounting standards, in many instances, to ensure accurate and reliable financial reporting. ICE was unable either to determine or record the proper entries to its accounts to make them balance correctly and at the end of the year had to rely on the OCFO's general ledger accountant to make the entries for them.
 - Develop and communicate accounting policies and procedures throughout ICE and the components it serviced to ensure accuracy and consistency in financial reporting, particularly for significant account balances such as intragovernmental and intradepartmental receivables and payables, accounts payable and undelivered orders, and environmental, legal, and post-employment benefits information;
 - Timely respond to data requests from the OCFO during the year; and
 - Establish adequate internal controls to reasonably ensure the integrity of financial data and that adhered to GAO's *Standards*. For example, there were insufficient supervisory reviews for journal entries made to the general ledger.

Cause/Effect: Several events during FY 2004 led to the above conditions. The combination of these events, together with managing and accounting for its own daily operations, severely taxed the resources of ICE. Specifically,

- ICE absorbed substantial additional workload in FY 2004 by taking on the accounting functions for several major DHS components and implementing the reorganization creating the Tri-bureaus, with the attendant transfer-in and transfer-out of operations and assets;
- ICE was required to establish significant shared services agreements both within and outside DHS. However, ICE was unable to get agreement on significant reimbursable amounts from the other DHS bureaus until late in the fiscal year;
- The accounting records and data of other DHS components transferred to ICE from legacy agencies during FY 2004, i.e., components of S&T and IAIP were not well organized, lacked detail support for balances, were not always reconciled, and were not timely delivered to ICE. In addition the decision to transfer the accounting functions of legacy agencies was not finalized until late in FY 2003, leaving little time to thoroughly plan the FY 2004 transition;
- ICE experienced turnover in several key accounting positions starting in the summer of 2003, and had insufficient resources throughout the year to properly address many of these conditions; and
- ICE did not significantly modify its procedures to meet the FY 2004 accelerated reporting deadlines.

It should also be noted that, although the DHS CFO became involved in addressing the disagreements among the Tri-bureaus related to shared services, agreements were not reached until late in the fiscal year, after absorbing much management attention and creating much uncertainty for ICE during the fiscal year.

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Further, the OCFO was unable to provide sufficient timely assistance to help address the other conditions cited above in a timely manner.

The current conditions at ICE indicate a void in its financial management infrastructure that likely will continue to jeopardize the integrity of DHS financial reporting until the fundamental issues of process and internal control, which includes management, human capital, and oversight, have been addressed. These conditions extend to the integrity of accounting data that is used to track the obligation and expenditure of appropriated amounts. ICE management has inappropriately placed reliance on the external audit process to identify errors and control deficiencies. Due to a lack of resources, ICE management has become reactive rather than proactive in addressing accounting errors and problems and has fallen behind in their plan for building sound financial management and systems infrastructure.

Criteria: FMFIA requires that agencies establish internal controls according to standards prescribed by the Comptroller General and specified in the GAO's *Standards*. According to these standards, management should ensure that they have an organizational structure that supports the planning, directing, and controlling of operations to meet agency objectives; clearly defines key areas of authority and responsibility; and provides for appropriate lines of reporting. Management is to identify the knowledge and skills needed for various jobs and establish good human capital practices. The standards also define internal control as an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.

Recommendations: We recommend that ICE, in coordination and with the assistance of the OCFO:

- a) Develop additional detailed accounting policies and procedures governing all areas of its financial management process. These procedures should be specific enough to be considered a blueprint for performing the accounting operations for ICE, as well as for all of the bureaus for which it provides accounting services;
- b) Establish policies and procedures to obtain agreement on all shared services agreements among the Tri-Bureaus within the first quarter of the fiscal year. The OCFO must also maintain a leadership role in the process, to ensure the agreements are executed timely and equitably;
- c) Perform a comprehensive internal control self-assessment to identify areas where its financial operations are not compliant with FMFIA, GAO's *Standards*, and OMB Circular A-127, *Financial Management Systems*; and
- d) Hire and develop accounting staff with appropriate skills to implement and maintain an effective financial reporting process and internal controls that will ensure the integrity of financial data submitted monthly to the OCFO.

C. Financial Reporting in the Office of Chief Financial Officer and DHS Components

Background: Financial reporting at DHS is dependent upon the quality of financial reporting at its individual bureaus and the ability of the OCFO to consolidate information timely and consistently. The consolidation process is accomplished, in large part, by using the Department of the Treasury's (Treasury) *Treasury Information Executive Repository* (TIER), a data warehouse through which DHS bureaus submit their financial information. TIER interfaces with the CFO Vision software, which is used to prepare DHS consolidated and individual bureau financial statements. The OCFO is using TIER as a temporary system

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solution until a permanent financial reporting system architecture for DHS can be implemented, which is currently under development and known as the “*eMerge2*”¹ program.

The OCFO, working with the bureaus and the auditors, developed a timeline of activities, including TIER submission dates that should have allowed us to complete our audit work by the accelerated November 15, 2004 reporting deadline. The audit plan depended significantly on the preparation of a draft Section 2, *Financial Information*, of the Performance and Accountability Report (PAR)², based on accurate June 30, 2004 balances and its submission to us by late July.

Conditions: We noted the following internal control weaknesses related to financial reporting in the OCFO and DHS bureaus:

1. The OCFO did not:
 - Adhere to the schedule set early in the audit process to successfully meet the accelerated reporting deadline of November 15, 2004. For example, the OCFO could not prepare timely June 30 financial statements because some bureaus did not meet the agreed-upon submission dates, and fell behind in preparing the requested portions of a draft Section 2.
 - Prepare a balanced³ consolidated financial statement until November 2004. In addition, the consolidated financial statement disclosures and notes contained critical flaws, inconsistencies and errors when provided to us approximately one week before the filing deadline of November requiring material adjustments to correct.
 - Prepare accurate periodic, e.g., quarterly, consolidated financial statements, as required by OMB, and FACTS II⁴ submissions, as required by Treasury, due primarily to delays in bureau submissions of TIER inputs. Our review of the quarterly submissions also indicated that the OCFO made adjustments to the quarterly FACTS II submissions, often without support, to ensure validity checks would be met.
 - Implement sufficient procedures and monitoring controls to ensure that monthly TIER submissions received from bureaus were prepared timely and accurately. The OCFO performed only limited data quality and reasonableness checks for TIER and CFO Vision input and output, and did not require the bureaus to verify the accuracy of financial reports produced by TIER. The OCFO has not required the bureaus to use recently installed TIER analytical tools to improve the integrity and reliability of financial data at the bureau.
 - Implement sufficient monitoring control procedures to verify that bureaus were complying with its financial reporting policies and procedures relating to all elements of the DHS PAR, including the financial statements, related notes, Management’s Discussion and Analysis (MD&A), RSI, RSSI, and other financial reporting matters, such as proper identification and reconciliation of intra-departmental eliminating entries. Also, the instructions issued by the OCFO did not

¹ *eMerge2* stands for “Electronically Managing Enterprise Resources for Government Effectiveness and Efficiency”.

² PAR Section 2 contains: the financial statements with note disclosures, Required Supplementary Information (RSI), and Required Supplementary Stewardship Information (RSSI).

³ Balanced in this context means: assets equal liabilities plus net position, on a consolidated basis, as presented on the balance sheet.

⁴ FACTS II stands for *Federal Agencies’ Centralized Trial-Balance System II*. FACTS II is a Treasury computer program that allows agencies to submit to Treasury one set of accounting data. Reports produced from this data include adjusted trial balances and budgetary reports.

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address unique reporting considerations existing in some bureaus. Further, the OCFO was late to require the bureaus to complete the GAO's *Checklist for Federal Accounting, Reporting, and Disclosures*, and as a result, several bureaus were late with these submissions.

- Implement procedures and related controls that will ensure accuracy and completeness in the FMFIA reporting process. In addition, we noted that DHS has not reported some material weaknesses that we have reported herein. We also noted a lack of timeliness in reporting by some bureaus, and corrective actions and milestones were not presented for some findings.
2. Coast Guard:
 - The financial reporting process is complex and labor-intensive and requires a significant number of “on-top” adjustments (adjustments made outside the core accounting system for presentation of financial information given to DHS for consolidation). In addition there is a significant amount of manual integration of data from three separate general ledger systems and corrections to overcome system and process deficiencies;
 - The processes that finance center personnel used for making year-end closing entries did not consistently include sufficient supporting documentation or internal controls at an appropriate level, such as management review and approval of individual adjusting entries. In addition, the software application used to record on-top adjustments did not consistently include the reason codes for individual entries;
 - The accuracy of financial information is highly dependent on the knowledge and experience of a limited number of key financial personnel, rather than on clearly documented procedures manuals and process flow documentation; and
 - Weaknesses in financial management oversight hinder its ability to prepare accurate, complete, and timely financial information for consolidation into the DHS financial statements. As described above and in the rest of this Appendix, we noted weaknesses related to the financial reporting process; maintenance and quality of financial records; policies and procedures; and the application of some aspects of financial accounting standards.
 3. ICE, Emergency, Preparedness and Response (EPR) and the Office of State and Local Government Coordination and Preparedness (SLGCP, formerly the Office for Domestic Preparedness) have not adopted rapid close procedures to ensure that accurate and timely TIER submissions are consistently performed during the year. Similar to last year, policies and procedures for exporting data from the general ledger for periodic TIER submissions were not documented, quality control reviews of financial reports were not regularly performed, documentation of on-top adjustments was lacking, and/or TIER input was not routinely reconciled with CFO Vision output provided by the OCFO.
 4. Coast Guard, SLGCP, and ICE did not have effective financial information systems or sufficiently documented processes to accumulate present cost data by DHS strategic goal, as required by Statement of Financial Accounting Standard (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards*. In addition, these bureaus, and EPR, did not have documentation to support the process to validate that the full cost by strategic goal, as presented in the notes to the consolidated financial statements, was materially consistent with actual costs incurred.
 5. At EPR, the monthly TIER submissions did not accurately and completely reflect the financial transactions of the Strategic National Stockpile (SNS). By law, EPR did not have full control over the accounting process for the SNS, and it was unable to implement an effective process to obtain financial information from other Federal entities involved in the management and administration of

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the SNS. Consequently, EPR and the OCFO estimated and recorded financial activity, e.g., expenses, based on budgets instead of actual transactions, and used estimates to record certain amounts of the net SNS transfer-out balance presented in the statement of net position, which could not be substantiated with actual source documentation supporting the balances.⁵

6. Through a reimbursable agreement, SLGCP's legacy agency provides financial processing and reporting services to SLGCP.⁶ Although SLGCP management has been involved in the FY 2004 financial statement audit process, they are not actively involved in the financial reporting of SLGCP activities. In addition, SLGCP has not obtained a thorough understanding of control activities over the financial reporting processes performed by its accounting services provider on its behalf.

A further discussion of ICE's financial reporting problems is given in Comment B - *Financial Management and Oversight at Immigration and Customs Enforcement*.

Cause/Effect: The OCFO and bureau financial management continued to restructure accounting and financial reporting processes during FY 2004, however, late submission of the DHS FY 2003 PAR coupled with accelerated reporting in FY 2004 left the OCFO and bureau financial managers little time to make substantial changes and improve controls before this year's audit cycle began. The financial reporting weaknesses at the OCFO can be attributed directly to weaknesses described in Comment A, *Financial Management Structure*. As already described above, some bureaus have not developed adequate policies and procedures to perform a rapid close of monthly activity and accurately export data from the general ledger for periodic TIER submissions. This has caused errors and delays in DHS financial reporting. The conditions at Coast Guard have surfaced because of Coast Guard's greater relative size within DHS. Coast Guard will need time, appropriate skilled personnel, and resources to correct these weaknesses.

EPR was unable to adequately maintain financial records for the SNS because it did not have full control over the process. Four different Federal entities played a role in SNS accounting. Because all of these entities were unable to coordinate a timely reconciliation of their records and activities, EPR was unable to maintain accurate balances for SNS' obligations, undelivered orders (UDOs), operating expenses, inventory, and accounts payable during FY 2004. SNS was transferred out of DHS to the Department of Health and Human Services in August 2004.

Regarding the presentation of cost data by responsibility segment and major program, most DHS bureaus use financial management systems developed several years ago, before the creation of DHS and well before DHS adopted its strategic goals. Consequently, many information systems do not contain financial data in a format that facilitates full compliance with SFFAS No. 4, e.g., the allocation of costs to programs and reporting of costs by strategic goal within the DHS structure. As a result, many bureaus must perform manual analyses and computations to comply with this accounting standard.

SLGCP places a significant amount of reliance on the legacy agency to process and report its transactions because it lacks resources to perform effective oversight of the financial reporting process and related control activities performed on its behalf. As a result, SLGCP lacks assurance that the processing of its financial activities coincides with its business operations and are accurately reported and properly controlled.

⁵ By law, SNS was transferred to the Department of Health and Human Services in August 2004.

⁶ The Office of Justice Programs, a component of the Department of Justice, is SLGCP's legacy agency, and also referred to herein as SLGCP's accounting services provider.

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

Recommendations: We recommend that:

1. The OCFO:
 - a) Obtain the necessary skills and resources, through appropriate human resource practices or contracting, to ensure it meets internal deadlines that are part of the accelerated reporting timeline, to assist the bureaus to do the same, to meet and properly support other quarterly external reporting deadlines, and to advise the bureaus as described in b) below;
 - b) Assist the bureaus with an assessment to determine the reasons for TIER reporting delays; provide management oversight to correct weaknesses; streamline the reporting process; and enhance reporting efficiency in the bureaus;
 - c) Establish written policies and procedures that, through implementation, will provide reasonable assurance that the inputs and outputs to and from TIER and CFO Vision are materially accurate and complete. These procedures should include periodic Bureau reconciliations of TIER inputs to TIER-produced trial balances and CFO Vision Bureau financial statements, timely confirmations to the OCFO that such reconciliations have been completed and reconciling items have been resolved. Conduct training on the use of TIER analytical tools to improve the integrity of financial data submitted to the OCFO;
 - d) Develop and implement monitoring controls that will ensure that the bureaus comply with the DHS financial reporting policies and procedures for the PAR, including financial statements and notes, MD&A, RSI, RSSI, and other financial reporting matters. Implement an OCFO process to prepare financial statements and notes, MD&A, RSSI and RSI that are in full compliance with required reporting standards. This process should include at a minimum the bureaus' completion of GAO's *Checklist for Federal Accounting, Reporting, and Disclosures*, in time to prepare an up-to-date draft PAR Section 2 according to the internal accelerated reporting timeline. The bureaus should have a significant role and responsibility in preparing and reviewing the completed PAR. The checklist is a tool to help the OCFO prepare financial statements according to GAAP, and it is particularly needed in this decentralized reporting environment and in the absence of other adequate controls; and
 - e) Provide instruction and management oversight of the FMFIA evaluation process to improve comprehensiveness of review, coordination with the external audit process, and consistency in reporting by the bureaus.

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2. Coast Guard:
 - a) Conduct an assessment of its current financial reporting process, with the goal of implementing appropriate internal controls and reducing complexity;
 - b) Improve documentation for year-end closing entries, including management review and approval and clear identification of all on-top adjustments with all associated account entries;
 - c) Reduce the reliance on the limited number of key personnel by cross training personnel and documenting the financial reporting process;
 - d) Develop procedures and internal controls for providing oversight and guidance for operating units, and program offices that provide key financial information; and
 - e) Evaluate the existing financial management organizational and internal control structure and conduct an assessment to determine the number of personnel needed along with requisite skills and abilities and make improvements as indicated.
3. ICE, EPR, and SLGCP:
 - a) Conduct an assessment of the monthly closing process to identify and correct weaknesses that impede timely and efficient reporting processes; reduce the number of on-top adjustments and improve documentation for them; improve integration of information systems; and design a quicker, more accurate monthly closing process and TIER submission. Perform regular quality control reviews of financial reports;
 - b) Reconcile CFO Vision financial statements to TIER input on a monthly basis, with differences investigated and resolved;
 - c) Cross-train additional personnel in the financial reporting and TIER submission process, especially in the quality assurance review of the data submitted, to ensure that sufficient resources are available to assist at peak financial reporting periods; and
 - d) Document key Standard Operating Procedures (SOPs) for significant financial reporting processes.
4. Coast Guard, EPR, SLGCP, and ICE should consider modifying information systems, or if not feasible, develop manual processes, to accumulate, present, and validate cost data by DHS strategic goal, as required by SFFAS No. 4. SLGCP should work with its legacy agency to develop automated or manual processes to accumulate and present cost data by DHS strategic goal. These bureaus should thoroughly document the process beginning with data sources through preparation and delivery of the note disclosure to the OCFO at a level of detail appropriate to fully define and document all internal controls embedded in the process.
5. SNS was transferred to HHS on August 13, 2004, and consequently, we have not included recommendations for management related to SNS.
6. SLGCP should designate an official to perform a financial oversight role and take responsibility for monitoring the financial processing and reporting activities performed by the accounting services provider on SLGCP's behalf.

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D. Financial Systems Functionality and Technology

Background: Controls over information technology (IT) and related financial systems are essential elements of financial reporting integrity. Effective general controls in an IT and financial systems environment are typically defined in six key control areas: entity-wide security program planning and management, access control, application software development and change control, system software, segregation of duties, and service continuity. In addition to reliable controls, financial management system functionality is important to program monitoring, increasing accountability of financial and program managers, providing better information for decision-making, and increasing the efficiency and effectiveness of services provided by the Federal government.

During FY 2004, DHS took many actions to improve its IT general control environment and to address prior year general IT control issues. For example, DHS implemented an automated security certification and accreditation (C&A) tool and improved its software change control policies and practices. In addition, during FY 2004 DHS awarded a contract for the eMerge² program, which will help consolidate financial management and IT activities across DHS. Despite these improvements, as in FY 2003, we again identified significant general IT control weaknesses related to financial reporting at DHS and its bureaus, which, collectively, limit DHS' ability to ensure that critical financial and operational data is maintained in a manner to ensure confidentiality, integrity, and availability.

Conditions: As in FY 2003, we noted the following IT and financial system control and functionality weaknesses at DHS and its bureaus:

1. Regarding entity-wide security program planning and management, we noted:
 - Despite the implementation of an automated tool to assist with the DHS security C&A efforts, such efforts were still not completely implemented in a manner that ensures the detection and prevention of technical security weaknesses;
 - Security training and awareness programs, especially those related to the detection and prevention of technical weaknesses, can be improved;
 - Security plans did not consistently document existing system security controls, were incomplete, or otherwise did not meet requirements set forth in OMB Circular A-130, *Management of Federal Information Resources*; and
 - Security risk assessments were not regularly performed and were not performed consistently.
2. Regarding access controls, we noted:
 - Instances of missing user passwords on key servers and databases, weak user passwords, and weaknesses in user account management. Also, we noted several cases where user accounts were not periodically reviewed for appropriateness, including authorizations to use group user accounts and excessive access privileges; and
 - Instances where workstations, servers, or network devices were configured without necessary security patches, or were not configured in the most secure manner. We also identified many user accounts that were not configured for automatic log-off or account lockout.

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3. Regarding system software, we noted:
 - Instances where policies and procedures for restricting and monitoring access to operating system software were not implemented, or were inadequate. In some cases, the ability to monitor security logs did not exist; and
 - Changes to sensitive operating system settings were not always documented.
4. Regarding segregation of duties, we noted:
 - Instances where individuals were able to perform incompatible functions, such as the changing, testing, and implementing software, without sufficient compensating controls in place; and
 - Instances where key security positions were not defined or assigned, and descriptions of positions were not documented or updated.
5. Regarding service continuity, we noted:
 - Several bureaus had incomplete business continuity plans and systems with incomplete disaster recovery plans. Some plans did not contain current system information, emergency processing priorities, procedures for backup and storage, or other critical information; and
 - Some bureau service continuity plans were not consistently tested, and individuals did not receive training on how to respond to emergency situations.

Cause/Effect: Many of these weaknesses were inherited from the bureaus that came into DHS, and will take several years to fully address. Management has undertaken a complicated task of merging numerous and varying financial management systems and control environments into a DHS environment. At many of the larger bureaus, IT and financial system support operations are decentralized, contributing to challenges in integrating DHS IT and financial operations. In addition, financial system functionality weaknesses can be attributed to non-integrated legacy financial systems that do not have the embedded functionality called for by OMB Circular A-127.

Criteria: The *Federal Information Security Management Act (FISMA)*, passed as part of the *Electronic Government Act of 2002*, mandates that Federal entities maintain IT security programs in accordance with OMB and National Institute of Standards and Technology (NIST) guidance. OMB Circular A-130, and various NIST guidelines describe specific essential criteria for maintaining effective general IT controls. In addition, OMB Circular A-127 prescribes policies and standards for executive departments and agencies to follow in developing, operating, evaluating, and reporting on financial management systems. In particular, OMB Circular A-127 specifies the need for integrated financial systems and to account for financial data using the USSGL at the transaction level.

Recommendations: DHS needs to place further emphasis on the monitoring and enforcement of policies and procedures through the performance of periodic security control assessments and audits. Focus should be placed on implementing and enforcing a DHS-wide security C&A program, and technical security control training for system administrators and security officers. Many of the technical issues identified during our review, which were also identified during FY 2003, such as weak technical security controls and the lack of contingency planning, can be addressed through a more effective security C&A program and security training program.

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We recommend that DHS:

1. For entity-wide security program planning and management, ensure that:
 - a) Implementation and enforcement of the C&A program continues;
 - b) A DHS-wide security training and awareness program is designed and implemented consistent with OMB and NIST guidance. A key focus of the training program should be on the detection and prevention of technical weaknesses;
 - c) Information security planning efforts more consistently follow relevant Federal guidance (OMB and NIST);
 - d) Security risk assessments are completed in a consistent manner per OMB and NIST guidance; and
 - e) The above recommended entity-wide security efforts are implemented in a consistent manner across bureaus.
2. For access control, ensure that:
 - a) Password controls meet DHS password requirements and are enforced on all systems;
 - b) A password account management process is implemented within the bureaus to ensure the periodic review of user accounts;
 - c) A DHS-wide patch and security configuration process is designed and implemented;
 - d) A vulnerability assessment process is implemented, whereby systems are periodically reviewed for security weaknesses; and
 - e) The above recommendations are included as part of the DHS C&A program.
3. For system software, ensure that bureau personnel comply with the established policies and procedures for monitoring, use, and changes related to operating systems.
4. For segregation of duties, ensure that:
 - a) Responsibilities are documented so that incompatible duties are consistently separated. If this is not feasible given the smaller size of certain functions, then sufficient compensating controls, such as periodic peer reviews, should be implemented; and
 - b) Policies and procedures are developed and documented to assign key security positions and maintain current position descriptions.
5. For service continuity, ensure that:
 - a) Bureaus develop and implement complete business continuity plans and system disaster recovery plans;
 - b) Bureau-specific and DHS-wide testing of key service continuity capabilities are performed; and
 - c) A DHS-wide service continuity training program is designed and implemented.

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E. Fund Balance with Treasury

Background: Fund Balance with Treasury (FBWT) represents accounts held at Treasury from which an agency can make disbursements to pay for its operations. Regular reconciliation of an agency's records with Treasury for FBWT is essential to monitoring and safeguarding these funds, improving the integrity of various U.S. Government financial reports and providing a more accurate measurement of budget resources and status. FBWT at ICE, and the other DHS bureaus it services, and the Coast Guard totaled approximately \$6.8 billion or 14 percent of total DHS assets at September 30, 2004. The majority of these funds represented appropriated amounts that were obligated but not yet disbursed at September 30, 2004.

Conditions: We noted the following internal control weaknesses related to FBWT:

At ICE and Coast Guard:

- Did not complete timely reconciliations of their FBWT accounts during the year, as required by the Treasury Financial Manual (TFM), by performing all of the required procedures to completely reconcile FBWT, including reconciliations to FMS 6652, *Statement of Differences*; FMS 6653/54 *Undisbursed Appropriation Account Ledger/Trial Balance*; SF 224 *Statement of Transactions*; and/or FMS 6655 *Receipt Account Trial Balance/Ledger*, and did not clear items carried in suspense clearing accounts timely during the year. At times, hundreds of unresolved items were carried in suspense, some of which were more than a year old, totaling several hundred million dollars in unreconciled balances; and
- Lacked written SOPs to direct and document the correct reconciliation processes and internal controls to ensure that monthly collection and disbursement activity were reported accurately and timely to the Treasury.

Cause/Effect: Turnover in key personnel and a general lack of appropriate resources contributed to the FBWT reconciliation conditions at ICE. The Coast Guard did not complete timely reconciliations because of continued difficulties in overcoming the FY 2003 implementation of a new financial system. Although by September 30, 2004, the Coast Guard had completed their FBWT reconciliation, they had not completed the reconciliation timely during the year. Failure to implement timely and effective reconciliation processes could increase the risks of fraud and mismanagement of funds; lead to inaccurate financial reporting; and affect the Government's ability to effectively monitor the status of its budget.

Criteria: The TFM⁷ states, "Federal agencies must reconcile their Standard General Ledger (SGL) account No.1010 and any related sub-accounts, with the FMS 6652, 6653, 6654 and 6655 on a monthly basis (at minimum). They must review those accounts each month to maintain the accuracy and reliability of their fund balance records for both prior year and current year appropriations. Agencies must reconcile no-year, revolving, deposit and trust fund accounts. They also must reconcile clearing and receipt accounts. This detailed reconciliation assures that agency data accumulated in the fund balance account is accurate. It also allows the agency to resolve differences in a timely manner. Federal agencies must research and resolve differences reported on the monthly FMS 6652. They also must resolve all differences between the balances reported on their general ledger FBWT accounts and balances reported on the FMS 6653, 6654 and 6655. When resolving differences, agencies should maintain detailed reconciliation worksheets that, if needed, can be reviewed by the Agency's auditors or Treasury." TFM

⁷ TFM, Supplement I TFM 2-5100 (November 1999)

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Section 5145, *Reconciling Budget Clearing Account Differences*, states, "Agencies must reconcile all Budget Clearing Account Balances, including F3875 accounts. They must reclassify these balances to appropriate Treasury account symbols." TFM Section 5125 – *Background*, specifies the procedures to be performed when reconciling FBWT.

Recommendations: We recommend that ICE and the Coast Guard:

- a) Prepare monthly reconciliations of FBWT, including resolution of differences;
- b) Perform all procedures required by the TFM including sections 5125, 5145 and Supplement I TFM 2-5100;
- c) Research and clear items held in suspense promptly during the year. Typically, significant balances should not be held in suspense more than 30 days; and
- d) Develop and implement written SOPs to direct and document their FBWT reconciliation processes. The SOPs should be based on Treasury guidance and tailored to the bureaus' operations and financial accounting systems. The procedures should also include timely reviews by supervisory personnel.

F. Property, Plant, and Equipment

Background: Property, plant and equipment (PP&E) represents approximately 17 percent of total DHS assets and more than 60 percent of non-monetary assets. DHS uses a wide variety of capital assets to accomplish its mission, some of which are not typically maintained by non-defense agencies, such as aircraft, and boats and vessels. These assets often have long useful lives, and undergo extensive routine servicing that may increase their value or extend their useful lives. In addition, DHS has several internal use software development projects underway that will result in capitalized software balances in future years. Consequently, application of proper accounting standards to account for PP&E is important to the accuracy of DHS' consolidated financial statements.

Conditions: We noted the following internal control weaknesses related to PP&E at DHS bureaus:

1. Coast Guard has not:
 - Implemented appropriate controls and related processes to properly, accurately, and timely record PP&E additions, transfers from other agencies, and disposals in its fixed asset system;
 - Developed and documented methodologies and assumptions to support the value of PP&E that is not supported by original acquisition or other documentation;
 - Implemented asset identification and tagging processes that include sufficient detail, e.g., serial number, to clearly differentiate and accurately track assets in the fixed asset system. In addition, the Coast Guard lacks adequate procedures to update movements and change in status of PP&E in a timely manner, e.g., active or inactive, including those related to the Integrated Deepwater System Program (Deepwater) and vessels that are under repair or being converted;
 - Developed an effective physical inventory process and appropriate support for the valuation method and classification of repairable PP&E;
 - Properly accounted for some improvements and impairments to buildings and structures, and selected useful lives for depreciation purposes, consistent with GAAP; and

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- Established procedures to identify and evaluate lease agreements to determine proper classification and accounting as either capital or operating.
2. ICE has not consistently applied procedures to identify and capitalize software development costs or to reclassify software placed into production from software in development. At September 30, 2004, software costs were not considered material to the consolidated financial statements; however, software development costs are expected to increase in future years.

Cause/Effect: Coast Guard has implemented policies and procedures affecting PP&E; however, they are lacking in comprehensiveness and, therefore, do not provide reasonable assurance that all transactions affecting PP&E will be accounted for consistent with GAAP. In addition, the fixed asset module of the Coast Guard's core accounting system is not updated for effective tracking of all PP&E and its capabilities are not fully utilized to clearly differentiate and accurately track assets. The Coast Guard also lacks sufficient policies and procedures and documentation for PP&E. As such, we were unable complete audit procedures over approximately \$2.6 billion of PP&E.

ICE lacks sufficient SOPs that clearly define accounting policies for software development costs. Over the next few years, ICE anticipates spending significant resources developing new software, such as US VISIT. Therefore, the lack of SOPs would increase the risk of financial statement errors due to misapplication of accounting standards for software.

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

- PP&E be recorded at historical cost with an adjustment recorded for depreciation. In the absence of such information, estimates may be used based on a comparison of similar assets with known values or inflation-adjusted current costs;
- Leases be valued at inception to determine the proper accounting treatment as either a capital or operating lease; and
- PP&E accounts be adjusted for disposals, retirements and other removal of PP&E, including associated depreciation.

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

Recommendations: We recommend that:

1. Coast Guard:
 - a) Improve controls and related procedures to ensure that additions, transfers, and disposals are recorded accurately and timely in the fixed asset system; that the serial number is entered in the fixed asset system at the time of asset purchase to facilitate identification and tracking; and that the status of assets is accurately maintained in the system;
 - b) Develop and document methodologies and assumptions to support the value of PP&E that is not evidenced by original acquisition or otherwise sufficient documentation;

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- c) Develop and implement internal controls to ensure the quality, sufficiency, and retention of documentation for future PP&E acquisitions and disposals;
 - d) Revise procedures for performing physical inventories of repairable items, to include procedures for resolving differences and reporting results, to ensure that repairable PP&E is accurately and completely classified and recorded. Support the pricing methodology used to value repairable PP&E to ensure that balances, as presented in the financial statements, approximate amortized historical cost;
 - e) Review policies and procedures to account for improvements and impairments to buildings and structures; identify proper useful lives for depreciation purposes that are consistent with GAAP; and correct material departures from GAAP; and
 - f) Establish procedures to ensure that lease agreements are identified and evaluated for proper classification as either capital or operating leases.
2. ICE:
- a) Perform a review of its existing software capitalization policy to determine adequacy for financial reporting purposes. The policy should be sufficiently detailed to allow developers and accounting personnel to identify the various phases of the software development life cycle and the associated accounting treatment, as described in SFFAS No. 10; and
 - b) Develop and implement procedures for developers to track and notify accounting personnel when software has been placed into production so that accounting personnel can properly classify and amortize the software costs.

G. Operating Materials and Supplies, and Seized Property

Background: Operating Materials and Supplies (OM&S) are maintained by the Coast Guard in significant quantities, and consist of tangible personal property to be consumed in normal operations to service marine equipment, aircraft, and other operating equipment. The majority of the Coast Guard's OM&S is physically located at either two Inventory Control Points (ICPs) or in the field. The ICPs use the Naval Electronics Supply Support System (NESSS) and the Aircraft Logistics Management Information System (ALMIS) to track inventory, and field held OM&S is recorded in a different system as subsidiary records supporting the general ledger. The Coast Guard's policy requires regularly scheduled physical counts of OM&S, which are important to the proper valuation of OM&S and its safekeeping. The Secret Service is responsible for the storage, maintenance, and disposal of seized counterfeit currency.

Conditions: We noted the following internal control weaknesses related to OM&S and seized counterfeit currency:

1. At Coast Guard:
 - Internal controls over physical counts at field locations were not operating effectively during FY 2004. For example, items were not always properly bar-coded or tagged and on hand quantities frequently did not agree to the perpetual inventory records, and procedures did not sufficiently address whether all inventory on hand was properly recorded in the perpetual records or require discrepancies' timely resolution. Coast Guard plans to implement corrective action over field held OM&S, to include implementation of internal controls, in FY 2005;

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- Policies and procedures for conducting physical inventories of OM&S at the ICPs remained in draft and lacked key elements of an effective physical inventory, e.g., reconciliation of sample population to perpetual records, statistically valid methods of sampling, and proper evaluation and reporting of results. Comprehensive step-by-step physical inventory instructions that clearly addressed each objective of a physical inventory were not communicated in a clear and timely manner. In addition, we noted instances where personnel did not comply with established procedures, and did not properly report findings;
 - Warehouse locations recorded in NESSS were not always current. Some locations listed in NESSS did not exist and one NESSS record could not be located; and
 - The weighted average pricing methodology used to value OM&S was not appropriately supported to demonstrate that all recorded prices approximated historical cost.
2. At the Secret Service, while the counterfeit currency records reflected the results of the physical inventories, they did not accurately reflect the activity for the year.

Cause/Effect: The Coast Guard did not have sufficient time between DHS' financial statement audits to fully implement our FY 2003 recommendations related to field held OM&S. Lack of comprehensive and effective policies and controls over the performance of physical counts may result in inventory discrepancies or errors in the physical inventory process that could result in financial statement misstatements. The Coast Guard's support for the calculated weighted average pricing of OM&S included some inaccuracies, and the lack of completeness of the sampled universe might have affected the reliability of the analysis. The Secret Service inventory system did not provide the information necessary to reconcile activity during the year.

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

Recommendations: We recommend that:

1. Coast Guard:
 - a) Update OM&S physical count policies, procedures, and controls, and provide training to personnel responsible for conducting physical inventories;
 - b) Implement effective oversight and monitoring procedures to ensure that physical inventory counts are performed and evaluated in accordance with policies and procedures;
 - c) Perform a review of the inventory information contained in NESSS to identify and correct discrepancies between the perpetual records and actual physical item counts and warehouse locations;
 - d) Consider developing risk-based cycle counting procedures for OM&S; and
 - e) Provide adequate support for the weighted-average price used to value OM&S.
2. Secret Service update its policies and procedures to ensure that the annual activity related to counterfeit currency is properly reflected in the records in a timely manner.

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H. Undelivered Orders, Accounts and Grants Payable, and Disbursements

Background: During FY 2004, ICE began providing accounting services for several significant directorates and programs, including S&T, IAIP, Management, and BTS Headquarters, and continued as accounting service provider for CIS. Most of the prior service providers were legacy agencies outside of DHS. The legacy agencies, for at least some of the components, continued to make disbursements related to prior year obligations and some current year obligations. The legacy agencies charged ICE Treasury accounts, often without reporting the transactions to ICE. As a result, ICE had difficulty maintaining accurate records related to obligations and UDOs. UDOs represent obligations for which delivery of services or goods has not been made. Accurate UDO balances are essential to maintaining budgetary status and estimating ICE's and other components' accounts payable at year-end.

SLGCP uses its legacy agency's grants management system to support SLGCP's grant making activities. Beginning in April 2004, this system allowed grantees to submit their financial status reports electronically via web-based connections. The Transportation Security Administration (TSA) entered into a significant number of grant agreements during FY 2004. Although the management of most of these grants was transferred to SLGCP in the third quarter of FY 2004, the TSA retains administrative responsibilities for these grants until closeout.

Conditions: We noted the following internal control weaknesses related to UDOs, accounts and grants payable, and disbursements:

1. At ICE:

- Disbursements made by legacy agencies for S&T and IAIP directorates were not identified and accounted for until the transactions were listed as differences by Treasury in monthly reports used to reconcile FBWT. Consequently, we noted that more than \$200 million of disbursements were not recorded in the general ledger when they occurred;
- ICE did not establish sufficient controls to prevent duplicate payments to vendors related to prior year obligations or to prevent temporary anti-deficient situations in certain Treasury accounts used by both ICE and the legacy agencies to make disbursements;
- ICE did not have sufficient controls to ensure that open obligations were properly liquidated when corresponding accounts payable were recorded;
- Policies related to verification and validation of obligations performed by field personnel did not clearly define responsibilities and have not been issued to all field locations;
- We noted an error rate of approximately 10 percent when examining approvals for disbursements for S&T and IAIP. Specifically, evidence of review and approval of invoices and receipt of goods and services could not be located; and
- The method used during FY 2004 to estimate accounts payable for S&T, IAIP and the other components that ICE performs accounting services for, was not based on historical disbursements or other information unique to those particular programs. In addition, subsidiary records used to compute accounts payable, i.e. Open Document File (used to track UDOs), did not agree to the general ledger during the year, however were reconciled at year end.

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2. At Coast Guard:
 - Coast Guard did not have adequate controls to periodically review and validate UDOs or to ensure that recorded obligations were valid, and obligations incurred were recorded timely;
 - Coast Guard did not record contract awards related to Deepwater in the general ledger in a timely manner, resulting in an understatement of obligations approximating \$105 million at the time of our testwork. In addition we noted a lack of segregation of duties associated with the creation and approval of purchase requisitions, certification of funds availability, and the recording of the obligation;
 - Facts and Figures Quick (FAFQ) programming logic was not properly configured to extract data into a report that accurately reflected the general ledger and could be used to evaluate and analyze the transaction history of UDOs;
 - The transaction codes in the Coast Guard's general ledger to record advance payments and related UDOs was not in conformance with the TFM and could result in a misstatement to the financial statements;
 - Policies and procedures related to the automated requisition and procurement process were not consistently followed in all regions. Specifically, the Financial and Procurement Desktop (FPD) system could be overridden to allow non-conforming numbering for purchase requisitions, and as a result there was a risk that commitments would not be properly tracked and/or matched with obligations in the accounting records. Further, a system problem existed that affected the synchronization of transactions recorded in FPD and the core accounting system, resulting in an overstatement of UDOs of \$5.6 million that had to be corrected;
 - The Procurement Management Effectiveness Assessment (MEA), which is an on-site assessment of procurement activity for compliance with Federal statutes and regulations, was not fully performed as planned in FY 2004. The MEA is an important risk assessment and monitoring control function that, when properly performed, assists in assessing compliance with applicable laws and regulations; and
 - The verification process used to validate the accuracy of accounts payable included erroneous data. Consequently inaccurate statistics would have been used in estimating accounts payable at year-end.
3. SLGCP did not perform sufficient monitoring over the legacy agency's activities performed on its behalf. Certain control weaknesses were identified in the legacy agency's financial systems. For example, the web-based grantee reporting system was not certified and accredited. Consequently, SLGCP management did not have assurance that the system controls associated with its grant accruals and the related financial statement line items were properly designed and effectively operating.
4. At TSA several grants tested did not have the following on file: performance reports; the application package SF-424, *Application for Federal Assistance*, and SF-270, *Request for Advance or Reimbursement*, signed by the grant officer and/or the program officer. We also noted that the TSA did not have policies or procedures in place to properly monitor compliance with the *Single Audit Act Amendments of 1996* (OMB's Circular A-133) and laws and regulations supporting OMB A-50, *Audit Follow-up*, as revised.

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Cause/Effect: Some of the conditions at ICE resulted from difficulties with the transfer of S&T, IAIP, and DHS management accounting operations from legacy agencies to ICE in FY 2004. (See Comment B - *Financial Management and Oversight at Immigration and Customs Enforcement*, for further details.) In addition, procedures for verification and validation of obligations were not clearly written and understood by field personnel. These procedural weaknesses resulted in the misclassification of open obligations and misstatements of undelivered and delivered orders.

Coast Guard's greater relative size within DHS, compared to its legacy department, has meant that it has received proportionally greater scrutiny. Because SLGCP management did not perform sufficient monitoring of its financial reporting processes, SLGCP could not take timely action to ensure that control weaknesses identified in the legacy agency's systems used to process SLGCP's transactions would not materially impact its financial statement balances. These weaknesses could result in a misstatement of grant payables, expenses and/or UDOs. At TSA, if grants are not appropriately monitored, it is possible that funding will not be used for its intended purpose.

Criteria: GAO's *Standards* hold that transactions should be properly authorized, documented, and recorded accurately and timely. OMB Circular A-123, *Management Accountability and Control*, states that "transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports." SFFAS No. 1, *Accounting for Selected Assets and Liabilities*, states, "When an entity accepts title to goods, whether the goods are delivered or in transit, the entity should recognize a liability for the unpaid amount of the goods. If invoices for those goods are not available when financial statements are prepared, the amounts owed should be estimated."

Recommendations: We recommend that:

1. ICE:
 - a) Improve procedures to prevent duplicate payments to vendors from accounts used by both ICE and legacy agencies, including the proper liquidation of obligations when accounts payable are recorded. Also, establish written procedures that require legacy agencies to timely submit all information affecting ICE's accounting for component disbursements and work with legacy agencies to implement them. If possible, consider transferring all accounting services for prior year obligations from legacy agencies into ICE;
 - b) Strengthen controls over the timely liquidation of obligations when accounts payable are recorded;
 - c) Adhere to disbursing policies and procedures, which require disbursements to be made only after proper approval of the invoice has been obtained and evidence of the receipt of goods and services has been received;
 - d) Expand the policies and procedures documentation related to obligation verification and validation to more clearly communicate the process to field personnel. The policies should be updated to require the completion of a receiving report for all goods and services before invoices are approved for payment. If necessary, additional training should occur to enhance understanding of the procedures; and
 - e) Use historical data that is specific to the operations of S&T, IAIP, Management, BTS Headquarters, and CIS when estimating accounts payable for financial statement purposes. In addition, UDO subsidiary records should be routinely reconciled to the general ledger.

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2. Coast Guard:
 - a) Improve controls related to processing obligation transactions, to include periodic review and validation of UDOs. Emphasize to all funds managers the need to perform effective monthly reviews of open obligations. Develop effective monitoring controls for reviewing and approving obligation transactions prior to processing;
 - b) Improve segregation of duties at Deepwater related to the creation and approval of purchase requisitions, certification of funds availability, and the recording of the obligations;
 - c) Evaluate programming logic and transactions codes used to record advances for which an obligation was not previously recorded to ensure the obligation and UDO is properly recorded;
 - d) Assess programming logic of Facts & Figures Quick and implement appropriate corrective action;
 - e) Update the program logic of FPD to improve document numbering of purchase requisitions. The system design of FPD and the core accounting system should be evaluated to ensure that obligation transactions are correctly processed;
 - f) Revise Commandant Instruction 4200.30B, *Program Management Review Program*, in order to implement effective oversight and monitoring procedures of the contract acquisition process, including the frequency of MEA's at major procurement regions; and
 - g) Improve controls over data validation used in the accounts payable estimation process.
3. SLGCP should designate an official to perform a financial oversight role and take responsibility for monitoring its financial processing and reporting activities performed by its legacy agency. This official should obtain appropriate assurances from its legacy agency, e.g., Statement on Auditing Standards No. 70, *Service Organizations*, review report, to be able to assess that general and application controls relevant to SLGCP's financial activities are properly designed and operating effectively.
4. TSA:
 - a) Implement policies and procedures to ensure that performance reports for grants and agreements are received in accordance with grant award documents and OMB's requirements;
 - b) Implement policies and procedures to ensure that grantees are being monitored for compliance with OMB's Circular A-133 and A-50; and
 - c) Implement document retention policies and procedures that include printing out approvals and placing them in award files, and printing out application packages when they are received.

I. Budgetary Accounting

Background: Budgetary accounts are a category of general ledger accounts where transactions related to appropriations and other authorities to obligate and spend agency resources are recorded. During FY 2004, ICE began providing accounting services for several significant directorates and programs, including S&T, IAIP, Management, and BTS Headquarters and continued as accounting service provider for CIS. Most of the prior service providers were legacy agencies outside of DHS. The Coast Guard has a complex budget that includes budget authority from a variety of sources: annual, multi-year, and no-year appropriations; and several revolving, special, and trust funds.

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Conditions: We noted the following internal control weaknesses related to budgetary accounting:

1. At ICE:

- Weaknesses existed in controls that might have allowed ICE to become anti-deficient or prevented management from knowing if they were anti-deficient. As stated in our Independent Auditors' Report, we were unable to complete our audit of the financial statements as of and for the year ended September 30, 2004 and accordingly, we were unable to complete our procedures related to ICE's compliance with the *Anti-Deficiency Act*;
- The transfer of accounting records and responsibilities from prior accounting services providers was not coordinated properly. FY 2003 ending balances for budgetary accounts often did not equal FY 2004 beginning balances, with the differences unexplained. The legacy agencies continued to approve payments and make disbursements for prior year obligations, but ICE was unable to get timely information on these activities, if any at all, to update the relevant accounting records;
- Obligations were not recorded in a timely manner. For example, approximately \$200 million in FY 2004 obligations for S&T were not recorded in the general ledger because of insufficient controls to prevent S&T from using its prior legacy service provider and lack of coordination. Other obligations related to S&T, IAIP, Management, and BTS Headquarters were not recorded timely in the general ledger;
- Disbursements and resulting adjustments to obligation balances related to operations transferred to CBP, i.e., Border Patrol, were not reported timely to CBP, causing misstatements in the financial statements of both bureaus;
- Contracting officer approvals were not clearly documented on obligating documents, and in one instance a contracting officer approved a purchase for an amount in excess of the officer's authority; and
- Weaknesses existed in controls over the preparation, submission and reconciliation to the general ledger of the SF 132, *Apportionment and Reapportionment Schedule*, and the SF 133, *Report on Budget Execution*. Information reported on the SF-133 did not agree with the accounting records and was not reconciled timely resulting in inaccuracies in the June 2004 financial statements.

2. At Coast Guard:

- The electronic validation and/or edit checks within the budget module of the general ledger accounting system, which could flag and prevent the recording of commitments (a reservation of funds for future obligation) or obligations in excess of appropriations, apportionments, or allotments, was not fully utilized;
- Weaknesses existed in controls over the recording of budgetary authority, commitments, obligations and related disbursements and rescissions. For example, budget authority recorded in the Coast Guard's main general ledger system was understated by \$1.2 billion as of March 31, 2004, and FY 2004 budget authority for acquisition, construction and improvements appropriations was overstated by \$26 million. Coast Guard did not properly record \$60 million in budget authority that was transferred from the Department of the Navy, resulting in inaccuracies in the June 2004 financial statements;

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- Weaknesses existed in controls over the preparation, submission and document retention of the SF 132 and SF 133 reports. For example, some SF-132s combined multiple appropriations without advanced written OMB approvals;
 - Approximately five percent of contracting officers listed with warrant authority had expired warrants at the time of our testwork. There were no automated system controls to preclude the processing of procurement transactions if the contracting officer's warrant authority had expired. The Coast Guard did not maintain an accurate, up-to-date listing of currently warranted contracting officers; and
 - Commitments were not routinely monitored for aging or released timely so that funds could be committed and obligated elsewhere. At the time of our testwork, more than one-third of recorded unobligated commitments (approximately 1,200) were over 90 days old, and a substantial portion of those were recorded prior to FY 2004.
3. At EPR, the statement of budgetary resources was misstated through August 31, 2004 because of its method of accounting for investments. EPR recorded an audit adjustment to correct the misstatement as of September 30, 2004.

Cause/Effect: Several of the conditions at ICE resulted from difficulties with the transfer of the accounting operations of S&T, IAIP and other components from legacy agencies to ICE in FY 2004. ICE and legacy agency management did not coordinate the transition process to ensure that all transactions were properly recorded in the general ledgers of S&T, IAIP directorates and other components during the transfer of accounts to ICE. These conditions can also be attributed directly to weaknesses described in Comment B - *Financial Management and Oversight at Immigration and Customs Enforcement*.

Coast Guard chose not to use the system configuration controls to flag commitments and obligations that might be in excess of appropriated amounts. Other system and processing limitations hampered the timely recording of budget authority. Weaknesses in policies and procedures also contributed to the conditions.

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

Criteria: The *Anti-Deficiency Act* prohibits agencies from obligating or disbursing more than their appropriations and apportionments, has strict requirements for reporting violations, and includes penalties for violations. GAO *Standards* hold that transactions should be properly authorized, documented, and recorded accurately and timely. OMB Circular A-11 *Preparation, Submission, and Execution of the Budget*, requires Federal agencies to submit their apportionment requests on an SF-132 for each appropriation unless permission is granted otherwise. According to JFMIP's *Core Financial System Requirements*, an agency's core financial management system must ensure that an agency does not obligate or disburse funds in excess of those appropriated and/or authorized, and specific system edits and user notifications related to funds control must be in place. The Federal Acquisition Regulation (FAR) Section 1.16 addresses the authorities and responsibilities granted contracting officers. Treasury's USSGL guidance specifies the accounting entries related to investment transactions.

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Recommendations: We recommend that:

1. ICE:
 - a) Perform a review in sufficient detail to determine if ICE, or any component where ICE performs accounting services, has violated the *Anti-Deficiency Act* during FY 2004, and report any violations in accordance with U.S.C. Title 31;
 - b) Record the obligations entered into by the legacy agency on S&T's behalf into S&T's general ledger at the transaction level; and implement procedures to ensure that S&T obligations entered into by the legacy agency are recorded timely;
 - c) Improve policies and procedures to ensure that contracting officers do not approve purchases that exceed their authority and to require their signature on the original obligating documentation; and
 - d) Improve its policies and procedures related to preparation of the SF 132 and SF 133 and periodic, e.g. quarterly, reconciliation of these reports to the general ledger. Reconciliations should be performed at the Treasury Appropriation Fund Symbol (TAFS) level, with differences investigated and properly corrected.
2. Coast Guard:
 - a) Activate the electronic edit checks in its budget module and general ledger systems to prevent incurring commitments and obligations in excess of appropriations and apportionments and consider establishing automated controls to prevent processing of procurement transactions by contracting officers who do not have active warrant authority;
 - b) Develop procedures and controls related to the review and processing of Treasury warrants prior to recording them into the main general ledger system. Review the appropriation data received from Treasury; and then make appropriate revisions and changes.
 - c) Improve controls related to preparation of the SF 132 and SF 133 and periodic, e.g., quarterly, reconciliation of these reports to the general ledger. Reconciliations should be performed at the TAFS level, with differences investigated and properly corrected;
 - d) Obtain proper advance written approval from OMB to prepare the SF-132 with combined appropriations. If approved, the Coast Guard should prepare a schedule in the notes to the SF-132 indicating the specific amounts by appropriation, and improve its document retention;
 - e) Revise controls and related policies and procedures to:
 - Review and update the warrant authority of active contracting officers more frequently; implement system controls to flag procurement transactions when the officer's warrant is expired; and improve documentation for each officer's warrant history;
 - Periodically review commitments, and determine the feasibility of modifying the budget module to transmit all commitments, regardless of dollar amount, to the general ledger system; and
 - f) Develop and provide specific training related to any internal controls and related policy and procedure changes.
3. EPR should correct its method of accounting for investments during the year, related to its National Flood Insurance Program, to follow the recommended method presented in the Treasury's USSGL guidance.

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J. Intragovernmental and Intradepartmental Balances

Background: DHS conducts business with other Federal agencies resulting in intragovernmental receivables, payables, and the reporting of revenues and expenses from intragovernmental transactions. Federal accounting and reporting regulations require Federal agencies to routinely identify and reconcile intragovernmental balances and transactions with trading partners. These procedures help ensure that intragovernmental balances properly eliminate in the government-wide consolidated financial statements. DHS bureaus also conduct business with each other, resulting in the same type of transactions and balances that must be netted against each other to produce accurate consolidated financial statements for DHS.

Conditions: Regarding intragovernmental balances, we noted that ICE, (including S&T, IAIP, BTS Headquarters, Management and CIS – DHS components where ICE functions as accounting services provider), EPR, and Coast Guard have not developed and adopted effective SOPs or established systems to completely track, confirm, and reconcile intra-DHS balances and/or transactions with trading partners, in a timely manner. In addition, DHS did not reconcile its fourth quarter intragovernmental balances with other federal entities. Consequently, the DHS “Material Difference/Status of Disposition Certification Report,” submitted to Treasury for September 30, 2004, showed material differences “unknown or unreconciled” or “accounting/reporting errors” in excess of \$370 million and \$715 million, respectively. These conditions also impacted DHS’ ability to accurately report transactions with government trading partners in the consolidated financial statements and in the RSI section of the financial statements, as required.

Regarding intradepartmental balances, we noted that throughout the year DHS was unable to produce accurate consolidated financial statements due, in part, to significant out-of-balance conditions between DHS bureaus. Intra-DHS transactions between ICE, CBP, CIS and other DHS components did not eliminate correctly at the consolidated level during the year. Further, DHS was unable to completely reconcile out-of-balance intradepartmental transactions at year-end, resulting in the need for significant “top-side” adjustments, based primarily on estimates and analytical comparisons, to close the general ledger and prepare consolidated financial statements. Many of these topside adjustments cannot be supported with sufficient documentation that evidences reviews for completeness and accuracy.

Cause/Effect: Financial system limitations at ICE (and for DHS components it services), and the Coast Guard prevented these bureaus from tracking activity with government trading partners and thus, manual processes have been established. Accounting data for DHS components that ICE services, e.g., S&T and IAIP, and provided to ICE did not include detailed supporting schedules of trading partner activity that would have facilitated the reconciliation process. Coast Guard has not fully utilized its accounting system functionality to identify and track intragovernmental balances. EPR did not reconcile intradepartmental accounts timely during the year due to partner code configuration differences between EPR’s and DHS’s IT systems, that were by corrected by the end of the year. A lack of resources in the OCFO prevented the accountant responsible for intragovernmental reconciliations from researching and reconciling intragovernmental differences in a timely manner during the year and at year-end. Reconciling trading partner activity and balances at least quarterly is necessary to identify material out-of-balance conditions between federal entities and to support an accurate consolidation of DHS with the government-wide financial statements. The significant restructuring of DHS that created ICE, CBP, and CIS contributed significantly to the out-of-balance conditions between DHS bureaus.

Criteria: The *Treasury Federal Intragovernmental Transactions Accounting Policies Guide*, dated October 23, 2002, requires quarterly reconciliation of intragovernmental asset, liability and revenue amounts with trading partners. Further, the TFM, Section 4060, *Intragovernmental Activity/Balances*,

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requires reporting agencies to reconcile and confirm intragovernmental activity and balances quarterly for specific reciprocal groupings. OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*, requires the presentation of transactions with trading partners to be presented in RSI. It also requires agency financial statements to be presented on a consolidated basis, including the elimination of significant intradepartmental transactions and balances for reporting purposes.

Recommendation: We recommend that all DHS bureaus and programs, in conjunction with the DHS OCFO, develop and implement procedures to positively confirm and reconcile, at least on a quarterly basis, all intragovernmental activity and balances with their intragovernmental trading partners including other DHS component entities, as prescribed by Treasury guidance. In addition, transactions with trading partners should be completely and accurately presented in the RSI section of the Department's PAR. These procedures also should ensure that all intradepartmental activity and balances are identified and properly eliminated for DHS' consolidated financial statements.

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Independent Auditors' Report Appendix II – Other Reportable Conditions in Internal Control

K. Deferred Revenue on Immigration and Naturalization Applications

Background: CIS accepts millions of applications annually and typically collects more than \$1 billion in fees from applicants seeking immigration and naturalization services. Applications are received and processed at four service centers, the National Benefits Center, over 30 district offices, and numerous satellite offices. Upon receipt of an application, CIS personnel input the data into a variety of information systems. Numerous ad hoc systems are used to perform monitoring and file tracking functions during the acceptance and adjudication process. To determine the amount of revenue to be deferred at the end of the reporting period, CIS relies on automated application tracking systems, in particular the CLAIMS 3 LAN⁸ and CLAIMS 4⁹. A query of these systems is performed to determine the total number of pending applications and the associated fees received for each of these applications. The accuracy of the deferred revenue calculation depends on the reliability of the application status recorded in the systems. Federal accounting standards require that application revenue must be deferred until adjudication is complete, and consequently the status (e.g., completion) of applications has a direct effect on DHS' consolidated financial statements. There are a number of information systems initiatives underway to improve the efficiency of and the quality of management information from the application and adjudication process.

Conditions: We noted the following internal control weaknesses related to the acceptance and adjudication of immigration and naturalization applications at CIS:

- Not all applications were maintained in the primary databases – CLAIMS 3 LAN and CLAIMS 4. Numerous ad hoc systems, including some manual systems, were used to perform monitoring and file tracking functions during the acceptance and adjudication process that were not integrated. Procedures have not been implemented to compare the actual pending applications tracked in the ad-hoc systems with the number being estimated for the deferred revenue, leading to processing and quality assurance inefficiencies;
- CIS lacked SOPs for identifying the accuracy and reliability of CLAIMS 4 data and the query of CLAIMS 4, which provides the number of pending naturalization applications and the associated fee that is used in the deferred revenue calculation;
- Quality assurance procedures, adopted to verify the accuracy of application status data in CLAIMS 3, were not consistently performed by the service centers and the National Benefits Center. In addition, the information provided to CIS headquarters as a result of the quality assurance procedures was not in sufficient detail to permit analysis of results, support conclusions and develop corrective actions. The lack of such quality assurance procedures in previous years led to bureau-wide end of the year inventories that were disruptive to CIS operations and delayed the completion of year-end financial reporting; and
- Fees collected with immigration applications were not always deposited in accordance with Treasury guidelines.

Cause/Effect: Policy and initiatives to replace ad hoc systems used to track the status of applications and associated fees have been slow in development. The lack of integrated systems and use of ad hoc systems create significant inefficiencies and increase the risk of errors and reporting inconsistencies. The lack of SOPs increases the risk of inconsistency by creating a lack of standardization, and of errors in the data. Due to the concerns over data quality in both the local and national feeder systems, and the reporting

⁸ CLAIMS 3 LAN is the acronym for Computer Linked Application Information Management Systems, Version 3, Local Area Network.

⁹ CLAIMS 4 is the acronym for Computer Linked Application Information Management Systems, Version 4.

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process, CIS had to perform an extensive service-wide inventory of pending (SWIP) applications in previous years to accurately state deferred revenue in its financial statements. A SWIP is labor-intensive and time-consuming, but necessary in the absence of adequate quality assurance procedures to verify perpetual application inventory systems and determine adjustments to deferred revenue.

Overall, resources are insufficient to address the volume of applications received, thus preventing the applications from being input into the respective system within one day of receipt. As a result, fees accompanying the applications are also often not deposited within the Treasury required time frame. The contract for data entry and deposit services at the service centers have conflicting performance clauses that provides inconsistent guidance on timing of fee deposits.

Criteria: OMB Circular A-127 requires that financial management systems provide effective and efficient interrelationships between software, hardware, personnel, procedures, controls, and data contained within the systems. Because CIS' various application and adjudication systems support preparation of the financial statements, they are considered financial systems. OMB Circular A-123 states that "transactions should be promptly recorded, properly classified and accounted for in order to prepare timely accounts and reliable financial and other reports." SFFAS No. 1, states, "Federal entities may receive advances and prepayments from other entities for goods to be delivered or services to be performed. Before revenues are earned, the current portion of the advances and prepayments should be recorded as other current liabilities. After the revenue is earned (goods or services are delivered, or performance progress is made), the entity should record the appropriate amount as a revenue or financing source and should reduce the liability accordingly."

Section 8030.20 of the TFM stipulates that "agencies will deposit receipts totaling \$5,000 or more on the same day received prior to depository cutoff time" and "monies received too late in the day to meet the deposit cutoff time must be deposited the following business day. Agencies must have adequate internal controls in place to ensure the security of all undeposited funds."

Recommendations: We recommend that CIS:

- a) Continue the information systems initiatives underway to improve the efficiency and quality of management information from the application and adjudication process and gradually reduce the number of ad hoc systems in use;
- b) Develop and implement policies and procedures to verify the accuracy and reliability of CLAIMS 4 and CLAIMS 3 LAN and the query of CLAIMS 4 and CLAIMS 3 LAN for reporting deferred revenue. CIS personnel should be trained on proper implementation of the SOPs;
- c) Require all locations to perform quality assurance counts of pending applications with a frequency (e.g., rotating quarters) that is sufficient to provide reasonable assurance of the completeness and accuracy of data used to compute deferred revenue. The results of the quality assurance counts (e.g., the error rate) should be recorded and used to develop a quality assurance function. Policies governing cycle counts should be developed and followed; and
- d) Revise policies and procedures, including contractor agreements, to ensure that fee receipts are deposited in accordance with Treasury guidelines.

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L. Environmental Liabilities

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

The Plum Island Animal Disease Center (PIADC) was transferred to DHS from the Department of Agriculture and is dedicated to the study of animal diseases to better protect the food supply. Previously the PIADC was a U.S. Army installation. The type of research conducted at PIADC and its past use as a military facility are indicators that the land and buildings may require substantial environmental clean-up to eliminate environmental contaminants. PIADC is now part of DHS' S&T Directorate.

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

1. At Coast Guard:

- Consistent policies or procedures have not been developed for the identification, evaluation, and estimation of potential environmental remediation of Coast Guard sites, thereby resulting in different approaches by shore facility commands and ultimately varying liability estimates;
- Personnel do not always follow stated policies and procedures, such as current year indexing and usage of contingency factors for possible unknown conditions;
- Environmental liability estimates associated with lighthouses/light stations did not include future Phase II (soil testing) assessment or remediation costs;
- The estimates for both shore facilities and vessels were misstated due to ineffective procedures. In addition, we noted that the Coast Guard did not properly index the liability costs to current year dollars, nor did they properly include contingency factors for unknown conditions resulting in a potential understatement of the liability in the financial statements;
- Consistent policies and procedures have not been developed to estimate the cost of remediation of specific projects, such as lighthouses and small arms firing ranges; and
- There is no management review of the environmental compliance and remediation estimates reported at year-end to ensure accuracy and consistency in recording the liability in the financial statements.

2. At S&T, policies and procedures have not been developed to determine if an environmental liability exists at the PIADC and if so to accurately estimate and record an environmental liability for the cost of cleanup.

Cause/Effect: Coast Guard has not developed consistent written agency-wide policies to define the technical approach, cost estimation methodology, and overall management of its environmental remediation projects, resulting in inconsistency in its estimates and possible misstatement of the liability in their financial statements.

Criteria: SFFAS No. 6, paragraph 85, defines environmental cleanup costs as those costs for removing, containing, and/or disposing of (1) hazardous waste from property, or (2) material and/or property that consists of hazardous waste at permanent or temporary closure or shutdown of associated PP&E. Paragraph 88 states that these cleanup costs meet the definition of liability provided in SFFAS No. 5, *Accounting for Liabilities of the Federal Government*. In addition, SFFAS No. 6, paragraph 96, states that

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remediation estimates shall be revised periodically to account for material changes due to inflation or deflation and changes in regulations, plans and/or technology. New remediation cost estimates should be provided if there is evidence that material changes have occurred; otherwise estimates may be revised through indexing.

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

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

Recommendations: We recommend that

1. Coast Guard:
 - a) Implement policies and procedures to ensure the proper calculation and review of cost estimates for consistency and accuracy in financial reporting; and
 - b) Develop and implement policies and procedures to apply indexing and contingencies to environmental estimates on a consistent basis, and to require their documentation.
2. S&T evaluate the PIADC facility using a qualified environmental specialist to determine if an environmental liability exists, and if so to accurately estimate and record an environmental liability for the cost of cleanup.

M. Custodial Activity Performed by Customs and Border Protection

Background: CBP, as a component of DHS, has continued to perform an important revenue collection function for the U.S. Treasury. CBP collects approximately \$24 billion in import duties, taxes and fees annually on merchandise arriving in the United States from foreign countries. Receipts of import duties and related refunds are presented in the statement of custodial activity in the DHS consolidated financial statements. CBP is the only DHS bureau with significant custodial responsibilities.

Generally, an importer is required to pay CBP the appropriate duties, taxes, and fees at the port of arrival (port of origin). An exception is made, however, for goods transported "in-bond" from the port of origin to another port (port of destination) within the United States. Merchandise traveling in-bond is not subject to duties, taxes, and fees until it reaches the port of destination where it is ultimately released into the commerce or destroyed. The bonded carrier is ultimately obligated by their official bond to ensure the integrity of the merchandise until disposition and the payment of appropriate duty, if any, is due. It is CBP's responsibility to control the movement and disposition of in-bond shipments with effective policies and regulations that result in either collection of applicable duties, taxes, and fees at the port of destination or the export of the merchandise. CBP has developed a compliance measurement program, called TINMAN, to select, review and determine overall compliance of in-bond movements.

Drawback is a remittance in whole or in part, of duties, taxes, or fees previously paid by an importer. Drawback typically occurs when the imported goods on which duties, taxes, or fees have been previously

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paid are subsequently exported from the United States or destroyed prior to entering the commerce of the United States. Depending on the type of claim, the claimant may have up to eight years from the date of importation to file for drawback.

Conditions: We noted the following internal control weaknesses related to in-bond movements of imported goods.

CBP:

- Did not have a reliable process of monitoring the movement of in-bond shipments;
- Lacked adequate written SOPs for the use of TINMAN; and
- Lacked consistent performance of a compliance measurement program to periodically assess the risk and compute an estimate of underpayment of duties, taxes and fees.

We also noted the following internal control weaknesses at CBP related to the drawback of duties, taxes, and fees paid by importers:

- The revenue accounting system, Automated Commercial System (ACS), lacked controls to detect and prevent excessive drawback claims and payments, necessitating inefficient manual processes to compensate. ACS did not have the capability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries or export documentation upon which the drawback claim was based. For example, ACS did not contain electronic edit checks that would flag duplicate claims for export of the same merchandise;
- Drawback review policies did not require drawback specialists to review all related drawback claims against the underlying consumption entries to determine whether, in the aggregate, an excessive amount was claimed; and
- At final liquidation of a drawback claim, although ACS flags a drawback in excess of the gross amount paid on an import, ACS does not have a control to prevent a claim from being processed for an erroneous amount.

Cause/Effect: Much of the in-bond and drawback process was manual, placing an added burden on limited resources.

For in-bond, we noted that in most cases in-bond imports were opened correctly in the system at the arrival ports; however, the ports did not have the resources to close out all in-bond movements that were received at the destination port. Policies and procedures have not been developed and/or implemented to reliably and accurately track and close in-bond movements in a timely manner. System limitations reduced the effectiveness of physical inspections and the reliability of in-bond reports and prevented electronic comparisons of entry and export information. Without an adequate process to track and close in-bond movements and an effective compliance measurement program, CPB lacks assurance that: (i) declared quantity and type of cargo moving in-bond is accurate and complete, (ii) cargo actually reaches its scheduled destination, and (iii) calculated and collected revenue for cargo moving in-bond is accurate and complete in relation to the entry summary filing.

For drawback, CBP did use a sampling approach to compare, verify, and match consumption entry and export documentation to drawback claims submitted by importers. However, procedural limitations decreased the effectiveness of this approach. The inherent risk of fraudulent claims or claims made in error is high for the drawback program, and therefore, good internal controls are essential to manage and reduce the risk of erroneous payments.

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Criteria: Under FMFIA, management must implement cost-effective controls to safeguard assets and ensure reliable financial reporting. Further, while DHS was not subject to FFMIA, OMB's *Revised Implementation Guidance*, states that financial systems should "routinely provide reliable financial information consistently, accurately, and reported uniformly" to support management of current operations. In addition, CBP policies require that all in-bond transactions should be closed out timely to ensure that goods are not diverted into commerce without filing and paying the proper amount of duties, taxes, and fees. JFMIP publications and OMB Circular No. A-127 outlines the requirements for Federal systems. JFMIP's *Core Financial System Requirements*, states that the core financial system must maintain detailed information by account sufficient to provide audit trails and to support billing and research activities. Circular No. A-127 requires that the design of financial systems should eliminate unnecessary duplication of a transaction entry. Wherever appropriate, data needed by the systems to support financial functions should be entered only once and other parts of the system should be updated through electronic means consistent with the timing requirements of normal business/transaction cycles.

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

Recommendations: We recommend that CBP:

- a) Design in-bond monitoring and reconciliation controls into the new systems that will replace ACS in the future;
- b) Develop and implement SOPs that define procedures and responsibilities for the TINMAN program;
- c) Reinstate the compliance measurement audits over the in-bond program, including a methodology for measurement of results from inspections performed based on TINMAN selection;
- d) Implement effective internal controls over drawback claims as part of any new systems initiatives, including the ability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries and exportation documentation for which the drawback claim is based, and identify duplicate or excessive drawback claims;
- e) Adopt a review methodology to allow a statistical projection from drawback testing; and
- f) Revise current policies and procedures to require drawback specialists to review all prior related drawback claims against a designated consumption entry to determine whether, in the aggregate, an excessive amount was claimed against the consumption entries.

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Independent Auditors' Report Appendix III – Compliance and Other Matters

(Findings A – J and K – M are presented in Appendices I and II, respectively)

N. Federal Managers' Financial Integrity Act of 1982

OMB Circular A-123 requires agencies and Federal managers to (i) develop and implement management controls; (ii) assess the adequacy of management controls; (iii) identify needed improvements; (iv) take corresponding corrective action; and (v) report annually on management controls (commonly known as management's FMFIA report). We noted that DHS management's FMFIA report did not contain corrective action plans for all material weaknesses identified in its PAR. DHS and its components – CIS, Coast Guard, EPR, ICE, TSA and DHS – have not established effective systems, processes, policies and procedures to evaluate and report on internal accounting and administrative controls, and conformance of accounting systems to properly and accurately report on compliance with Sections FMFIA Sections 2 and 4.

Recommendations: We recommend that DHS improve its process to ensure compliance with FMFIA in FY 2005.

O. Federal Information Security Management Act (Electronic Government Act of 2002)

DHS is required to comply with the FISMA, which was enacted as part of the *Electronic Government Act of 2002*. FISMA requires agencies and departments 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 non-compliance with FISMA that have been reported by us in Appendix I within Comment D– *Financial Systems Functionality and Technology*.

Recommendations: We recommend that DHS follow the recommendations provided in Appendix I, Comment D.

P. Single Audit Act Amendments of 1996, Laws and Regulations Supporting OMB Circular No. A-50, Audit Follow-up, as revised, and the Robert T. Stafford Disaster Relief and Emergency Assistance Act as amended October 2000 (Stafford Act)

As grant-making agencies, EPR, SLGCP and TSA are required to comply with certain provisions of OMB Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations, Subpart D – Federal Agencies and Pass-Through Entities*, and OMB Circular No. A-50, *Audit Follow-up*. The circulars require agencies awarding grants to ensure they receive grantee reports timely, to follow-up on grantee single audit findings, and to communicate program identification information to the grantees. In addition, under the Stafford Act, EPR must perform cost-share analysis of applicable grants to ensure that the grantees are funding their appropriate share of program costs.

Although certain procedures have been implemented to monitor grantees and their audit findings, we noted that EPR, SLGCP and TSA did not have procedures in place to fully comply with provisions in OMB Circulars No. 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. Since single audits typically are performed by other entities outside of DHS, procedures related to these reports are not

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Independent Auditors' Report Appendix III – Compliance and Other Matters

always entirely within EPR's, SLGCP's and TSA's control. We noted that EPR was not in full compliance with the *Stafford Act* because certain cost-share analysis and follow-up were not timely performed or provided to State grantees in one regional office. In addition, EPR had not always provided notification of the *Catalog of Federal Domestic Assistance* (CFDA) number to grantees.

Recommendations: We recommend that:

1. DHS management develop and implement department-wide policies and procedures to ensure compliance with OMB Circulars A-133 and A-50, including the identification of which bureau must comply. Until policy guidance is received from DHS management, EPR and SLGCP should perform the following in FY 2005:
 - a) Develop and implement a tracking system to identify each grantee for which an OMB Circular A-133 single audit is required and the date the audit report is due;
 - b) Use the tracking system to ensure audit reports are received timely, or to follow-up when reports are overdue; and
 - c) Perform reviews of grantee audit reports, issue related management decisions, and ensure that the grantees take appropriate corrective action, on a timely basis.
2. In addition, EPR should perform the following in FY 2005:
 - a) Ensure that grants management specialists review and document the results of their cost-share analyses for reasonableness and accuracy, and perform timely follow-up if their analyses indicate potential issues with the cost-share amounts; and
 - b) Ensure that all grant identifying information, including CFDA numbers, is communicated to the grantees timely and that evidence of such communication be maintained in the applicable grant file.
3. TSA should implement policies and procedures to effectively monitor grantee's performance to meet the requirements of OMB A-50, and obtain, review and maintain the appropriate performance reports, i.e., SF-424 and SF-270.

Q. Improper Payments Information Act of 2002

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

DHS did not:

- Properly define programs and activities;
- Institute a systematic method of reviewing all programs and identifying those it believed were susceptible to significant erroneous payments; and

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- Properly sample or compute the estimated dollar amount of improper payments.

Recommendation: We recommend that DHS follow the guidance provided in OMB M-03-13 in FY 2005, including re-examining the definition of a program, completing the necessary susceptibility assessments, instituting sampling techniques to allow for statistical projection of the results, and providing information for proper disclosure in its PAR.

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Independent Auditors' Report Appendix IV – Status of Prior Year Findings

<u>Summary of Conditions</u> <u>As Reported in 2003 Performance and Accountability Report</u>	<u>FY 2004</u> <u>Status/ Disposition</u>
A. Financial Management and Personnel	
1. OCFO has not established a hierarchy of financial reporting authority; assessed critical process needs necessary to install proper internal controls over financial reporting; developed standard operating procedures over financial reporting; or hired or contracted sufficient qualified personnel to properly perform the financial reporting function.	Repeated as Material Weakness (Comments A and C)
2. The Coast Guard and SNS have weaknesses in financial management oversight over the financial reporting process.	Partially Repeated as Material Weakness (Comment C)
B. Financial Reporting	
1. OCFO and the DHS bureaus have not prepared timely consolidated financial statements; implemented electronic interfaces between bureaus and OCFO for reporting; compared TIER and CFO Vision to Treasury USSGL roll-ups and financial statement crosswalks; reviewed bureau reports for consistent use of the USSGL; prepared financial reporting instructions related to TIER and to all elements of the PAR; prepared RSSI correctly; adopted an effective process to compile year-end consolidated financial statements; identified laws and regulations that may have a direct and material effect on the financial statements; or implemented procedures to ensure accuracy and completeness of FMFIA.	Partially Repeated as Material Weakness (Comment C)
2. Coast Guard has a reporting process that is complex and requires a significant number of on-top entries, and lacks documentation of internal controls.	Repeated as Material Weakness (Comment C)
3. CIS, ICE, EPR, and Coast Guard do not have documented policies and procedures for exporting data from the general ledger for the TIER submission routinely; quality control procedures over financial reports are not regularly performed; TIER input is not reconciled to outputs provided by the OCFO; and the accuracy of financial information is highly dependent on the knowledge of a few individuals.	Partially Repeated as Material Weakness (Comment C)

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Independent Auditors' Report Appendix IV – Status of Prior Year Findings

C. Financial Systems Functionality and Technology

- | | |
|---|---|
| 1. OCFO and DHS bureaus have IT and financial system control and functionality weaknesses in entity-wide security program planning and management, access controls, application software development and change controls, system software, segregation of duties, and service continuity. | Partially Repeated as Material Weakness
(Comment D) |
|---|---|

D. Property, Plant, and Equipment

- | | |
|--|---|
| 1. Coast Guard has not maintained cost documentation for some PP&E; accounted properly for depreciation of improvements made for some PP&E; established policies related to the useful lives of certain vessels; and properly classified repairable items as PP&E. | Partially Repeated as Material Weakness
(Comment F) |
| 2. TSA lacks a property management system that interfaces and reconciles with the general ledger and does not have adequate policies and procedures for the reporting of acquisitions and disposals of property | Corrected |
| 3. CIS/ICE has not consistently applied procedures to identify and capitalize software development costs or properly reclassify software placed into production. | Repeated as Material Weakness
(Comment F) |

E. Operating Materials and Supplies

- | | |
|--|---|
| 1. Coast Guard procedures and internal controls over physical counts were not operating effectively; OM&S was not always properly tagged; on-hand quantities frequently did not agree to the perpetual inventory records; and the policies were not updated to ensure correct financial reporting. | Repeated as Material Weakness
(Comment G) |
|--|---|

F. Actuarial Liabilities

- | | |
|--|--|
| 1. Secret Service did not record the actuarial pension liability for employees who elected to participate in the D.C. Pension Plan. | Corrected |
| 2. Coast Guard did not determine or record the amounts and timing of future payments related to certain entitlements consistent with Federal accounting standards. | Removed
(Not Significant to Consolidated Financial Statements) |

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Independent Auditors' Report Appendix IV – Status of Prior Year Findings

G. Transfers of Funds, Assets, and Liabilities to DHS

- | | |
|--|--|
| <p>1. OCFO and DHS bureaus lack procedures to verify accuracy and completeness of March 1, 2003 transferred balances; lack controls to verify the accuracy of monthly financial reports received from legacy agencies; some Memorandums of Understanding (MOU) did not specify the reimbursement terms for services provided; and after the transfer date, some agencies operating under an MOU with DHS had difficulty providing required financial statement information needed for DHS to produce its operating statements for the seven months ended September 30, 2003.</p> | <p>Partially Repeated as Material Weakness
(Comment B – related to transfers of legacy agency records to ICE)</p> |
|--|--|

Reportable Conditions:

H. Drawback Claims on Duties, Taxes, and Fees

- | | |
|--|--|
| <p>1. CBP lacks an automated system to track and compare drawback claims to detect and prevent excessive or erroneous drawback amounts; lacks a single integrated system; and policies and procedures for reviewing claims and supervisory review need to be improved.</p> | <p>Repeated as Reportable Condition
(Comment M)</p> |
|--|--|

I. In-Bond Movements of Imported Goods

- | | |
|--|--|
| <p>1. CBP does not have a reliable process to monitor in-bond movement and also did not utilize its existing in-bond movement compliance measurement process to assess risk and compute an estimate of underpayment of duties, taxes and fees.</p> | <p>Repeated as Reportable Condition
(Comment M)</p> |
|--|--|

J. Acceptance and Adjudication of Immigration and Naturalization Applications

- | | |
|---|--|
| <p>1. CIS lacks SOPs for tracking and reporting the status of immigration and naturalization applications; related system interfaces; and policies that require periodic cycle counts of its pending applications to verify the accuracy of deferred revenue.</p> | <p>Repeated as Reportable Condition
(Comment K)</p> |
|---|--|

K. Fund Balance with Treasury (FBWT)

- | | |
|--|---|
| <p>1. Coast Guard did not perform timely reconciliation procedures for FBWT, and lacks SOPs on FBWT reconciliation procedures.</p> | <p>Repeated as Material Weakness
(Comment E)</p> |
|--|---|

IV.3

Appendices

Independent Auditors' Report Appendix IV – Status of Prior Year Findings

L. Intragovernmental Balances

- | | |
|---|--|
| 1. Coast Guard, EPR, CBP, Secret Service, CIS/ICE, and certain programs that are accounted for by legacy agencies do not have effective SOPs to track, confirm, or reconcile intragovernmental balances and transactions with trading partners. | Partially Repeated as
Material Weakness
(Comment J) |
|---|--|

M. Strategic National Stockpile

- | | |
|--|--|
| 1. SNS has fragmented accounting processes; inventory balances that were not properly valued at historical cost; IT system limitations; and lack of policies and procedures over essential accounting processes. | Removed
(SNS was transferred to
HHS in August 2004) |
|--|--|

N. Accounts Payable and Undelivered Orders (UDO)

- | | |
|---|--|
| 1. CIS/ICE had errors in the source data used to calculate accounts payable, and field personnel did not always review UDOS. | Repeated as
Material Weakness
(Comment H) |
| 2. TSA policies and procedures were not in place to accurately compute and accrue accounts payable transactions, and TSA did not have a reliable method to estimate accounts payable. | Corrected |
| 3. Coast Guard had difficulty recording accurate UDO and accounts payable balances at year-end and during the year. | Repeated as
Material Weakness
(Comment H) |

Appendices

Management's Response to the Independent Auditor's Report

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



Homeland Security

MEMORANDUM FOR CLARK KENT ERVIN
INSPECTOR GENERAL

November 18, 2004

FROM: Andrew Maner
Chief Financial Officer

SUBJECT: Management Response – Independent Auditor's Report on the Department of Homeland Security Fiscal Year 2004 Financial Statements

On behalf of Secretary Ridge, I am responding to the Independent Auditor's Report on the Department's fiscal year 2004 financial statements included in the Department's fiscal year 2004 *Performance and Accountability Report*.

We appreciate your efforts to audit the Department's fiscal year 2004 financial statements and provide relevant and objective recommendations on how our office can improve the Department's financial reporting practices including those at several of the components. Our second year of operation has been very challenging with the tri-bureau issues and the reassignment of the legacy agencies accounting functions to U.S. Immigration and Customs Enforcement. All of the Department's organizational elements are to be commended for their participation in this effort. Moreover, the accompanying report of your auditors would not have been possible without your office's professional assistance, technical expertise and commitment.

We concur with the ten reportable conditions that are considered to be material weaknesses as well as three other reportable conditions contained in the auditor's report. Corrective actions will be prepared to address these as well as other inherited weaknesses that were still identified in the auditor's report. We will provide your office with new or updated action plans, as appropriate, to correct these conditions. As you are well aware, some of these conditions can take several years to correct. The affected Department organizational elements will continue to focus on and strive to improve their efforts to address the conditions and noncompliance issues contained in the auditor's report.

The ability of my office to produce financial statements and the ability of your staff to carry out the audit provide clear evidence of the professional, cooperative working relationship between our staffs. I am confident that these effective relationships and partnerships will result in recognizable and measurable improvements and efficiencies in our respective reporting and auditing practices.

Sincerely,

A handwritten signature in black ink, appearing to read "A. Maner".

Andrew Maner
Chief Financial Officer

Financial Information

**Department of Homeland Security
Consolidated Balance Sheets
As of September 30, 2004 and 2003
(In Millions)**

	<u>2004 (unaudited)</u>	<u>2003</u>
ASSETS		
Intra-governmental Assets		
Fund Balance with Treasury (Notes 2,3)	\$33,436	\$27,343
Investments (Note 4)	1,625	1,546
Advances and Prepayments (Note 5)	2,886	3,054
Other Intra-governmental Assets (Note 11)	481	415
Total Intra-governmental Assets	38,428	32,358
Tax, Duties, and Trade Receivables, Net (Note 6)	1,273	1,140
Operating Materials and Supplies, Inventory, Net (Notes 8,27)	496	1,162
Property, Plant and Equipment, Net (Note 10)	9,746	9,138
Other (Note 11)	863	750
TOTAL ASSETS (Note 2)	\$50,806	\$44,548
LIABILITIES		
Intra-governmental Liabilities		
Due to the Treasury General Fund (Note 6)	\$1,257	\$1,209
Accounts Payable	911	398
Other Intra-governmental Liabilities (Note 17)	563	349
Total Intra-governmental Liabilities	2,731	1,956
Accounts Payable	2,791	1,979
Claims and Claims Settlement Liabilities (Note 13)	1,417	754
Deferred Revenue and Advances from Others (Note 14)	2,020	1,969
Accrued Payroll and Benefits (Note 15)	2,692	2,275
Military Service and other Retirement Benefits (Note 16)	26,502	25,285
Other Liabilities (Note 17)	4,166	2,450
TOTAL LIABILITIES (Note 12)	42,319	36,668
Commitments and Contingencies (Notes 18,19)		
NET POSITION		
Unexpended Appropriations	25,504	23,560
Cumulative Results of Operations	(17,017)	(15,680)
TOTAL NET POSITION (Note 27)	8,487	7,880
TOTAL LIABILITIES AND NET POSITION	\$50,806	\$44,548

The accompanying notes are an integral part of these statements.

Financial Information

**Department of Homeland Security
Consolidated Statement of Net Cost
For the Year Ended September 30, 2004 (unaudited)
(In Millions)**

Directorates and Other Components:	Intra-governmental	With the Public	Total
Border and Transportation Security (Note 20)			
Gross Cost	\$3,042	\$15,453	\$18,495
Less Earned Revenue	(549)	(2,359)	(2,908)
Net Cost	2,493	13,094	15,587
Emergency Preparedness and Response			
Gross Cost	690	7,220	7,910
Less Earned Revenue	(119)	(1,901)	(2,020)
Net Cost of Continuing Operations	571	5,319	5,890
Cost of Transferred Operations (Note 27)	98	-	98
Net Cost	669	5,319	5,988
Information Analysis & Infrastructure Protection			
Gross Cost	349	148	497
Less Earned Revenue	-	-	-
Net Cost	349	148	497
Science and Technology			
Gross Cost	359	396	755
Less Earned Revenue	-	-	-
Net Cost	359	396	755
United States Coast Guard			
Gross Cost	1,186	7,131	8,317
Less Earned Revenue	(90)	(67)	(157)
Net Cost	1,096	7,064	8,160
United States Secret Service			
Gross Cost	389	997	1,386
Less Earned Revenue	(18)	-	(18)
Net Cost	371	997	1,368
United States Citizenship and Immigration Service			
Gross Cost	553	1,205	1,758
Less Earned Revenue (Note 14)	15	(1,325)	(1,310)
Net Cost	568	(120)	448
Departmental Operations and Other			
Gross Cost	138	192	330
Less Earned Revenue	(5)	-	(5)
Net Cost	133	192	325
TOTAL NET COST (Notes 20, 21)	\$6,038	\$27,090	\$33,128

The accompanying notes are an integral part of these statements.

Financial Information

**Department of Homeland Security
Consolidated Statement of Changes in Net Position
For the Year Ended September 30, 2004 (unaudited)
(In Millions)**

	Cumulative Results of Operations	Unexpended Appropriations
BEGINNING BALANCES	\$(15,680)	\$23,560
Budgetary Financing Sources:		
Appropriations Received (Note 22)	-	33,410
Appropriations Transferred in(out) (Note 27)	-	(398)
Recissions and Other Adjustments (Note 3)	-	(2,398)
Appropriations Used	28,670	(28,670)
Non-exchange Revenue	2,308	-
Donations and Forfeitures of Cash/Equivalents	3	-
Transfers in(out) without Reimbursement	672	-
Other	73	-
Other Financing Sources:		
Donations and Forfeitures of Property	8	-
Transfers in(out) Without Reimbursement (Note 27)	(685)	-
Imputed Financing from costs absorbed by others	742	-
Total Financing Sources	31,791	1,944
Net Cost of Operations	(33,128)	-
ENDING BALANCES	\$(17,017)	\$25,504

The accompanying notes are an integral part of these statements.

Financial Information

**Department of Homeland Security
Combined Statement of Budgetary Resources
For the Year Ended September 30, 2004 (unaudited)
(In Millions)**

BUDGETARY RESOURCES

Budget Authority:

Appropriations Received	38,303
Borrowing Authority	26
Net Transfers	757

Unobligated Balance

Beginning of Period (Note 22)	8,659
Net Transfers	41

Spending Authority from Offsetting Collections

Earned	
Collected	6,282
Receivable from Federal Sources	9
Change in Unfilled Customer Orders	
Advance Received	87
Without Advance From Federal Sources	258
Transfers from Trust Funds	55

Subtotal	6,691
Recoveries of Prior Year Obligations	1,982
Temporarily Not Available Pursuant to Public Law	(17)
Permanently Not Available (Note 22)	(2,563)
TOTAL BUDGETARY RESOURCES	\$53,879

STATUS OF BUDGETARY RESOURCES

Obligations incurred:

Direct (Note 22)	\$43,628
Reimbursable (Note 22)	2,880

Total Obligations incurred	46,508
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Unobligated Balance

Apportioned	5,691
Exempt from Apportionment	42

Unobligated Balance Not Available	1,638
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TOTAL STATUS OF BUDGETARY RESOURCES	\$53,879
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(Continued)

Financial Information

Department of Homeland Security
Combined Statement of Budgetary Resources, Continued
For the Year Ended September 30, 2004 (unaudited)
(In Millions)

RELATIONSHIP OF OBLIGATIONS TO OUTLAYS

Obligated Balance, Net, Beginning of Period	\$19,689
Obligated Balance Transferred, Net	(559)
Obligated Balance, Net, End of Period	
Accounts Receivable	(437)
Unfilled Customer Orders from Federal Sources	(981)
Undelivered Orders	21,354
Accounts Payable	5,866
Total Obligated Balance, Net, End of Period	<u><u>\$25,802</u></u>
Outlays	
Disbursements	\$37,601
Collections	(6,424)
Total Outlays	<u>31,177</u>
Less: Offsetting Receipts	(3,779)
NET OUTLAYS	<u><u>\$27,398</u></u>

The accompanying notes are an integral part of these statements.

Financial Information

**Department of Homeland Security
Consolidated Statement of Financing
For the Year Ended September 30, 2004 (unaudited)
(In Millions)**

Resources Used to Finance Activities:

Budgetary Resources Obligated

Obligations Incurred	\$46,508
Less: Spending Authority from Offsetting Collections and Recoveries	(8,673)
Obligations Net of Offsetting Collections and Recoveries	37,835
Less: Offsetting Receipts	(3,779)
Net Obligations	34,056

Other Resources

Donations and Forfeiture of Property	8
Transfers in(out) Without Reimbursement	(685)
Imputed Financing from Costs Absorbed by Others	742
Net Other Resources Used to Finance Activities	65

Total Resources Used to Finance Activities **34,121**

Resources Used to Finance Items Not Part of the Net Cost of Operations

Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but not yet Provided	5,029
Resources that Fund Expenses Recognized in Prior Periods	578
Budgetary Offsetting Collections and Receipts that do not Affect Net Cost of Operations:	
Offsetting Receipts - Customs and Border Protection	(1,182)
Other	(816)
Resources that Finance the Acquisition of Assets or Liquidation of Liabilities	1,575
Other Resources or Adjustments to Net Obligated Resources that do not Affect Net Cost of Operations	(471)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	4,713

Total Resources Used to Finance the Net Cost of Operations **29,408**

(Continued)

Financial Information

**Department of Homeland Security
Consolidated Statement of Financing, Continued
For the Year Ended September 30, 2004 (unaudited)
(In Millions)**

Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period:

Components Requiring or Generating Resources in Future Periods:

Increase in Annual Leave Liability	202
Increase in Environmental and Disposal Liability	62
Increase in Exchange Revenue Receivable from the Public	(32)
Increase in Military Service and Other Retirement benefits	1,217
Other	919
Total Components of Net Cost of Operations that will Require or Generate Resources in Future Periods	2,368

Components not Requiring or Generating Resources:

Depreciation and Amortization (Note 10)	1,011
Revaluation of Assets or Liabilities	39
Other	302
Total components of Net Cost of Operations that will not Require or Generate Resources	1,352

Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	3,720
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Net Cost of Operations	\$33,128
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The accompanying notes are an integral part of these statements.

Financial Information

**Department of Homeland Security
Statements of Custodial Activity
For the Year Ended September 30, 2004 and the Seven Months Ended
September 30, 2003
(In Millions)**

	2004 (unaudited)	2003
Sources of Custodial Revenue & Collections		
Revenue Received		
Duties	\$20,966	\$11,927
User Fees	924	454
Excise Taxes	2,271	1,264
Fines and Penalties	57	43
Interest	11	8
Miscellaneous	225	3
Total Cash Collections	24,454	13,699
Accrual Adjustment	(5)	(3)
Total Custodial Revenue	24,449	13,696
Disposition of Custodial Revenue		
Transferred to Non-Federal Entities	182	59
Transferred to Federal Entities	23,287	13,082
Refunds and Drawbacks	970	558
Retained by the Department	10	(3)
Total Disposition of Custodial Revenue	24,449	13,696
Net Custodial Activity	\$0	\$0

The accompanying notes are an integral part of these statements.

Notes to the Consolidated Financial Statements

1. Summary of Significant Accounting Policies

A. Reporting Entity

The U.S. Department of Homeland Security (DHS or Department) was established by the *Homeland Security Act of 2002* (the Act), Public Law (P.L.) 107-296, dated March 25, 2002, as an executive department of the United States government. The primary mission of DHS is to:

- Prevent terrorist attacks within the United States;
- Reduce the vulnerability of the United States to terrorism;
- Minimize the damage, and assist in the recovery, from terrorist attacks and natural disasters that occur within the United States;
- Carry out all functions of entities transferred to the Department, including acting as a focal point regarding natural and manmade crises and emergency planning;
- Ensure that the functions of the agencies and subdivisions within the Department that do not directly relate to securing the homeland are not diminished or neglected except by a specific, explicit Act of Congress;
- Ensure that the overall economic security of the United States is not diminished by efforts, activities, and programs aimed at securing the homeland; and
- Monitor connections between illegal drug trafficking and terrorism, coordinate efforts to sever such connections, and otherwise contribute to efforts to interdict illegal drug trafficking.

The Department is composed of the following organizational elements, hereafter referred to as components:

Directorates:

Information Analysis and Infrastructure Protection Directorate (IAIP)

Border and Transportation Security Directorate (BTS):

- U.S. Customs and Border Protection (CBP)
- U.S. Immigration and Customs Enforcement (ICE), including Federal Protection Service (FPS) and Federal Air Marshal Service (FAM)
- Transportation Security Administration (TSA)
- Federal Law Enforcement Training Center (FLETC)
- Office of State and Local Government Coordination and Preparedness (SLGCP), including former Office of Domestic Preparedness (ODP)

Emergency Preparedness and Response Directorate (EPR)

Science and Technology Directorate (S&T)

Management Directorate

Other Components:

U.S. Coast Guard (USCG)

U.S. Secret Service (USSS)

U.S. Citizenship and Immigration Services (CIS)

Office of the Inspector General (OIG)

Financial Information

Pursuant to the Department's Fiscal Year 2004 Appropriations Act, P.L. 108-90, effective October 1, 2003, the FAM program was realigned, within BTS, from TSA to ICE.

The FY 2004 Appropriations Act also established the DHS Working Capital Fund, as authorized by the Homeland Security Act of 2002, for expenses and equipment necessary for maintenance and operations of administrative services that are determined to be performed more advantageously as central services.

On July 21, 2004, the President signed the *Project Bioshield Act of 2004, P.L. 108-276*. The act authorized the transfer of the Strategic National Stockpile (SNS) functions, personnel, assets, unexpended balances and liabilities to the Department of Health and Human Services (HHS). Pursuant to *Project Bioshield Act of 2004*, on August 13, 2004, the Department transferred the SNS from the DHS Directorate for Emergency Preparedness and Response to HHS. Although the program has been transferred operations related to the SNS activities are reflected in the Department's Consolidated Statement of Net Cost through the date of transfer.

On January 26, 2004, the Secretary, under the statutory authority for reorganization contained in the *Homeland Security Act of 2002*, notified the Congress of the Department's intent to merge the Office of Domestic Preparedness (ODP) with the Office of State and Local Government Coordination (SLGC) to form a new Office of State and Local Government Coordination and Preparedness (SLGCP). In accordance with Section 872 of the *Homeland Security Act of 2002*, this reorganization plan is considered to have become formalized 60 days after the provision of the notice. The SLGCP reports directly to the Secretary and is responsible for information flow between the Department and State and local governments, for State and local grant award functions, and for building and sustaining the terrorism preparedness of the first responder community. In addition, select grant award functions currently administered by EPR and TSA will be transferred to SLGCP, beginning in FY 2005. Consequently, the Department expects to report a change of the reporting entity upon passage of the Department's FY 2005 appropriation bill that will affect the presentation of net cost in the Consolidated Statement of Net Cost and related notes beginning in FY 2005.

During FY 2004, the Department accomplished a reduction in the number of financial management functions that maintained general ledgers and underlying controls supporting the consolidation of the Department's financial statements. Effective October 1, 2003, U.S. ICE assumed the financial management functions previously provided to the components for S&T and IAIP by the Departments of Justice, Commerce, Energy, Defense, Agriculture, and the General Services Administration (GSA). In addition, CBP assumed the financial management functions previously provided for the Agricultural Quarantine Inspection Program by the Agricultural Research, United States Department of Agriculture (USDA). EPR assumed, for most of FY 2004, the financial management functions previously provided for the SNS by HHS, until the SNS was transferred back to HHS as described above.

B. Basis of Accounting and Presentation

The financial statements have been prepared from the accounting records of DHS and its components in conformity with accounting principles generally accepted in the United States, and the Office of Management and Budget (OMB) Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. Accounting principles generally accepted for Federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB), the official accounting standards-setting body of the Federal Government.

These financial statements are provided to meet the requirements of the *Accountability of Tax Dollars Act of 2002*. They consist of the Consolidated Balance Sheet, the Consolidated Statement of Net Cost, the Consolidated Statement of Changes in Net Position, the Combined Statement of Budgetary Resources, the Consolidated Statement of Financing, and the Statement of Custodial Activity as of and for the year ended September 30, 2004.

Financial Information

Comparative financial information is only presented for the Consolidated Balance Sheet and the Statement of Custodial Activity and the related note disclosures. The Department obtained a waiver from OMB to present comparative FY 2003 information for all other financial statements, related footnotes, and supplemental information.

The Department's financial statements reflect the reporting of entity activities which include appropriations received to conduct its operations and revenue generated from those operations. They also reflect the reporting of certain non-entity (custodial) functions it performs on behalf of the Federal Government and others (CBP has the authority to assess and collect duties, taxes, and fees for the government of Puerto Rico and the Virgin Islands).

Transactions are recorded on an accrual and a budgetary basis of accounting. The Consolidated Balance Sheet, the Consolidated Statement of Net Cost, and the Consolidated Statement of Changes in Net Position are reported using the accrual basis of accounting. Under the accrual basis, revenues are recorded when earned and expenses are recognized when a liability is incurred, regardless of when cash is exchanged. The Combined Statement of Budgetary Resources is reported using the budgetary basis of accounting. Budgetary accounting facilitates compliance with legal constraints and controls over the use of Federal funds. Budgetary accounting generally differs from the accrual basis of accounting in that obligations are recognized when new orders are placed, contracts awarded, and services received, that will require payments during the same or future periods. The Consolidated Statement of Financing reconciles differences between the budgetary and accrual basis of accounting. Non-entity revenue and refunds are reported on the Statement of Custodial Activity using a modified cash basis. With this method, revenue from cash collections are reported separately from receivable accruals, and cash disbursements are reported separately from payable accruals.

Intragovernmental assets and liabilities result from activity with other Federal agencies. All other assets and liabilities result from activity with parties outside the Federal government, such as domestic and foreign persons, organizations, or governments. Intra-governmental earned revenues are collections or accruals of revenue from other Federal agencies, and intra-governmental costs are payments or accruals to other Federal agencies. Transactions and balances among the Department's entities have been eliminated from the Consolidated Balance Sheet, the Consolidated Statement of Net Cost, and the Consolidated Statement of Changes in Net Position. As provided by OMB Bulletin No. 01-09, the Statement of Budgetary Resources is presented on a combined basis; therefore, intra-departmental transactions and balances have not been eliminated from this statement. In accordance with OMB Bulletin No. 01-09, intra-departmental transactions and balances have been eliminated from all the amounts on the Consolidated Statement of Financing, except for obligations incurred and spending authority from offsetting collections and adjustments, which are presented on a combined basis.

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

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

Financial Information

C. Entity Revenue and Financing Sources

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

Appropriations are recognized as financing sources when related expenses are incurred or assets are purchased. Revenue from reimbursable agreements is recognized when the goods or services are provided by DHS. Prices for goods and services sold to the public are based on recovery of full cost or are set at a market price. Reimbursable work between Federal appropriations is subject to the *Economy Act* (31 U.S.C. 1535) or other statutes authorizing reimbursement. Prices for goods and services sold to other Federal government agencies are generally limited to the recovery of direct cost. DHS recognizes as imputed financing the amount of accrued pension and post-retirement benefit expense for current civilian employees paid on behalf of DHS by the Office of Personnel Management (OPM), as well as amounts paid from the Treasury Judgment Fund in settlement of claims, legal settlements, or court assessments. When costs that are identifiable to DHS and directly attributable to DHS operations are paid for by other agencies, the Department recognizes these amounts as imputed costs.

Exchange revenues are recognized when earned, i.e., goods have been delivered or services have been rendered. Non-exchange revenues are recognized when a specifically identifiable, legally enforceable claim to resources arises, and to the extent that collection is probable and the amount is reasonably estimable. Non-exchange revenues primarily consists of user fees collected by CBP to off-set certain costs of operations. Other financing sources, such as donations and transfers of assets without reimbursements, also are recognized on the Consolidated Statement of Changes in Net Position during the period in which the donations and transfers occurred.

Fees for flood mitigation products and services, such as insurance provided through EPR's National Flood Insurance Program (NFIP) are established at rates necessary to sustain a self-supporting program. NFIP premium revenues are recognized ratably over the life of the policies. Deferred revenue relates to unearned premiums reserved to provide for the remaining period of insurance coverage.

CIS requires advance payments of the fees for adjudication of applications or petitions for immigration, nationality, and citizenship benefits. Revenue associated with the application fees received is not considered earned until the application is adjudicated.

D. Non-Entity Assets, Revenue, and Disbursements

Non-entity assets are those held by the Department but are not available for use by the Department. Non-entity fund balance with Treasury represents funds available to pay refunds and drawback claims of duties, taxes and fees; and other non-entity amounts to be distributed to the Treasury General Fund and other Federal agencies in the future.

Non-entity revenue reported on the Department's Statement of Custodial Activity includes duties, excise taxes, and various fees collected by the CBP and the CIS that are subsequently remitted to Treasury's General Fund or to other Federal agencies. CBP assesses duties, taxes, and fees on goods and merchandise brought into the United States from foreign countries. At the time importers' merchandise is brought into the United States, importers are required to file entry documents. Generally, within ten working days after release of the merchandise into the United States commerce, the importer is to submit an entry document with payment of estimated duties, taxes, and fees. Non-entity tax and trade accounts receivables and custodial revenue is

Financial Information

recognized when CBP is entitled to collect duties, user fees, fines and penalties, refunds and drawback overpayments, and interest associated with import/export activity on behalf of the Federal government that have been established as a specifically identifiable, legally enforceable claim and remain uncollected as of year-end. Generally, CBP records an equal and off-setting liability due to the Treasury General Fund for amounts recognized as non-entity tax and trade receivable and custodial revenue. CBP accrues an estimate of duties, taxes and fees related to commerce released prior to year end where receipt of payment is anticipated subsequent to year end.

Non-entity revenue is recognized when the cash CBP is entitled to collect on behalf of the Federal government is received. These revenue collections primarily result from current fiscal year activities. Application fees collected by CIS for nonimmigrant petitions are recorded as deferred revenue at the time of collection.

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

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

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

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

Financial Information

E. Fund Balance with Treasury, Cash, and Other Monetary Assets

Entity fund balance with Treasury amounts are primarily appropriated, revolving, trust, deposit, receipt, special, and working capital fund amounts remaining as of fiscal year-end from which the Department is authorized to make expenditures and pay liabilities resulting from operational activity, except as restricted by law. Except for small amounts within EPR, the Department does not maintain cash in commercial bank accounts. Certain receipts are processed by commercial banks for deposit into individual accounts maintained at the U.S. Treasury. The Department's cash and other monetary assets primarily consists of undeposited collections, imprest funds, cash used in undercover operations, cash held as evidence, and seized cash. Cash and other monetary assets are presented as a component of other assets in the accompanying Consolidated Balance Sheets.

F. Investments, Net

Investments consist of United States government non-marketable Treasury securities and are reported at cost or amortized cost net of premiums or discounts. The Bureau of Public Debt manages certain trust fund and revolving fund investments for DHS, including the USCG Oil Spill Liability Trust Fund and EPR's National Flood Insurance Program (NFIP) revolving fund. Premiums or discounts are amortized into interest income over the terms of the investment using the effective interest method. No provision is made for unrealized gains or losses on these securities because it is the Department's intent to hold investments to maturity.

G. Advances and Prepayments

Intra-governmental advances consist primarily of EPR's disaster recovery and assistance grants to other Federal agencies tasked with mission assignments. Advances are expensed when drawn by the grant recipients. At year-end, the amount of grant funding unexpended by grant recipients is estimated, based on cash transactions reported by the grant administrator used by EPR. In accordance with OMB A-110, the Department provides advance funds to grant recipients to incur expenses related to the approved grant. Advances are made within the amount of the total grant obligation and are intended to cover immediate cash needs.

Advances and Prepayments to the public, presented as a component of other assets in the accompanying Consolidated Balance Sheets, consist primarily of EPR's disaster recovery and assistance grants to states and other grants to states. The largest category is Emergency Management Performance Grants, a consolidation of grant programs that supports state and local emergency management staffs and operations, insurance policy acquisition costs. Insurance policy acquisition costs include commissions incurred at policy issuance. Commissions are amortized over the period in which the related premiums are earned, generally one to three years.

H. Tax, Duties, and Trade Receivables, Net

Tax, Duties, and Trade Receivables consists of import duties, user fees, fines and penalties, refunds and drawback overpayments, which have been established as a specifically identifiable, legally enforceable claim and remain uncollected as of year-end. These receivables are net of amounts deemed uncollectible. Uncollectible determinations consider the debtor's payment record and willingness to pay, the probable recovery of amounts from secondary sources, such as sureties, and an analysis of aged receivable activity.

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I. Accounts Receivable, Net

Accounts receivable represent amounts owed to the Department by other Federal agencies and the public as the result of the provision of goods and services to them. Intra-governmental accounts receivable results from reimbursable work such as CIS investigative services; CBP passenger processing, trade compliance and enforcement activities; EPR activities to safeguard communities around chemical weapon storage sites; TSA information technology and communication services; and USCG services provided to the Department of Defense for repairing of boats or aircraft. Intra-governmental accounts receivable are considered to be fully collectible.

Public accounts receivable consist of amounts due to CBP from commercial air and sea vessel carriers for immigration user fees, 1931 Act overtime services, surety companies breached surety bonds; reimbursable services and user fees collected and interest assessed by CBP; premiums and restitution due to EPR from Write Your Own (WYO) insurance companies participating in EPR's Federal Insurance and Mitigation Administration flood insurance program and amounts due from insurance policy holders; amounts due to the USCG's Oil Spill Liability Trust Fund to recover costs incurred to respond to oil pollution incidents and to collect civil fines and penalties from parties responsible for oil spills recognized when the claim arises; and security fees assessed by TSA on the public and air carriers. Public accounts receivable are presented net of an allowance for doubtful accounts, which is based on analyses of debtors' ability to pay, specific identification of probable losses, aging analysis of past due receivables, and historical collection experience. Interest due on past due receivables is fully reserved until collected.

J. Credit Program Receivables, Net

EPR operates the Community Disaster Loan program to support any local government which has suffered a substantial loss of tax and other revenues as a result of a major disaster and which demonstrates a need for Federal financial assistance in order to perform its governmental functions. Under the program, the Department makes direct loans to local governments who meet statutorily set eligibility criteria.

Credit program receivables consist of such loans outstanding and are recorded in other assets in the accompanying Consolidated Balance Sheet. Loans are accounted for as receivables as funds are disbursed. For loans obligated prior to October 1, 1991, loan principal and interest receivable are reduced by an allowance for estimated uncollectible amounts. The allowance is estimated based on past experience and an analysis of outstanding balances.

Post 1991 obligated direct loans and the resulting receivables are governed by the *Federal Credit Reform Act of 1990 (FCRA)*. Under FCRA, for direct loans disbursed during a fiscal year, the corresponding receivable is adjusted for subsidy costs. Subsidy costs are an estimated long-term cost to the United States government of its loan programs. The subsidy cost is equal to the present value of the estimated cash outflows over the life of the loans minus the present value of the estimated cash inflows, discounted at the applicable Treasury interest rate. Administrative costs such as salaries and contractual fees are not included in the subsidy costs. Subsidy costs can arise from interest rate differentials, interest subsidies, delinquencies and defaults, and other cash flows. EPR calculates the subsidy costs based on a subsidy calculator model created by OMB.

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

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K. Operating Materials, Supplies, and Inventory, Net

Operating materials and supplies (OM&S) are primarily consumed during normal operations to service USCG and ICE vessels and aircraft. OM&S are valued based on the weighted moving average method or on the basis of actual prices paid. OM&S are expensed when consumed or issued for use. Excess, obsolete and unserviceable OM&S are stated at net realizable value net of an allowance based on the condition of various asset categories, as well as USCG and ICE's historical experience with using or disposing of such assets.

Inventories consist primarily of USCG Supply Fund's uniform clothing, subsistence provisions, retail stores, general stores, technical material and fuel, and USCG Yard Fund's supplies. Inventories on hand at year-end are stated at cost using standard price/specific identification, last acquisition price, or weighted average cost methods, which approximates historical cost. Revenue on inventory sales and associated cost of goods sold are recorded when merchandise is sold to the end user. USCG's inventory is restricted to sales within the USCG, and is not available for sale to other government agencies.

Pursuant to the *Project BioShield Act of 2004*, which was approved July 21, 2004, the Department transferred the SNS inventory and associated programs, effective August 13, 2004, from EPR to HHS. Additional information related to the transfer can be found in Note 27.

L. Seized and Forfeited Property

Prohibited seized and forfeited property results primarily from CBP criminal investigations and passenger/cargo processing. Seized property is not considered an asset of the Department and is not reported as such in the Department's financial statements; however, the Department has a stewardship responsibility until the disposition of the seized items are determined, i.e., judicially or administratively forfeited or returned to the entity from which it was seized. Non-prohibited seized property, including monetary instruments, real property, and tangible personal property of others in the actual or constructive possession of DHS will be transferred to the Treasury Forfeiture Fund and is not presented in the accompanying consolidated financial statements of DHS.

Forfeited property is property for which the title has passed to the United States government. As noted above, non-prohibited forfeited property or currency becomes assets of the Treasury Forfeiture Fund. However, prohibited forfeited items, such as counterfeit goods, narcotics, or firearms, are held by CBP until disposed or destroyed. In accordance with Statement of Federal Financial Accounting Standard (SFFAS) No. 3, *Accounting for Inventory and Related Property*, analyses of changes in seized and forfeited property of prohibited items are disclosed in Note 9.

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

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M. Property, Plant, and Equipment, Net

DHS's property, plant, and equipment (PP&E) consists of aircraft, vessels, vehicles, land, structures, facilities, leasehold improvements, software, information technology, and other equipment. PP&E is recorded at cost and is depreciated using the straight line method over the estimated useful lives of the assets. In cases where historical cost information was not maintained, PP&E is capitalized using an estimated cost based on the cost of similar assets at the time of acquisition or the current cost of similar assets discounted for inflation since the time of acquisition. The Department owns some of the buildings in which it operates. Other buildings are provided by the General Services Administration (GSA), which charges rent equivalent to the commercial rental rates for similar properties.

The multi-use heritage assets consist primarily of buildings and structures owned by CBP and USCG, and are included in general PP&E on the Consolidated Balance Sheet. The physical quantity information for the multi-use heritage assets is included in the Required Supplementary Stewardship Information for heritage assets.

In accordance with the FASAB Technical Bulletin 2003-1, dated June 13, 2003, and related the Department of Treasury's Financial Management Service's (FMS) guidance, PP&E transferred to DHS from legacy agencies during the seven months ended September 30, 2003, pursuant to the *Homeland Security Act of 2002*, were recorded at the net book value of the transferring agency.

The Department capitalizes acquisitions of PP&E when the cost equals or exceeds an established threshold and has a useful life of two years or more. Costs for construction projects are recorded as construction-in-progress until completed, and are valued at actual (direct) costs, plus applied overhead and other indirect costs. Capitalized internal use software includes the full cost, including an allocation of indirect costs incurred during the software development stage. DHS is developing capitalization thresholds for consistent use across all components. Until completion of such, the capitalization thresholds of the legacy agencies transferred to DHS are maintained. The ranges of capitalization thresholds used by DHS Components, by primary asset category, are as follows:

Asset Description	Capitalization Threshold
Land	Regardless of cost to \$100,000
Buildings and improvement	\$25,000 to \$200,000
Equipment and capital leases	\$5,000 to \$50,000
Software	\$200,000 to \$750,000

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

N. Liabilities

Liabilities represent the probable and measurable future outflow or other sacrifice of resources as a result of past transactions or events. Since the Department is a component of the United States government, a sovereign entity,

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the Department's liabilities cannot be liquidated without legislation that provides resources or an appropriation. Liabilities covered by budgetary resources are those liabilities for which Congress has appropriated funds or funding is otherwise available to pay amounts due. Liabilities not covered by budgetary or other resources represent amounts owed in excess of available, congressionally appropriated funds or other amounts, and there is no certainty that the appropriations will be enacted. The United States government, acting in its sovereign capacity, can abrogate liabilities of the Department arising from other than contracts.

O. Environmental Cleanup Costs and Contingent Liabilities

The Department has responsibility to remediate its sites with environmental contamination, and is party to various administrative proceedings, legal actions, and tort claims which may result in settlements or decisions adverse to the Federal government. The Department has accrued a liability for future cleanup of environmental hazards when losses are determined to be "probable", which is generally when the Department is legally responsible for creating the hazard or is otherwise related in such a way that the Department is legally liable to remediate the contamination, and the cost can be estimated. These liabilities are a component of other liabilities on the accompanying Consolidated Balance Sheets.

Contingent liabilities are liabilities where the existence or amount of the liability cannot be determined with certainty pending the outcome of future events. The Department recognizes contingent liabilities when loss is probable and reasonably estimable. The Department discloses contingent liabilities in the notes to the consolidated financial statements when the conditions for liability recognition are not met and when loss from future events is more than remote. Payments made from the Treasury Judgment Fund for settlement of DHS legal claims and judgments are recognized as an imputed financing source in the accompanying Consolidated Statement of Net Position.

DHS has accrued environmental liabilities where losses are determined to be probable and the amounts can be estimated. In accordance with Federal accounting guidance, the liability for future cleanup of environmental hazards is "probable" when the government is legally responsible for creating the hazard or is otherwise related to it in such a way that it is legally liable to clean up the contamination.

P. Grants Liability

EPR, SLGCP (formerly ODP), and TSA award grants and cooperative agreements to Federal, state, and local governments, universities, non-profit organizations, and private sector companies for the purpose of building capacity to respond to disasters and emergencies, conduct research into preparedness, enhance and ensure the security of passenger and cargo transportation by air, land, or sea, and other DHS-related activities. EPR estimates a year-end grant accrual representing the amounts payable to grantees, using historical disbursement patterns over a period of 20 quarters to predict unreported grantee expenditures. The SLGCP and TSA grant liability accrual is estimated using known reported expenditures reported by grantees and the estimated daily expenditure rate for the period subsequent to the latest grantee submission in relation to the cumulative grant amount. Effective October 1, 2004, TSA grants activity will be transferred to SLGCP. Grants issued by TSA through September 30, 2004 will be maintained jointly by TSA and SLGCP. Grants liabilities are combined with accounts payable to the public in the accompanying Consolidated Balance Sheet.

Q. Claims and Claims Settlement Liabilities

EPR administers the National Flood Insurance Program (NFIP) through sale or continuation-in-force of insurance in communities that enact and enforce appropriate flood plain management measures. Claims and claims settlement liability represents an estimate of NFIP losses that are unpaid at the balance sheet date and is based

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on the loss and loss adjustment expense factors inherent in the NFIP insurance underwriting operations experience and expectations. Estimation factors used by the insurance underwriting operations reflect current case basis estimates and give effect to estimates of trends in claim severity and frequency. These estimates are continually reviewed, and adjustments, reflected in current operations, are made as deemed necessary. Although the insurance underwriting operations believes the liability for unpaid losses and loss adjustment expenses is reasonable and adequate in the circumstances, the insurance underwriting operations' actual incurred losses and loss adjustment expenses may not conform to the assumptions inherent in the estimation of the liability. Accordingly, the ultimate settlement of losses and the related loss adjustment expenses may vary from the amount included in the financial statements.

R. Debt and Borrowing Authority

Debt is reported within other intra-governmental liabilities and results from Treasury loans and related interest payable to fund NFIP and Disaster Assistance Direct Loan Program (DADLP) operations. NFIP loan and interest payments are financed by flood premiums and map collection fees. Additional funding for NFIP may be obtained through Treasury borrowing authority of \$1.5 billion. DADLP annually requests borrowing authority to cover the principal amount of direct loans not to exceed \$25 million less the subsidy due from the program account. DADLP borrowing authority is for EPR "State Share Loans". Borrowing authority for Community Disaster Loans is requested on an "as needed basis". At the end of the fiscal year, borrowing authority is reduced by the amount of any unused portion.

S. Annual, Sick, and Other Accrued Leave

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

T. Workers' Compensation

A liability is recorded for actual and estimated future payments to be made for workers' compensation pursuant to the *Federal Employees' Compensation Act* (FECA). The actual liability is presented as a component of intra-governmental other liabilities, and the actuarial liability is presented within accrued payroll and benefits in the accompanying Consolidated Balance Sheet. The FECA program is administered by the U.S. Department of Labor (DOL), which initially pays valid claims and subsequently seeks reimbursement from Federal agencies employing the claimants. Reimbursement to DOL on payments made occurs approximately two years subsequent to the actual disbursement. Budgetary resources for this intra-governmental liability are made available to the Department as part of its annual appropriation from Congress in the year in which the reimbursement takes place.

Additionally, a liability due to the public is recorded that includes the expected liability for death, disability, medical and miscellaneous costs for approved compensation cases. The liability is determined using an actuarial method that utilizes historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period. The Department allocates the actuarial liability to its components based on payment history provided by DOL. The accrued liability is not covered by budgetary resources and will require future funding.

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U. Military Service and Other Retirement Benefits

DHS and Component Civilian Workforce Pension and Other Benefits

The Department recognizes the full annual cost of its civilian employees' pension benefits; however, the assets of the plan and liability associated with pension costs are recognized by the OPM rather than the Department.

Most employees of the Department hired prior to January 1, 1984, participate in the Civil Service Retirement System (CSRS), to which the Department contributes 8.5 percent of base pay for regular CSRS employees, and 9 percent of base pay for law enforcement agents.

The majority of employees hired after December 31, 1983 are covered by the Federal Employees Retirement System (FERS) and Social Security. For the FERS basic annuity benefit the Department contributes 10.7 percent of base pay for regular FERS employees and 22.7 percent for law enforcement agents. A primary feature of FERS is that it also offers a defined contribution plan to which the Department automatically contributes 1 percent of base pay and matches employee contributions up to an additional 4 percent of base pay. The Department also contributes the employer's Social Security matching share for FERS participants. Information regarding FERS can be found at the following web site: <http://www.tsp.gov>.

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

The difference between the full annual cost of CSRS or FERS retirement, ORB and OPEB benefits and the amount paid by the Department is recorded as an imputed cost and off-setting imputed financing source in the accompanying Consolidated Statement of Net Cost, Consolidated Statement of Changes in Net Position, and Consolidated Statement of Financing.

USCG – Military Retirement System Liability

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

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

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payments from the Treasury to the Fund. The future cost and liability of the Fund is determined using claim factors and claims cost data developed by the DoD, adjusted for USCG retiree and actual claims experience. The USCG uses the current year actual costs to project costs for all future years.

USCG – Post-employment Military Travel Benefit

USCG uniformed service members are entitled to travel and transportation allowances for travel performed or to be performed under orders, without regard to the comparative costs of the various modes of transportation. These allowances, upon separation from the service, include the temporary disability retired list placement, release from active duty, retirement, and entitlement for travel from the member's last duty station to home or the place from which the member was called or ordered to active duty, whether or not the member is or will be an active member of a uniformed service at the time the travel is or will be performed.

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

USSS – Uniformed Division and Special Agent Pension Liability

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

V. Use of Estimates

Management has made certain estimates and assumptions in the reporting of assets, liabilities, revenues, expenses, obligations incurred, spending authority from offsetting collections, and note disclosures in the consolidated financial statements. Actual results could differ from these estimates. Significant estimates include: the allocation of trust fund receipts, year-end accruals of accounts and grants payable, contingent legal and environmental liabilities, accrued workers' compensation, allowance for doubtful accounts receivable, allowances for obsolete inventory and OM&S balances, allocations of indirect common costs to construction-in-progress, subsidy re-estimates, deferred revenues, NFIP claims and settlements, MRS and other pension, retirement, and post-retirement benefit assumptions, and certain non-entity receivables and payables related to custodial activities. Certain accounts payable balances are estimated based on current payments that relate to prior periods or a current assessment of services/products received but not yet paid.

W. Taxes

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

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X. Reclassifications

Certain 2003 balances have been reclassified for consistent disclosures with 2004 balances.

2. Non-Entity Assets

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

Intra-governmental:	2004 (unaudited)	2003
Fund Balance with Treasury	\$3,342	\$1,720
Receivables Due From Treasury (note 11)	170	109
Total Intra-governmental	3,512	1,829
Public:		
Tax, Duties, and Trade Receivables, Net (note 6)	1,273	1,140
Other	36	64
Total Public	1,309	1,204
Total Non-Entity Assets	4,821	3,033
Total Entity Assets	45,985	41,515
Total Assets	\$50,806	\$44,548

Non-entity fund balance with Treasury consists of special and deposit funds, permanent appropriations, and miscellaneous receipts that are available to pay non-entity liabilities presented as a component of other liabilities on the Consolidated Balance Sheet. Non-entity fund balance with Treasury at September 30, 2004 and 2003, includes (in deposit fund) approximately \$2.9 billion (unaudited) and \$1.4 billion of duties collected by CBP on imports of Canadian softwood lumber and \$375 million (unaudited) and \$247 million (in special fund) Injured Domestic Industries (IDI) at September 30, 2004 and 2003, respectively. These assets off-set accrued liabilities at September 30, 2004 and 2003 (see note 17). Non-entity fund balance with Treasury also consists of trust-related assets primarily from cash held on behalf of obligors and fees, fines and penalties collected that are managed by CIS.

Non-entity receivables due from Treasury represent an estimate of duty, tax and/or fee refunds and drawbacks that will be reimbursed by a permanent and indefinite appropriation account and will be used to pay estimated duty refunds and drawbacks payable of \$132 million (unaudited) and \$98 million at September 30, 2004 and 2003, respectively (see note 17). Duties and taxes receivable from public represents amounts due from importers for goods and merchandise imported to the United States, and upon collection, will be available to pay the accrued intragovernmental liability due to the Treasury General Fund, which equaled \$1.3 billion (unaudited) and \$1.2 billion at September 30, 2004 and 2003, respectively.

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3. Fund Balance with Treasury

A. Fund Balance with Treasury

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

	2004 (unaudited)	2003
Appropriated Funds	\$27,587	\$23,645
Trust Funds	48	74
Revolving, Liquidating, and Working Capital Funds	435	237
Special Funds	2,131	1,709
Deposit Funds	3,235	1,678
Total Fund Balance with Treasury	\$33,436	\$27,343

Appropriated funds consist of amounts appropriated annually by Congress to fund the operations of DHS and its components. Appropriated funds include clearing funds totaling a negative \$457 million and \$316 million at September 30, 2004 and 2003, respectively, which represent reconciling differences with Treasury balances.

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

Revolving funds are used for continuing cycles of business-like activity, in which the fund charges for the sale of products or services and uses the proceeds to finance its spending, usually without requirement for annual appropriations. The working capital fund is a fee-for-service fund established to support operations of DHS component bureaus. Also included are the liquidating and financing funds for credit reform and the national flood insurance fund of \$321 million and \$84 million at September 30, 2004 and 2003, respectively.

Special funds are receipts and/or off-setting receipt funds earmarked for specific purposes including the disbursement of non-entity monies received in connection with antidumping and countervailing duty orders and findings to qualifying IDI of \$375 million and \$247 million at September 30, 2004 and 2003, respectively. DHS also has entity special funds for immigration user fees of \$154 million and \$89 million at September 30, 2004 and 2003, respectively; CBP user fees of \$730 million (unaudited) and \$640 million at September 30, 2004 and 2003, respectively; immigration examination fees of \$715 and \$470 million at September 30, 2004 and 2003 respectively; and inspection fees, flood map modernization subsidy, off-set, and refund transfers.

Deposit funds represent amounts received as an advance that are not accompanied by an order and include non-entity collections that do not belong to the Federal government and for which final disposition has not been determined at year end, including \$2.9 billion and \$1.4 billion of duties collected on imports of Canadian softwood lumber at September 30, 2004 and 2003, respectively (see notes 2 and 17).

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B. Status of Fund Balance with Treasury

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

Unobligated Balances:	2004 (unaudited)	2003
Available	\$5,718	\$6,657
Unavailable	1,638	2,888
Obligated Balance Not Yet Disbursed	25,802	19,642
Subtotal	33,158	29,187
Adjustments for:		
Receipt, Clearing, and Deposit Funds	3,466	1,366
Borrowing Authority	(1,500)	(1,608)
Investments	(1,612)	(1,537)
Receivable Transfers and Imprest Fund	(76)	(65)
Total Status of Fund Balance with Treasury	\$33,436	\$27,343

Adjustments are made to reconcile the budgetary status to fund balance with Treasury for the following reasons:

- Receipt, clearing and deposit funds represent amounts on deposit with Treasury that have no budget status at September 30, 2004 and 2003. Included in adjustments for deposit funds are restricted balances of \$2.9 billion and \$1.4 billion at September 30, 2004 and 2003, respectively, of non-entity funds, and receipts that are not available for obligation.
- Borrowing authority is in budgetary status for use by EPR for disaster relief purposes.
- Budgetary resources have investments included; however, the money has been moved from the Fund Balance with Treasury asset account to investments.
- Receivable transfers of currently invested balances increases the budget authority at the time the transfer is realized and obligations may be incurred before the actual transfer of funds.
- Imprest funds the money has been moved from fund balance with Treasury to imprest funds with no change in the budgetary status.

Portions of the unobligated balances available, unavailable and obligations balance not yet disbursed contains CBP's user fees account balance of \$730 and \$640 million (at September 30, 2004 and 2003), which is restricted by law in its use to offset costs incurred by CBP until authority is granted through appropriations acts.

Portions of the unobligated balance unavailable includes amounts appropriated in prior fiscal years that are not available to fund new obligations. However, it can be used for upward and downward adjustments for existing obligations in future years.

The obligated not yet disbursed balance represents amounts designated for payment of goods and services

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ordered but not received or goods and services received but for which payment has not yet been made. Part of this balance contains obligations from the disaster relief fund of \$6.4 billion (unaudited) and \$8.1 billion at September 30, 2004 and 2003, respectively.

DHS returned to Treasury \$214 million (unaudited) and \$65 million (unaudited) for indefinite no-year authority; and \$2.3 billion (unaudited) and \$1.5 billion in authority unavailable for obligations pursuant to public law respectively (e.g. rescissions), during the year ended September 30, 2004 and the seven months ended September 30, 2003, respectively; and \$26 million (unaudited) in borrowing authority was returned during the year ended September 30, 2004.

4. Investments

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

Type of Investment	2004 (unaudited)	2003
<i>U.S. Treasury Securities:</i>		
USCG – Non-Marketable, Par Value	\$839	\$965
EPR – Non-Marketable, Market-Based	786	581
Total Intra-governmental Investments	\$1,625	\$1,546

Non-marketable, market-based investments include discounts of \$13 million (unaudited) and \$9 million at September 30, 2004 and 2003 respectively; in addition, market value of investments approximates cost.

Unexpended funds in the USCG oil spill liability trust fund (oil spill fund) and the gift fund are invested by the U.S. Treasury – Bureau of Public Debt in U.S. government securities. Interest and principal on invested balances in the USCG's oil spill fund are considered investment authority and are available for use by the USCG to offset the cost of oil spill cleanup, payment of environmental claims against the fund, and for specific funding of cleanup related operations. EPR maintains investments for the gifts and bequests fund and the NFIP. EPR investments are restricted to Treasury bonds, bills, notes, and overnight securities. The current EPR investments portfolio consists principally of overnight securities, which have neither market value variances nor unamortized premium or discount.

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5. Advances and Prepayments – Intra-governmental

Intra-governmental advances and prepayments at September 30 consisted of the following (in millions):

	2004 (unaudited)	2003
Disaster Relief Fund	\$2,718	\$2,816
Other	168	238
Total Intra-governmental Advances and Prepayments	\$2,886	\$3,054

Disaster relief fund (DRF) advances consists of EPR's disaster assistance grants to other Federal agencies tasked with mission assignments that support state and local emergency management staffs and operations.

Advances and prepayments made to the public are presented as a component of other assets on the accompanying Consolidated Balance Sheets (see note 11).

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6. Tax, Duties, and Trade Receivables, Net

Tax, duties, and trade receivables at September 30 consisted of the following (in millions):

As of September 30, 2004 (unaudited):

Receivables Category	Gross Receivables	Allowance	Total Net Receivables
Duties	\$1,127	(\$95)	\$1,032
Excise Taxes	73	(2)	71
User Fees	80	(1)	79
Fines/Penalties	798	(745)	53
Refunds and Drawback	180	(142)	38
Total Tax, Duties, and Trade Receivables, Net	\$2,258	(\$985)	\$1,273

As of September 30, 2003:

Receivables Category	Gross Receivables	Allowance	Total Net Receivables
Duties	\$1,020	(\$102)	\$918
Excise Taxes	73	(1)	72
User Fees	71	(1)	70
Fines/Penalties	694	(621)	73
Refunds and Drawback	36	(29)	7
Total Tax, Duties, and Trade Receivables, Net	\$1,894	(\$754)	\$1,140

When a violation of import/export law is discovered, a fine or penalty is established, typically for the full value of the merchandise. After receiving the notice of assessment, the importer or surety has a period of time to either file a petition requesting a review of the assessment or pay the assessed amount. Once a petition is received, CBP investigates the circumstances as required by its mitigation guidelines and directives. Until this process has been completed, CBP records an allowance on fines and penalties of approximately 94 percent (90 percent at September 30, 2003) of the total assessment based on historical experience of fines and penalties mitigation and collection. Duties and taxes receivable are non-entity assets for which there is an offsetting liability due to the Treasury General Fund.

Financial Information

7. Credit Program Receivables, Net

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

	2004 (unaudited)	2003
	Loans Receivable, Net	Loans Receivable, Net
Community Disaster Loans	\$6.8	\$14.5

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

B. Direct Loans Obligated Prior to FY 1992 (Present Value Method, in millions):

Direct loans obligated prior to FY1992 have been fully collected during FY 2004, and therefore no balances remained as of September 30, 2004 (unaudited).

	Loans Receivable, Gross	Interest Receivable	Allowance for Loan Losses	Value of Assets Related to Direct Loans
At September 30, 2003:				
Community Disaster Loans	\$.167	\$.004	(\$0.017)	\$.154

C. Direct Loans Obligated After FY 1991 (in millions):

	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Value of Assets Related to Direct Loans
At September 30, 2004 (unaudited):				
Community Disaster Loans	\$129.4	\$62.5	(\$185.1)	\$6.8

	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Value of Assets Related to Direct Loans
At September 30, 2003:				
Community Disaster Loans	\$130.9	\$54.5	(\$171.0)	\$14.4

Financial Information

D. Total Amount of Direct Loans Disbursed, Post-1991: None.

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

Subsidy Expense for New Direct Loans Disbursed: None

Modifications and Reestimates (Prior reporting year): \$4.5

Total Direct Loan Subsidy Expense: None

F. Direct Loan Subsidy Rates

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

	2004 (unaudited)		2003	
	Community Disaster Loans	State Share Loans	Community Disaster Loans	State Share Loans
Interest Subsidy Cost	2.48 %	(2.40) %	(0.84) %	(4.48) %
Default Costs	- %	- %	- %	- %
Other	90.78 %	0.38 %	93.01 %	0.38 %

G. Schedule for Reconciling Subsidy Cost Allowance Balances (in millions):

	2004 (unaudited)	2003
Beginning Balance of the Subsidy cost allowance	\$171	\$163
Adjustments:		
(a) Loans written off	(1.7)	-
(b) Subsidy allowance amortization	11.3	8
Ending balance of the subsidy cost allowance before reestimates	180.6	171
Add subsidy reestimate by component		
(a) Technical/default reestimate	4.5	-
Ending balance of the subsidy cost allowance	\$185.1	\$171

Financial Information

H. 2004 Administrative Expenses (unaudited) (in millions):

Community Disaster and State Share Loans	<u><u>\$.5</u></u>
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8. Operating Materials, Supplies, Inventory, and Stockpile, Net (unaudited)

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

	2004 (unaudited)	2003
OM&S		
Items Held for Use	\$360	\$417
Items Held for Future Use	84	80
Excess, Obsolete and Unserviceable Items	7	10
Less: Allowance for Losses	(7)	(10)
Total OM&S, Net	<u><u>444</u></u>	<u><u>497</u></u>
Inventory		
Inventory Purchased for Resale	53	58
Less: Allowance for Losses	(1)	(1)
Total Inventory, Net	<u><u>52</u></u>	<u><u>57</u></u>
Strategic National Stockpile (note 27)	-	608
Total OM&S, Inventory, and Stockpile, Net	<u><u>\$496</u></u>	<u><u>\$1,162</u></u>

The Strategic National Stockpile was transferred to the Department of Health & Human Services (HHS) on August 13, 2004, as further explained in note 27.

Financial Information

9. Prohibited Seized Property (unaudited)

Prohibited seized property item counts, as of September 30, and activity for the fiscal year ended September 30, 2004 and the seven months ended September 30, 2003, are as follows:

Seizure Activity						
Seized Property:	Fiscal Year Ended September 30, 2004					Seized Property:
Category	Balance October 1, 2003	New Seizures	Remissions	New Forfeitures	Adjustments	September 30 Weight/Items
Illegal Drugs:						
Cannabis (marijuana)	331	560,809	0	(561,551)	2,587	2,176
Cocaine	153	36,632	0	(36,630)	(11)	144
Heroin	22	1,591	0	(1,597)	2	18
Firearms and Explosives	7,757	3,830	(3,145)	(634)	(20)	7,788
Counterfeit Currency (US/Foreign)	2,853,395	1,346,492	(1,112,180)	0	(199,964)	2,887,743
Pornography	178	353	(5)	(367)	(26)	133
Forfeiture Activity						
Forfeited Property:	Fiscal Year Ended September 30, 2004					Forfeited Property:
Category	Balance October 1, 2003	New Forfeitures	Transfers	Destroyed	Adjustments	September 30 Weight/Items
Illegal Drugs:						
Cannabis (marijuana)	113,531	561,551	(6,114)	(521,349)	(48,962)	98,657
Cocaine	16,970	36,630	(298)	(34,971)	(983)	17,348
Heroin	2,977	1,597	(8)	(13,980)	11,959	2,545
Firearms and Explosives	1,340	634	(1,699)	(39)	61	297
Pornography	80	367	0	(414)	4	37

Financial Information

Prohibited Seized Property, Continued (unaudited)

Seizure Activity						
Seized Property:	Seven Months Ended September 30, 2003					Seized Property:
Category	Balance March 1, 2003	New Seizures	Remissions	New Forfeitures	Adjustments	September 30 Weight/Items
Illegal Drugs:						
Cannabis (marijuana)	1,191	321,745	0	(322,573)	(32)	331
Cocaine	164	19,298	0	(19,280)	(29)	153
Heroin	18	382	0	(381)	3	22
Firearms and Explosives	6,992	2,554	(396)	(1,390)	(3)	7,757
Counterfeit Currency (US/Foreign)	2,892,538	224,215	(165,877)	0	(97,481)	2,853,395
Pornography	235	153	(3)	(187)	(20)	178
Forfeiture Activity						
Forfeited Property:	Seven Months Ended September 30, 2003					Forfeited Property:
Category	Balance March 1, 2003	New Forfeitures	Transfers	Destroyed	Adjustments	September 30 Weight/Items
Illegal Drugs:						
Cannabis (marijuana)	160,105	322,573	0	(359,768)	(9,379)	113,531
Cocaine	14,309	19,280	(23)	(16,221)	(375)	16,970
Heroin	4,033	381	(31)	(1,373)	(33)	2,977
Firearms and Explosives	292	1,390	(2)	(5)	(335)	1,340
Pornography	89	187	(1)	(202)	7	80

Financial Information

This schedule is presented for material prohibited (non-valued) seized and forfeited property only. These items are retained and ultimately destroyed by CBP and USSS and are not transferred to the Departments of Treasury or Justice Asset Forfeiture Funds or other Federal agencies. Adjustments include reclassification of property categories and minor adjustments to the balances transferred-in on March 1, 2003. The ending balance for firearms includes only those seized items that can actually be used as firearms. Illegal drugs are presented in kilograms and a significant portion of the weight includes packaging, which often cannot be reasonably separated from the weight of the drugs since the packaging must be maintained for evidentiary purposes. Firearms, explosives, and pornography are presented in number of items; and counterfeit currency is presented in number of bills.

USCG also seizes and takes temporary possession of small boats, equipment, contraband, and other illegal drugs. USCG usually disposes of these properties within three days by transfer to CBP (who transfers non-prohibited seized property to the Treasury Forfeiture Fund), the Drug Enforcement Administration, or foreign governments, or by destroying it. Because USCG never takes ownership of the property and keeps it for a short duration, seized property in USCG possession at year end is considered insignificant and therefore is not itemized and is not reported in the consolidated financial statements of DHS.

Financial Information

10. Property, Plant, and Equipment, Net

Property, plant, and equipment (PP&E), at September 30 consisted of the following (in millions):

As of September 30, 2004 (unaudited):	Service Life	Gross Cost	Accumulated Depreciation/ Amortization	Total Net Book Value
Land and Land Rights	N/A	\$54	\$ -	\$54
Improvements to Land	3-50 yrs	23	10	13
Construction in Progress	N/A	1,570	-	1,570
Buildings, Other Structures, and Facilities	2-50 yrs	3,556	1,697	1,859
Equipment:				
ADP Equipment	3-5 yrs	280	115	165
Aircraft	10-20 yrs	2,885	1,919	966
Vessels	5-10 yrs	4,045	1,843	2,202
Vehicles	3-6 yrs	484	311	173
Other Equipment	2-20 yrs	3,418	1,500	1,918
Assets Under Capital Lease	2-20 yrs	81	21	60
Leasehold Improvements	3-50 yrs	264	62	202
Internal Use Software	3-10 yrs	694	162	532
Internal Use Software- in Development	N/A	32	-	32
Total Property, Plant, and Equipment		\$17,386	\$7,640	\$9,746

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As of September 30, 2003:	Service Life	Acquisition Cost (with Transfers at NBV)	Accumulated Depreciation/Amortization (unaudited)	Total Net Book Value	Unaudited Net Book Value
Land and Land Rights	N/A	\$54	\$ -	\$54	\$40
Improvements to Land	3-50 yrs	7	-	7	-
Construction in Progress	N/A	1,377	-	1,377	665
Buildings, Other Structures, and Facilities	2-50 yrs	1,894	31	1,863	1,084
Equipment:					
ADP Equipment	3-5 yrs	34	6	28	-
Aircraft	10-20 yrs	1,152	102	1,050	617
Vessels	5-10 yrs	2,264	77	2,187	134
Vehicles	3-6 yrs	368	168	200	1
Other Equipment	2-20 yrs	1,803	31	1,772	299
Leasehold Improvements	3-50 yrs	160	7	153	-
Internal Use Software	3-10 yrs	236	34	202	38
Internal Use Software – in Development	N/A	245	-	245	-
Total Property, Plant, and Equipment		\$9,594	\$456	\$9,138	\$2,878

Change in Presentation of Book Value

In accordance with FASAB Technical Bulletin 2003-1 (TB 2003-1) *Certain Questions and Answers Related to the Homeland Security Act of 2002*, for the seven months ended September 30, 2003, the Department presented legacy assets within the principle financial statements, as assets that were transferred at book value net of the accumulated depreciation book value.

Beginning in FY 2004, the assets transferred into DHS during 2003 are presented at gross acquisition cost, less accumulated depreciation since acquisition, resulting in increases in these amounts when compared with the 2003 presentation; however, there is no effect of this change on the total net book value of the transferred assets. Although the presentation in the financial statement notes has changed from 2003 (presented assets equal to net book value) to 2004 (present assets and accumulated depreciation at gross book value), the underlying accounting and presentation for PP&E remains consistent with TB 2003-1 and SFFAS No. 6 *Accounting for Property, Plant, and Equipment*.

Financial Information

The formation of the Department of Homeland Security, pursuant to the *Homeland Security Act of 2002*, constituted a government re-organization as opposed to a transfer of assets. Therefore, all DHS assets, regardless of origin are presented at book value.

Cost Basis Conversion (unaudited):

As of September 30, 2004:	As of 9/30/03 (with March 1 transfers at NBV)	Accumulated Depreciation /Amortization at 3/1/03	Conversion to Acquisition Cost Basis at 9/30/03	FY 2004 Net Additions	Other Adjustments/ Reclassifications	Gross Cost Basis at 9/30/04
Land and Land Rights	\$54	\$ -	\$54	\$ -	\$ -	\$54
Improvements to Land	7	14	21	2	-	23
Construction in Progress	1,377	-	1,377	193	-	1,570
Buildings, Other Structures, and Facilities	1,894	1,609	3,503	124	(71)	3,556
Equipment:						
ADP Equipment	34	-	34	246	-	280
Aircraft	1,152	1,756	2,908	(23)	-	2,885
Vessels	2,264	1,656	3,920	125	-	4,045
Vehicles	368	21	389	95	-	484
Other Equipment	1,803	1,069	2,872	546	-	3,418
Assets Under Capital Lease	-	4	4	6	71	81
Leasehold Improvements	160	15	175	89	-	264
Internal Use Software	236	29	265	429	-	694
Internal Use Software- in Development	245	-	245	(213)	-	32
Total Property, Plant, and Equipment	\$9,594	\$6,173	\$15,767	\$1,619	\$0	\$17,386

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Accumulated Depreciation Conversion (unaudited):

As of September 30, 2004:	As of 9/30/03 (with March 1 transfers at NBV)	Accumulated Depreciation/ Amortization at 3/1/03	Conversion to Acquisition Cost Basis at 9/30/03	FY 2004 Depreciation Expense and Disposition	Other Adjustments/ Reclassifications	Gross Accumulated Depreciation at 9/30/04
Land and Land Rights	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Improvements to Land	-	14	14	(4)	-	10
Construction in Progress	-	-	-	-	-	-
Buildings, Other Structures, and Facilities	31	1,609	1,640	63	(6)	1,697
Equipment:						
ADP Equipment	6	-	6	109	-	115
Aircraft	102	1,756	1,858	61	-	1,919
Vessels	77	1,656	1,733	110	-	1,843
Vehicles	168	21	189	122	-	311
Other Equipment	31	1,069	1,100	400	-	1,500
Assets Under Capital Lease	-	4	4	11	6	21
Leasehold Improvements	7	15	22	40	-	62
Internal Use Software	34	29	63	99	-	162
Internal Use Software- in Development	-	-	-	-	-	-
Total Property, Plant, and Equipment	\$456	\$6,173	\$6,629	\$1,011	\$0	\$7,640

Financial Information

11. Other Assets

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

	2004 (unaudited)	2003
Intra-governmental:		
Accounts Receivable	\$311	\$306
Receivables Due From Treasury (note 2)	170	109
Total Intra-governmental	481	415
Public:		
Accounts Receivable and Related Interest	773	591
Allowance for Doubtful Accounts	(375)	(291)
Advances and Prepayments	356	365
Cash and Other Monetary Assets	87	59
Credit Program Receivables, Net (note 7)	7	15
Other	15	11
Total Public	863	750
Total Other Assets	\$1,344	\$1,165

Intra-governmental accounts receivable results from reimbursable work performed by USCG, ICE, EPR, TSA and CBP. Accounts receivable with the public consists of amounts due to CBP, TSA, EPR, USCG, and ICE for reimbursable services and user fees. Advances and prepayments with the public consist primarily of National Flood Insurance payments made by EPR.

Financial Information

12. Liabilities Not Covered by Budgetary Resources

Liabilities not covered by budgetary resources at September 30 consisted of the following (in millions):

	2004 (unaudited)	2003
Intra-governmental:		
Accrued FECA Liability (note 15)	\$240	\$178
Other	10	12
Total Intra-governmental	250	190
Public:		
Military Service and Other Retirement Benefits (note 16)	26,502	25,285
Accrued Payroll and Benefits:		
Accrued Leave (note 15)	663	461
Other Employment Related Liability (note 15)	105	184
Actuarial FECA Liability (note 15)	1,398	1,125
Claims and Claims Settlement Liabilities (note 13)	9	44
Other:		
Environmental Cleanup Costs (note 19)	144	98
Contingent Liabilities (note 19)	54	58
Capital Lease Liability (notes 17 and 18)	148	167
Other	-	3
Total Public	29,023	27,425
Total Liabilities Not Covered by Budgetary Resources	\$29,273	\$27,615
Liabilities Covered by Budgetary Resources or Non-Entity Assets	13,046	9,053
Total Liabilities	\$42,319	\$36,668

DHS anticipates that the liabilities listed above will be funded from future budgetary resources when required. Budgetary resources are generally provided for unfunded leave when it is used. The USCG's environmental liability for 2004 increased to \$159 million (\$144 million unfunded) from \$98 million unfunded. This increase is due to a revised estimating methodology that considers cost indexing and unknown contingency factor usage on various shore sites; new liabilities associated with lighthouse and small arms firing ranges sites; and a revised methodology for estimating the environmental liability for vessel cleanup and decommissioning to provide more consistency by vessel type.

Financial Information

13. Claims and Claims Settlement Liabilities

	2004 (unaudited)	2003
National Flood Insurance Program	\$1,357	\$672
Cerro Grande Fire Assistance Act	60	82
Total Claims and Claims Settlement Liabilities	\$1,417	\$754

A. National Flood Insurance Program (NFIP)

The NFIP liability for unpaid losses and related loss adjustment expenses and amounts paid for the year ended September 30, 2004 and the seven months ended September 30, 2003 (unaudited) consisted of the following (in millions):

	2004 (unaudited)	2003
Transferred-in NFIP liability (March 1, 2003)	\$ -	\$59
Beginning Balance – September 30, 2003	672	-
Incurred losses and increase estimated losses	1,505	803
Less: Amounts paid during current period	(820)	(190)
Total NFIP Liability at September 30	\$1,357	\$672

The increase in incurred losses was primarily due to the four hurricanes (Charley, Frances, Ivan, and Jeanne) that damaged the State of Florida and other U.S. coastal areas during the months of August and September 2004.

B. Cerro Grande Fire Assistance Act

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

At September 30, 2004 and 2003, the liability for unpaid claims and claim adjustment expenses represents an estimate of the known probable and estimable losses that are unpaid as of September 30, 2004 and 2003, based on the Final Rules dated March 21, 2001, entitled, the Disaster Assistance: Cerro Grande Fire Assistance, Final Rule, published in the Federal Register Part II at 44 CFR Chapter I, Part 295. This estimated claims liability for September 30, 2004 and 2003, includes \$9 million (unaudited) and \$44 million, respectively, which is unfunded.

Financial Information

14. Deferred Revenue and Advances from Others

Deferred revenue at September 30, and CIS application fee activity for the year end September 30, 2004 and seven months ended September 30, 2003 (unaudited), consisted of the following (in millions):

	2004 (unaudited)	2003
CIS Application Fees:		
March 1, 2003 transferred-in balance	\$ -	\$829
Beginning Balance – September 30, 2003	949	-
Collection deposited	1,354	580
Less: earned revenue (completed applications)	(1,429)	(439)
Adjustments for undeposited collections and other	15	(21)
Total CIS Application Fees	889	949
EPR Unexpired NFIP premium	1,095	1,008
Advances from Others	14	12
Deferred Credits	22	-
Total Deferred Revenue	\$2,020	\$1,969

CIS requires advance payments of the fees for applications or petitions for immigration, nationality, and citizenship benefits. EPR's deferred revenue relates to unearned NFIP premiums that are reserved to provide for the unexpired period of insurance coverage.

Financial Information

15. Accrued Payroll and Benefits

	2004 (unaudited)	2003
Accrued Funded Payroll and Benefits	\$495	\$499
Accrued Unfunded Leave	663	461
Unfunded Employment Related Liabilities	105	184
Actuarial FECA Liability	1,398	1,125
Other	31	6
Total Accrued Payroll and Benefits	\$2,692	\$2,275

Workers' Compensation

Claims incurred for the benefit of DHS employees under FECA are administered by DOL and are ultimately paid by DHS. The accrued liability representing money owed for current claims at September 30, 2004 and 2003 includes \$240 million (unaudited) and \$178 million, respectively, and is included in other liabilities (see note 17). Future workers' compensation estimates, generated from an application of actuarial procedures developed by the DOL, for the future cost of approved compensation cases at September 30, 2004 and 2003, were \$1.4 billion and \$1.1 billion, respectively. Workers' compensation expense was \$130 million (unaudited) for the fiscal year ended September 30, 2004.

16. Military Service and Other Retirement Benefits

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

	2004 (unaudited)	2003
USCG Military Retirement and Healthcare Benefits	\$23,037	\$21,745
USCG Post-Employment Military Travel Benefits (unaudited)	83	201
USSS DC Pension Plan Benefits (unaudited)	3,382	3,339
Total Military Service and Other Retirement Benefits Liability	\$26,502	\$25,285

Financial Information

A. Military Retirement System Expense (unaudited)

The components of the Military Retirement System (MRS) expense for the year ended September 30, 2004, consisted of the following (in millions):

Defined Benefit Plan:

Normal cost	\$419
Interest on the liability	1,162
Actuarial losses/(gains)	(101)
Actuarial Assumption Change	39
Plan Amendments	432
Total Defined Benefit Plan Expense	<u>1,951</u>

Post-retirement Healthcare:

Normal cost	143
Interest on the liability	219
Losses/(gains) due to change in medical inflation rate assumptions	(128)
Total Post-retirement Healthcare Expense	<u>234</u>

Total MRS Expense	<u><u>\$2,185</u></u>
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The USCG's MRS is comprised of the CG Military Retirement System and the CG Military Health Services System. The USCG's military service members (both active duty and reservists) participate in the MRS. USCG receives an annual "Retired Pay" appropriation to fund MRS benefits, thus the MRS is treated as a pay-as-you-go plan. The retirement system allows voluntary retirement for active members upon credit of at least 20 years of active service at any age. Reserve members may retire after 20 years of creditable service with benefits beginning at age 60. The health services plan is a post-retirement medical benefit plan which covers all active duty and reserve members of the USCG. The retirement plan's only assets are accounts receivable representing unintentional overpayments of retiree benefits. The plan may subsequently recover such amounts through future benefit payment adjustments or may elect to waive its right to recover such amounts. The health services plan has no assets.

The unfunded accrued liability, presented as a component of the liability for military service and other retirement in the accompanying Consolidated Balance Sheet, represents both retired pay and health care benefits for non-Medicare eligible retirees/survivors. On October 1, 2002, USCG transferred the actuarial liability for payments for the health care benefits of Medicare eligible retirees and survivors to the Department of Defense Medicare-Eligible Retiree Health Care Fund (the Fund). USCG makes monthly payments to the Fund for current service members. Valuation of the plan's liability is based on the actuarial present value of accumulated plan benefits derived from the future payments that are attributable, under the retirement plan's provisions, to a participant's credited service as of the valuation date. Credited service is the years of service from active duty base date (or constructive date in the case of active duty reservists) to date of retirement measured in years and completed

Financial Information

months. The present value of future benefits is then converted to an unfunded accrued liability by subtracting the present value of future employer/employee normal contributions. USCG plan participants may retire after 20 years of active service at any age with annual benefits equal to 2.5 percent of retired base pay for each year of credited service up to 75 percent of basic pay. Personnel who became members after August 1, 1986 may elect to receive a \$30,000 lump sum bonus after 15 years of service and reduced benefits prior to age 62. Annual disability is equal to the retired pay base multiplied by the larger of (1) 2.5 percent times years of service, or (2) percent disability. The benefit cannot be more than 75 percent of retired pay base. If a USCG member is disabled, the member is entitled to disability benefits, assuming the disability is at least 30 percent (under a standard schedule of rating disabilities by Veterans Affairs) and either: (1) the member has 8 years of service, (2) the disability results from active duty, or (3) the disability occurred in the line of duty during a time of war or national emergency or certain other time periods.

Military retirement system changes from prior year consist of the following:

- (1) Concurrent Receipts – on November 24, 2003, Public Law 108-136 came into effect. This law approves the phase-in of full concurrent receipt of military retired pay and veterans' disability compensation for certain military retirees who have veterans' disability compensation rated at 50 percent or higher. These new benefits are to begin phase-in beginning January 1, 2004 until full implementation on January 1, 2014.
- (2) Combat-Related Special Compensation (CRSC) – the CRSC program became effective May 31, 2003, for qualified retirees with combat-related disabilities. CRSC benefits are available for retirees with 20 years of service and who have disabilities that are the direct result of armed conflict, especially hazardous military duty, or training exercises that simulate war, or are caused by an instrumentality of war. The retiree must be compensated by the Department of Veterans Affairs and rated at least 10% disabled. The amount of the CRSC benefits is equal to the amount of VA disability compensation offset from retired pay based on those disabilities determined to be combat-related.
- (3) "Redux" Benefit – prior assumptions of the percentages of Redux participants electing the \$30,000 lump sum for both officers and enlisted were 41.59% and 48.5%, respectively. The actual combined experience of those electing the Redux benefit is 37.5%. The current assumption has been reduced to 40%.

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

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

B. District of Columbia Police and Fireman's Retirement System for U.S. Secret Service Employees (unaudited)

Special agents and personnel in certain job series hired by USSS before January 1, 1984, are eligible to transfer to the District of Columbia Police and Fireman's Retirement System (DC Pension Plan) after completion of ten years of protection related experience. All uniformed USSS officers who were hired before January 1, 1984, are automatically covered under this retirement system. Participants in the DC Pension Plan make contributions of 7 percent of base pay with no matching contribution made by USSS. Annuitants of this plan receive benefit payments directly from the DC Pension Plan. The USSS reimburses the District of Columbia for the difference between benefits provided to the annuitants, and payroll contributions received from current employees.

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This liability is presented as a component of the liability for military service and other retirement benefits in the accompanying consolidated balance sheet. SFFAS No. 5 Accounting for Liabilities of the Federal Government requires the administrative entity (administrator) to report the actuarial liability. However, the USSS adopted the provisions of SFFAS No. 5 because the administrator, the DC Pension Plan, is not a Federal entity and as such the liability for future funding would not otherwise be recorded in the United States government-wide consolidated financial statements.

The liability and expense are computed using the aggregate cost method. The primary actuarial assumptions used to determine the liability at September 30, 2004 are:

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

Total expenses related to the DC Pension Plan for the fiscal year ended September 30, 2004, were \$173 million, of which \$16 million was funded but not paid at September 30, 2004.

Financial Information

17. Other Liabilities

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

	2004 (unaudited)	2003
Intra-governmental:		
Accrued FECA Liability	\$240	\$178
Advances from Others	139	77
Employer Benefits Contributions and Payroll Taxes	69	57
Other Intra-governmental Liabilities	115	37
Total Intra-governmental Other Liabilities	563	349
Public:		
Duties for Imports of Canadian Softwood Lumber (note 2)	2,940	1,439
Injured Domestic Industries (note 2)	332	247
Contingent Legal Liabilities (notes 12 and 19)	80	75
Capital Lease Liability (notes 12 and 18)	148	167
Environmental and Disposal Liabilities (notes 12 and 19)	159	98
Refunds and Drawbacks (note 2)	132	98
Other Public Liabilities	375	326
Total Public Other Liabilities	4,166	2,450
Total Other Liabilities	\$4,729	\$2,799

Intra-governmental accrued FECA liability primarily represents the unfunded workers' compensation for current claims. Intra-governmental other liabilities consist principally of current liabilities, while the majority of public other liabilities are considered non-current.

The *Continued Dumping and Subsidy Offset Act of 2000* calls for CBP to collect and disburse monies received in connection with antidumping and countervailing duty orders and findings to qualifying Injured Domestic Industries (IDI). Antidumping duties are collected when it is determined that a class or kind of foreign merchandise is being released into the U.S. economy at less than its fair value to the detriment of a U.S. industry. Countervailing duties are collected when it is determined that a foreign government is providing a subsidy to its local industries to manufacture, produce, or export a class or kind of merchandise for import into the U.S. commerce to the detriment of a U.S. industry. Antidumping and countervailing duties collected and due to IDIs at September 30, 2004 and 2003, totaled \$332 million and \$247 million, respectively. CBP has collected Canadian softwood lumber

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duties of \$2.9 billion and \$1.4 billion, respectively, as of September 30, 2004 and 2003. The duties will eventually be distributed, pursuant to rulings by the Department of Commerce (DOC). Duties for imports of Canadian softwood lumber are included in non-entity fund balance with Treasury, and represent a non-entity liability for which there is an anti-dumping dispute currently being litigated.

Refunds and Other Payments

Disbursements from the refunds and drawback account for the fiscal year ended September 30, 2004, and the seven months ended September 30, 2003 consisted of the following (in millions):

	2004 (unaudited)	2003
Refunds	\$566	\$399
Drawback	404	159
Total	\$970	\$558

The disbursements include interest payments of \$45 million. In certain instances, a refund may be identified prior to liquidation for amounts remitted by the importer. These refunds are funded from the collections rather than the refunds and drawback account. For the fiscal year ended September 30, 2004, these refunds totaled \$251 million.

Amounts refunded during the fiscal year ended September 30, 2004, identified by entry year, consisted of the following (in millions):

Entry Year:	2004 (unaudited)	2003
2004	\$531	\$ -
2003	128	314
2002	64	84
2001	24	52
Prior Years	223	108
Total	\$970	\$558

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

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The total amounts of antidumping and countervailing duties vary from year to year depending on decisions from DOC. Antidumping and countervailing duty refunds (included in total refunds presented above) and associated interest refunded for the fiscal year ended September 30, 2004 and the seven months ended September 30, 2003, consisted of the following (in millions):

	2004 (unaudited)	2003
Antidumping and countervailing duty refunds	\$75	\$57
Interest	19	13
Total Antidumping and countervailing duty refunds	\$94	\$70

18. Leases

A. Operating Leases (unaudited)

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

As of September 30, 2004, estimated future minimum lease commitments under operating leases for equipment and GSA controlled leases are as follows (in millions):

	GSA	Non-GSA	Total
FY 2005	\$604	\$62	\$666
FY 2006	642	63	705
FY 2007	655	64	719
FY 2008	659	65	724
FY 2009	675	65	740
Beyond FY 2009	2,937	143	3,080
Total future minimum lease payments	\$6,172	\$462	\$6,634

The estimated future lease payments for GSA controlled leases are based on payments made during the year ended September 30, 2004. Lease payments to GSA are expected beyond FY 2009; however, costs cannot be reasonably estimated.

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B. Capital Leases

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

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

19. Contingent Liabilities and Other Commitments

A. Legal Contingent Liabilities

The estimated contingent liability recorded in the accompanying financial statements included with other liabilities for all probable and estimable litigation related claims at September 30, 2004, was \$80 million (unaudited), of which \$26 million is funded. (At September 30, 2003, the estimated contingent liability was \$75 million, of which \$17 million was funded). Asserted and pending legal claims for which loss is reasonably possible was estimated to range from \$3.8 billion to \$3.9 billion (unaudited), at September 30, 2004 and 2003. Approximately \$3.4 billion of this estimated range involves cases related to the 1995 bombing of Alfred P. Murrah Federal Building in Oklahoma City, that were transferred to DHS with the Federal Protective Service from the legacy agency.

The Department is subject to various other legal proceedings and claims. In management's opinion, the ultimate resolution of other actions will not materially affect the Department's financial position or net costs.

B. Environmental Cleanup Liabilities

The Department is responsible to remediate its sites with environmental contamination, and is party to various administrative proceedings, legal actions, and tort claims which may result in settlements or decisions adverse to the Federal government.

The source of remediation requirements to determine the environmental liability is based on compliance with Federal and state or local environmental laws and regulations. The major Federal laws covering environmental response, cleanup and monitoring are the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and the Resource Conservation and Recovery Act (RCRA). Environmental cleanup liability of \$159 million (\$15 million funded) (unaudited), as of September 30, 2004 and \$98 million as of September 30, 2003, is presented with other liabilities in the accompanying Consolidated Balance Sheet. The liabilities consist primarily of fuel storage tank program, fuels, solvents, industrial, chemicals, and other environmental cleanup associated with normal operations of the USCG. For Plum Island Animal Disease Center, under S&T, potential environmental liabilities that are not presently estimable could exist due to the facility's age, old building materials used, and other materials associated with the facility's past use as a United States Army installation for coastline defense. Cost estimates for environmental and disposal liabilities are subject to revision as a result of changes in technology and environmental laws and regulations.

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C. NFIP Premiums

NFIP premium rates are generally established for actuarially rated policies with the intent of generating sufficient premiums to cover losses and loss adjustment expenses of a historical average loss year and to provide a surplus to compensate the Insurance Underwriting Operations for the loss potential of an unusually severe loss year due to catastrophic flooding. Notwithstanding the foregoing, subsidized rates are charged on a countrywide basis for certain classifications of insured. These subsidized rates produce a premium less than the loss and loss adjustment expenses expected to be incurred in a historical average loss year. The subsidized rates do not include a provision for losses from catastrophic flooding. Subsidized rates are used to provide affordable insurance on construction or substantial improvements started on or before December 31, 1974, or before the effective date of the initial Flood Insurance Rate Map (i.e., an official map of a community on which NFIP has delineated both the special hazard areas and the non-subsidized premium zones applicable to the community). Any future loss potential of catastrophic flooding cannot be meaningfully quantified as it relates to insurance policies in effect. Accordingly, the financial statements do not include any liability provision for future loss due to catastrophic flooding.

D. Duty and Trade Refunds

There are various trade related matters that fall under the jurisdiction of other Federal agencies, such as the DOC, which may result in refunds of duties, taxes, and fees collected by CBP, i.e., duties collected by CBP on imports of Canadian softwood lumber. Until a decision is reached by the other Federal agencies, CBP does not have sufficient information to estimate a contingent liability amount for trade related refunds under jurisdiction of other Federal agencies. All known refunds as of September 30, 2004, and 2003, have been recorded.

E. Loaned Aircraft and Equipment

DHS is generally liable to the DoD for damage or loss to aircraft on loan to ICE. As of September 30, 2004, ICE had 16 aircraft loaned from DoD with an acquisition value of \$94 million (unaudited). (These aircraft were reported as on loan to CBP, as of September 30, 2003. During FY 2004, CBP transferred these loaned aircraft to ICE.) No damage or aircraft losses were accrued as of September 30, 2004.

F. Other Contractual Arrangements

In addition to future lease commitments discussed in Note 18, DHS is committed under contractual agreements for goods and services that have been ordered but not yet received (undelivered orders) at fiscal year end. Aggregate undelivered orders for all DHS activities amounted to \$21 billion in FY 2004.

TSA entered into Letters of Intent with eight major airports in which TSA may reimburse the airports for 75 percent of the cost (estimated at \$957 million) needed to modify the facilities for security purposes. These Letters of Intent would not obligate or commit TSA until funds are authorized and appropriated. In addition, the airports shall have title to any improvements to its facilities. During fiscal years 2004 and 2003, approximately \$213 million and \$47 million, respectively, were appropriated, obligated and are available for payments to the airports upon submission to TSA of an invoice for the modification costs incurred. As of September 30, 2004, TSA has received invoices or documentation for cost incurred totaling over \$72 million related to FY 2004 and 2003 Letters of Intent.

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20. Consolidated Statement of Net Cost & Net Costs of DHS Components (unaudited)

Operating costs are summarized in the Consolidated Statement of Net Cost by responsibility segment, as applicable to the reporting period. The net cost of operations is the gross (i.e., total) cost incurred by the Department, less any exchange (i.e., earned) revenue. A responsibility segment is the component that carries out a mission or major line of activity, and whose managers report directly to Departmental Management. For FY 2004 the Department's responsibility segments were responsible for accomplishing the three objectives of the President's *National Strategy for Homeland Security*.

During FY 2004, the Department interpreted the *National Strategy* and developed its first Strategic Plan, which included seven goals:

1. **Awareness:** Identify and understand threats, assess vulnerabilities, and determine potential impacts. Disseminate timely and actionable information to our homeland security partners and the American public.
2. **Prevention:** Detect, deter, thwart, and mitigate threats to our homeland.
3. **Protection:** Safeguard our people and their freedoms, critical infrastructure, property, and the economy of our Nation from acts of terrorism, natural disasters and other emergencies.
4. **Response:** Lead, manage and coordinate the national response to acts of terrorism, natural disasters, and other emergencies.
5. **Recovery:** Lead national, state, local, and private sector efforts to restore services and rebuild communities after any act of terrorism, natural disaster, and other emergency.
6. **Service:** Serve the public effectively by facilitating lawful trade, travel and immigration.
7. **Organizational Excellence:** Value our most important resource, our people. Create a culture that promotes a common identify, innovation, mutual respect, accountability and teamwork to achieve efficiencies, effectiveness, and operational synergies.

Beginning with the FY 2005 budget, the Department integrated budget and performance information as required by the President's Management Agenda and the Government Performance and Results Act. To integrate performance and financial information, a supplemental schedule of net cost is included in Other Accompanying Information, in which costs by program are allocated to Departmental strategic goals.

Due to the complexity of the Border and Transportation Security Directorate organizational structure, a supplemental schedule is presented to show the net cost of the Directorate's suborganizations.

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Statement of Net Cost sub-schedule:

Components of Border and Transportation Security (BTS) Directorate (in millions)
For the year ended September 30, 2004 (unaudited)

	Intragovernmental	With the Public	Total
BTS HQ (Office of Undersecretary)			
Gross Cost	\$6	\$5	\$11
Less Earned Revenue	-	-	-
Net Cost	6	5	11
CBP			
Gross Cost	1,545	4,582	6,127
Less Earned Revenue	(62)	(273)	(335)
Net Cost	1,483	4,309	5,792
ICE, FPS, and FAM			
Gross Cost	742	3,586	4,328
Less Earned Revenue	(366)	(12)	(378)
Net Cost	376	3,574	3,950
TSA			
Gross Cost	571	5,387	5,958
Less Earned Revenue	(95)	(2,071)	(2,166)
Net Cost	476	3,316	3,792
SLGCP			
Gross Cost	151	1,698	1,849
Less Earned Revenue	(2)	(1)	(3)
Net Cost	149	1,697	1,846
FLETC			
Gross Cost	27	195	222
Less Earned Revenue	(24)	(2)	(26)
Net Cost	3	193	196
BTS Directorate Total			
Gross Cost	3,042	15,453	18,495
Less Earned Revenue	(549)	(2,359)	(2,908)
NET COST - BTS	\$2,493	\$13,094	\$15,587

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21. Gross Cost and Earned Revenue by Budget Subfunction (BSF) Classification (unaudited)

The Department's costs and revenue are included in the Financial Report of the United States government, which is published by the Department of the Treasury. The Financial Report of the United States Government presents gross costs and earned revenue by budget subfunction (BSF). The following is the Department's gross cost and earned (exchange) revenue by BSF for the year ended September 30, 2004 (in millions) and reported net of intra-departmental eliminations:

	National Defense	Pollution Control & Abatement	Agricultural Research & Services	Transportation	Community & Regional Development	Income Security	Administration of Justice	General Government	2004 Total
Agency Gross Cost:									
Gross Cost - Federal	\$769	\$19	\$31	\$1,723	\$896	\$ -	\$3,712	\$337	\$7,487
Less: Intra-Departmental Eliminations	(15)	-	(4)	(27)	(30)	-	(447)	(160)	(683)
Inter-Departmental Gross Cost - Federal	754	19	27	1,696	866	-	3,265	177	6,804
Gross Cost - Public	563	95	(269)	13,017	7,586	152	10,733	865	32,742
Agency Gross Cost	\$1,317	\$114	(\$242)	\$14,713	\$8,452	\$152	\$13,998	\$1,042	\$39,546
Agency Exchange Revenue:									
Exchange Revenue - Federal	\$1	\$ -	\$109	\$316	\$151	\$ -	\$532	\$336	\$1,445
Less: Intra-Departmental Eliminations	(1)	-	(72)	(131)	(31)	-	(358)	(86)	(679)
Inter-Dept. Exchange Revenue - Federal	-	-	37	185	120	-	174	250	766
Exchange Revenue - Public	-	17	5	2,121	1,901	-	1,546	62	5,652
Agency Exchange Revenue	\$ -	\$17	\$42	\$2,306	\$2,021	\$ -	\$1,720	\$312	\$6,418
Agency Net Cost	\$1,317	\$97	(\$284)	\$12,407	\$6,431	\$152	\$12,278	\$730	\$33,128

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22. Combined Statement of Budgetary Resources (SBR) (unaudited)

The Combined Statement of Budgetary Resources (SBR) provides information about how budgetary resources were made available as well as their status at the end of the period. It is the only financial statement exclusively derived from the entity's budgetary general ledger in accordance with budgetary accounting rules that are incorporated into generally accepted accounting principles for the Federal government. The total Budgetary Resources of \$53,879 million for FY 2004 includes new budget authority, unobligated balances at the beginning of the year and transferred in/out, spending authority from offsetting collections, recoveries of prior year obligations, and adjustments.

A. Appropriations Received

Appropriations received on the SBR of \$38,303 million will not match the amounts reported on the Consolidated Statement of Changes in Net Position (SCNP) of \$33,410 million due to \$4,893 million of trust and special fund receipts that are not reflected in the unexpended appropriations section of the SCNP.

B. Permanently Not Available/Adjustments

Budgetary resources permanently not available on the SBR of \$2,563 million do not agree with the unavailable appropriations returned to Treasury of \$2,398 million on the SCNP due to: (1) reclassification of trust funds from unexpended appropriation to cumulative net results of operations which has no effect on the SBR; (2) authority permanently unavailable that was processed through cumulative results of operations and not unexpended appropriations; (3) repayments of debt that were processed through payables and not unexpended appropriations; and (4) reductions of borrowing authority that have no effect on the proprietary accounts.

C. Apportionment Categories of Obligations Incurred

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

	Apportionment Category A	Apportionment Category B	Exempt from Apportionment	Total
Obligations Incurred - Direct	\$24,260	\$18,634	\$734	\$43,628
Obligations Incurred - Reimbursable	2,015	854	11	2,880
Total Obligations Incurred	\$26,275	\$19,488	\$745	\$46,508

D. Borrowing Authority for EPR

The NFIP has borrowing authority of \$1.5 billion available as of September 30, 2004 for disaster relief purposes. NFIP loans are for a three year term. Interest rates are obtained from the Bureau of Public Debt. Simple interest is calculated monthly, and is offset by any interest rebate, if applicable. Interest is paid semi-annually on October 1 and April 1. Partial loan repayments are permitted. Principal repayments are required only at maturity, but are

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permitted at any time during the term of the loan. At the end of the Fiscal Year, borrowing authority is reduced by the amount of any unused portion. EPR's liability for borrowed amounts was \$8 million at September 30, 2004.

Under Credit Reform, the unsubsidized portion of direct loans is borrowed from the Treasury. The repayment terms of EPR's borrowing from Treasury are based on the life of each cohort of direct loans. Proceeds from collections of principal and interest from the borrowers are used to repay the Treasury. In addition, an annual reestimate is performed to determine any change from the original subsidy rate. If an upward reestimate is determined to be necessary, these funds are available through permanent indefinite authority. Once these funds are appropriated, the original borrowings are repaid to the Treasury.

EPR maintains three funds under the Credit Reform Act:

- 70-4234: Disaster Assistance Direct Loan Financing
- 70-0703: Disaster Assistance Direct Loan Program (no year)
- 70-0703: Disaster Assistance Direct Loan Program (annual)

E. Non-Budgetary, Credit Program, and Financing Account

Included in the SBR are amounts for DHS's one financing account in EPR for Disaster Assistance Direct Loan. This non-budgetary financing account is not presented separately on the SBR because the amounts and impact are immaterial. Financing account information for the fiscal year ended September 30, 2004 is presented below (in millions):

Budgetary Resources

Budget Authority:	
Borrowing Authority	\$26
Spending Authority from Offsetting Collections:	
Receivable from Federal Sources	(3)
Recoveries of Prior Year Obligations	3
Permanently Not Available:	
Other Authority Withdrawn	(26)
Total Budgetary Resources	\$0
Total Status of Budgetary Resources	\$0
Total Outlays	\$0

F. Explanation of Differences between the Combined Statement of Budgetary Resources and the Budget of the United States Government

The SBR has been prepared to coincide with the amounts shown in the President's Budget (Budget of the United States Government). The actual amounts for FY 2004 in the President's Budget have not been published at the time these financial statements were prepared. The President's Budget with the actual FY 2003 amounts was released in February 2004, and the actual FY 2004 amounts are estimated to be released in February 2005. The Department's FY 2003 budget amounts does not match the FY 2003 President's Budget, primarily due to the SBR reflecting only seven months covering the period from March 1, 2003 to September 30, 2003, whereas the

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President's Budget has been annualized and covers the period from October 1, 2002 to September 30, 2003. The SBR includes expired appropriations while the Budget does not.

G. Adjustments to Beginning Balance of Budgetary Resources

The Oil Spill Liability Trust Fund is managed by the U.S. Department of Treasury's Bureau of Public Debt (BPD). During FY 2004, the Office of Budget and Management (OMB) directed two adjustments to comply with OMB Circular A-11 and applicable U.S. Standard General Ledger Guidance. The BPD was first required to change FACTS II budgetary reporting to reflect receipts unavailable for obligation upon collection, rather than unobligated funds exempt from apportionment. The second change required adjusting the Fund's beginning balances to reflect investment authority available. These changes required a downward adjustment of \$782 million to the unobligated balance as presented in the Statement of Budgetary Resources.

23. Permanent Indefinite Appropriations

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

- CBP has a permanent and indefinite appropriation, which is used to disburse tax and duty refunds, and duty drawbacks. Although funded through appropriations, refund and drawback activity is, in most instances, reported as a custodial activity of the Department. This presentation is appropriate because refunds are custodial revenue-related activity in that refunds are a direct result of taxpayer overpayments of their tax liabilities. Federal tax revenue received from taxpayers is not available for use in the operation of the Department and is not reported on the Consolidated Statement of Net Cost. Likewise, the refunds of overpayments are not available for use by the Department in its operations. Refunds and drawback disbursements totaled \$970 million (unaudited) for the fiscal year ended September 30, 2004 and \$558 for the seven months ended September 30, 2003, and are presented as a use of custodial revenue on the Statement of Custodial Activity.
- USSS has a permanent and indefinite appropriation which is used to reimburse the District of Columbia Police and Fireman's Retirement System (DC Pension Plan) for the difference between benefits provided to the annuitants (employees) eligible to participate in the DC Pension Plan (see note 16), and payroll contributions received from current employees.

These appropriations are not subject to budgetary ceilings established by Congress. CBP's refunds payable at year end are not subject to funding restrictions. Refund payment funding is recognized as appropriations are used.

24. Legal Arrangements Affecting the Use of Unobligated Balances of Budget Authority

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

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appropriation was made have been carried out and disbursements have not been made against the appropriation for two consecutive years.

Included in the cumulative results of operations for special funds is \$1,015 million that represents the Department's authority to assess and collect user fees relating to merchandise and passenger processing, to assess and collect fees associated with services performed at certain small airports or other facilities, retain amounts needed to offset costs associated with collecting duties, and taxes and fees for the government of Puerto Rico. These special fund balances are restricted by law in their use to offset specific costs incurred by the Department. In addition, the Department is required to maintain \$30 million in its User Fees Account. Part of the passenger fees in the User Fees Account, totaling approximately \$730 million (unaudited) and \$640 million at September 30, 2004 and 2003 respectively, is restricted by law in its use to offset specific costs incurred by the Department and are available to the extent provided in Department Appropriation Acts.

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

25. Explanation of the Relationship Between Liabilities Not Covered by Budgetary Resources and the Changes in Components Requiring or Generating Resources in Future Periods (unaudited)

The relationship between the amounts reported as liabilities not covered by budgetary resources on the balance sheet and amounts reported as components requiring or generating resources in future periods on the Statement of Financing were analyzed. The differences are primarily due to the increase in the USCG actuarial pension liability of \$1.3 billion in fiscal year 2004, which does not generate net cost of operations or require the use of budgetary resources.

26. Dedicated Collections

The Department administers various Trust Funds that receive dedicated collections. In the U.S. Government budget, Trust Funds are accounted for separately and used only for specified purposes. A brief description of the major Trust Funds and their purpose follows.

A. Oil Spill Liability Trust Fund

The Oil Spill Liability Trust Fund (OSLTF) was established by the Oil Pollution Act (OPA) of 1990, P.L. 101-380, to help facilitate cleanup activities and compensate for damages from oil spills. OSLTF account includes the parent OSLTF fund that is managed by BPD, the USCG Oil Spill Recovery transfer account, the USCG Trust Fund Share of Expenses transfer account, and the USCG OPA Claims transfer account. These three transfer accounts fund outlays through SF-1151 non-expenditure transfers from the BPD OSLTF parent fund.

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B. Boat Safety Account

The USCG's Boat Safety Account was established by Federal Boat Safety Act (FBSA) of 1971, P.L. 92-75, to "encourage greater State participation and uniformity in boating safety efforts, and particularly to permit the States to assume the greater share of boating safety education, assistance, and enforcement activities." The Boat Safety Account receives funding from the Department of Interior's Sport Fish Restoration Account, which is funded in part from the Aquatic Resource Trust Fund (ARTF) managed by Bureau of Public Debt (BPD). Funds are available until expended (no-year). Outlays in this account are funded through SF-1151 non-expenditure transfers from the Sport Fish account.

Condensed financial information as of and for the fiscal year ended September 30, 2004 and as of and for the seven months ended September 30, 2003, is presented below (in millions):

	2004 (unaudited)		2003	
	Oil Spill Liability Trust Fund	Boat Safety Account	Oil Spill Liability Trust Fund	Boat Safety Account
Assets:				
Investments	\$838	\$ -	\$965	\$ -
Other Assets	26	68	48	58
Total Assets	\$864	\$68	\$1,013	\$58
Liabilities:				
Accounts Payable	\$1	\$19	\$ -	\$23
Other Liabilities	-	-	3	-
Total Liabilities	1	19	3	23
Net Position:				
Transfers In without Reimbursement	1,010	35	1,000	100
Non-Exchange Revenue	(32)	64	52	-
Less: Program Expenses	(115)	(50)	(42)	(65)
Net Position	863	49	1,010	35
Total Liabilities and Net Position	\$864	\$68	\$1,013	\$58

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27. Transfer of the Strategic National Stockpile (unaudited)

The transfer of the Strategic National Stockpile (SNS) pursuant to Project Bioshield Act of 2004 had an effect on all of the Department's fiscal year 2004 financial statements, except for the Statement of Custodial Activity.

The following lines on the Department's Consolidated Balance Sheet, Consolidated Statement of Net Cost, Consolidated Statement of Changes in Net Position, Consolidated Statement of Financing, and Combined Statement of Budgetary Resources include the transfer out of assets, liabilities, net position, and budgetary resources of the SNS as of August 13, 2004, the date of transfer.

Consolidated Balance Sheet (in millions)

Fund Balance with Treasury	\$626
Operating Materials and Supplies, Inventory and Stockpile	924
Property, Plant and Equipment, Net	5
Total Assets	<u>\$1,555</u>
Accounts Payable	\$88
Unexpended Appropriations	538
Cumulative Results of Operations	929
Total Liabilities and Net Position	<u>\$1,555</u>

Consolidated Statement of Net Cost (in millions)

Costs – Intra-governmental	\$98
Less Earned Revenue – Intra-governmental	-
Net Cost – Intra-governmental	<u>\$98</u>
Costs – With the Public	\$ -
Less Earned Revenue – With the Public	-
Net Cost – With the Public	<u>\$ -</u>
Net Cost of Operation	<u>\$98</u>

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Consolidated Statement of Changes in Net Position (SCNP) and Consolidated Statement of Financing (SOF) (in millions)

Appropriations Transferred In/Out (Unexpended Appropriations) – SCNP only	\$538
Other Financing Sources (Non-Exchange): Transfers In/Out without Reimbursement (Cumulative Results) – Both SCNP and SOF	<u>\$929</u>
Combined Statements of Budgetary Resources (in millions)	
Budgetary Resources – Budget Authority – Net Transfers, Current Year	\$11
Budgetary Resources – Budget Authority – Net Transfers, Balance	<u>\$53</u>
Budgetary Resources – Unobligated Balance – Net Transfers	\$64
Budgetary Resources – Relationship of Obligations to Outlays – Obligated Balance Transferred, Net	<u>\$561</u>

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Required Supplementary Information (unaudited)

Deferred Maintenance

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

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

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

Poor. Facility/equipment does not meet most maintenance standards and requires frequent repairs to prevent accelerated deterioration and provide a minimal level of operating function. In some cases, this includes condemned or failed facilities. Based on periodic condition assessments, an indicator of condition is the percent of facilities and item of equipment in each of the good, fair, or poor categories.

In FY 2004, the Department reported \$591 million in deferred maintenance on general property, plant, and equipment, and heritage assets. This amount represents maintenance on vehicles, vessels, and buildings and structures owned by the Department that was not performed when it should have been or was scheduled to be and which is delayed for a future period.

A summary of deferred maintenance at September 30, 2004 is presented below (in millions):

	Deferred Maintenance	Asset Condition
Building & Structures	\$467	Poor to Fair
Equipment (vehicles and vessels)	92	Poor to Fair
Heritage assets	32	Poor to Fair
Total	\$591	

See accompanying Independent Auditors' Report.
Required Supplementary Information

Financial Information

Intra-Governmental Transaction Disclosures

Intra-governmental transaction amounts represent transactions between Federal entities included in the Financial Report of the United States Government (formerly the Consolidated Financial Statements of the United States Government) published by the U.S. Department of the Treasury. All amounts presented are net of intra-departmental eliminations.

The amount of intra-governmental assets and liabilities classified by trading partner at September 30, 2004 and 2003, are summarized below (in millions).

Intra-governmental Assets as of September 30, 2004 (in Millions)

Partner Agency	Fund Balance with Treasury	Investments and Related Interest	Advances and Prepayments	Other
Treasury General Fund	\$ -	\$-	\$ -	\$170
Department of Commerce	-	-	3	-
Department of Interior	-	-	-	69
Department of Justice	-	-	83	61
Department of Labor	-	-	63	-
Department of the Navy	-	-	12	17
Department of State	-	-	-	13
Department of Treasury	33,436	1,625	15	40
Social Security Administration	-	-	-	5
Department of the Army	-	-	-	12
National Science Foundation	-	-	-	6
Department of Transportation	-	-	2,673	6
Office of the Secretary of Defense Agencies	-	-	37	80
Other	-	-	-	2
Totals	\$33,436	\$1,625	\$2,886	\$481

See accompanying Independent Auditors' Report.
Required Supplementary Information

Financial Information

Intra-governmental Assets as of September 30, 2003 (in Millions)

Partner Agency	Fund Balance with Treasury	Investments and Related Interest	Advances and Prepayments	Other
Treasury General Fund	\$ -	\$ -	\$ -	\$109
Department of Commerce	-	-	10	-
Department of Interior	-	-	8	62
Department of Justice	-	-	11	54
Department of the Navy	-	-	87	(113)
Department of State	-	-	-	23
Department of Treasury	27,343	1,546	32	184
General Services Administration	-	-	-	7
National Science Foundation	-	-	-	8
Environmental Protection Agency	-	-	-	5
Department of Transportation	-	-	2,772	40
Dept of Health & Human Services	-	-	37	-
U.S. Army Corps of Engineers	-	-	-	7
Office of the Secretary of Defense Agencies	-	-	-	40
Other	-	-	97	(11)
Totals	\$27,343	\$1,546	\$3,054	\$415

See accompanying Independent Auditors' Report.
Required Supplementary Information

Financial Information

Intra-governmental Liabilities as of September 30, 2004 (in Millions)

Partner Agency	Due to Treasury	Accounts Payable	Other
Treasury General Fund	\$1,257	\$ -	\$8
Department of Agriculture	-	16	2
Department of Commerce	-	-	-
Department of Interior	-	12	-
Department of Justice	-	123	30
Department of Labor	-	-	242
Department of the Navy	-	38	7
Department of State	-	7	13
Department of Treasury	-	(4)	26
Department of Veterans Affairs	-	10	4
Department of the Army	-	24	41
Office of Personnel Management	-	4	52
Social Security Administration	-	-	9
General Services Administration	-	18	63
Environmental Protection Agency	-	10	1
Department of the Air Force	-	18	2
Department of Transportation	-	12	34
Department of Health & Human Services	-	40	6
Department of Energy	-	127	3
U.S. Army Corps of Engineers	-	136	-
Office of the Secretary of Defense Agencies	-	316	12
Other	-	4	8
Totals	\$1,257	\$911	\$563

See accompanying Independent Auditors' Report.
Required Supplementary Information

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Intra-governmental Liabilities as of September 30, 2003 (in Millions)

Partner Agency	Due to Treasury	Accounts Payable	Other
Treasury General Fund	\$1,209	\$-	\$3
Department of Justice	-	17	6
Department of Labor	-	-	184
Department of the Navy	-	78	(10)
Department of State	-	4	5
Department of Treasury	-	5	10
Department of the Army	-	6	-
Office of Personnel Management	-	-	27
General Services Administration	-	57	10
Department of Transportation	-	-	34
Department of Health & Human Services	-	24	-
U.S. Army Corps of Engineers	-	20	59
Office of the Secretary of Defense Agencies	-	124	9
Other	-	63	12
Totals	\$1,209	\$398	\$349

See accompanying Independent Auditors' Report.
Required Supplementary Information

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FY 2004 Intra-governmental Exchange Revenue from Trade Transactions (in Millions)

Partner Agency	Exchange Revenue
Executive Office of the President	\$8
Department of Agriculture	7
Department of Commerce	7
Department of Interior	7
Department of Justice	152
Department of the Navy	24
Department of State	52
Department of Treasury	70
Department of the Army	102
Social Security Administration	101
General Services Administration	16
National Science Foundation	13
Environmental Protection Agency	25
Department of Transportation	135
Department of Health & Human Services	19
Department of Education	7
National Transportation Safety Board	16
Other	5
Totals	\$766

FY 2004 Cost to Generate Intra-governmental Exchange Revenue, by BSF (in Millions)

Budget Subfunction	Cost
Transportation	\$123
Community and Regional Development	87
Administration of Justice	147
General Government	840
Total	\$1,197

See accompanying Independent Auditors' Report.
Required Supplementary Information

Financial Information

FY 2004 Intra-governmental Non-Exchange Revenue (in Millions)

Partner Agency	Transfers-In	Transfers-Out
Department of Interior	\$ -	\$7
Department of Treasury	240	161
General Services Administration	101	-
Environmental Protection Agency	-	16
Department of Transportation	-	13
Other	2	5
Totals	\$343	\$202

See accompanying Independent Auditors' Report.
Required Supplementary Information

Financial Information

Combined Schedule of FY 2004 Budgetary Resources by Responsibility Segments (in Millions)

BUDGETARY RESOURCES	Border and Transportation Security	Emergency Preparedness & Response	Information Analysis & Infrastructure Protection	Science & Technology	U.S. Coast Guard	U.S. Secret Service	U.S. Citizenship & Immigration Services	Departmental Offices & Other	Total
Budget Authority:									
Appropriations Received	\$19,467	\$6,793	\$839	\$918	\$6,928	\$1,341	\$1,551	\$466	\$38,303
Borrowing Authority	-	26	-	-	-	-	-	-	26
Net Transfers	619	(63)	-	-	204	-	(25)	22	757
Unobligated Balance:									
Beginning of Period	3,464	3,306	25	352	1,023	101	190	198	8,659
Net Transfers	76	(45)	11	-	-	(1)	-	-	41
Spending Authority from Offsetting Collections:									
Earned:									
Collected	3,843	2,046	1	-	311	27	11	43	6,282
Receivable from Federal Sources	(30)	(3)	-	-	42	-	(4)	4	9
Change in Unfilled Customer Orders:									
Advances Received	37	25	-	22	(25)	22	10	(4)	87
Without Advances From Federal Sources	(21)	215	-	2	(5)	(2)	7	62	258
Transfers from Trust Funds	3	-	-	-	52	-	-	-	55
Total Spending Authority from Offsetting Collections	3,832	2,283	1	24	375	47	24	105	6,691

(continued)

Financial Information

Combined Schedule of FY 2004 Budgetary Resources by Responsibility Segments (in Millions), continued

	Border and Transportation Security	Emergency Preparedness & Response	Information Analysis & Infrastructure Protection	Science & Technology	U.S. Coast Guard	U.S. Secret Service	U.S. Citizenship & Immigration Services	Departmental Offices & Other	Total
Recoveries of Prior Year Obligations	1,220	483	6	-	63	16	187	7	1,982
Temporarily Not Available Pursuant to Public Law	-	(17)	-	-	-	-	-	-	(17)
Permanently Not Available	(2,056)	(288)	(15)	(5)	(145)	(46)	(4)	(4)	(2,563)
TOTAL BUDGETARY RESOURCES	\$26,622	\$12,478	\$867	\$1,289	\$8,448	\$1,458	\$1,923	\$794	\$53,879
STATUS OF BUDGETARY RESOURCES									
Obligations Incurred:									
Direct	\$21,543	\$9,958	\$760	\$891	\$7,021	\$1,362	\$1,557	\$536	\$43,628
Reimbursable	1,934	389	1	17	350	42	49	98	2,880
Total Obligations Incurred	23,477	10,347	761	908	7,371	1,404	1,606	634	46,508
Unobligated Balances Available:									
Apportioned	2,091	2,026	80	381	858	11	110	134	5,691
Exempt from Apportionment	-	10	-	-	32	-	-	-	42
Unobligated Balances Not Available	1,054	95	26	-	187	43	207	26	1,638
TOTAL STATUS OF BUDGETARY RESOURCES	\$26,622	\$12,478	\$867	\$1,289	\$8,448	\$1,458	\$1,923	\$794	\$53,879

(continued)

Financial Information

Combined Schedule of FY 2004 Budgetary Resources by Responsibility Segments (in Millions), continued

	Border and Transportation Security	Emergency Preparedness & Response	Information Analysis & Infrastructure Protection	Science & Technology	U.S. Coast Guard	U.S. Secret Service	U.S. Citizenship & Immigration Services	Depart- mental Offices & Other	Total
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS									
Obligated Balance, Net, Beginning of Period	\$7,605	\$8,038	\$192	\$119	\$2,489	\$268	\$679	\$299	\$19,689
Obligated Balance Transferred, Net	-	(561)	2	-	-	-	-	-	(559)
Obligated Balance, Net, End of Period:									
Accounts Receivable	(198)	(21)	-	-	(145)	-	(69)	(4)	(437)
Unfilled Customer Orders from Federal Sources	(488)	(336)	(1)	(2)	(72)	(9)	(2)	(71)	(981)
Undelivered Orders	9,035	8,463	412	356	2,044	246	427	371	21,354
Accounts Payable	2,378	2,038	140	217	751	54	176	112	5,866
Total Obligated Balance, Net, End of Period	\$10,727	\$10,144	\$551	\$571	\$2,578	\$291	\$532	\$408	\$25,802
Outlays:									
Disbursements	\$19,200	\$6,983	\$400	\$455	\$7,182	\$1,368	\$1,563	\$450	\$37,601
Collections	(3,883)	(2,070)	(1)	(23)	(339)	(49)	(21)	(38)	(6,424)
Total Outlays	15,317	4,913	399	432	6,843	1,319	1,542	412	31,177
Less: Offsetting Receipts	(2,292)	(2)	-	-	(20)	(1)	(1,464)	-	(3,779)
NET OUTLAYS	\$13,025	\$4,911	\$399	\$432	\$6,823	\$1,318	\$78	\$412	\$27,398

See accompanying Independent Auditors' Report.
Required Supplementary Information

Financial Information

Custodial Activity

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

CBP reviews selected documents to ensure all duties, taxes, and fees owed to the Federal government are paid and to ensure regulations are followed. If CBP believes duties, taxes, fees, fines, or penalties are due in addition to estimated amounts previously paid by the importer/violator, the importer/violator is notified of the additional amount due. CBP regulations allow the importer/violator to file a protest on the additional amount due for review by the Port Director. A protest allows the importer/violator the opportunity to submit additional documentation supporting their claim of a lower amount due or to cancel the additional amount due in its entirety. Work in progress will continue until all protest options have expired or an agreement is reached. During this protest period, CBP does not have a legal right to the importer/violator's assets, and consequently CBP recognizes accounts receivable only when the protest period has expired or an agreement is reached. For FY 2004, CBP had legal right to collect \$1.3 billion of receivables. In addition, there is an additional \$1.58 billion representing records still in the protest phase. CBP recognized as write-offs \$136 million of assessments that DHS has statutory authority to collect at year end, but has no future collection potential. Most of this amount represents fines, penalties, and interest. CBP also estimated that trust funds are neither overstated nor understated as of September 30, 2004.

USCG collects various fines, penalties, and miscellaneous user fees from the public that are deposited to the general fund miscellaneous receipts of the U.S. Treasury. USCG does not collect taxes or duties. As of September 30, 2004, USCG had outstanding general fund receipt receivables due to the Treasury General Fund of \$14 million.

**See accompanying Independent Auditors' Report.
Required Supplementary Information**

Financial Information

Segment Information (in millions):

	9/30/2004			9/30/2003		
	Working Capital Fund	Revolving Fund: Supply	Revolving Fund: Yard	Working Capital Fund	Revolving Fund: Supply	Revolving Fund: Yard
Fund Balance with Treasury	\$51	\$32	\$30	\$90	\$12	\$51
Accounts Receivable	4	6	6	1	14	1
Property, Plant and equipment	-	-	55	28	-	55
Other Assets	-	36	14	10	41	(45)
Total Assets	\$55	\$74	\$105	\$129	\$67	\$62
Accounts Payable	\$3	\$23	\$3	\$1	\$13	(\$3)
Other Liabilities	-	-	47	7	-	9
Total Liabilities	3	23	50	8	13	6
Cumulative Results of Operations	52	51	55	121	54	56
Total Liabilities and Net Position	\$55	\$74	\$105	\$129	\$67	\$62
Total Costs	\$77	\$99	\$79	\$16	\$3	\$8
Exchange Revenue	8	96	78	26	7	7
Excess of Revenues and Financing Sources over Costs	(\$69)	(\$3)	(\$1)	\$10	\$4	(\$1)

The Department's Working Capital Fund (WCF) is a fee-for-service entity that is fully reimbursable. The WCF provides a variety of support services primarily to the Department's components, and to other Federal entities. The WCF operates on a revolving fund basis, whereby current-operating expenses charged to the customer finance the cost of goods and services. The overall financial goal of the fund is to fully cover the operating expenses while building a minimal capital improvement reserve.

The USCG Yard revolving fund (Yard Fund) finances the industrial operations at the USCG Yard in Curtis Bay, Maryland and other USCG industrial sites. The USCG Supply revolving fund (Supply Fund) finances the procurement of uniform clothing, commissary provisions at USCG dining facilities, general stores, technical material, and fuel for vessels over 180 feet in length.

**See accompanying Independent Auditors' Report.
Required Supplementary Information**

Financial Information

Risk Assumed Information

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

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

**See accompanying Independent Auditors' Report.
Required Supplementary Information**

Financial Information

Required Supplementary Stewardship Information (unaudited)

Heritage Assets

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

The following table summarizes activity related to Heritage Assets from October 1, 2003, to September 30, 2004 (in number of units).

	USCG	CBP	Total
Beginning Balance	\$19,619	4	19,623
Additions	516	-	516
Withdrawals	(205)	-	(205)
Ending Balance	\$19,930	4	19,934

USCG possesses artifacts that can be divided into four general areas: ship's equipment, lighthouse and other aids-to-navigation items, military uniforms, and display models. The addition of artifacts is the result of gifts to USCG.

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

See accompanying Independent Auditors' Report.
Required Supplementary Stewardship Information

Financial Information

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

Buildings and Structures - USCG does not acquire or retain heritage buildings and structures without an operational use. Most real property, even if designated as historical, is acquired for operational use and is transferred to other government agencies or public entities when no longer required for operations. Of the USCG buildings and structures designated as heritage, including memorials, recreational areas and other historical areas, over two-thirds are multi-use heritage. The remaining are historical lighthouses, which are no longer in use and awaiting disposal; their related assets; and a gravesite. CBP also has four multi-use heritage assets located in Puerto Rico. All multi-use heritage assets are reflected on the Consolidated Balance Sheet. Financial information for multi-use heritage assets is presented in the principal statements and notes. Deferred maintenance information for heritage assets and general PP&E is presented in the required supplementary information.

Stewardship Investments

Stewardship investments are substantial investments made by the Federal government for the benefit of the nation. When incurred, they are treated as expenses in calculating net cost, but they are separately reported as Required Supplementary Stewardship Information (RSSI) to highlight the extent of investments that are made for long-term benefit. Investments are not presented for FY 2003 since amounts reported in the Department's Consolidated Statement of Net Cost is not presented on a comparative basis.

Summary of Stewardship Investments (in millions)

Programs	Non-Federal Property	Human Capital	Research and Development
TSA– Airport Improvement Program	\$287	\$-	\$-
TSA – Port Security Grant Program	218	-	-
TSA – Intercity Bus Security Grant Program	18	-	-
TSA – Highway Watch Cooperative Agreement	-	8	-
TSA – Applied Research Projects	-	-	30
TSA – Operation Safe Commerce	-	-	50
EPR–National Fire Academy and Emergency Management Institute	-	25	-
SLGCP – First Responders Training Programs	-	23	-
USCG – R&D	-	-	19
Total	\$523	\$56	\$99

See accompanying Independent Auditors' Report.
Required Supplementary Stewardship Information

Financial Information

Investments in Non-federal Physical Property

These investments represent federally financed (but not federally owned) purchases, construction, or major renovation of physical property owned by state and local governments, including major additions, alterations, and replacements, the purchase of major equipment; and the purchase or improvement of other physical assets. Based on a review of the Department's programs, TSA has made significant investments in Non-federal Physical Property.

TSA

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 nine airports to provide for the facility modifications necessary to accommodate in-line EDS screening solutions at these airports.

In-line systems also allow TSA to achieve maximum baggage throughput capacity. For example, a stand-alone EDS system 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. 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 explosive detection systems.

Port Security Grant Program: This program provides grants to critical national seaports to support efforts in port security 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 Grant Program: This program improves security for intercity bus operators and passengers. TSA will award grants based on the following program categories:

- Vehicle specific security enhancements, such as, but not limited to, protecting or isolating the driver, alarms, security mirrors, etc.;
- 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;
- 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 – new vice replacement) to terminals, garages and facilities, including but not limited to: fencing, lighting, secured access, locking down of vehicles, and other general securing of bus yards/depots.

**See accompanying Independent Auditors' Report.
Required Supplementary Stewardship Information**

Financial Information

Investments in Human Capital

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

TSA

Highway Watch Cooperative Agreement: This cooperative agreement between the TSA and the American Trucking Associations (ATA) expands ATA's Highway Watch program, which trains highway professionals to identify and report safety and security situations on our Nation's roads. The program will provide 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 will allow Federal agencies and industry stakeholders to quickly move to prevent an attack or to immediately respond if an attack occurs.

EPR

National Fire Academy and Emergency Management Institute: These investments represent costs of training and professional development provided by EPR's National Fire Academy and Emergency Management Institute. During FY 2004, training was provided to over 67,000 emergency management "first responders" at the state and local fire and emergency response community and its allied professionals. EPR links its investments in Human Capital to two outcomes:

- **Percentage of respondents reporting that they are better prepared to deal with disasters and emergencies as a result of the training they received.** EPR's target in FY 2004 was 78% and they achieved 76.4%. EPR's long term goal in FY 2010 is 90%.
- **Percentage of counties in the US and territories with established Community Emergency Response Team (CERT) teams.** EPR's target in FY 2004 was 5% and they achieved 23.9%.

SLGCP

Training Programs: In FY 2004, SLGCP trained approximately 250,000 first responders to prevent and respond to acts of terrorism. Examples of training programs include:

- **The Center for Domestic Preparedness (CDP)** provided training for State, local, tribal, and parish emergency responders on all matters pertaining to terrorism to include Weapons of Mass Destruction.
- **The National Domestic Preparedness Consortium (NDPC)** is a partnership between SLGCP, three nationally recognized public universities, and the U.S. Department of Energy. The NDPC works with SLGCP to identify training needs for all emergency response disciplines responsible for WMD terrorism prevention, deterrence and incident response.

See accompanying Independent Auditors' Report.
Required Supplementary Stewardship Information

Financial Information

- **Continuing and Emerging Training:** SLGCP, in conjunction with Federal, State and local training providers as well as emergency response practitioners, identified emerging training needs based on continuous task analysis and performance assessment, exercise after action reports, and data reported in State and Urban Area homeland security strategies.

Investments in Research and Development

These investments represent expenses incurred to support the search for new or refined knowledge and ideas and for the application or use of such knowledge and ideas for the development of new or improved products and processes with the expectation of maintaining or increasing national productive capacity or yielding other future benefits. Based on a review of the Department's programs, TSA and the USCG have made significant investments in Research and Development.

TSA

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 explosive trace detection (ETD) technology; and infrastructure protection research related to use biometrics for access controls for passenger 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 will function like a venture capital fund to utilize existing technology to monitor the movement and integrity of containers through the supply chain. Selected ports will test new technologies and initiatives in selected supply chains. The new technologies will 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.

USCG

The USCG's Research and Development Program seeks to research, develop, test and evaluate technologies, materials, and human factors directly related to improving the performance of the Coast Guard's missions. During FY 2004, the USCG collaborated with 35 external partners to demonstrate progress towards closing USCG mission performance gaps:

- **Maritime Safety** – Maritime Safety research supports the Coast Guard's efforts by enhancing capabilities toward eliminating deaths, injuries, and property damage associated with maritime transportation, fishing, and recreational boating.

**See accompanying Independent Auditors' Report.
Required Supplementary Stewardship Information**

Financial Information

- **Maritime Mobility** – This research supports the enhancement of capabilities required to perform the Aids to Navigation and Ice Operations missions.
- **Marine Environmental Protection** – This program focuses on elimination of the influx of aquatic nuisance species (ANS) and prevention and response strategies to major oil and hazardous substance discharges.
- **Homeland Security** – Homeland Security research supports enhancements in the enforcement of laws and treaties and security of the Nation's ports, waterways, and coastal zone. The two major investment areas within this R&D program include detection, identification and classification of maritime threats and the improvement of interdiction capabilities.
- **Technology Investment** – Technology Investment research supports the Coast Guard's efforts towards DHS Strategic Goal of Organizational Excellence. The primary purpose of this research is to increase performance capabilities and to free resources to perform other high priority functions. The two primary areas of focus within this program are Technology Awareness and Assessment and Command Center Concept Exploration.

See accompanying Independent Auditors' Report.
Required Supplementary Stewardship Information

Financial Information

Other Accompanying Information (unaudited)

Net Costs of DHS Sub-organizations by Strategic Goals (in millions)

	Awareness	Prevention	Protection	Response	Recovery	Service	Organizational Excellence	TOTAL
BTS Directorate:								
BTS HQ	\$ -	\$9	\$1	\$1	\$ -	\$ -	\$ -	\$11
CBP	-	5,379	-	-	-	413	-	5,792
ICE	58	3,155	737	-	-	-	-	3,950
TSA	151	2,473	1,018	37	-	-	113	3,792
SLGCP	-	-	1,846	-	-	-	-	1,846
FLE	22	88	85	-	-	-	1	196
Subtotal – BTS Directorate	231	11,104	3,687	38	-	413	114	15,587
EPR Directorate	-	-	1,592	1,125	3,271	-	-	5,988
IAIP Directorate	140	-	357	-	-	-	-	497
S&T Directorate	66	439	126	100	24	-	-	755
USCG	560	4,840	1,564	975	113	108	-	8,160
USSS	-	-	1,368	-	-	-	-	1,368
CIS	-	99	-	-	-	349	-	448
Departmental Operations/Other	-	-	-	-	-	-	325	325
TOTAL DHS	\$997	\$16,482	\$8,694	\$2,238	\$3,408	\$870	\$439	\$33,128

See accompanying Independent Auditors' Report.
Other Accompanying Information