DEPARTMENT OF HOMELAND SECURITY

Office of Inspector General

U.S. Customs and Border Protection's FY 2007 Internal Controls

OIG-08-15 November 2007

Office of Inspector General

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

Homeland Security

NOV 2 7 2007

Preface

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

This report addresses the strengths and weaknesses of the U.S. Customs and Border Protection's (CBP) FY 2007 Internal Controls. It is based on interviews with employees and officials of relevant agencies and institutions, direct observations, and a review of applicable documents.

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

Richard L. Skinner

Richard L. Skinner
Inspector General

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Independent Auditors' Report

Inspector General
U.S. Department of Homeland Security:

Commissioner
U.S. Customs and Border Protection:

We have audited the accompanying consolidated balance sheets of the U.S. Department of Homeland Security's (DHS) Customs and Border Protection (CBP) as of September 30, 2007 and 2006, and the related consolidated statements of net cost, changes in net position, and custodial activity, and combined statements of budgetary resources (hereinafter referred to as "consolidated financial statements") for the years then ended. The objective of our audits was to express an opinion on the fair presentation of these consolidated financial statements. In connection with our fiscal year 2007 audit, we also considered CBP's internal controls over financial reporting and performance measures and tested CBP's compliance with certain provisions of applicable laws, regulations, and contracts agreements that could have a direct and material effect on these consolidated financial statements.

SUMMARY

As stated in our opinion on the consolidated financial statements, we concluded that CBP's consolidated financial statements as of and for the years ended September 30, 2007 and 2006, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, CBP changed its method of reporting the reconciliation of budgetary resources obligated to the net cost of operations in fiscal year 2007.

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

1. Drawback of Duties, Taxes, and Fees
2. Information Technology
3. Entry Process
   - Compliance Measurement Program
   - Bonded Warehouse and Foreign Trade Zones
   - In-Bond Program
   - Continued Dumping and Subsidy Offset Act of 2000 (CDSOA) Refunds

We consider the first two significant deficiencies, above, to be material weaknesses.

We noted no deficiencies involving the design of the internal control over the existence and completeness assertions related to key performance measures.

The results of our tests of compliance with certain provisions of laws, regulations, and contract agreements disclosed the following instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements.*

- Federal Information Security Management Act (Electronic Government Act of 2002)
- Federal Financial Management Improvement Act of 1996 (FFMIA)

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

OPINION ON THE FINANCIAL STATEMENTS

We have audited the accompanying consolidated balance sheets of the U.S. Department of Homeland Security's (DHS) Customs and Border Protection (CBP) as of September 30, 2007 and 2006, and the related consolidated statements of net cost, changes in net position, and custodial activity, and the combined statements of budgetary resources for the years then ended.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of CBP as of September 30, 2007 and 2006, and its net costs, changes in net position, budgetary resources, and custodial activity for the years then ended, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, CBP changed its method of reporting the reconciliation of budgetary resources obligated to the net cost of operations in fiscal year 2007.

The information in the Management Discussion and Analysis and Required Supplementary Information sections is not a required part of the consolidated financial statements, but is supplementary information required by U.S. generally accepted accounting principles and OMB Circular No. A-136, *Financial Reporting Requirements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The information in the Performance Results section and Other Accompany Information section are presented for purposes of additional analysis and are not required as part of the consolidated financial statements. This information has not been subjected to auditing procedures and, accordingly, we express no opinion on it.

INTERNAL CONTROL OVER FINANCIAL REPORTING

Our consideration of the internal control over financial reporting was for the limited purpose described in the Responsibilities section of this report and would not necessarily identify all deficiencies in the internal control over financial reporting that might be significant deficiencies or material weaknesses.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects CBP's ability to initiate, authorize, record, process, or report financial data reliably in accordance with U.S. generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of CBP's consolidated financial statements that is more than inconsequential will not be prevented or detected by CBP's internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by CBP's internal control.

In our fiscal year 2007 audit, we consider the deficiencies, described in Exhibits I and II, to be significant deficiencies in internal control over financial reporting. However, of the significant deficiencies described in Exhibits I and II, we believe that the significant deficiencies presented in Exhibit I are material weaknesses. Exhibit IV presents the status of prior year reportable conditions.

INTERNAL CONTROL OVER PERFORMANCE MEASURES

Our tests of internal control over performance measures, as described in the Responsibilities section of this report, disclosed no deficiencies involving the design of the internal control over the existence and completeness assertions related to key performance measures.

COMPLIANCE AND OTHER MATTERS

Our tests of compliance with certain provisions of laws, regulations, and contract agreements, as described in the Responsibilities section of this report, exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed one instance of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 07-04, and is described in Exhibit III.

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

The results of our tests of FFMIA disclosed no instances in which CBP's financial management systems did not substantially comply with Federal accounting standards.

We have noted certain additional matters that we have reported in the DHS Consolidated management letter.

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RESPONSIBILITIES

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

Management is responsible for the consolidated financial statements, including:

- Preparing the consolidated financial statements in conformity with U.S. generally accepted accounting principles;
- Preparing the Management Discussion and Analysis (including the performance measures) and Required Supplementary Information;
- Establishing and maintaining effective internal control; and

- Complying with laws, regulations, and contracts agreements applicable to CBP, including FFMIA.

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

Auditors' Responsibilities. Our responsibility is to express an opinion on the fiscal year 2007 and 2006 consolidated financial statements of CBP based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 07-04. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of CBP's internal control over financial reporting. Accordingly, we express no such opinion.

An audit also includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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 audits provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2007 audit, we considered CBP's internal control over financial reporting by obtaining an understanding of CBP's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls as a basis for designing our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards* and OMB Bulletin No. 07-04. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our audit was not to express an opinion on the effectiveness of CBP's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of CBP's internal control over financial reporting.

As required by OMB Bulletin No. 07-04 in our fiscal year 2007 audit, with respect to internal control related to performance measures determined by management to be key and reported in the Management Discussion and Analysis and Performance sections, we obtained an understanding of the design of internal controls relating to the existence and completeness assertions and determined whether these internal controls had been placed in operation. We limited our testing to those controls necessary to report deficiencies in the design of internal control over key performance measures in accordance with OMB Bulletin 07-04. However, our procedures were not designed to provide an opinion on internal control over reported performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether CBP's fiscal year 2007 consolidated financial statements are free of material misstatement, we performed tests of CBP's compliance with certain provisions of laws, regulations, and contract agreements, noncompliance with which could have a direct

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and material effect on the determination of the consolidated financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 07-04, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, and contract agreements applicable to CBP. However, providing an opinion on compliance with laws, regulations, and contract agreements was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 07-04 and FFMIA, we are required to report whether CBP's financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements.

CBP's responses to the findings identified in our audit are presented in Exhibits I, II, III. We did not audit CBP's response and, accordingly, we express no opinion on it.

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

KPMG LLP

November 13, 2007

Material Weaknesses

A. Drawback of Duties, Taxes and Fees

Background:

CBP, as a component of DHS, continued to perform an important revenue collection function for the U.S. Treasury. CBP collects approximately $30 billion in import duties, taxes and fees annually on merchandise arriving in the United States from foreign countries.

Drawback is a remittance in whole or in part, of duties, taxes, or fees previously paid by an importer. Drawback typically occurs when the imported goods on which duties, taxes, or fees have been previously paid are subsequently exported from the United States or destroyed prior to entering the commerce of the United States. Depending on the type of drawback claim, the claimant has up to eight years from the date of importation to file for drawback. At the end of FY 2005, the U.S. Congress enacted the Miscellaneous Trade and Technical Corrections Act of 2004 (Public Law 108-429) that stipulated the timeframe for liquidating claims; this new process is known as deemed-liquidation by CBP. As a result of the new deemed-liquidation process, CBP implemented new policies and procedures during FY 2006 that require the payment of claims in an accelerated timeframe.

Condition:

We noted the following weaknesses related to internal controls over drawback of duties, taxes, and fees paid by the importer:

- The Automated Commercial System (ACS) lacked automated controls to detect and prevent excessive drawback claims and payments, necessitating inefficient manual processes that do not effectively compensate for the lack of automated controls. ACS did not have the capability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries or export documentation upon which the drawback claim was based. For example, ACS did not contain electronic edit checks that would flag duplicate claims for export of the same merchandise;

- In addition, we noted that ACS lacked controls to prevent overpayment of drawback claims at the summary line level that were subject to the deemed liquidation process put in place during FY 2006. Specifically, we noted approximately $8K of overpayments. CBP does not have the capability to determine the total drawback overpayments as the result of deemed-liquidation;

- Drawback review policies did not require drawback specialists to review all or a statistically valid sample of prior drawback claims against the underlying consumption entries (UCE) to determine whether, in the aggregate, an excessive amount was claimed. CBP has no absolute assurance that a selected import entry is not being over-claimed by different drawback claims;

- CBP drawback review policy and procedures allowed drawback specialists, with supervisory approval, to judgmentally decrease the number of ACS selected UCEs randomly selected for review, thus decreasing the review's effectiveness. Further, CBP implemented a new sampling methodology for selecting UCEs, however, the methodology is not considered to be statistically valid; and

- The initial period for document retention related to a drawback claim is only 3 years from the date of payment. However, there are several situations that could extend the life of the drawback claim well beyond those 3 years.

Cause/Effect:

Much of the drawback process was manual, placing an added burden on limited resources. CBP did use a sampling approach to compare, verify, and match consumption entry and export documentation to drawback claims submitted by importers. However, system and procedural limitations decreased the effectiveness of this approach. The inherent risk of fraudulent claims or claims made in error was high, which increased the risk of erroneous payments.

Criteria:

Under the Federal Managers Financial Integrity Act (FMFIA), management must implement cost-effective controls to safeguard assets and ensure reliable financial reporting. Office of Management and Budget (OMB)'s *Revised Implementation Guidance for the Federal Financial Management Improvement Act* states that financial systems should "routinely provide reliable financial information consistently, accurately, and reported uniformly" to support management of current operations. Joint Financial Management Improvement Program (JFMIP) publications and OMB Circular A-127, *Financial Management Systems,* outlines the requirements for Federal systems. JFMIP's *Core Financial System Requirements* states that the core financial system must maintain detailed information by account sufficient to provide audit trails and to support billing and research activities. OMB Circular A-127 requires that the design of financial systems should eliminate unnecessary duplication of a transaction entry. Whenever 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* requires agencies to assess the risk of erroneous payments and develop a plan to correct control weaknesses. In addition to the legal requirements stated above, CBP's *Drawback Handbook*, dated March 2007, states that management reviews are necessary to maintain a uniform national policy of supervisory review.

Recommendations:

We recommend that CBP:

1. Implement effective internal controls over drawback claims as part of any new systems initiatives, including the ability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries and export documentation for which the drawback claim is based, and identify duplicate or excessive drawback claims;

2. Implement automated controls within ACS to prevent overpayment of a drawback claim that is subject to deemed-liquidation;

3. While the Automated Commercial Environment (ACE) is in development, we recommend that CBP collaborate with ACE developers/engineers to ensure that the new system eliminates the need for statistical sampling of UCEs and prior related drawback claims as drawback claims. In addition, until ACE is implemented, we recommend that CBP explore other statistical approaches for selecting UCEs and prior related drawback claims under the current ACS environment; and

4. Continue to work with the U.S. Congress to lengthen the required document retention period for all supporting documentation so that it corresponds with the drawback claim life cycle.

CBP Response:

See management's response included in the attached letter.

B. Information 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.

Condition:

During FY 2007, CBP took corrective actions to address prior year IT control weaknesses. However, during FY 2007, we continued to find IT general and application control weaknesses at CBP. The most significant weaknesses from a financial statement audit perspective relate to information security. Collectively, the IT control weaknesses limit CBP's ability to ensure that critical financial and operational data is maintained in such a manner as to ensure confidentiality, integrity, and availability. Because of the sensitive nature of the issues identified, we will issue a separate restricted distribution report to address those issues in detail.

Criteria:

The *Federal Information Security Management Act* (FISMA), passed as part of the *E-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, *Management of Federal Information Resources*, and various NIST guidelines describe specific essential criteria for maintaining effective general IT controls. In addition, OMB Circular A-127 prescribes policies and standards for executive departments and agencies to follow in developing, operating, evaluating, and reporting on financial management systems.

Recommendation:

Due to the sensitive nature of these findings, our separate report will recommend that CBP management implement and enforce certain procedures to address the general and application control vulnerability of its financial systems.

CBP Response:

See management's response included in the attached letter.

Other Significant Deficiencies

C. Entry Process

1. Compliance Measurement Program

Background:

CBP utilizes the Compliance Measurement (CM) program to measure the effectiveness of its control mechanisms over the collection of taxes, duties, and fees. The CM program is also used to determine the revenue gap that is reported in "Other Accompanying Information" in the financial statements.

Condition:

We noted the following weaknesses related to CBP's CM Program:

- CM Coordinators' guidance related to sampling, review procedures, and documentation requirements is ineffective related to the monthly review of CM results completed by import specialists. CBP issued a memorandum to the ports addressing changes to the Compliance Measurement (CM) program. The memorandum included an updated Appendix B listing the responsibilities of various personnel within the CM process. Section 2.6 states that "On a monthly basis, the CM Coordinator will randomly sample the CM reviews completed by Import Specialists to verify that the reviews have been done in accordance with the procedures set forth herein." However, there is a weakness in the guidance in that it does not provide the CM Coordinators with a sampling methodology, required review procedures, and related documentation requirements for the monthly review;

- Non-compliance with CM guidelines requiring periodic reviews at the port level. During FY 2007, we noted that four CM Coordinators were not performing the monthly reviews of CM reviews performed by the Import Specialists as required in the memorandum discussed above. At an additional six sites, there was no documentation to confirm performance of the monthly reviews. In addition, we noted that at one site, the Compliance Review Tracking Quarterly (CRTQ) function was used to follow-up on Entry Summary CM selectivity hits; however, the CRTQ was not run weekly as required by Appendix B. Further at another port, the SSXM Coordinator position was left vacant for six months; consequently no cargo monitoring reports were run or reviewed during this time. During the review of entries identified on the various monitoring reports, we noted that sites selected for testing were not inputting Import Specialist Discrepancy Adjustment (ISDA) remarks in compliance with Directives 3550-074A (dated May 14, 2004) and 3550-074B (dated September 15, 2006) and Appendix B. We noted two different types of discrepancies from the guidelines noted above: ISDA remarks were entered beyond the 120 day requirement at six ports and the ISDA remarks did not provide sufficient detail at four ports;

- The National Analysis Specialist Division (NASD) port audits were stopped during FY 2006. In prior years, NASD performed port audits to identify errors during the performance of a CM review. In fiscal year 2005, KPMG recommended using a risk-based approach to select which ports to audit. In addition, we recommended compiling the results of the port audits to identify potential trends or weaknesses on a national level, and to calculate a revenue impact for the discrepancies noted. During FY 2007, CBP suspended the performance of port audits. Instead, CBP-HQ relies on the Self-Inspection program to determine how the ports are performing the CM examinations. We noted that questions on the self-inspection program worksheets do not provide the equivalent information that the twenty-five point port audit review provided; and

- Untimely results of CM exams. The memorandum for CM changes noted in condition 1 above includes an adjustment extending the deadline for ISDA comments from the Import Specialists to 120 days. Due to the extension in imputing results, CBP is unable to analyze the results of CM exams in a timely manner.

We noted that the first three conditions above have been addressed by CBP in their prior year corrective action plan (CAP) submitted in response to CM findings from the FY2005 and FY2006 financial statement audits. We note that CBP is in the process of designing and implementing standardized web-based queries for CM coordinators to use on a monthly basis to verify that CM reviews have been completed in accordance with the procedures set forth in the CM guidelines. The queries in development are being designed to identify both missing SSXM and ISDA remarks. In addition, a query is being developed that will generate a statistically valid random sample of entry summary reviews for the CM coordinator to review each month. In addition to the standardized queries being developed at the port level, a series of queries will be run by the CM coordinator at HQ each month which will randomly select CM reviews performed nationwide to ensure that ports are in compliance with CM guidelines and requirements. CBP will release standard operating procedures (SOPs) to address each of these items.

We noted that the proposed CM monitoring system will not be implemented until FY 2008.

Cause/Effect:

CBP has been challenged to balance its commitment of limited resources to two important mission objectives – trade compliance, including the collection of taxes, duties and fees owed to the Federal government, and securing the U.S. borders from potential terrorist entry. While these mission objectives do overlap somewhat, there are differences in how resources are deployed. In fiscal year 2006, CBP made significant improvements in its custodial review controls and measurement processes, procedures and policies.

The weaknesses in the CM program could result in CBP incorrectly evaluating the effectiveness of its control environment over the collections of duties, taxes, and fees. In addition, errors within the CM program could result in a misstatement of the "revenue gap" disclosure in the Management Discussion and Analysis section of CBP's Performance and Accountability Report.

Recommendations:

We recommend that CBP implement the following to improve the CM program:

1. Provide additional detail in the guidelines, specifying the sample size, procedures to perform, and documentation requirements for the CM Coordinator's review of Import Specialists' review. The guidance should also readdress the timing requirements for the monitoring reports or data queries and documentation retention;

2. Conduct periodic training to ensure that all port personnel have comprehensive knowledge of the CM program requirements; and

3. Re-formalize and implement effective procedures for the port audit process performed by NASD, or readdress the self-inspection program to provide a more comprehensive and in-depth review of port activity (similar to what was accomplished under the previously performed port audits), including ensuring that the port is performing the reviews accurately.

2. Bonded Warehouse and Foreign Trade Zones

Background:

Bonded Warehouses (BW) are facilities under the joint supervision of CBP and the BW proprietor used to store merchandise that has not made entry into U.S. commerce.

Foreign Trade Zones (FTZ) are secured areas under the joint supervision of CBP and the FTZ operator that are considered outside of the CBP territory upon activation. Authority for establishing these facilities is granted by the U.S. Department of Commerce's Foreign Trade Zones Board under the Foreign Trade Zones Act of 1934, as amended (19 U.S.C 81a-81u). Foreign and domestic merchandise may be admitted into zones for operations not otherwise prohibited by law, including storage, exhibition, assembly, manufacturing, and processing.

Condition:

We noted the following internal control weaknesses related to the BW and FTZ processes:

- CBP lacked the ability to maintain one centrally managed list of all BWs and FTZs;

- Inconsistent procedures followed by the ports for completing the risk assessments and compliance reviews or lack thereof by the ports of completing the risk assessments and compliance reviews; and

- Annual compliance review schedules are completed by the ports and provided to Headquarters once a year. The HQ retrieval and review of the surveys can take up to 6 months to compile and analyze.

Criteria:

Under FMFIA, management must implement cost-effective controls to safeguard assets and ensure reliable financial reporting. OMB's *Revised Implementation Guidance for FFMIA,* states that financial systems should "routinely provide reliable financial information consistently, accurately, and reported uniformly" to support management of current operations.

Cause/Effect:

CBP's current system ACS does not maintain a complete listing of BWs and FTZs.

In addition, port personnel were not aware of the requirements and were following outdated procedures for the risk assessments and compliance reviews. CBP-HQ cannot effectively monitor or determine the overall compliance of the BW/FTZ process if inconsistent procedures were being followed at the ports for completing the risk assessment and compliance reviews.

Processes do not exist for the ports to provide on a timely basis the results of the BW/FTZ compliance review schedules and risk assessments to CBP-HQ for review. As a result, CBP-HQ cannot determine the effectiveness of the BW/FTZ program without the ability to track the results on a consistent timely basis from the ports.

It is possible that BW/FTZ operators and users may be able to operate BWs and FTZs that contain merchandise about which CBP has no knowledge.

Recommendations:

We recommend that CBP:

1. Continue the current plan to compile a population of all BWs and FTZ's within ACE; and
2. Ensure adequate communication of the ports requirements related to compliance reviews and risk assessments and provide effective timely training so that all responsible personnel are aware of and can consistently execute all of the requirements; and
3. Implement a compliance review schedule template to be utilized by all ports for transmission to CBP-HQ. Ensure timely response and review by HQ personnel.

3. In-Bond Program

Background:

In-bond entries occur when merchandise is transported through one port; however, the merchandise does not officially enter U.S. commerce until it reaches the intended port of destination. An In-bond also allows foreign merchandise arriving at one U.S. port to be transported through the U.S. and be exported from another U.S. port without appraisement or the payment of duty. In 1998, CBP implemented a tracking and audit system within the Automated Commercial System (ACS). It was designed to provide "real time" tracking of in-bond shipments from origin to destination, including entry and exportation. This tracking and audit system also serves as a compliance measurement system through random examinations and port audit reviews to ensure compliance. The tracking and audit system was designed to prevent diversion of In-bond shipments being imported and exported. The tracking and audit system calls for randomly selected ports to perform physical examinations at the time of arrival and departure as well as for post audit reviews of carrier activity.

Condition:

We noted the following internal control weaknesses related to the In-bond process:

- Inconsistent procedures followed by the ports for completing compliance reviews/audits of in-bond entries or the overall lack of the completion of such reviews/audits;

- Inconsistent review of required monthly reports related to in-bond activity at the ports and significant system limitations of the monthly reports which limit the overall usefulness;

- CBP is unable to determine the status of the in-bond shipments with the information available within ACS;

- National policies or procedures do not exist to monitor the results of in-bond audits; and

- CBP has not implemented a CMP to measure the revenue gap and effectiveness of controls over trade compliance related to the In-bond process.

Criteria:

Under FMFIA, management must implement cost-effective controls to safeguard assets and ensure reliable financial reporting. OMB's *Revised Implementation Guidance for FFMIA,* states that financial systems should "routinely provide reliable financial information consistently, accurately, and reported uniformly" to support management of current operations.

Cause/Effect:

In recent years, several new directives and a new handbook have been implemented for the in-bond program to address the performance of the program at the port level; however, there are currently no procedures in place to address headquarters' oversight of the program on a national level.

The lack of an automatic compilation and analysis of audit results at the national level results in the inability to determine the overall effectiveness of the in-bond audits and weaknesses in the overall in-bond program will not be known or identified at the national level.

Recommendations:

We recommend that CBP:

1. Communicate to the ports the requirements for the in-bond program and provide adequate training for appropriate personnel to ensure that the requirements are carried out accurately;

2. Develop policies and procedures for the review of required monthly reports and address system limitations related to the required monthly reports to improve their usefulness. The policies and procedures should state how often the monthly reports are to be reviewed and the exact procedures to follow when completing the review;

3. Implement a standard procedure to periodically compile the results of all in-bond audits performed during the year and develop an analysis function in order to evaluate importers' compliance with regulations as well as the overall effectiveness of the in-bond audits at a national level; and

4. Consider the cost/effectiveness of implementing a CMP (revenue gap calculation) over in-bond to assess the risk of revenue loss and violations of trade regulations by importers.

EXHIBIT II

4. Continued Dumping and Subsidy Offset Act of 2000 (CDSOA) Refunds

Background:

The Tariff Act of 1930, section 731 (19 U.S.C 1673), provides for the imposition of antidumping duties (AD) when the Department of Commerce's (DOC) International Trade Administration (ITA) determines that foreign merchandise is being sold to the U.S. at less than fair value. The International Trade Commission (ITC) determines whether the import of such merchandise threatened an industry in the U.S. with material injury, caused the establishment of an industry in the U.S. to be materially retarded, or caused an industry in the U.S. to be materially injured. The Continued Dumping and Subsidy Offset Act of 2000 (CDSOA) amended the Tariff Act of 1930 by adding a new section. Section 754 (see 19 U.S.C 1675c) requires that, "...assessed duties...must be distributed to affected domestic producers for certain qualifying expenditures..." that were incurred after the issuance of the related duty order or finding.

Public Law 109-171, section 7601 (a) repealed Section 754 related to good entered into U.S commerce after October 1, 2007. However, CDSOA refunds will continue for several years as the previous fiscal year entries liquidate and are refunded to the injured industry.

When the ITC or ITA concludes its Antidumping review, antidumping duties are moved into a special account for distribution to injured domestic industries, or refunded to the importers against whom the duties were levied.

At least 90 days prior to the end of a fiscal year, CBP is required to publish in the Federal Register a notice of intention (NOI) to distribute assessed duties received as the continued dumping and subsidy offset for that fiscal year.

The NOI must indicate the total amount of funds available for distribution, the case name and the number of the particular order or finding, a list of domestic producers that would be potentially eligible to receive a distribution, and instructions for filing the certification to claim a distribution (19 C.F.R. § 159.62).

Condition:

During FY 2007, CBP began a process of validating and verifying (desk review began in 2007 and on-site began in 2005) CDSOA disbursement certification. However, statistical risk based verification was not completed with final analyzed results as the program is still in development.

Criteria:

Under FMFIA, management must implement cost-effective controls to safeguard assets and ensure reliable financial reporting. OMB's *Revised Implementation Guidance for FFMIA,* states that financial systems should "routinely provide reliable financial information consistently, accurately, and reported uniformly" to support management of current operations.

The *Improper Payments Information Act of 2002* requires agencies to assess the risk of erroneous payments and develop a plan to correct control weaknesses.

Cause/Effect:

CBP is required, by law, to examine each certification filed, calculate the amount disbursed to each claimant and make all disbursements within the first 60 days following the fiscal year in which the certification was filed. CBP is limited on time and resources to review all certifications that are submitted.

CBP may make CDSOA disbursements based on incorrect certifications filed by injured domestic industries resulting in potential incorrect payments. Without proper verification of certifications being submitted, these erroneous claims may go undetected.

Recommendation:

CBP is currently in the process of developing a verification process for CDSOA disbursements. KPMG recommends that CBP continue with the development of this process in order to ensure compliance with the law.

CBP Response:

See management's response included in the attached letter.

Compliance with Laws and Regulations
(Findings A – B and C are presented in Exhibits I and II, respectively)

D. Federal Information Security Management Act (E-Government Act of 2002)

CBP is required to comply with the FISMA, which was enacted as part of the *E-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 B – *Information Technology*.

Recommendation:

We recommend that CBP fully implement the requirements of FISMA in fiscal year 2008.

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

CBP is required to comply with FFMIA, which requires that an agency's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. We noted instances of non-compliance with FFMIA in relation to Federal financial management systems requirements and the United States Government Standard General Ledger at the transaction level.

Specifically, we noted the following weaknesses:

1. With respect to Federal financial management system requirements, CBP's inventory transactions do not interface between the inventory systems and the financial system (SAP) and non-entity accounts receivable do not interface between ACS and SAP; and

2. With respect to the United States Government Standard General Ledger at the transaction level, inventory activity (usage, turn-ins, interagency transfers) and non-entity accounts receivable are not recorded at the transaction level in SAP. Non-entity accounts receivable information is maintained in ACS, SAP, and on manually prepared schedules. ACS is made up of several financial modules that track receivables through entry or case number. Year-end balances are posted through the ACS/SAP interface and through manual calculations for receivables not recorded through the ACS/SAP interface.

Recommendation:

We recommend that CBP improve its processes to ensure compliance with the FFMIA in fiscal year 2008.

CBP Response:
See management's response included in the attached letter.

Prior Year Condition	As Reported at September 30, 2006	Status as of September 30, 2007
Drawback of Duties, Taxes and Fees	**Material Weakness:** ACS lacked controls to detect and prevent excessive drawback claims and payments, requiring inefficient manual processes to compensate and the drawback review policies did not require drawback specialists to review all related drawback claims.	**Continue as a material weakness:** Weaknesses continue to exist related to the drawback process. See control finding letter A.
Information Technology	**Material Weakness:** Weaknesses were noted in entity-wide security, system access, segregation of duties, service continuity, and system software change management.	**Continue as a material weakness:** Although improvements were made, weaknesses still remained in all areas noted during fiscal year 2007. See control finding letter B.
Financial Reporting – Property, Plant, and Equipment	**Reportable Condition:** Weaknesses were noted in the accountability of property, plant, and equipment.	**No longer considered a reportable condition.**
Financial Reporting – Intra Departmental Imputed Financing Costs	**Reportable Condition:** Weaknesses were noted in CBP's ability to track and properly record in a timely manner all intra-departmental imputed financing costs.	**No longer considered a reportable condition.**
Financial Reporting – Financial Statement Presentation	**Reportable Condition:** Weaknesses were noted in CBP's ability to properly prepare financial statements that complied with all reporting requirements of OMB A-136 and applicable federal accounting standards.	**No longer considered a reportable condition.**
Entry Process – Compliance Measurement Program	**Reportable Condition:** Several weaknesses existed related to CMP, such as inconsistent procedures followed at the ports, reduced CMP sample size, lack of NASD port audits, and little review or analysis on the CM data to ensure that it was inputted correctly.	**Continue as a significant deficiency:** Although improvements were made, weaknesses still remain during fiscal year 2007. See control finding letter D.
Entry Process – Bonded Warehouse and Foreign Trade Zones	**Reportable Condition:** Several weaknesses existed related to BW/FTZ, such as the lack of official guidance and training to address the monitoring of BW/FTZ, lack of management review of the BW/FTZ surveys, and the lack of a revenue gap calculation related to BW/FTZ.	**Continue as a significant deficiency:** Weaknesses continue to exist related to the bonded warehouse and foreign trade zone process. See control finding letter D.
Entry Process – In Bond	**Reportable Condition:** Several weaknesses existed related to in-bond, such as the lack of official guidance and training to address the monitoring of in-bond	**Continue as a significant deficiency:** Although improvements were made, weaknesses still remain during fiscal year 2007. See control finding letter

Prior Year Condition	As Reported at September 30, 2006	Status as of September 30, 2007
	shipments at the port level, lack of CBP-HQ review of the in-bond program, and the overall inability to determine the effectiveness of the in-bond program for CBP in its entirety.	D.
Non-compliance with the *Federal Information Security Management Act*	**Instance of non-compliance:** CBP was not in substantial compliance with FISMA. 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.	**Continue reporting as an instance of non-compliance:** Although improvements were made, CBP did not substantially comply with all categories of FISMA. See compliance finding letter E.
Non-compliance with the *Federal Financial Management Improvement Act of 1996*	**Instance of non-compliance:** CBP was not in substantial compliance with FFMIA, which requires that an agency's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. We noted instances of non-compliance with FFMIA in relation to Federal financial management systems requirements, the United States Government Standard General Ledger at the transaction level, and Federal accounting standards	**Continue reporting as an instance of non-compliance:** Although improvements were made, CBP did not substantially comply with all categories of FFMIA. See compliance finding letter F.
Non-compliance with the *Improper Payments Act of 2002 (IPIA)*	**Instance of non-compliance:** CBP was not in substantial compliance with IPIA, which requires agencies to review all programs and activities they administer annual 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. We noted that CBP did not complete IPIA sampling and testwork as it	**No longer considered an instance of non-compliance.**

Prior Year Condition	As Reported at September 30, 2006	Status as of September 30, 2007
	relates to custodial activity disbursements and as a result could not provide complete IPIA information to DHS.	

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