




# DEPARTMENT OF HOMELAND SECURITY

Office of Inspector General  
Washington, DC 20528

February 13, 2004

## **MEMORANDUM**

TO: The Honorable Tom Ridge, Secretary

FROM: Clark Kent Ervin, Inspector General 

SUBJECT: *Independent Auditors' Report* on DHS' Financial Statements  
Audit Report No. OIG-04-10

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This memorandum transmits and serves as an executive summary of the *Independent Auditors' Report* prepared by the independent public accounting firm KPMG LLP (KPMG), which audited DHS' financial statements as of September 30, 2003, and for the seven months then ended, as required by the Accountability of Tax Dollars Act of 2002.

DHS is to be congratulated on preparing its first set of financial statements for audit, a noteworthy event accomplished under difficult circumstances. When this audit started in May 2003, DHS was just two months old and represented one of the largest and most complex reorganizations of the federal government ever. DHS was still in the process of organizing itself and transferring agencies and programs, and its ability to produce financial statements was untested. Despite limited staff with many other responsibilities, DHS agreed to accept the challenge of a financial statement audit even though it added strain to its relatively limited resources. DHS management agreed with the Office of Inspector General that an audit would establish a solid baseline from which it could plan for and build good financial management processes. Thanks to this audit, DHS now has that solid baseline for improvement.

### **Summary of Auditors' Opinion**

KPMG gave a qualified opinion on the consolidated balance sheet and statement of custodial activity, meaning that, except for certain items described below, they were presented fairly and free of material misstatements. KPMG was unable to provide an opinion on the remaining statements for the reasons also discussed below.

The qualification on the balance sheet related to: (1) the lack of sufficient documentation provided prior to the completion of KPMG's audit procedures to support \$2.9 billion in property, plant, and equipment at the U.S. Coast Guard; (2) KPMG's inability to observe inventory or otherwise verify \$497 million in operating materials and supplies at the U.S.

Coast Guard; and (3) the lack of sufficient documentation provided prior to the completion of KPMG's audit procedures to support retirement benefits recorded at \$3.3 billion at the U.S. Secret Service and post-employment benefits recorded at \$201 million at the U.S. Coast Guard. Unlike some of the other large bureaus that came into DHS, the U.S. Coast Guard's financial statements had never been audited on a stand-alone basis, nor had they been audited at the level of detail required at DHS. It is not uncommon for a large established agency such as the U.S. Coast Guard to require additional time to get its processes and systems in place to facilitate a financial statement audit. The U.S. Secret Service has already started corrective actions related to its retirement benefits.

KPMG was unable to provide an opinion on the consolidated statements of net cost and changes in net position, the combined statement of budgetary resources, and the consolidated statement of financing for several reasons. First, several "legacy" agencies (agencies from which component entities or functions were transferred to DHS) submitted accounting and financial information over which DHS had limited control. Consequently, the auditors were unable to complete procedures relating to revenue, costs, and related budgetary transactions reported by the legacy agencies to DHS. In addition, the U.S. Coast Guard was unable to provide sufficient documentation prior to the completion of KPMG's audit procedures to support certain revenues, costs and related budgetary transactions.

### **Internal Controls**

Under standards issued by the American Institute of Certified Public Accountants, "reportable conditions" are matters coming to the auditors' attention relating to significant deficiencies in the design or operation of internal controls that, in the auditors' judgment, could adversely affect the department's ability to record, process, summarize, and report financial data consistent with the assertions of 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.

### **Summary of Material Weaknesses**

The following are highlights from the material weaknesses described in the *Independent Auditors' Report*.

***Financial Management and Personnel:*** DHS' Office of the Chief Financial Officer (OCFO) needs to establish financial reporting roles and responsibilities, assess critical needs, and establish standard operating procedures (SOPs). These conditions were not unexpected for a newly created organization, especially one as large and complex as DHS. The U.S. Coast Guard and the Strategic National Stockpile had weaknesses in financial oversight that have led to reporting problems, as discussed further below.

***Financial Reporting:*** Key controls to ensure reporting integrity were not in place, and inefficiencies made the process more error prone. At the U.S. Coast Guard, the financial reporting process was complex and labor-intensive. Several DHS bureaus lacked clearly documented procedures, making them vulnerable to the loss of key people.

***Financial Systems Functionality and Technology:*** The auditors found weaknesses across DHS in its entity-wide security program management and in controls over system access, application software development, system software, segregation of duties, and service continuity. Many bureau systems lacked certain functionality to support the financial reporting requirements.

***Property, Plant, and Equipment (PP&E):*** The U.S. Coast Guard was unable to support \$2.9 billion in PP&E due to insufficient documentation provided prior to the completion of KPMG's audit procedures, including documentation to support its estimation methodology. The Transportation Security Administration (TSA) lacked a comprehensive property management system and adequate policies and procedures to ensure the accuracy of its PP&E records.

***Operating Materials and Supplies (OM&S):*** Internal controls over physical counts of OM&S were not effective at the U.S. Coast Guard. The U.S. Coast Guard also had not recently reviewed its OM&S capitalization policy, leading to a material adjustment to its records when an analysis was performed.

***Actuarial Liabilities:*** The U.S. Secret Service did not record the pension liability for certain of its employees and retirees, and when corrected, the auditors had insufficient time to audit the amount recorded. The U.S. Coast Guard also was unable to provide sufficient documentation to support \$201 million in post-service benefits.

***Transfers of Funds, Assets, and Liabilities to DHS:*** DHS lacked controls to verify that monthly financial reports and transferred balances from legacy agencies were accurate and complete.

### **Other Reportable Conditions**

The following are highlights from the *Independent Auditors' Report*.

***Drawback Claims on Duties, Taxes, and Fees:*** The Bureau of Customs and Border Protection's (CBP) accounting system lacked automated controls to detect and prevent excessive drawback claims and payments.

***Import Entry In-bond:*** CBP did not have a reliable process of monitoring the movement of "in-bond" shipments -- i.e., merchandise traveling through the U.S. that is not subject to duties, taxes, and fees until it reaches a port of destination. CBP lacked an effective compliance measurement program to compute an estimate of underpayment of related duties, taxes, and fees.

***Acceptance and Adjudication of Immigration and Naturalization Applications:*** The Bureau of Citizenship and Immigration Services' (CIS) process for tracking and reporting the status of applications and related information was inconsistent and inefficient. CIS did not perform cycle counts of its work in process that would facilitate the accurate calculation of deferred revenue and reporting of related operational information.

***Fund Balance with Treasury (FBWT):*** The U.S. Coast Guard did not perform required reconciliations for FBWT accounts and lacked written SOPs to guide the process, primarily as the result of a new financial system that substantially increased the number of reconciling differences.

***Intra-governmental Balances:*** Several large DHS bureaus had not developed and adopted effective SOPs or established systems to track, confirm, and reconcile intra-governmental balances and transactions with their trading partners.

***Strategic National Stockpile (SNS):*** The SNS accounting process was fragmented and disconnected, largely due to operational challenges caused by the laws governing the SNS. A \$485 million upwards adjustment had to be made to value the SNS in DHS' records properly.

***Accounts Payable and Undelivered Orders:*** CIS and the Bureau of Immigration and Customs Enforcement, TSA, and the U.S. Coast Guard had weaknesses in their processes for accruing accounts payable and /or reporting accurate balances for undelivered orders.

### **Status of Prior Year Material Weaknesses**

DHS inherited 18 material weaknesses from the former U.S. Customs Service, the former Immigration and Naturalization Service, the Federal Emergency Management Agency, and TSA. KPMG determined that nine of the material weaknesses were corrected or partially corrected. The remaining ones were consolidated into the seven DHS material weaknesses or reclassified to a reportable condition or other matter for management's attention.

### **Compliance with Laws and Regulations**

KPMG identified weaknesses in DHS' reporting process for the Federal Managers' Financial Integrity Act of 1982 and instances of non-compliance with the Federal Information Security Management Act. KPMG also noted instances where DHS was not in full compliance with Office of Management and Budget Circular A-133, subpart D – *Federal Agencies and Pass-Through Entities* and Appendix B, *Compliance Supplement*.

### **OIG Responsibility**

We contracted with KPMG to audit the financial statements of DHS as of September 30, 2003 and for the seven months then ended. The contract required that the audit be done in accordance with U.S. generally accepted government auditing standards, OMB's bulletin,

*Audit Requirements for Federal Financial Statements, and the GAO/PCIE Financial Audit Manual.*

In connection with the contract, we reviewed KPMG's report and related documentation and inquired of its representatives. Our review, as differentiated from an audit in accordance with U.S. generally accepted government auditing standards, was not intended to enable us to express, and we do not express, opinions on DHS' financial statements or internal controls. Likewise, we cannot and do not express conclusions on DHS' compliance with laws and regulations. KPMG is solely responsible for the attached auditor's report dated January 30, 2003 and the conclusions expressed in the report. However, our review disclosed no instances where KPMG did not comply, in all material respects, with U.S. generally accepted government auditing standards.

Attachment