

Department of Homeland Security **Office of Inspector General**

Independent Auditors' Report on
U.S. Customs and Border Protection's
FY 2011 Financial Statements





Homeland
Security

MAR 27 2012

Preface

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

The attached report presents the results of the U.S. Customs and Border Protection's (CBP) financial statement audits for fiscal year (FY) 2011 and FY 2010. We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the audits. The contract required that KPMG perform its audits according to generally accepted government auditing standards and guidance from the Office of Management and Budget and the Government Accountability Office. KPMG concluded that CBP's consolidated financial statements as of and for the years ended September 30, 2011 and 2010, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles. The FY 2011 independent auditors' report discusses four significant deficiencies in internal control, one of which is considered a material weakness. KPMG is responsible for the attached auditors' report, and the conclusions expressed in the report. We do not express opinions on CBP's financial statements or provide conclusions on compliance with laws and regulations.

The recommendations herein have been discussed in draft with those responsible for implementation. We trust 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.


Anne L. Richards

Assistant Inspector General for Audits



KPMG LLP
1676 International Drive
McLean, VA 22102

Independent Auditors' Report

Acting Inspector General
U.S. Department of Homeland Security:

Acting Commissioner
U.S. Customs and Border Protection:

We have audited the accompanying consolidated balance sheets of the U.S. Customs and Border Protection (CBP), a Component of the U.S. Department of Homeland Security (DHS), as of September 30, 2011 and 2010, 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 2011 audit, we also considered CBP's internal control over financial reporting and tested CBP's compliance with certain provisions of applicable laws, regulations, and contracts 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, 2011 and 2010, are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.

Our consideration of internal control over financial reporting resulted in identifying certain deficiencies that we consider to be a material weakness and other deficiencies that we consider to be significant deficiencies, as defined in the Internal Control Over Financial Reporting section of this report, as follows:

Material Weakness:

- A. Drawback of Duties, Taxes, and Fees

Significant Deficiencies:

- B. Property, Plant, and Equipment
- C. Entry Process
 - 1. In-Bond Program
 - 2. Trade Compliance Measurement
 - 3. Bonded Warehouse and Foreign Trade Zones
- D. Information Technology

The results of our tests of compliance with certain provisions of laws, regulations, and contracts disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards* and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended.

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



Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of the U.S. Customs and Border Protection, a Component of the U.S. Department of Homeland Security, as of September 30, 2011 and 2010, 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, 2011 and 2010, 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.

The information in the Management's 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. 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.

The information in the Commissioner's Message, Performance Section, Message from the Chief Financial Officer, Other Accompanying Information, and Acronyms as reflected in CBP's *Fiscal Year 2011 Performance and Accountability Report* is presented for purposes of additional analysis, and is 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 was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, in our fiscal year 2011 audit, we identified certain deficiencies in internal control over financial reporting that we consider to be a material weakness and other deficiencies that we consider to be significant deficiencies.

A deficiency in internal control 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 and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described in Exhibit I to be a material weakness.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in Exhibit II to be significant deficiencies.

Exhibit III presents the status of prior year significant deficiencies and the material weakness.

We noted certain additional matters that we will report to the management of CBP in a separate letter.



Compliance and Other Matters

The results of our tests of compliance as described in the Responsibilities section of this report disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 07-04.

* * * * *

Responsibilities

Management's Responsibilities. Management is responsible for the consolidated financial statements; establishing and maintaining effective internal control; and complying with laws, regulations, and contracts applicable to CBP.

Auditors' Responsibilities. Our responsibility is to express an opinion on the fiscal year 2011 and 2010 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 2011 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, but not for the purpose of expressing 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. We did not test all controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*.

As part of obtaining reasonable assurance about whether CBP's fiscal year 2011 consolidated financial statements are free of material misstatement, we performed tests of CBP's compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct 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. 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 contracts applicable to CBP. However, providing an opinion on compliance with laws, regulations, and contracts was not an objective of our audit and, accordingly, we do not express such an opinion.

CBP's response to the findings identified in our audit is presented in Management's Response to the Independent Auditors' Report. 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 CBP's management, DHS' management, the DHS Office of Inspector General, OMB, the U.S. Government Accountability Office, and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

January 27, 2012

Material Weakness

A. Drawback of Duties, Taxes, and Fees

Background:

U.S. Customs and Border Protection (CBP) performs an important revenue collection function for the U.S. Department of the Treasury. CBP collected approximately \$33.9 billion in import duties, taxes, and fees in fiscal year (FY) 2011 on merchandise arriving in the U.S. 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.

The conditions cited below have existed for several years; however, since FY 2009 CBP's planned remediation for many of these conditions were tied to systems modernization through the Automated Commercial Environment (ACE). In FY 2010, funding for the implementation of ACE was reduced, and a systems solution is currently unfunded. During FY 2010 and continuing into FY 2011, CBP began an effort to improve the drawback process as a whole and is currently reassessing the planned solutions to conditions below.

Condition:

The following weaknesses related to internal control over drawback of duties, taxes, and fees paid by the importer were identified:

- CBP is unable to prevent, or detect and correct excessive drawback claims against an entry summary due to the inherent limitations of the Automated Commercial System (ACS) and the lack of controls therein. An entry summary can comprise numerous line items; however, ACS does not have the capability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries (UCEs), their individual line items, or export documentation upon which the drawback claim was based.
- Currently, the drawback module within ACS provides information to ensure that the total amount of all drawback claims against a given import entry does not exceed 100% of the total amount of duties, taxes, and fees collected, at the entry summary level. By law, the amount paid for drawback claims against a given import entry should not exceed 99% of the duties, taxes, and fees collected at the individual line item level and the entry summary level. In addition, export information is not linked to the drawback module and, therefore, electronic comparisons of export data cannot be performed within ACS to ensure that overpayments of drawback claims are not made.
- Drawback review policies did not require Drawback Specialists to review all, or a statistically valid sample, of prior drawback claims against a selected import entry to determine whether, in the aggregate, an excessive amount had been claimed against import entries. CBP utilizes a "validity tree" approach when selecting prior drawback claims for review. The validity tree approach requires CBP to review the largest prior related drawback claims; however, this approach is not statistical. In addition, drawback review policy and procedures allow Drawback Specialists, with supervisory approval, to judgmentally decrease the number of UCEs randomly selected for review, which decreases the review's effectiveness. Further, CBP's sampling methodology for selecting UCEs is not considered to be statistically valid and CBP's Drawback Handbook does not include procedures for statistically projecting errors noted in the sample.

EXHIBIT I

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

Cause/Effect:

Due to system functionality limitations, much of the drawback process is manual, placing an added burden on limited resources. CBP uses a sampling approach to compare, verify, and match consumption entry and export documentation to drawback claims submitted by importers. However, system and procedural limitations decrease the effectiveness of this approach.

The inherent risk of fraudulent claims or claims made in error is high, which increases the risk of erroneous payments. Since all, or a statistically valid sample, of the related drawback claims are not reviewed for a selected import entry, the possibility exists that the related drawback claims, in aggregate, will exceed the amount of duty and tax collected on the related import entry. In addition, the length of the drawback claim lifecycle often extends beyond the document retention period, which is set by statute at three years after payment of the claim.

Criteria:

Presented in *Index of Financial Reporting and Internal Control Criteria* behind Exhibit III.

Recommendations:

We recommend that CBP:

1. Continue to pursue alternative compensating controls and measures that may ultimately identify the potential revenue loss exposure to CBP, as the incorporation of drawback processing is not in the near-term schedule for ACE production. These alternative internal controls over drawback claims may result in the ability to compare, verify, and track essential information on drawback claims to the related UCEs and export documentation for which the drawback claim is based, and identify duplicate or excessive drawback claims;
2. Develop and implement automated controls to prevent overpayment of a drawback claim; and
3. Analyze current policies and procedures performed at the Drawback Centers, determine the cost/benefit of current procedures, and revise as necessary.

CBP Response:

See management's response included in the attached letter.

Other Significant Deficiencies**B. Property, Plant, and Equipment****Background:**

U.S. Customs and Border Protection (CBP) has acquired substantial new technology, facilities, and other assets in recent years through purchase and construction. CBP's increased assets primarily include construction of border fencing (both physical and virtual), purchase of inspection equipment at Ports of Entry, and new construction at Port of Entry facilities.

Condition:

Several weaknesses were identified related to CBP's accounting for property, plant, and equipment (PP&E). Specifically, CBP:

- Did not have a fully implemented, documented, formal review process in place to determine if the Percentage of Completion (POC) amounts, reported by Project/Construction Managers, were correct and led to accurate financial reporting under U.S. generally accepted accounting principles as it related to construction prior to the second quarter of FY 2011. Therefore, CBP did not detect inaccurate POCs reported throughout the first quarter or obtain supporting documentation for the POCs submitted by the Project/Construction Managers. Once CBP issued formalized guidance in the second quarter, the POC amounts reported varied, including both increases and decreases, from the POC amounts reported in the first quarter of the FY. In addition, the POC amounts continued to vary from the second quarter to the third quarter as a result of additional changes made to the process. Furthermore, the formalized guidance did not provide instructions on how to calculate POCs for general funding projects and thus CBP did not record a POC for the six projects identified as general funding projects.
- Did not properly classify six *American Recovery and Reinvestment Act* projects. CBP recognized these projects as repairs and maintenance, which did not require a POC, when in fact the projects were ongoing leasehold improvements, which required a POC.
- Did not properly and timely record certain construction-in-progress (CIP) settlement transactions. Specifically, there were 73 instances in which assets were untimely moved from CIP to fixed assets, resulting in the misclassification of assets in the general ledger. These delays spanned from one to twenty-six months. As a result of these late settlements, depreciation for the assets was understated from the time the assets were placed in service to when the assets were settled. To correct total depreciation in the general ledger, CBP recorded an additional \$30.9 million in accumulated depreciation and depreciation expense. In addition, 16 assets were identified in which CBP understated the value of its assets that were placed in service. CBP did not recognize the full value of the asset until further invoices were received. Furthermore, CBP settled a project to the incorrect general ledger account and settled four projects to the incorrect sub-asset number. A project was also capitalized when it should have been expensed and another settlement was recorded in duplicate. Lastly, CBP did not properly complete and review certain Technically Complete (TECO) forms, which indicate when a project has been completed and determines when the transaction to record the settlement should occur.
- Did not properly perform and/or document certain annual physical inventories related to real and personal property and did not detect assets incorrectly recorded, misclassified, or not recorded in the general ledger. In addition, the personal property inventory instructions did not provide sufficient detail for documenting the inventory results on the count sheets.

EXHIBIT II

- Recorded certain asset additions for an amount other than the amount paid, without proper supporting documentation, in an untimely manner, or used the incorrect general ledger account. Furthermore, the transactions performed to record the asset additions did not consistently comply with the United States Standard General Ledger at the transaction level.
- Did not properly input the correct capitalization date for 23 asset reclassifications, which in turn affected the corresponding accumulated depreciation balance.
- Improperly recorded certain asset retirements. Specifically, some assets that were retired were still in use, did not have proper approval and/or supporting documentation, or the transaction used to record the retirement included an incorrect general ledger account.
- Untimely recorded certain asset retirements and did not properly write-down the value of some assets that were no longer providing their expected services. Of the retirement transactions tested, one to thirty-four months lapsed between when an asset was physically removed from service and when it was retired from the system.

Criteria:

Presented in *Index of Financial Reporting and Internal Control Criteria* behind Exhibit III.

Cause/Effect:

CBP did not document and/or fully implement policies and procedures and does not have sufficient oversight of its policies and procedures, to ensure that all PP&E transactions are recorded timely and accurately. As a result, CBP's CIP, PP&E, depreciation expense, and accumulated depreciation may be misstated at any point during the FY by the recording of transactions, which are incorrect, unsupported, or untimely.

Recommendations:

We recommend that CBP:

1. Ensure standard operating procedures are in place and used by all Facilities, Management and Engineering Program Management Offices to create construction projects and to determine accurate POCs for all capitalized projects;
2. Review current policies and procedures for the proper recordation of asset additions, transfers and retirements with regard to asset valuations and depreciation;
3. Determine whether existing policies and procedures regarding purchase orders and goods receipt are sufficient, revise policies where necessary, and communicate policies and procedures to receivers of goods throughout CBP;
4. Establish and implement internal controls to ensure that timely and accurate transfer of completed assets from CIP to final asset settlement occurs;
5. Revise the current TECO process to include detailed accountability of time gaps, identify and correct problem areas, and establish procedures and training materials to ensure that the timely and correct accounting of assets occurs;
6. Clearly define and communicate instructions regarding the requirements for the performance and documentation of physical inventories; and
7. Request system changes, where possible, to require the submission of detailed supporting documentation, and to ensure the proper authorization for retirement has been obtained, prior to the completion of the asset retirement transaction.

C. Entry Process

1. In-Bond Program

Background:

General In-Bond Process

An in-bond entry allows the movement of cargo through the United States without payment of duty or appraisal prior to entry into domestic or foreign commerce. The cargo may enter commerce after it arrives at the destination port and an entry is filed. An in-bond also allows foreign merchandise arriving at one U.S. port to be transported through the U.S. for export from another U.S. port without the payment of duty. The shipment might not enter commerce if the shipment is entered into a Bonded Warehouse or admitted into a Foreign Trade Zone.

Compliance Audit and In-Bond

In 1998, CBP implemented an audit system within the Automated Commercial System (ACS) to serve as a compliance measurement system. This audit system, known as Tin-Man, utilizes random physical examinations and post audit reviews to ensure bonded carrier compliance with bond obligations. Tin-Man is used to select ports to perform physical examinations at the time of arrival and departure and to perform post audit reviews of carrier activity. Once each week, ports throughout the U.S. should be assigned post audits and physical examinations to perform based on a U.S. Government Accountability Office approved algorithm.

In-Bond Shipments Overdue for Export (M02) Report

In-bond shipments overdue for export are included on the M02 report. Items on this report are in-bond movements transmitted by importers or brokers via the Automated Manifest System (AMS), Automated Broker Interface, or paper that have not been exported within the required time limit. Review of the M02 report is designed to identify, but is not limited to, cargo that has not been exported and therefore may have physically, but not formally entered into U.S. commerce, administrative or clerical errors with paperwork, or system processing errors.

Monthly List of In-Bond Shipments Overdue (M07) Report

In-bond shipments overdue are included on the M07 report. Data on paperless and conventional in-bond movements transmitted by AMS participants, as well as in-bond information input via the "In-Bond Departure" function in ACS appear on this report. Review of the M07 report is designed to identify cargo that has not arrived at the original destination port of entry communicated to CBP.

Condition:

The following weaknesses were identified over the in-bond program:

- Ports are required to submit a summary of post audits conducted and the associated results to Headquarters. However, due to a system limitation in ACS, Headquarters cannot run an oversight report to determine if ports have completed all required audits. The "In-Bond Exam/Audit Selection" report in ACS is designed to provide this function, but it currently does not accurately list the history of all in-bonds selected for audit and is not consistent with the listing of incomplete Tin-Man audits on the "In-Bond Exam Audit Table" report.
- Headquarters completes a monthly analysis of the post audits and results submitted from the ports to determine the overall compliance rate of the in-bond program; however, documentation of this analysis is not maintained.

EXHIBIT II

- The M02 report does not track air in-bonds.
- The design of the M02 and M07 reports causes these monitoring reports to contain old and outdated information. Therefore, the ports have been instructed to focus on the most current issues and are not required to completely resolve all items on the M02 and M07 reports. Thus, items on the reports may go unresolved.
- Tin-Man is designed to assign both examinations of cargo and post audits on a weekly basis. The frequency of the current year examinations and audits is determined by an algorithm based on prior year results in Tin-Man. In FY 2010, Tin-Man was not reset by the Office of Information Technology at the beginning of the fiscal year for cargo examinations; therefore, no cargo examinations for the ports were generated by Tin-Man. As the current year frequency is based on prior year results, some ports did not receive any cargo examinations designated by Tin-Man in FY 2011.

Criteria:

Presented in *Index of Financial Reporting and Internal Control Criteria* behind Exhibit III.

Cause/Effect:

A Headquarters memorandum to all field offices was issued in August 2011, indicating the retention guidelines for in-bond audits, in-bond examinations, the M02 report, and the M07 report; however, not all ports were in compliance with the memorandum during FY 2011. Additionally, due to a flaw in the design of the M02 and M07 reports, there is no requirement for ports to completely resolve all items on the reports each time they are reviewed. The inability to effectively monitor the in-bond process and verify the arrival of in-bond merchandise at the port level could result in the loss of fines and penalty custodial revenue.

Current ACS system limitations restrict the ability of CBP to accurately monitor the in-bond process, both at the Headquarters and port levels. The lack of an automatic compilation and analysis of audit results at the national level hampers CBP's ability to ensure complete information is received from the ports to determine the effectiveness of in-bond audits and common in-bond errors.

Recommendations:

We recommend that CBP:

1. Continue to monitor and review the Tin-Man audit results to ensure that the national in-bond compliance rate continues;
2. Implement the "M1" release in the Automated Commercial Environment (ACE), which will replace the M02 and M07 reports, and continue to monitor the in-bond system through the new in-bond compliance system being developed in the Automated Targeting System (ATS); and
3. Continue to provide outreach and guidance to the field as necessary.

2. Trade Compliance Measurement

Background:

Trade Compliance Measurement (TCM) provides key data to CBP for the management of risk associated with trade compliance and revenue collection. CBP utilizes TCM to measure the effectiveness of its control mechanisms deployed and its execution in collecting revenues

EXHIBIT II

rightfully due to the U.S. Department of the Treasury. Further, TCM is used to determine the revenue gap that is reported as “Other Accompanying Information” in the financial statements.

In February 2010, the targeting platform in ACS was replaced by ATS and the findings platform was replaced by ACE. This change affected all future entries, whether filed in ACE or ACS. All determinations from entry summary reviews are recorded in the Validation Activity (VA) tool in ACE.

Condition:

Improvements over the TCM process were observed in FY 2011; however, the following weaknesses related to TCM were identified:

- TCM Coordinators inconsistently use data queries and reports to monitor TCM as TCM Coordinators in the field stated that the ACE reporting functionality is not operating effectively. Instances were identified when the ACE reports listed entries with a VA that had already been closed and/or the reports would not list TCM hits with open VAs. Therefore, the TCM Coordinators did not have a standard functioning method of monitoring TCM.
- Ports did not fully understand the use of the ACE Inbox, which hosts TCM hits. Ports that generate more than 100 hits were not aware of the ACE Inbox functionality allowing users to view additional TCM hits needing attention.
- Headquarters provides the ports with a monthly database, which provides an effective tool to analyze and monitor TCM hits; however, the Headquarters Database for the FY 2011 TCM hits was not made available to the ports until February 2011.
- CBP Directive 3550-074C, *Uniform Input of Entry Summary Review Findings Using the ACE Validation Activity*, issued March 18, 2011, does not provide sufficient information to the TCM Coordinators on how to appropriately review the ACE reports and the Headquarters Database. Details regarding the review, annotations, and maintenance of the reports were not provided.

Criteria:

Presented in *Index of Financial Reporting and Internal Control Criteria* behind Exhibit III.

Cause/Effect:

Incomplete guidelines and inconsistent use of the reporting tools to monitor TCM, may lead ports to inadequately monitor the TCM process throughout the FY, resulting in a lack of appropriate review of TCM entries. With inadequate oversight of the TCM data, CBP may have an inaccurately projected revenue gap. Additionally, CBP may incorrectly evaluate the effectiveness of its control environment over the collections of duties, taxes, and fees.

Recommendations:

We recommend that CBP:

1. Continue distribution of the monthly TCM database, which satisfies the requirements for TCM Coordinator and Headquarters oversight of the TCM process at the port level;
2. Ensure ports are appropriately reviewing the ACE reports in accordance with CBP Directive 3550-074C and issue new or updated guidance as needed; and

3. Communicate, at least quarterly, current issues needing attention and resolutions in place to the ports.

3. Bonded Warehouse and Foreign Trade Zones

Background:

Bonded Warehouses (BWs) are facilities under CBP's supervision used to store merchandise that has not made entry into the U.S. commerce. The merchandise stored in such warehouses is secured by the bond on the warehouse. Merchandise is entered into the BW by submission of the CBP Entry Summary Form 7501 and can be stored in the bonded facility for up to five years.

Foreign Trade Zones (FTZs) are secure areas under CBP supervision considered outside of CBP territory. Authority for establishing these facilities is granted by the Foreign Trade Zones Board under the *Foreign Trade Zones Act of 1934*, as amended (19 United States Code (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. Merchandise is admitted into an FTZ using CBP Form 214.

Condition:

Improvements over the BW and FTZ processes were observed in FY 2011; however, the following internal control weaknesses were identified:

- While CBP has developed national databases within ACE, which contain an inventory of all BWs and FTZs, CBP does not use the databases to document the assessed risk of each BW or FTZ, scheduled compliance reviews, or the results of compliance reviews. Although ACE is the system of record, CBP uses SharePoint to document the assessed risk of each BW or FTZ, scheduled compliance reviews, or the results of compliance reviews. In addition, CBP has not conducted a reconciliation of the Facilities Information Resource Management System codes within SharePoint due to known system issues. Furthermore, there are no requirements for Headquarters or the field offices to compare the ACE database to the compliance review schedules submitted by the ports to ensure that all compliance reviews are performed.
- Headquarters compiles a survey that is completed by the ports at the end of each FY to determine the current status of the BW and FTZ programs. CBP performed an analysis over the FY 2011 survey results; however, the detailed analysis was not readily available and was unable to be provided. Additionally, the FY 2011 memo that Headquarters distributed to the ports with the intent to communicate the compliance results of the BW/FTZ programs did not contain detail of CBP's internal analysis and results. The memo reiterated the responsibilities of the CBP Officers over the bonded facilities and commented on the external auditor's results on the operating effectiveness of the program.

Criteria:

Presented in *Index of Financial Reporting and Internal Control Criteria* behind Exhibit III.

Cause/Effect:

CBP does not have updated, formal guidance related to Headquarters' monitoring of the BW and FTZ programs, including procedures to ensure all necessary compliance reviews are scheduled and completed.

EXHIBIT II

Headquarters cannot effectively monitor the BW and FTZ programs as there is no formal requirement for Headquarters to reconcile the database with the compliance reviews conducted.

Recommendations:

We recommend that CBP:

1. Continue to monitor the compliance review results to ensure that the high national compliance rate continues;
2. Continue to review facility profiles in ACE to make sure that profiles are constantly updated;
3. Work within the constraints of the current fiscal parameters to develop additional training and information sharing processes for the ports; and
4. Continue to provide outreach and guidance to the field as necessary.

D. 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 five key control areas: security management, access control, configuration management, segregation of duties and contingency planning. 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 2011, CBP took corrective action to address prior year IT control deficiencies. For example, CBP made improvements over various system logical access processes and system security settings. However, during FY 2011 new and continuing general IT control weaknesses were identified that could potentially impact CBP's financial data. The most significant weaknesses from a financial statement audit perspective related to controls over access to programs and data. Collectively, the IT control weaknesses limit CBP's ability to ensure that critical financial and operational data is maintained in such a manner to ensure confidentiality, integrity, and availability. Additionally, CBP's current system of record used to process entries imported into the U.S. cannot support all of CBP's operations, which limits CBP's ability to effectively manage and monitor the custodial revenue and drawback processes. Because of the sensitive nature of the issues identified, we will issue a separate restricted distribution report that discusses the IT general control and functionality control deficiencies in more detail.

Criteria:

Presented in *Index of Financial Reporting and Internal Control Criteria* behind Exhibit III.

Cause/Effect:

Funding for IT development and implementation has been reduced in recent years, resulting in delays of systems which would replace or enhance current systems. In addition, because of the presence of IT control and financial system functionality weaknesses, there is added pressure on mitigating controls to operate effectively.

EXHIBIT II

Recommendation:

We recommend that CBP improve the application and general controls over its financial systems to ensure adequate security, protection, and functionality of the information systems.

CBP Response:

See management's response included in the attached letter.

Status of Prior Year Material Weakness and Significant Deficiencies

Prior Year Condition	As Reported at September 30, 2010	Status as of September 30, 2011
Drawback of Duties, Taxes, and Fees	Material weakness: The Automated Commercial System (ACS) lacked controls to detect and prevent excessive drawback claims and payments, requiring inefficient compensating manual processes. 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 in FY 2011. See control finding letter A.
Financial Reporting	Significant deficiency: CBP did not have an effective process in place to timely review and analyze contractor information that could impact the financial statements. CBP did not have proper segregation of duties or sufficient review over manual journal entries. Additionally, CBP did not have sufficient controls or documented policies in place to detect errors in its population used to search for unrecorded accounts payable.	Significant deficiency was remediated in FY 2011.
Property, Plant, and Equipment (PP&E)	Significant deficiency: Weaknesses existed related to timely addressing the valuation of the Secure Border Initiative network (SBInet). As a result, a write-off was identified but was not timely recorded. Weaknesses existed related to the untimely transfer of construction-in-progress (CIP) to fixed assets and an understated value of assets that were placed into service. Several weaknesses existed related to oversight of PP&E, such as not properly performing inventory counts, and recording addition and retirement transactions untimely or inaccurately.	Continue as a significant deficiency: Weaknesses continue to exist related to untimely transfer of CIP to fixed assets and recording PP&E additions, reclassifications, and retirements. Additionally, weaknesses continue to exist with recording the percentage of completion for certain construction projects. See control finding B.
Inactive Obligations	Significant deficiency: Weaknesses existed in CBP's policies and procedures related to the monitoring of obligations and the timely deobligation of inactive obligations.	Significant deficiency was remediated in FY 2011.
Entry Process – In-Bond	Significant deficiency: Several weaknesses existed related to in-bond, such as lack of official guidance related to monitoring in-bond shipments at the port level, lack of CBP Headquarters review of the in-bond program, and the overall inability to determine the effectiveness of	Continue as a significant deficiency: Weaknesses continued to exist related to in-bond, such as ACS system issues preventing appropriate Headquarters oversight, inadequate documentation of the monthly in-bond analysis,

Prior Year Condition	As Reported at September 30, 2010	Status as of September 30, 2011
	the in-bond program for CBP in its entirety.	inability to track air in-bonds, ineffective monitoring of the M02 and M07 reports, and Tin-Man system limitations. See control finding letter C, section 1.
Entry Process –Trade Compliance Measurement (TCM)	Significant deficiency: Weaknesses existed related to TCM, such as inconsistent procedures followed at the ports and development and/or implementation of policies and procedures to ensure reliability and accuracy of TCM input results.	Continue as a significant deficiency: Improvements were identified; however, weaknesses continue to exist related to TCM, such as inconsistent use of data queries and reports by TCM Coordinators, Automated Commercial Environment (ACE) reporting functionality limitations, inadequate training on ACE capabilities, inadequate monitoring and insufficient review guidance. See control finding letter C, section 2.
Entry Process – Bonded Warehouse (BW) and Foreign Trade Zones (FTZ)	Significant deficiency: Several weaknesses existed related to the BW and FTZ processes, such as inadequate monitoring and documentation, lack of risk assessment guidance and inconsistent procedures at the port level.	Continue as a significant deficiency: Weaknesses continue to exist related to the BW and FTZ programs, such as inadequate monitoring and documentation. See control finding letter C, section 3.
Information Technology (IT)	Significant deficiency: Weaknesses existed related to IT general and application controls and IT functionality. Specifically, these included findings in the area of general IT security planning and management, logical and physical access to programs and data, segregation of duties, software change management, business continuity, and the ability of systems to accurately and completely track financial transactions.	Continue as a significant deficiency: Weaknesses continue to exist related to IT general and application controls and IT functionality. In FY 2011, the majority of prior year findings were unresolved and several new findings were identified. See control finding letter D.

Index of Financial Reporting and Internal Control Criteria

(Listed Alphabetically by Criteria Source)

Criteria	Reference	Report Exhibit
<i>Code of Federal Regulations, Title 19</i>	Sections 111.23(a), 163.4, 191.51(b)(1)	I-A
	Sections 18.2(d), 18.6(b), 18.8(b)	II-C-1
	Sections 19.4(a), 146.3	II-C-3
<i>Federal Information Security Management Act</i>		II-D
Office of Management and Budget (OMB) Circular No. A-123, <i>Management's Responsibility for Internal Control</i>		I-A, II-B, II-C-1, II-C-3
OMB Circular No. A-127, <i>Financial Management Systems</i>		II-D
OMB Circular No. A-130, <i>Management of Federal Information Resources</i>		II-D
OMB Circular No. A-136, <i>Financial Reporting Requirements</i>	Section II, Subsection 5.3	II-C-2
Statement of Federal Financial Accounting Standards (SFFAS) No. 6, <i>Accounting for Property, Plant, and Equipment</i>		II-B
SFFAS No. 7, <i>Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting</i>	Section 69.2	II-C-2



**U.S. Customs and
Border Protection**

JAN 20 2012

MEMORANDUM FOR: Anne L. Richards
Assistant Inspector General for Audits
Department of Homeland Security

FROM: Deborah J. Schilling
Chief Financial Officer
U.S. Customs and Border Protection

SUBJECT: Management Response to Independent Auditor's Report on U.S.
Customs and Border Protection's Fiscal Year 2011 Financial
Statements

On behalf of U.S. Customs and Border Protection (CBP), I am responding to the Independent Auditor's Report on CBP's Fiscal Year (FY) 2011 Financial Statements, which is included in our FY 2011 Performance and Accountability Report.

I accept the independent public accounting firm's (KPMG LLP), *unqualified* opinion on CBP's FY 2011 Financial Statements, which concluded that CBP's consolidated financial statements are fairly presented in all material respects in conformity with accounting principles.

CBP has reviewed and concurs with the one material weakness and the three significant deficiencies. Mission Action Plans (MAPs) outlining CBP's strategy to correct these conditions were completed and provided to the Office of Financial Management, Department of Homeland Security. CBP will continue to work to resolve all auditor identified weaknesses.

CBP appreciates the opportunity to review this year's audit report and looks forward to continuing our professional auditing relationship with your office. If you have any questions or would like additional information, please contact me at (202) 344-2300, or a member of your staff may contact Jaye M. Williams, Executive Director, Financial Operations, at (202) 344-2364.

A handwritten signature in blue ink that reads "Deborah J. Schilling".

Deborah J. Schilling

Appendix A
Report Distribution

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