



Department of Homeland Security Office of Inspector General

Independent Review on the U.S. Coast Guard's Reporting of FY 2009 Drug Control Obligations





Homeland
Security

January 27, 2010

Preface

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

This report presents the results of the review of the Table of Prior Year Drug Control Obligations and related disclosures of the U.S. Coast Guard for the fiscal year ended September 30, 2009, for the Office of National Drug Control Policy. We contracted with the independent public accounting firm KPMG LLP to perform the review. U.S. Coast Guard management prepared the Table of Prior Year Drug Control Obligations and related disclosures to comply with requirements of the Office of National Drug Control Policy Circular, *Drug Control Accounting*, dated May 1, 2007. Due to the U.S. Coast Guard's inability to provide assurance as to the integrity of the financial data in the detailed accounting submissions, KPMG LLP was unable to complete its review and report on the Table of Prior Year Drug Control Obligations and related disclosures.

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.

A handwritten signature in cursive script that reads "Richard L. Skinner".

Richard L. Skinner
Inspector General



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January 18, 2010

Ms. Anne Richards
Assistant Inspector General for Audits
Office of the Inspector General
U.S. Department of Homeland Security
1120 Vermont Avenue, NW
Washington, DC 20005

Dear Ms. Richards:

We were engaged to review the Table of Prior Year Drug Control Obligations and related disclosures (Section 6A), and the accompanying management's assertions (Section 6B) of the Department of Homeland Security's (DHS) United States Coast Guard (USCG) for the year ended September 30, 2009. USCG management is responsible for the Table of Prior Year Drug Control Obligations and related disclosures, and the assertions.

The Office of National Drug Control Policy (ONDCP) Circular: *Drug Control Accounting* (May 1, 2007), requires management to disclose any material weaknesses or other findings affecting the presentation of data reported. Management reported that it "cannot provide assurances as to the integrity of the financial data contained" in its Table of Prior Year Drug Control Obligations and related disclosures.

In accordance with applicable professional standards, without a positive assertion provided by management, we are unable to complete our review of USCG's Table of Prior Year Drug Control Obligations and related disclosures, and management's assertion. Accordingly, we are unable to provide an Independent Accountants' Report on the Table of Prior Year Drug Control Obligations and related disclosures, and management's assertions pursuant to the requirements of ONDCP Circular: *Drug Control Accounting* (May 1, 2007).

Sincerely,

Scot G. Janssen,
Partner

U.S. Department of
Homeland Security

United States
Coast Guard



Commandant
United States Coast Guard

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JAN 14 2010

Mr. John Shiffer
Department of Homeland Security
Director of Financial Management
Office of the Inspector General
1120 Vermont Avenue, 10th Floor, NW
Washington, D.C. 20005

Dear Mr. Shiffer,

In accordance with the Office of National Drug Control Policy Circular: *Annual Accounting of Drug Control Funds* dated May 1, 2007, enclosed is the Coast Guard's report of FY 2009 drug control obligations, drug control, methodology and assertions. Per your KPMG auditor's guidance received on December 18th, 2009, my staff addressed this request for additional supporting documentation and changes to the FY 2009 Annual Accounting of Drug Control Funds, dated November 30th, 2009.

If you require further assistance on this information, please contact LCDR Rebecca Ore at (202) 372-3512.

Sincerely,

A handwritten signature in black ink, appearing to read "T.W. Jones".

T.W. JONES
Captain, U.S. Coast Guard
Chief, Office of Budget and Programs

Copy: DHS Budget Office

Enclosures:

- (1) USCG FY 2009 Annual Accounting of Drug Control Funds
- (2) Exhibit 1 – Materiel Weaknesses in Internal Control – U.S. Coast Guard
- (3) USCG Assurance Statement
- (4) KPMG Auditor Comments with USCG Response

**DEPARTMENT OF HOMELAND SECURITY
 UNITED STATES COAST GUARD
 ANNUAL ACCOUNTING OF
 FY 2009 DRUG CONTROL FUNDS
 6A. DETAILED OBLIGATION SUBMISSION**

(a) Table of Prior Year Drug Control Obligations (dollars in millions)

RESOURCE SUMMARY	2009 Actual
Drug Resources by Function:	Obligations
• Interdiction	\$1,053.665
• Research and Development	<u>\$2.261</u>
Total Resources by Function	\$1,055.926
Drug Resources by Decision Unit:	
• Operating Expenses (OE)	\$771.224
• Reserve Training (RT)	\$15.607
• Acquisition, Construction, and Improvements (AC&I)	\$266.834
• Research, Development, Test and Evaluation (RDT&E)	\$2.261
Total Drug Control Obligations	\$1,055.926
<i>Interagency Crime and Drug Enforcement [non-add]</i>	<i>[\$708]</i>

(1) Drug Methodology

Over twenty years ago, the Coast Guard designed its cost allocation methodology to systematically allocate costs to the Coast Guard’s primary mission areas. This methodology allocated Coast Guard costs based on the level of effort (e.g. time) that Coast Guard resources (cutters, aircraft, boats, and personnel) spent on various types of missions. This view of the Coast Guard budget provided valuable insight into the multi-mission use of assets and personnel. However, for many years the only information taken into consideration was the previous year’s operational activity. Prior to 1998, operational data (resource hours) and obligation data were downloaded only at the end of the fiscal year to develop mission cost allocations for the year just completed and budgetary projections for current and future years taking into account incremental changes. Starting in 2000 an improved methodology, known as the Mission Cost Model (MCM), was developed to present Coast Guard missions more accurately using activity based cost accounting principles. Further, the Coast Guard has developed an operating hour baseline as a method to approximate the future allocation of resource hours for each asset class to multiple Coast Guard missions. This is the revised basis for funding allocations in budget projections. The operating hour allocation, or baseline, is developed and modified based upon budget line item requests and national priorities.

The Coast Guard’s drug control funding estimates are computed by closely examining the decision units, or appropriations, that comprise the Coast Guard’s drug control budget estimates. These decision units consist of: Operating Expenses (OE); Reserve Training (RT); Acquisition, Construction, and Improvement (AC&I); and Research, Development, Test, and Evaluation (RDT&E).

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(1) Drug Methodology (cont.)

Each decision unit contains its own unique spending authority and methodology. For example, AC&I includes funding that remains available for obligation up to five years after appropriation and RDT&E includes funding which does not expire. Unless stipulated by law, OE and RT funding must be spent in the fiscal year it is appropriated and therefore the methodology for these two appropriations is the same.

Operating Expenses

The majority of the funds the Coast Guard allocates to the drug interdiction program are in the (OE) decision unit. OE funds are used to operate Coast Guard facilities; maintain capital equipment; improve management effectiveness; and recruit, train, sustain, and compensate, an active duty military and civilian workforce. In the OE budget, the amount allocated to the drug interdiction program is derived by allocating a share of the actual expenditures based upon the percentage of time aircraft, cutters, and boats spent conducting drug interdiction activities. The Coast Guard tracks the resource hours spent on each of the 11 Coast Guard programs by using a web-based Abstract of Operations (AOPS) data collection and report system. Coast Guard AOPS data is used to develop the amount of time each asset class spends conducting each Coast Guard mission. Using financial data gathered from over 3,000 cost centers around the United States along with the AOPs information, the Coast Guard is able to allocate OE costs to each of the 11 program areas consisting of: Drug Interdiction; Migrant Interdiction; Ports, Waterways and Coastal Security; Other Law Enforcement; Defense Readiness; Search and Rescue; Marine Safety; Ice Operations; Marine Environmental Protection; Living Marine Resources; and Aids to Navigation.

Acquisition, Construction, and Improvements

In scoring drug control funding requests within the zero-based AC&I decision unit, professional judgment is used to evaluate every line item project requested in the FY 2009 AC&I budget for its anticipated contribution to Coast Guard's 11 program areas. For each AC&I project, a discrete profile is established to allocate the funding for that project to the various mission areas of the Coast Guard. In most cases, the driver is the percentage of time an asset contributes to the 11 program areas as determined from the OE Mission Cost Model (MCM). Otherwise, when a project is not related to any particular asset or series of asset classes, the project fund may benefit the Coast Guard's entire inventory and other expense categories. With this condition, the general OE AOPS MCM percentage is utilized. As with the other three appropriations, once the program percentage spreads are computed for each of these drivers in the FY 2009 AC&I MCM, the total bottom-line mission percentage is applied directly to the AC&I total direct obligations. This percentage allocation results in a repeatable mission spread process which the Coast Guard uses throughout its annual budget year presentations, namely OMB's MAX budget system for the President's Budget submission and the Chief Financial Officer's Statement of Net Cost report.

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(1) Drug Methodology (cont.)

Reserve Training

The Coast Guard allocates a portion of RT decision unit funds to the drug interdiction program. RT funds are used for Coast Guard Selected Reserve personnel who support and operate Coast Guard facilities, maintain capital equipment, improve management effectiveness, and assist in sustaining all Coast Guard operations. The final FY 2009 obligations for the RT decision unit are determined using the OE methodology.

Research, Development, Test and Evaluation

The final decision unit is RDT&E. As with the AC&I Appropriation, scoring of drug interdiction funding is accomplished within the zero-based RDT&E decision unit. Every line item requested in the FY 2009 RDT&E budget was evaluated for its anticipated contribution to drug interdiction efforts. Each RDT&E project has a discrete driver that is selected to allocate the costs for the project to various Coast Guard mission areas. These drivers are based upon experienced professional judgment. Once the unique program driver is chosen the program percentage spreads as determined from the OE MCM.

(2) Methodology Modifications

The methodology described above is consistent with the previous year.

(3) Material Weaknesses or Other Findings

As a result of the CFO Act audit and feedback provided in the enclosed Independent Auditors' Report: Exhibit I – Material Weaknesses in Internal Control (Enclosure 2) and described in the enclosed 2009 U.S. Coast Guard Assurance Statement (Enclosure 3), the Coast Guard has material weaknesses in financial management, financial reporting, and financial systems that impact the assurance of information in our financial reports. As such, we cannot provide assurances as to the integrity of the financial data contained in this report.

The Coast Guard has chartered an Audit Readiness Planning Team which is mapping processes, conducting gap analysis, tracking processes to assertions at the transaction level, and associating deliverables to milestones. Upon completion of this analysis, the Coast Guard will aggressively update Mission Action Plans that guide our implementation of internal controls leading to assurance over financial information. This information is used in the MCM to produce a portion of this report. Additionally, we will pursue improved internal controls in the collection of our Abstract of Operations information necessary to give assurance to the non-financial data used to produce a portion of this report.

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(4) Reprogrammings or Transfers

During FY 2009, the Coast Guard has no reports of transfers or reprogramming actions affecting in excess of \$1 million drug-related budget resources.

(5) Other Disclosures

The following provides a synopsis of the United States Coast Guard's FY 2009 Drug Control Funds reporting which describes:

1. The agency's overall mission and the role of drug interdiction efforts within the Coast Guard's multi-mission structure and
2. The Coast Guard's drug control budget submission.

Coast Guard Mission

The Coast Guard is a military service with mandated national security and national defense responsibilities and the United States' leading maritime law enforcement agency with broad, multi-faceted jurisdictional authority. The Coast Guard is a multi-mission maritime service consisting of 11 complementary program areas: Drug Interdiction; Migrant Interdiction; Ports, Waterways and Coastal Security; Other Law Enforcement; Defense Readiness; Search and Rescue; Marine Safety; Ice Operations; Marine Environmental Protection; Living Marine Resources; and Aids to Navigation.

The Coast Guard faces many of the same challenges as the other four military services when it comes to deciding which assets should be deployed for what missions and where. This is not only true between the broad categories of missions, but also within sub-sets of the various missions the Coast Guard undertakes. For example, assets used for the Enforcement of Laws and Treaties must be divided between drug interdiction and migrant interdiction, as well as enforcement of fishing regulations and international treaties. Due to the multi-mission nature of the Coast Guard and the necessity to allocate the effort of a finite amount of assets, there is a considerable degree of asset "cross-over" between missions. This crossover contributes to the challenges the Coast Guard faces when reporting costs for its mission areas.

Coast Guard's Drug Budget

In the annual National Drug Control Strategy (NDCS) Budget Summary, all agencies present their drug control resources broken out by function and decision unit. The presentation by decision unit is the one that corresponds most closely to the Coast Guard's congressional budget submissions and appropriations. It should be noted and emphasized that the Coast Guard does not have a specific appropriation for drug interdiction activities. As such, there are no financial accounting lines for each of Coast Guard's 11 programs. All drug interdiction operations, capital improvements, reserve support, and research and development efforts are funded out of general Coast Guard appropriations.

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Coast Guard's Drug Budget (cont.)

For the most part, the Coast Guard drug control budget is a reflection of the Coast Guard's overall budget. The Coast Guard's Operating Expenses appropriation budget request is incremental, focusing on the changes from the prior year base brought forward. The Coast Guard continues to present supplementary budget information through the use of the MCM, which allocates base funding and incremental requests by mission.

This general purpose MCM serves as the basis for developing drug control budget estimates for the OE and RT appropriations and provides allocation percentages used to develop the drug control estimates for the AC&I and RDT&E appropriations and the process is repeatable. Similarly, this is the same methodology used to complete our annual submission to ONDCP for the NDCS Budget Summary.

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6B. ASSERTIONS**

(1) Obligations by Budget Decision Unit – N/A. As a multi-mission agency, the Coast Guard is exempt from reporting under this section as noted in ONDCP Circular: *Drug Control Accounting*, Section 6a (1) (b).

(2) Drug Methodology

The MCM is an estimate of mission costs allocated across Coast Guard's 11 mission/programs, versus actual accounting of drug funded obligations. The information reported is timely and is derived from an allocation process involving the Coast Guard's financial statement information. In the Coast Guard's opinion, the methodology outlined below is a reasonable and accurate portrayal of the agency's mission/program presentations because it is repeatable and supported by the most current financial and abstract of operations data available. The following methodology was applied to derive the drug control information presented in the table in section 6A.

The Coast Guard does not have a discrete drug control appropriation and its financial systems are not structured to accumulate accounting data by operating programs or missions areas. Drug control funding data is developed using a systematic process for the OE and RT appropriations, and a combination of project analysis, subject matter review, and OE-based allocations for the AC&I and RDT&E appropriations.

Data: As outlined in the previous section, the Coast Guard reports its drug control funding to ONDCP for each of the four appropriations or decision units. The mechanics of how each decision unit's drug control data is derived as follows:

- **Operating Expenses and Reserve Training**– Budget Authority or Expenditures are allocated to the mission areas of the Coast Guard based upon the output of a MCM. This is basically an OE expenditure driven model used to present the mission based data shown in the OE and RT budget submissions across the 11 Coast Guard programs. The following data sources feed the FY 2009 OE/RT MCM:
 - 1) Core Accounting System (CAS) – FY 2009 actual expenses MCM uses FY 2007 financial data, adjusted to reflect changes in the Coast Guard's asset inventory from FY 2007 to FY 2009. These expenses are fed into the Standard Rates Model (SRM), along with Coast Guard's operating cost reports of the Engineering Logistics Center (ELC) and Coast Guard Yard and the cost per flight hour report from the Aircraft Repair & Support Center (AR&SC). The SRM uses an activity-based methodology to assign and allocate expenses to the Coast Guard's assets and certain non-asset intensive missions, such as Marine Safety. The resulting total cost pools serve as one of the major inputs to the MCM. If current year SRM data is not available, the previous year total cost pools are adjusted to fit the relevant fiscal year's asset inventory. The SRM is reconciled to the Coast Guard's Statement of Net Cost.

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6B. ASSERTIONS**

(2) Drug Methodology (cont.)

2) Naval Electronics Supply Support System (NESSS) – The ELC and Coast Guard Yard at Baltimore operate a stand alone financial system. Similar to the CAS, NESSS data is broken down by cost center, unit name, allotment fund code, and dollar amount. NESSS expense data is fed into the SRM and allocated to Coast Guard assets and certain non-asset intensive missions. NESSS financial data is included in the Coast Guard’s financial statements.

3) Aviation Maintenance Management Information System (AMMIS) - The Coast Guard AR&SC in Elizabeth City operates a stand alone financial system. Similar to the CAS, AMMIS data is broken down by cost center, unit name, allotment fund code, and dollar amount. AMMIS expense data is fed into the SRM and allocated to Coast Guard assets and certain non-asset intensive missions. AMMIS financial data is included in the Coast Guard’s financial statements.

4) 2009 Abstract of Operations– AOPS is a web-based information system that reports how an asset (aircraft, boat, or cutter) was utilized across various missions of the Coast Guard. Each unit or activity that performs a mission is responsible for including the resource hours in the AOPS database.

5) Other Expenses – The drug related pieces that feed this area of the model are the Tactical Law Enforcement Teams (TACLET), Law Enforcement Detachments (LEDET) and Special Projects. The percentage that drives the TACLET /LEDET resource areas are computed from team deployment days divided by the total deployment days in the fiscal year for the drug interdiction mission. The Special Projects percentage driver is formulated from professional judgment regarding how funding is used to support costs related to counter-drug operations such as High Intensity Drug Traffic Area activities and liaison costs for the Coast Guard’s Organized Drug Enforcement Task Force.

6) Mission Cost Model Application & Results – The two chief input drivers to the MCM are: 1) Financial costs of each Coast Guard asset and other expenses areas, made up of direct, support and overhead costs and 2) 2009 AOPS hours. The support and overhead costs for each asset and other expenses element is applied to hours projected from the 2009 AOPS. These costs are reflective of the more static conditions of Coast Guard operations relative to the support functions and administrative oversight. The direct costs are applied to the final AOPS hours to show the dynamic flow of operations experienced during fiscal year 2009. The overall affect of the computed amount from the static baseline and reality of AOPS results in a percentage to drive Coast Guard OE expenditures allocated across 11 programs.

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6B. ASSERTIONS**

(2) Drug Methodology (cont.)

- **Normalize to Budget Authority or Obligations** – The program percentages derived from the MCM are then applied to total OE and RT FY 2009 budget authority and obligations (see Attachments A & B respectively), depending upon the reporting requirement. Budget Authority (BA) is derived from the agency's annual enacted Appropriation and expenditure data is derived from the final financial accounting Report of Budget Execution (SF-133).
- **Acquisition, Construction & Improvements (AC&I)** – AC&I is a multi-year appropriation where funding may be available for up to 5 years depending on the nature of the project. The methodology used to develop the drug funding estimate is systematically different than that of OE and RT. AC&I drug funding levels, for either BA or obligations, is developed through an analysis of each project/line item. For each line item, a discrete driver is selected that best approximates the contribution that asset or project, when delivered, will contribute to each of the Coast Guard's 11 programs. The total program/mission area spreads for these drivers are based on the FY 2009 AC&I MCM output. To ensure consistency, the extract used for the analysis of enacted FY 2009 BA is used for the end of year analysis of obligations as well. For FY 2009 AC&I program and mission area spreads, the following data sources and methods were used:

AC&I Mission Cost Model – developed based on data feeds from the FY 2009 OE/RT MCM model as related in earlier OE and AC&I statements. The following data sets were then required to complete the AC&I MCM:

- 1) Drug related percentage – The percentage spread for each driver was extracted from the OE MCM. This information was further analyzed to:
 - (a) Ensure a discrete driver representing either a particular asset, series of assets, or mission was applied to each project; or
 - (b) A general OE percentage driver was used when the project's outcome was expected to benefit all inventory and/or agency needs.
 - 2) Mission cost results/application - Once the project drivers were extracted from the OE MCM, they were applied to the total AC&I BA levels derived from the agency's enacted Appropriation Bill in the FY 2009 AC&I MCM. The total allocated mission percentages from the AC&I MCM were then applied to the total AC&I 2009 obligations as reported from the CAS as of September 30, 2009 (see Attachment C).
- **Research, Development, Test & Evaluation (RDT&E)** – RDT&E is a no-year appropriation where funding, once appropriated, may be obligated indefinitely in the future until all balances are expended. The methodology used to develop the drug-funding estimate is similar to AC&I in that drug-funding costs are based on an analysis of each project. The program/mission area percentages are based upon subject matter expert review.

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(2) Drug Methodology (cont.)

RDT&E Mission Cost Model – Developed based on data feeds from the FY 2009 OE/RT MCM model as in earlier OE and AC&I statements. The following data sets were then required to complete the RDT&E MCM:

- 1) Drug related percentage – The percentage spread for each driver was extracted from the OE MCM. This information was further analyzed to:
 - a) Ensure a discrete driver representing either a particular asset, series of assets or mission was applied to each project or;
 - b) A general OE percentage driver was used when the project's outcome was expected to benefit all inventory and/or agency needs.
- 2) Mission cost results/application - Once the project drivers were extracted from the OE MCM, they were applied to the total RDT&E BA levels derived from the agency's enacted Appropriation Bill in the FY 2009 RDT&E MCM. The total allocated mission percentages from the RDT&E MCM were then applied to the total RDT&E 2009 obligations as reported from the CAS as of September 30, 2009 (See Attachment D). BA data is derived from the agencies enacted Appropriation and expenditure data is extracted from a Finance and Procurement Desktop transaction summary report by project.

Other Estimation Methods: Where the MCM allocates a percentage of time/effort expended to a given AC&I project/line item, in some cases changes were made to better represent the drug costs associated. As noted in the AC&I and the RDT&E methodology, experienced professional judgment is sometimes used to change a driver based on specific knowledge that a resource will be used differently than the historical profile indicates.

Financial Systems: Data is derived from CAS, ELC and Coast Guard Yard systems. No other financial systems or information are used in developing program or mission area allocations. The Coast Guard has not fully implemented corrective actions to remediate weaknesses identified by the independent auditors during the annual CFO audits. As a result, the Coast Guard could not assert to the completeness, existence (validity), accuracy, valuation or presentation of its financial data.

(3) Application of Drug Methodology - The methodology disclosed in this section was the actual methodology used to generate the table required by Section 6A. Documentation on each decision unit is provided.

(4) Reprogrammings or Transfers -- During FY 2009, Coast Guard had no transfers or reprogramming actions affecting in excess of \$1 million drug-related budget resources.

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6B. ASSERTIONS**

(5) Fund Control Notices – The FY 2009 data presented herein is associated with drug control funding reported in Coast Guard’s FY 2009 financial plan. ONDCP did not issue Coast Guard a Fund Control Notice for FY 2009.

**OPERATING EXPENSES (OE)
MISSION COST MODEL OUTPUT:**

	(dollars in thousands)	
	FY 2009	
	Obligations	% of total
1. Search and Rescue (SAR)	775,905	12.07%
2. Marine Safety (MS)	595,681	9.27%
3. Aids to Navigation (ATON)	1,095,051	17.03%
4. Ice Operations (IO)	117,502	1.83%
5. Marine Environmental Protection (MEP)	138,257	2.15%
6. Living Marine Resources (LMR)	582,252	9.06%
7. Drug Interdiction	771,224	12.00%
8. Other Law Enforcement (OTH-LE)	84,527	1.31%
9. Migrant Interdiction	476,460	7.41%
10. Ports, Waterways & Coastal Security (PWCS)	1,353,372	21.05%
11. Defense Readiness	438,487	6.82%
Total OE Obligations	\$ 6,428,718	100%

**RESERVE TRAINING (RT)
MISSION COST MODEL OUTPUT:**

	(dollars in thousands)	
	FY 2009	
	Obligations	% of total
1. Search and Rescue (SAR)	15,702	12.07%
2. Marine Safety (MS)	12,054	9.27%
3. Aids to Navigation (ATON)	22,162	17.03%
4. Ice Operations (IO)	2,377	1.83%
5. Marine Environmental Protection (MEP)	2,799	2.15%
6. Living Marine Resources (LMR)	11,784	9.06%
7. Drug Interdiction	15,607	12.00%
8. Other Law Enforcement (OTH-LE)	1,711	1.32%
9. Migrant Interdiction	9,642	7.41%
10. Ports, Waterways & Coastal Security (PWCS)	27,389	21.05%
11. Defense Readiness	8,875	6.82%
Total RT Obligations	\$ 130,102	100%

**ACQUISITION, CONSTRUCTION and IMPROVEMENTS
(AC&I) MISSION COST MODEL OUTPUT:**

	(dollars in thousands)	
	FY 2009	
	Obligations	% of total
1. Search and Rescue (SAR)	180,600	14.54%
2. Marine Safety (MS)	27,682	2.23%
3. Aids to Navigation (ATON)	51,430	4.14%
4. Ice Operations (IO)	30,622	2.46%
5. Marine Environmental Protection (MEP)	13,117	1.06%
6. Living Marine Resources (LMR)	183,334	14.76%
7. Drug Interdiction	266,834	21.48%
8. Other Law Enforcement (OTH-LE)	36,762	2.96%
9. Migrant Interdiction	142,213	11.45%
10. Ports, Waterways & Coastal Security (PWCS)	211,564	17.03%
11. Defense Readiness	98,122	7.90%
Total AC&I Obligations	\$ 1,242,280	100%

Note: Includes \$56.180 million recoveries of prior year obligations.

**RESEARCH, DEVELOPMENT, TEST and EVALUATION
(RDT&E) MISSION COST MODEL OUTPUT:**

	(dollars in thousands)	
	FY 2009	
	Obligations	% of total
1. Search and Rescue (SAR)	1,238	6.32%
2. Marine Safety (MS)	2,031	10.37%
3. Aids to Navigation (ATON)	1,745	8.91%
4. Ice Operations (IO)	360	1.84%
5. Marine Environmental Protection (MEP)	4,824	24.62%
6. Living Marine Resources (LMR)	929	4.74%
7. Drug Interdiction	2,261	11.54%
8. Other Law Enforcement (OTH-LE)	135	0.69%
9. Migrant Interdiction	1,398	7.14%
10. Ports, Waterways & Coastal Security (PWCS)	3,970	20.26%
11. Defense Readiness	701	3.58%
Total RDT&E Obligations	\$ 19,592	100%

Note: Includes \$497 thousand recoveries from prior year obligations.

Independent Auditors' Report
Exhibit I – Material Weaknesses in Internal Control – U.S. Coast Guard

I-A Financial Management and Reporting

Background: In fiscal year (FY) 2009, we were engaged to perform an examination of internal controls over financial reporting. The auditors' objective in an examination of internal control is to form an opinion on the effectiveness of internal control. When planning our examination, we gave appropriate emphasis to testing entity-level controls, such as management's risk assessment and monitoring processes, and other control environment elements that exist throughout the Department of Homeland Security (DHS or Department). Four Department-wide control environment conditions were identified through our examination procedures that have a pervasive influence on the control environment and effectiveness of control activities at the United States Coast Guard (Coast Guard). This Exhibit should be read in conjunction with the Department-wide conditions and recommendations described in Comment II-A, *Financial Management and Reporting*.

In previous years, we reported that the Coast Guard had several internal control deficiencies that led to a material weakness in financial reporting. In response, the Coast Guard developed its *Financial Strategy for Transformation and Audit Readiness* (FSTAR), which is a comprehensive plan to identify and correct conditions that are causing control deficiencies, which in some cases prevent the Coast Guard from preparing auditable financial statements. The Coast Guard did make progress in FY 2009 by completing its planned corrective actions over pension liabilities, allowing management to make assertions on completeness and accuracy on more than \$25 billion of accrued liabilities, which represents more than 50 percent of DHS' total liabilities. In addition, the Coast Guard sustained financial reporting assertions attained in the previous fiscal year over investments representing more than \$3 billion or the majority of the Department's balance for this line item, while also sustaining financial reporting assertions for contingent legal liabilities and *Federal Employees' Compensation Act* (FECA)-related line items. The FSTAR calls for substantially more activity in FY 2010; consequently, many of the financial reporting deficiencies we reported in the past remain uncorrected at September 30, 2009.

Conditions:

1. In FY 2009, we identified certain entity-level control weaknesses that may interfere with the timely completion of corrective actions planned for FY 2010 and beyond. The Coast Guard:
 - Does not have sufficient financial management personnel to identify and address control weaknesses, and to develop and implement effective policies, procedures, and internal controls to ensure that data supporting financial statement assertions are complete and accurate, and that transactions are accounted for consistent with GAAP;
 - Has not fully implemented an on-going Coast Guard-wide risk assessment by financial, IT, and program personnel;
 - Has not developed and/or fully implemented information and communication processes and controls relevant to financial reporting; and
 - Has not fully implemented adequate monitoring controls over headquarters, areas/districts, and units with significant financial activity.
2. Does not have properly designed, implemented, and effective policies, procedures, processes, and controls surrounding its financial reporting process, as necessary to:
 - Support beginning balances, year-end close-out, and the cumulative results of operations analysis in its general ledgers individually and/or in the aggregate;
 - Ensure that transactions and accounting events at Coast Guard headquarters, areas/districts, and units are appropriately supported and accounted for in its general ledgers;
 - Ensure financial statement disclosures submitted for incorporation in the DHS financial statements are accurate and complete;

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- Ascertain that intragovernmental activities and balances are identified and differences, especially with agencies outside DHS, are being resolved in a timely manner in coordination with the Department's Office of Financial Management (OFM);

Cause/Effect: The Coast Guard has not developed and implemented an effective general ledger system. The Core Accounting System (CAS), Aircraft Logistics Management Information System (ALMIS), and Naval Engineering Supply Support System (NESSS) general ledgers do not comply with the requirements of the *Federal Financial Management Improvement Act of 1996* (FFMIA). The general ledgers do not allow for compliance with the United States Standard General Ledger (USSGL) at the transaction level, and period-end and opening balances are not supported by transactional detail in the three general ledgers. The conditions described below in Comment I-B, *Information Technology Controls and Financial System Functionality* contribute to the financial reporting control deficiencies, and make correction more difficult. In addition, the Coast Guard was unable to provide reasonable assurance that internal controls over financial reporting are operating effectively and has acknowledged that pervasive material weaknesses exist in key financial processes. Consequently, the Coast Guard can not be reasonably certain that its financial statements are reliable, or assert to the completeness, existence, accuracy, valuation, rights and obligations, or presentation of their financial data related to their balances of fund balance with Treasury, accounts receivable, inventory and related property, general property, plant, and equipment, including heritage assets and stewardship land, actuarially-derived liabilities, environmental and other liabilities, and net position as reported in the Department's balance sheets as of September 30, 2009 and 2008.

Criteria: FFMIA Section 803(a) requires that Federal financial management systems substantially comply with (1) applicable Federal accounting standards, (2) Federal financial management system requirements, and (3) the USSGL at the transaction level. FFMIA emphasizes the need for agencies to have systems that can generate timely, reliable, and useful information with which to make informed decisions to ensure ongoing accountability.

The *Federal Managers' Financial Integrity Act of 1982* (FMFIA) requires that agencies establish internal controls according to standards prescribed by the Comptroller General. These standards are specified in the Government Accountability Office's (GAO) *Standards for Internal Control in the Federal Government (Standards)*. These standards define internal control as an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.

The GAO *Standards* require that internal controls be documented in management directives, administrative policies or operating manuals; transactions and other significant events be clearly documented; and information be recorded and communicated timely with those who need it within a timeframe that enables them to carry out their internal control procedures and other responsibilities. The GAO *Standards* also identify the control environment as one of the five key elements of control, which emphasizes the importance of conscientiousness in management's operating philosophy and commitment to internal control. These standards cover controls such as human capital practices, supervisory reviews, policies, procedures, monitoring, and segregation of duties.

The *Treasury Federal Intragovernmental Transactions Accounting Policies Guide*, dated August 6, 2009, and OMB Circular No. A-136, *Financial Reporting Requirements*, as revised, require Federal CFO Act and non-CFO Act entities identified in the Treasury Financial Manual (TFM) 2009, Vol. I, Part 2, Chapter 4700, *Agency Reporting Requirements for the Financial Report of the United States Government*, to perform quarterly reconciliations of intragovernmental activity/balances. TFM, Section 4706, *Intragovernmental Requirements*, provides guidance on OMB Circular No. A-136 requirements for reporting agencies to reconcile and confirm intragovernmental activity and balances quarterly for specific reciprocal groupings. TFM Bulletin 2007-03, *Intragovernmental Business Rules*, also provides standardized guidance to Federal agencies for reconciling and recording intragovernmental activities.

Recommendations: We recommend that the Coast Guard:

1. Continue the implementation of the FSTAR as planned;

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2. Conduct a human resource needs assessment and financial organizational assessment to identify gaps in skill sets, hire or realign personnel to fill the gaps, and assign personnel with responsibilities that best match their expertise, and consider updating the financial organizational structure based on the human resources needs assessment;
3. Improve entity-level controls by fully implementing a formal risk assessment process, evaluating and updating processes used to communicate policies and ensure that all transactions are recorded completely and accurately, and improve monitor controls over financial data supporting the general ledger and financial statements;
4. Implement accounting and financial reporting processes including an integrated general ledger system that is FFMA compliant; and
5. Establish new or improve existing policies, procedures, and related internal controls to ensure that:
 - a. The year-end close-out process, reconciliations, and financial data and account analysis procedures are supported by documentation, including evidence of effective management review and approval, and beginning balances in the following year are determined to be reliable and auditable;
 - b. All accounting transactions and balances are properly reflected in the financial statements consistent with GAAP;
 - c. Financial statement disclosures submitted for incorporation in the DHS financial statements are accurate and complete; and
 - d. All intragovernmental activity and balances are accurately reflected in the financial statements, and differences are resolved in a timely manner in coordination with the Department's OFM.

I-B Information Technology Controls and Financial System Functionality

Background: Information Technology (IT) general and application controls are essential for achieving effective and reliable reporting of financial and performance data. IT general controls (ITGC) are tested using the objectives defined by the GAO's *Federal Information System Controls Audit Manual (FISCAM)*, in five key control areas: security management, access control, configuration management, segregation of duties, and business continuity. Our procedures included a review of the Coast Guard's key ITGC environments.

We also considered the effects of financial systems functionality when testing internal controls since key Coast Guard financial systems are not compliant with FFMA and are no longer supported by the original software provider. Functionality limitations add to the challenge of addressing systemic internal control weaknesses, and strengthening the control environment at the Coast Guard.

In FY 2009, our IT audit work identified 20 IT findings, of which 11 were repeat findings from the prior year and 9 were new findings. In addition, we determined that the Coast Guard remediated 9 IT findings identified in previous years. Specifically, the Coast Guard took actions to improve aspects of its ITGC by strengthening access controls around key programs and data, and in its entity-wide security program.

Conditions: Our findings related to IT controls and financial system functionality are as follows:

Related to IT Controls:

Condition: We noted that the Coast Guard's core financial system configuration management process controls are not operating effectively and continue to present risks to DHS financial data confidentiality, integrity, and availability. Financial data in the general ledger may be compromised by automated and manual changes that are not adequately controlled. For example, the Coast Guard uses an IT scripting process to make updates to its core general ledger software as necessary to process financial data. However, the Coast Guard has not (a) fully developed testing standards to guide staff in the development and functional testing of IT scripts, (b) documented policies and procedures over testing plans that must be performed, and (c) ensured that all necessary approvals are obtained prior to implementation.

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All of our ITGC findings are described in detail in a separate *Limited Official Use* (LOU) letter provided to the Coast Guard and DHS management.

Related to financial system functionality:

We noted that financial system functionality limitations are contributing to control deficiencies reported elsewhere in Exhibit I, are inhibiting progress on corrective actions for the Coast Guard, and preventing the Coast Guard from improving the efficiency and reliability of its financial reporting processes. Some of the financial system limitations lead to extensive manual and redundant procedures to process transactions, verify accuracy of data, and to prepare financial statements. Systemic conditions related to financial system functionality include:

1. As noted above, the Coast Guard's core financial system configuration management process is not operating effectively due to inadequate controls over IT scripts. The IT script process was instituted as a solution primarily to compensate for system functionality and data quality issues;
2. Annual financial system account recertifications are not being performed due to limitations;
3. Financial system audit logs are not readily generated and reviewed, as some of the financial systems are lacking this capability;
4. Aspects of DHS-required system password requirements are not implemented because some financial systems cannot support the policy;
5. Production versions of operational financial systems are outdated, no longer supported by the vendor, and do not provide the necessary core functional capabilities (e.g., general ledger capabilities);
6. Financial systems functionality limitations are preventing the Coast Guard from establishing automated processes and application controls that would improve accuracy, reliability and facilitate efficient processing of certain financial data, such as:
 - Tracking of costs to support weighted average pricing for operating materials and supplies;
 - Maintaining data needed to support the calculation of accounting payable and provide detailed listings of accounts payable, which may reduce the resources spent by Coast Guard personnel in manually preparing the accounts payable accrual;
 - Ensuring proper segregation of duties such as automating the procurement process to ensure that only individuals who have proper contract authority can approve transactions;
 - Tracking detail transactions associated with intragovernmental business and eliminate the need for default codes such as Trading Partner Identification Number that cannot be easily researched; and
 - Ensuring that undelivered obligations are properly accounted for upon receipt of goods or services.

Cause/Effect: The IT system development activities did not incorporate adequate security controls during the initial implementation more than six years ago. The current IT configurations of many Coast Guard financial systems cannot be easily reconfigured to meet new DHS security requirements. The existence of these IT weaknesses leads to added dependency on other mitigating manual controls to be operating effectively at all times. Because mitigating controls often require more human involvement, there is an increased risk that human error could materially affect the financial statements. In addition, the Coast Guard's core financial systems are not FFMA compliant with the Federal Government's Financial System Integration Office (FSIO) requirements. See Comment I-A, *Financial Management and Reporting*, for a discussion of the related conditions causing significant noncompliance with the requirements of FFMA. Configuration management weaknesses are also among the principle causes of the Coast Guard's inability to support its financial statement balances for audit purposes.

Criteria: The *Federal Information Security Management Act* (FISMA), passed as part of the *E-Gov Act of 2002*, mandates that Federal entities maintain IT security programs in accordance with standards prescribed by the Secretary of Commerce.

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OMB Circular No. A-130, *Management of Federal Information Resources*, describes specific essential criteria for maintaining effective general IT controls.

FFMIA sets forth legislation prescribing policies and standards for Executive departments and agencies to follow in developing, operating, evaluating, and reporting on financial management systems. The purposes of FFMIA are to (1) provide for consistency of accounting by an agency from one fiscal year to the next, and uniform accounting standards throughout the Federal Government, (2) require Federal financial management systems to support full disclosure of Federal financial data, including the full costs of Federal programs and activities, (3) increase the accountability and credibility of federal financial management, (4) improve performance, productivity, and efficiency of Federal Government financial management, and (5) establish financial management systems to support controlling the cost of Federal Government.

OMB Circular No. A-123, *Management's Responsibility for Internal Control*, states, "Agency managers should continuously monitor and improve the effectiveness of internal control associated with their programs. This continuous monitoring, and other periodic evaluations, should provide the basis for the agency head's annual assessment of and report on internal control, as required by FFMIA." This Circular indicates that "control weaknesses at a service organization could have a material impact on the controls of the customer organization. Therefore, management of cross-servicing agencies will need to provide an annual assurance statement to its customer agencies in advance to allow its customer agencies to rely upon that assurance statement. Management of cross-servicing agencies shall test the controls over the activities for which it performs for others on a yearly basis. These controls shall be highlighted in management's assurance statement that is provided to its customers. Cross-servicing and customer agencies will need to coordinate the timing of the assurance statements."

DHS' *Sensitive Systems Policy Directive, 4300A*, as well as the DHS' *Sensitive Systems Handbook* documents policies and procedures adopted by DHS intended to improve the security and operation of all DHS IT systems including the Coast Guard IT systems.

Recommendations: We recommend that the DHS Office of Chief Information Officer, in coordination with the Office of the Chief Financial Officer (OCFO), implement the recommendations in our LOU letter provided to the Coast Guard and DHS management. In that letter, we provide more detailed recommendations to effectively address the deficiencies identified in the configuration management process.

I-C Fund Balance with Treasury

Background: Fund Balance with Treasury (FBWT) at the Coast Guard totaled approximately \$5.5 billion, or approximately 9.7 percent of total DHS FBWT, at September 30, 2009. The majority of these funds represented appropriated amounts that were obligated, but not yet disbursed, as of September 30, 2009. In FY 2008, we reported a material weakness in internal control over FBWT at the Coast Guard. In FY 2009, the Coast Guard corrected some FBWT control deficiencies and revised its remediation plan to include additional corrective actions that are scheduled to occur after FY 2009. Consequently, most of the conditions stated below are repeated from our FY 2008 report.

Conditions: The Coast Guard has not developed a comprehensive process, to include effective internal controls, to ensure that all FBWT transactions are recorded in the general ledger timely, completely, and accurately. For example, the Coast Guard:

- Did not properly design FBWT monthly activity reconciliations and/or could not provide detail transaction lists for amounts reported to Treasury for at least three of the six Coast Guard Agency Location Codes;
- Recorded adjustments to the general ledger FBWT accounts or activity reports submitted to Treasury, including adjustments to agree Coast Guard balances to Treasury amounts, that were unsupported;
- Does not have an effective process for clearing suspense account transactions related to FBWT due to over-reliance on vendor-provided data. The Coast Guard lacks documented and effective policies and procedures and internal controls necessary to support the completeness, existence, and

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accuracy of suspense account transactions. In addition, certain issues persist with industrial service orders (ISOs) and credit cards that preclude a complete and accurate population of suspense detail; and

- Was unable to provide military payroll data to support the summary payroll transactions processed through the Coast Guard's FBWT. In addition, the Coast Guard lacked formal policies and procedures for processing and documenting all military and civilian payroll transactions.

Cause/Effect: The Coast Guard had not designed and implemented accounting processes, including a financial system that complies with federal financial system requirements, as defined in OMB Circular No. A-127, *Financial Management Systems*, and the requirements of the *Joint Financial Management Improvement Program (JFMIP)*, now administered by the FSIO, to fully support the FY 2009 FBWT activity and balance as of September 30, 2009. Failure to implement timely and effective reconciliation processes could increase the risk of undetected errors and/or violations of appropriation laws, including instances of undiscovered *Anti-deficiency Act* violations or fraud, abuse, and mismanagement of funds, which could lead to inaccurate financial reporting and affect DHS' ability to effectively monitor its budget status.

Criteria: Statement of Federal Financial Accounting Standards (SFFAS) No. 1, *Accounting for Selected Assets and Liabilities*, paragraph 39 states, "Federal entities should explain any discrepancies between fund balance with Treasury in their general ledger accounts and the balance in the Treasury's accounts and explain the causes of the discrepancies in footnotes to financial statements. (Discrepancies due to time lag should be reconciled and discrepancies due to error should be corrected when financial reports are prepared). Agencies also should provide information on unused funds in expired appropriations that are returned to Treasury at the end of a fiscal year."

Per Fund Balance with Treasury Reconciliation Procedures, a Supplement to I FFM 2-5100, Section V, "Federal agencies must reconcile their SGL 1010 account and any related subaccounts [...] on a monthly basis (at minimum). [...] Federal agencies must [...] resolve all differences between the balances reported on their G/L FBWT accounts and balances reported on the FMS 6653, 6654 and 6655 [now the *Government-wide Accounting system (GWA)*]." In addition, "An agency may not arbitrarily adjust its FBWT account. Only after clearly establishing the causes of errors and properly documenting those errors, should an agency adjust its FBWT account balance. If an agency must make material adjustments, the agency must maintain supporting documentation. This will allow correct interpretation of the error and its corresponding adjustment."

Section 803(a) of FFMIA requires that Federal financial management systems comply with (1) applicable Federal accounting standards, (2) Federal financial management system requirements, and (3) the USSGL at the transaction level. FFMIA emphasizes the need for agencies to have systems that can generate timely, reliable, and useful information with which to make informed decisions to ensure ongoing accountability.

The GAO *Standards* hold that transactions should be properly authorized, documented, and recorded accurately and timely.

Recommendations: We recommend that the Coast Guard establish policies, procedures, and internal controls to ensure that FBWT transactions are recorded accurately and completely, and in a timely manner, and that all supporting documentation is maintained for all recorded transactions. These policies and procedures should allow the Coast Guard to:

1. Perform complete and timely FBWT reconciliations using the Treasury Government-wide Accounting tools;
2. Better manage its suspense accounts to include researching and clearing items carried in suspense clearing accounts in a timely manner during the year, and maintaining proper supporting documentation in clearing suspense activity; and
3. Maintain payroll data supporting payroll transactions processed through FBWT and have access to complete documentation, if needed.

I-D Property, Plant, and Equipment and Operating Materials and Supplies

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Background: The Coast Guard maintains approximately 52 percent of all DHS property, plant, and equipment (PP&E), including a large fleet of boats and vessels. Many of the Coast Guard's assets are constructed over a multi-year period, have long useful lives, and undergo extensive routine servicing that may increase their value or extend their useful lives. In FY 2009, the Coast Guard continued to revise corrective action plans as documented in FSTAR to address the PP&E process and control deficiencies, and execute remediation efforts. However, many of the FSTAR procedures are scheduled to occur over a multi-year timeframe. Consequently, many of the conditions cited below have been repeated from our FY 2008 report.

Operating Materials and Supplies (OM&S) are maintained by the Coast Guard in significant quantities and consist of tangible personal property to be consumed in normal operations to service marine equipment, aircraft, and other operating equipment. The majority of the Coast Guard's OM&S is physically located at either two Inventory Control Points (ICPs) or in the field. The Coast Guard's policy requires regularly scheduled physical counts of OM&S, which are important to the proper valuation of OM&S and its safekeeping. The conditions cited below for OM&S have been repeated from our FY 2008 report.

DHS' Stewardship PP&E consists of heritage assets, which are PP&E that are unique due to historical or natural significance; cultural, educational, or artistic (e.g., aesthetic) importance; or architectural characteristics. The majority of DHS' stewardship PP&E is maintained by the Coast Guard, and consists of both collection type heritage assets, such as artwork and display models, and non-collection-type heritage assets, such as lighthouses, sunken vessels, and buildings.

Conditions: The Coast Guard has not:

Regarding PP&E:

- Established its opening PP&E balances necessary to prepare a balance sheet as of September 30, 2009. In cases where original acquisition documentation has not been maintained, the Coast Guard has not developed and documented methodologies and assumptions to support the value of PP&E;
- Implemented appropriate controls and related processes to accurately, consistently, and timely record additions to PP&E and construction in process (CIP), transfers from other agencies, disposals in its fixed asset system, and valuation and classification of repairable PP&E;
- Implemented accurate and complete asset identification, system mapping, and tagging processes that include sufficient detail, e.g., serial number, to clearly differentiate and accurately track physical assets to those recorded in the fixed asset system; and
- Properly accounted for some improvements and impairments to buildings and structures, capital leases, and selected useful lives for depreciation purposes, consistent with GAAP.

Regarding OM&S:

- Implemented policies, procedures, and internal controls to support the completeness, accuracy, existence, valuation, and presentation assertions related to the FY 2009 OM&S and related account balances;
- Fully designed and implemented policies, procedures, and internal controls over physical counts of OM&S at field units to remediate conditions identified in previous years; and
- Established processes and controls to fully support the calculated value of certain types of OM&S to approximate historical cost.

Regarding stewardship PP&E:

- Fully designed and implemented policies, procedures, and internal controls to support the completeness, existence, accuracy, and presentation assertions over data utilized in developing required financial statement disclosures and related supplementary information for Stewardship PP&E.

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Cause Effect: The Coast Guard has had difficulty establishing its opening PP&E balances primarily because of poorly designed policies, procedures and processes implemented more than a decade ago, combined with ineffective internal controls. PP&E was not properly tracked or accounted for many years preceding the Coast Guard's transfer to DHS in 2003, and now the Coast Guard is faced with a formidable challenge of performing retroactive analysis in order to properly establish the existence, completeness, and accuracy of PP&E. Furthermore, the fixed asset module of the Coast Guard's CAS is not updated timely for effective tracking and reporting of PP&E on an ongoing basis. As a result, the Coast Guard is unable to accurately account for its PP&E, and provide necessary information to DHS OFM for consolidated financial statement purposes.

Coast Guard management deferred correction of most OM&S weaknesses reported in previous years, and acknowledged that the conditions we reported in prior years remained throughout FY 2009. Lack of comprehensive and effective policies and controls over the performance of physical counts, and appropriate support for valuation, may result in errors in the physical inventory process or inventory discrepancies that could result in financial statement misstatements.

The Coast Guard did not consider the new stewardship property reporting standards until late in the year, and did not have sufficient time to design and implement procedures to accumulate data needed for financial reporting purposes before the completion of the FY 2009 DHS AFR.

Criteria: SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, provides the general requirements for recording and depreciating property, plant and equipment. SFFAS No. 6 was recently amended by SFFAS No. 35, which clarifies that "reasonable estimates of original transaction data historical cost may be used to value general PP&E [...] Reasonable estimates may be used upon initial capitalization as entities implement general PP&E accounting for the first time, as well as by those entities who previously implemented general PP&E accounting."

The Federal Accounting Standards Advisory Board (FASAB)'s Federal Financial Accounting Standards Interpretation No. 7, dated March 16, 2007, defines "items held for remanufacture" as items "in the process of (or awaiting) inspection, disassembly, evaluation, cleaning, rebuilding, refurbishing and/or restoration to serviceable or technologically updated/upgraded condition. Items held for remanufacture may consist of: Direct materials, (including repairable parts or subassemblies [...]) and Work-in-process (including labor costs) related to the process of major overhaul, where products are restored to 'good-as-new' condition and/or improved/upgraded condition. 'Items held for remanufacture' share characteristics with 'items held for repair' and items in the process of production and may be aggregated with either class. Management should use judgment to determine a reasonable, consistent, and cost-effective manner to classify processes as 'repair' or 'remanufacture'."

SFFAS No. 29, *Heritage Assets and Stewardship Land*, provides the requirements for the presentation and disclosure of heritage assets. In summary, this standard requires that heritage assets and stewardship land information be disclosed as basic information in the notes to the financial statements, except for condition information, which is reported as required supplementary information (RSI).

FFMIA Section 803(a) requires each agency to implement and maintain a system that complies substantially with Federal financial management system requirements. OMB Circular No. A-127 prescribes the standards for federal agencies' financial management systems. That Circular requires an agency's system design to have certain characteristics that include consistent "internal controls over data entry, transaction processing, and reporting throughout the system to ensure the validity of information and protection of Federal Government resources."

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

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Recommendations: We recommend that the Coast Guard:

Regarding PP&E:

1. Adopt the provisions of SFAS No. 35, which provides alternatives to the Coast Guard to value general property, plant, and equipment to establish its opening balances for balance sheet presentation;
2. Implement appropriate controls and related processes to accurately and timely record additions to PP&E and CIP, transfers from other agencies, improvements, impairments, capital leases, depreciable lives, disposals in its fixed asset system, and valuation and classification of repairable PP&E;
3. Ensure that appropriate supporting documentation is maintained and readily available for audit; and
4. Implement processes and controls to record an identifying number in the fixed asset system at the time of asset purchase to facilitate identification and tracking; and ensure that the status of assets is accurately tracked in the subsidiary ledger.

Regarding OM&S:

5. Update OM&S physical count policies, procedures, and controls, and provide training to personnel responsible for conducting physical inventories at field units, and include key elements of an effective physical inventory in the policies;
6. Consider adopting an inventory control system for OM&S as a method of tracking usage and maintaining a perpetual inventory of OM&S on hand; and
7. Establish processes and controls to support the calculated value of OM&S to ensure accounting is consistent with GAAP.

Regarding stewardship PP&E:

8. Design and implement policies, procedures, and internal controls to support the completeness, existence, accuracy, and presentation and disclosure assertions related to the data utilized in developing disclosure and related supplementary information for Stewardship PP&E that is consistent with GAAP.

I-E Actuarial and Other Liabilities

Background: The Coast Guard maintains medical and post-employment travel benefit programs that require actuarial computations to record related liabilities for financial reporting purposes. The Military Retirement System (MRS) is a defined benefit plan that covers both retirement pay and health care benefits for all active duty and reserve military members of the Coast Guard. The medical plan covers active duty, reservists, retirees/survivors, and their dependents that are provided care at Department of Defense (DoD) medical facilities. The post-employment travel benefit program pays the cost of transportation for uniformed service members upon separation from the Coast Guard. Annually, participant and cost data is extracted by the Coast Guard from its records and provided to an actuarial firm as input for the liability calculations. The accuracy of the actuarial liability as reported in the financial statements is dependent on the accuracy and completeness of the underlying participant and cost data provided to the actuary as well as the reasonableness of the assumptions used.

The Coast Guard estimates accounts payable by adjusting the prior year revised accounts payable accrual estimate by the percentage change in budgetary authority for the current fiscal year. The revised prior year estimate is calculated by analyzing actual payments made subsequent to September 30 of the prior year to determine a range within which the accrual should fall, and using the mid-point of that range. The calculation is based on the results of a statistical sample of subsequent disbursements and actual or average amounts paid.

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

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Conditions: We noted the following internal control weaknesses related to actuarial and other liabilities. The Coast Guard has not:

Regarding medical and post-employment benefits:

- Implemented effective policies, procedures, and controls to ensure the completeness and accuracy of medical cost data and post-employment travel claims provided to, and used by, the actuary for the calculation of the medical and post-employment benefit liabilities. Reconciliations between subsidiary and general ledger amounts for medical expenditures are not effective;
- Implemented controls to prevent overpayments for medical services; and
- Implemented effective processes to account for military personnel data changes, including changes in leave balances and payroll corrections, in the appropriate reporting periods, and consequently the completeness and accuracy of leave and payroll accruals as well as data used for actuarial projections is not always reliable;

Regarding accounts payable estimates:

- Validated its methodology used to estimate accounts payable, e.g., the reliability of data, assumptions, and criteria used to calculate and subsequently validate the estimate for financial reporting;

Regarding environmental liabilities:

- Fully supported the completeness, existence, and accuracy assertions of the data utilized in developing the estimate for the FY 2009 environmental liability account balance; and
- Fully developed, documented, and implemented the policies and procedures in developing, preparing, and recording the environmental liability estimates related to shore facilities, and has not approved policies and procedures for the review of the environmental liability estimate related to vessels.

Cause/Effect: Much of the data required by the actuary comes from personnel and payroll systems that are outside of the Coast Guard's accounting organization and are managed by the Coast Guard's Pay and Personnel Center (PPC). Inaccurate medical costs submitted to the Coast Guard actuary could result in a misstatement of the actuarial medical liability and related expenses.

The Coast Guard has not yet developed comprehensive policies and procedures or corrective action plans to address the conditions above, and consequently, management is unable to assert to the accuracy and completeness of the accounts payable and payroll accruals recorded as of September 30, 2009.

Criteria: According to SFAS No. 5, *Accounting for Liabilities of the Federal Government*, Other Retirement Benefits (ORB) include all retirement benefits other than pension plan benefits. The ORB liability should be reported using the aggregate entry-age normal actuarial cost method. The liability is the actuarial present value of all future benefits less the actuarial present value of future normal cost contributions that would be made for and by the employees of under the plan.

According to SFAS No. 5, paragraph 95, the employer should recognize an expense and a liability for other post-employment benefits (OPEB) when a future outflow or other sacrifice of resources is probable and measurable on the basis of events occurring on or before the reporting date. Further, the long-term OPEB liability should be measured at the present value of future payments, which requires the employer to estimate the amount and timing of future payments, and to discount the future outflow over the period for which the payments are to be made.

The GAO *Standards* states that transactions should be properly authorized, documented, and recorded accurately and timely. SFAS No. 1 states, "When an entity accepts title to goods, whether the goods are delivered or in transit, the entity should recognize a liability for the unpaid amount of the goods. If invoices for those goods are not available when financial statements are prepared, the amounts owed should be estimated."

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

Recommendations: We recommend that the Coast Guard:

Regarding actuarial liabilities:

1. Implement effective policies, procedures, and controls to ensure the completeness and accuracy of medical cost data and post-employment travel claims provided to, and used by, the actuary for the calculation of the medical and post-employment benefit liabilities;
2. Perform a periodic reconciliation between the medical expenditures recorded in the subsidiary ledger and those recorded in the CAS, and address differences before data is provided to the actuary. This reconciliation should be performed for all significant sources of medical actuarial data, including TriCare and DoD Military Treatment Facilities (MTFs). In addition, this reconciliation should be reviewed by someone other than the preparer to ensure accuracy; and
3. Implement effective processes to account for military personnel data changes, including changes in leave balances and payroll corrections, and to ensure that updates are recorded in the proper accounting period;

Regarding accounts payable:

4. Analyze and make appropriate improvements to the methodology used to estimate accounts payable and support all assumptions and criteria with appropriate documentation to develop and subsequently validate the estimate for financial reporting;

Regarding environmental liabilities:

5. Develop and implement policies, procedures, processes, and controls to ensure identification of and recording of all environmental liabilities, define the technical approach, cost estimation methodology, and overall financial management oversight of its environmental remediation projects. Consider the "Due Care" requirements defined in FASAB Technical Release No. 2. The policies should include:
 - a. Procedures to ensure the proper calculation and review of cost estimates for consistency and accuracy in financial reporting, including the use of tested modeling techniques, use of verified cost parameters, and assumptions;
 - b. Periodically validate estimates against historical costs; and
 - c. Ensure that detailed cost data is maintained and reconciled to the general ledger.

I-F Budgetary Accounting

Background: Budgetary accounts are a category of general ledger accounts where transactions related to the receipt, obligation, and disbursement of appropriations and other authorities to obligate and spend agency resources are recorded. Each Treasury Account Fund Symbol (TAFS) with separate budgetary accounts must be maintained in accordance with OMB and Treasury guidance. The Coast Guard has over 90 TAFS covering a broad spectrum of budget authority, including annual, multi-year, and no-year appropriations; and several revolving, special, and trust funds.

Conditions: We noted the following internal control weaknesses related to budgetary accounting, many of which were repeated from our FY 2008 report. The Coast Guard has not:

- Fully implemented policies, procedures, and internal controls over the Coast Guard's process for validation and verification of undelivered order (UDO) balances that are operating effectively. Recorded obligations and UDO balances were not always complete, valid, accurate, and proper approvals and supporting documentation are not always maintained;

Independent Auditors' Report
Exhibit I – Material Weaknesses in Internal Control – U.S. Coast Guard

- Finalized and implemented policies and procedures to monitor unobligated commitment activity in CAS throughout the fiscal year. Currently, the Coast Guard performs only a year-end review to reverse commitments that are now longer valid;
- Designed and implemented effective procedures, processes, and internal controls to verify the completeness and accuracy of the year-end obligation "pipeline", which are obligations executed on or before September 30 but not recorded in the Coast Guard's CAS, and to record all executed obligations. These deficiencies affected the completeness, existence, and accuracy of the year-end "pipeline" adjustment that was made to record obligations executed before year end; and
- Established adequate internal controls to ensure that procurement transactions are processed only by individuals who have the appropriate warrant authority, e.g., those with expired warrant authority are unable to process transactions.

Cause/Effect: Several of the Coast Guard's budgetary control weaknesses can be corrected by modifications or improvements to the financial accounting system, process improvements, and strengthened policies and internal controls. Weak controls in budgetary accounting, and associated contracting practices increase the risk that the Coast Guard could violate the *Anti-deficiency Act* and overspend its budget authority. The financial statements are also at greater risk of misstatement. Reliable accounting processes surrounding obligations, UDOs, and disbursements are key to the accurate reporting of accounts payable in the DHS consolidated financial statements. The untimely release of commitments may prevent funds from being used timely for other purposes.

Criteria: According to the Office of Federal Financial Management's *Core Financial System Requirements*, dated January 2006, an agency's core financial management system must ensure that an agency does not obligate or disburse funds in excess of those appropriated or authorized, and "the Budgetary Resource Management Function must support agency policies on internal funds allocation methods and controls." The *Federal Acquisition Regulation (FAR)* Section 1.602 addresses the authorities and responsibilities granted to contracting officers. Treasury's USSGL guidance at TFM S2 09-02 (dated August 2009) specifies the accounting entries related to budgetary transactions.

FFMIA Section 803(a) requires that each Agency implement and maintain a system that complies substantially with Federal financial management system requirements. OMB Circular No. A-127 sets forth the standards for federal financial management systems.

Recommendations: We recommend that the Coast Guard:

1. Improve policies, procedures, and the design and effectiveness of controls related to processing obligation transactions, including periodic review and validation of UDOs. Emphasize to all fund managers the need to perform effective reviews of open obligations, obtain proper approvals, and retain supporting documentation;
2. Finalize policies and procedures to periodically review commitments, and make appropriate adjustments in the financial system;
3. Improve procedures, processes, and internal controls to verify the completeness and accuracy of the year-end obligation "pipeline" adjustment to record all executed obligations for financial reporting; and
4. Establish automated system controls to ensure that procurement transactions can be processed only by those with appropriate/valid warrant authority.

Dear Secretary Napolitano:

In accordance with your delegation of responsibilities to me, I have directed an evaluation of the internal control at the United States Coast Guard in effect during the fiscal year ended September 30, 2009. This evaluation was conducted in accordance with OMB Circular No. A-123, *Management's Responsibility for Internal Control*, Revised December 21, 2004. Based on the results of this evaluation, the United States Coast Guard provides the following assurance statements.

Reporting Pursuant to FMFIA Section 2. 31 U.S.C.3512 (d)(2)

The United States Coast Guard provides reasonable assurance that internal controls are achieving their intended objectives, with the exception of the following material weaknesses:

- **Compliance with Laws and Regulations**

As previously reported in my 2008 Assurance Statement, USCG identified a prior year (2007 and earlier) Anti-Deficiency Act (ADA) issue. During the past year, we have closely collaborated with the Department and adhered to DHS policy with regards to resolving this issue. Actions taken to improve the policy and internal controls in this area should prevent a recurrence. In addition, the USCG is developing enterprise-wide policies and procedures for assessing risk, testing effectiveness of controls and monitoring to more fully align with the Department's internal control program.

- **Internal Controls over Financial Reporting as detailed under the DHS FAA below**

Resolution of Prior Year Reportable Condition - Deepwater

During FY08, multiple control deficiencies were noted for the Deepwater program, which resulted in a reportable condition. Over the course of FY09, significant remediation efforts have resolved the major deficiencies identified in external audits and reports so that Deepwater is no longer identified as a reportable condition.

Reporting Pursuant to the DHS Financial Accountability Act. P.L. 108-330

The scope of the United States Coast Guard's Fiscal Year 2009 assessment of internal control over financial reporting was limited to performing tests of design and test of operational effectiveness over the following processes that generate balance sheet and statement of custodial activity accounts:

- Federal Employment Compensation Act
- Contingent Legal Liabilities
- Investments

These tests identified multiple successful controls with limited remaining control deficiencies for each sub-process, and resulted in the assessment of these sub-processes at the reportable condition level as detailed in the General Ledger Management section, below.

As in the prior year, the United States Coast Guard is unable to provide reasonable assurance that internal control over financial reporting is operating effectively. Management implemented remediation plans in accordance with the ICOFR Playbook for FY 2009 and is updating Mission Action Plans to aggressively remediate remaining key deficiencies. These plans will be published in the Fiscal Year 2010 update to the Coast Guard Financial Strategy for Transformation and Audit Readiness. The following material weaknesses have been identified:

- **Entity Level Controls (ELC):** In 2009, the USCG conducted an assessment of internal controls at the entity level using the Government Accountability Office (GAO) Internal Control Management and Evaluation Tool. Deficiencies were identified in the following areas: risk assessment; insufficient monitoring/review; and limited documented policies and procedures. Ongoing remediation efforts, including the proposed establishment of a Coast Guard Comptroller, will address remaining ELC deficiencies.
- **Fund Balance with Treasury:** The USCG is unable to fully reconcile its FBWT accounts. USCG cannot produce complete and accurate populations of suspense account transactions, nor distinguish posting from clearing transactions in suspense.
- **Human Resources & Payroll:** Although we have established compensating controls that will enable us to reconcile military payroll, the Joint Uniform Military Payroll System (JUMPS) does not directly provide the required accounting information to reconcile Treasury, payroll and general ledger details. The Post Retirement Benefits sub-process has a lack of controls which are being addressed and corrective actions are in process to ensure data integrity for the actuarial liability.
- **Property Management:** Documented policies and procedures related to property management sub-processes and related systems are being developed during this reporting period. Ongoing remediation efforts include developing adequate controls in Construction-in-Progress, Operating Material and Supplies, Personal and Real property. However, significant system limitations and inadequate costing processes remain. Progress with Property Management continues through improved valuation of previously unsubstantiated cost of assets and construction in progress.
- **General Ledger (GL) Management Function: Financial Reporting:** The three primary USCG general ledgers are not fully compliant with the USSGL and contain improper posting logic codes. Limitations of the GL systems, timing issues, and the use of multiple GL systems with different GL accounts, contribute to the inappropriate recording of transactions and a significant number of on-top adjustments at month's end.

The scope of USCG remediation efforts for the following GL sub-processes focused on executing corrective actions to design and implement internal controls. As a result, the following are noted as reportable conditions:

- **Contingent Legal Liabilities**
- **FECA**
- **Investments**
- **Budgetary Resources Management:** The three general ledger systems are not fully compliant with the USSGL at the transaction level. Two of the three do not interface with the Core Accounting System, except for Treasury Information Executive Repository (TIER) reporting at the summary GL level. The primary budgetary resource management system is not designed to manage and maintain complete budgetary accounting data and does not permit the necessary level of funds control, creating the risk of Anti-Deficiency Act violations.
- **Receivables Management:** USCG does not record certain balances in the general ledger in accordance with Generally Accepted Accounting Principles (GAAP) as promulgated by the Federal Accounting Standards Advisory Board (FASAB). In addition to systems limitations, this is due in large part to the lack of policies and procedures in several key sub-process areas related to accounts receivable.
- **Revenue Management:** USCG does not record certain balances in the general ledger in accordance with Generally Accepted Accounting Principles (GAAP) as promulgated by the Federal Accounting Standards Advisory Board (FASAB). There is no documented standard operating

procedure in place to ensure that all reimbursable agreements are closed-out appropriately with all bills and refunds generated as needed.

- **Environmental Liabilities:** USCG has no documented policies and procedures for Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) cases. USCG does not have sufficient support related to Environmental Liabilities resulting in potentially unrecorded and unidentified liabilities.
- **Information Systems:** GAO Tool assessments indicate that internal controls over financial systems are inadequate to detect or prevent material errors in the financial statements. A number of non-conformances are a root cause that will limit the USCG's ability to fully remediate material weaknesses in many financial reporting processes. Accordingly, this condition also represents a material weakness in internal control over financial reporting.

Reporting Pursuant to FMFIA Section 4. 31 U.S.C. 3512 (d)(2)(B)

The United States Coast Guard's financial management systems do not conform with government-wide requirements. The areas of non-conformance listed below were documented. Management is continuing to execute, and update as appropriate, Mission Action Plans to remediate the following:

- **U.S. Standard General Ledger**
The designs of the USCG's financial and mixed systems do not reflect financial information classification structures that are consistent with the U.S. Standard General Ledger and provide for tracking of specific program expenditures.
- **Integration of Financial and Mixed Systems**
The lack of integration of the USCG's financial and mixed systems precludes the use of common data elements to meet reporting requirements, and to collect, store, and retrieve financial information. Similar kinds of transactions are not processed throughout the systems using common processes, which could result in data redundancy and inconsistency.
- **Financial Reporting and Budgets**
The USCG's financial and mixed systems do not allow for financial statements and budgets to be prepared, executed, and reported in accordance with the requirements prescribed by OMB, e.g., OMB Circular A-11, preparation and submission of budget estimates, those prescribed by the U.S. Department of Treasury, and/or the Federal Accounting Standards Advisory Board (FASAB).
- **Laws and regulations**
The USCG's financial and mixed systems do not include a system of internal controls that ensure: resource use and financial reporting are consistent with laws, regulations, and policies; resources are safeguarded against waste, loss, and misuse; reliable data is obtained, maintained, and disclosed in reports; and transactions are processed in accordance with Generally Accepted Accounting Principles (GAAP)
- **System Adaptability**
The USCG does not evaluate how effectively and efficiently the financial and mixed systems support the USCG's changing business practices and make appropriate modifications to its information systems.
- **Risk assessment and security**
The Coast Guard has legacy financial and mixed systems that were developed without the benefit of today's security practice requirements. Because USCG lacks modern security evaluation software, intensive manual intervention is required to ensure proper security controls, oversight and auditing occurs to meet OMB and DHS security policies. Some of the legacy financial and mixed systems

were developed prior to the implementation of some of these regulations and are therefore, not designed to comply with them. Vessel Logistics System (VLS) and Core Accounting System (CAS) Suite are on the OMB high risk list.

- **Documentation and support**

Adequate technical systems documentation, training, and user support is not consistently available to enable the users of all of the financial and mixed systems to understand, maintain, and operate the systems in an effective and efficient manner.

- **Physical and logical controls**

The USCG's financial and mixed systems contain weaknesses in the standardization of physical and logical controls, and segregation of duties.

- **Software Development**

The USCG does not consistently apply a defined software development and change control process to software changes and development efforts for all financial and mixed systems. USCG does not perform complete monitoring of the access to, the use of, nor the control changes to, systems software. Furthermore, CG financial management and mixed systems do not conform to existing applicable functional requirements.

Reporting Pursuant to the Reports Consolidation Act. Section 3516(e)

In FY09, the USCG completed DHS sponsored independent verification and validation (V&V) of GPRA performance measure data. The Waterways Management: Aids to Navigation mission performance measure "5-year average collisions, allisions and groundings" was chosen for review. The review examined policies and procedures in this area and determined that they are adequate. The USCG's performance data used in the Performance and Accountability Report are complete and reliable, except for the following material inadequacy:

- **Financial Reporting:** The USCG does not have documentation and adequate controls to support the process to validate that the full cost by strategic goal, as presented in the notes to the consolidated financial statements, is materially consistent with actual costs incurred.


T. A. Allen
Commandant,
United States Coast Guard

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