

**CONSOLIDATED FINANCIAL
STATEMENTS FOR
FISCAL YEARS 2004 AND 2003**

Department of Transportation

Report Number: FI-2005-009

Date Issued: November 15, 2004



**U.S. Department of
Transportation**

Office of the Secretary
of Transportation
Office of Inspector General

Memorandum

Subject: ACTION: Report on Consolidated Financial
Statements for Fiscal Years 2004 and 2003, DOT
FI-2005-009

Date: November 15, 2004

From: Kenneth M. Mead
Inspector General

Reply to
Attn. of: JA-20

To: The Secretary

I respectfully submit the Office of Inspector General report on the Department of Transportation (DOT) Consolidated Financial Statements for Fiscal Years (FY) 2004 and 2003 (see attachment). This report is required by the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994.

UNQUALIFIED OPINION

This audit report concludes that DOT's Consolidated Financial Statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles. This is the fourth fiscal year in a row—2001, 2002, 2003, and 2004—that DOT has achieved an unqualified or “clean” opinion. The clean audit opinion signals to users of the financial statements that they can rely on the information presented. This occurred as the Department completed its transition to a new, commercial off-the-shelf accounting system, called Delphi. According to DOT officials, DOT is the first cabinet-level agency to have implemented, Department-wide, a modern commercial off-the-shelf accounting system.

The DOT Consolidated Financial Statements for FY 2004 show year-end assets of about \$68 billion, year-end liabilities (debts) of \$13 billion, costs of operations (program costs) of \$54 billion, and total budgetary resources (available financial resources) of \$105 billion. A significant portion of DOT's budgetary resources come from two trust funds, the Highway Trust Fund (HTF) and the Airport and Airway (Aviation) Trust Fund, which are supported by a mixture of passenger,

fuel, and user taxes. Tax collections deposited into those trust funds totaled \$44.4 billion during FY 2004.

On a cautionary note, less revenue than expected has been flowing into the trust funds for several years. The reduction is due to changes in the aviation and highway sectors, including the economic downturn and lower average airfares. At the same time, the costs of building, operating, and maintaining the systems have continued to increase. Historically, shortfalls have been subsidized by the U.S. Treasury's General Fund, but with the significant Federal deficit, this option may prove increasingly difficult in the future.

The Department made progress correcting the internal control deficiencies we reported last year. The Department made sufficient progress correcting two of the material weaknesses—the Department's information security program and FAA's oversight of cost-reimbursable contracts—that we are not reporting them as material weaknesses this year.

FAA deserves credit for addressing significant challenges this year. FAA encountered difficulties when it implemented DOT's Delphi accounting system and FAA's new procurement system, called Prism, in November 2003. For the most part, FAA financial managers were able to identify problems, track financial activities that were not properly processed, and develop timely corrective action plans because they have implemented more disciplined financial management processes over the last 3 years.

HTF agencies, on the other hand, were less successful overcoming the financial management deficiencies we reported last year. Because of the severity of the problems and the limited time available to implement corrective actions, the Federal Highway Administration (FHWA) was not able to make enough progress to correct the underlying process deficiencies. The deficiencies required HTF agency executives and financial managers, as well as the Office of Financial Management to make a concerted effort to clean up bad data and generate reliable financial statements. That largely manual effort was the key to obtaining a clean opinion this year. Continued executive-level attention, backed by skilled resources to implement disciplined processes, will be critical to correct the remaining deficiencies.

I want to acknowledge the extraordinary efforts made by each of the Operating Administrations, the Assistant Secretary for Budgets and Programs/Chief Financial Officer, and KPMG LLP and Clifton Gunderson LLP (contractors we engaged to audit the Federal Aviation Administration [FAA] and the HTF financial statements). Also, this clean opinion would not have been possible without your longstanding commitment to improving financial management

practices and the priority you repeatedly placed on meeting the Office of Management and Budget's accelerated reporting date of November 15, 2004.

INTERNAL CONTROLS

FAA, the HTF agencies,¹ the Department's Office of Financial Management, and the auditors had to exert extraordinary efforts to overcome significant financial management deficiencies in order to meet the accelerated due date for audited financial statements. These deficiencies were due to weaknesses in internal controls, which are the policies, procedures, and practices that need to operate effectively to produce reliable and timely financial information. We categorized the problems we identified into four material weaknesses and four reportable conditions. Responding to a draft of this report, DOT agreed with these findings and committed to taking timely corrective action.

Material Weaknesses

Material weaknesses are deficiencies in the design or operation of internal controls that do not reduce, to a relatively low level, the risk that significant errors, fraud, or noncompliance could occur and not be detected by employees in the normal course of performing their duties.

- **Financial Management and Reporting for Highway Trust Fund Agencies.** Last year we reported that HTF agencies lacked the financial management procedures needed to generate reliable financial statements, and this deficiency also existed this year. As a result, the financial statements FHWA submitted for audit contained several large, multi-billion dollar errors and omissions. For example, FHWA incorrectly added about \$2 billion to program costs. FHWA also incorrectly reallocated costs among programs, resulting in a total of \$8 billion in changes to program line items. These errors were corrected in the published financial statements, but the repeated substantial changes demonstrated that financial management and reporting processes were not operating effectively.
- **Financial Oversight of Highway and Transit Grants.** FHWA and the Federal Transit Administration (FTA) must do more to ensure that grant funds are protected from fraud, waste, and abuse. In FY 2004, FHWA needed to improve financial oversight on 41 of the 45 highway grant projects (valued at \$113 million) that we reviewed. In June 2003, we pointed out that a random

¹ Federal Highway Administration, National Highway Traffic Safety Administration, Federal Transit Administration, Federal Railroad Administration, Federal Motor Carrier Safety Administration, and the Bureau of Transportation Statistics.

sample of construction payments we reviewed showed that 7 percent of the payments were not adequately supported (\$7 million of the \$98 million). FHWA plans to begin reviewing state payment processes and testing a sample of payments during FY 2005. The key to achieving sustained improvements in this area will be follow-through to ensure that the reforms are implemented and that they operate effectively. While FTA has systems in place to monitor resources provided to transit authorities and municipalities, it too could do a better job of protecting Federal funds. For example, we recently found that FTA's oversight did not take action on significant irregularities in change orders on a \$2.25 billion project until they had accumulated to several hundred million dollars.

- **Reconciling Transactions Within DOT and With Other Federal Agencies.** Last year, we reported that DOT did not fully reconcile its transactions with other Federal agencies. To prepare DOT's financial statements, transactions among DOT's Operating Administrations must be tracked and eliminated to avoid overstating DOT's financial statement results. Similarly, Federal agencies' inability to account for transactions with other agencies is a major impediment to a clean audit opinion on the Financial Report of the United States Government. During FY 2004, DOT did not adequately track transactions among DOT Operating Administrations, which required management to perform extensive manual adjustments to prepare DOT's consolidated financial statements. DOT has begun taking steps to better account for transactions with other Federal agencies, but at the end of September 2004, it still had not identified the other agency associated with about half of the \$55 billion of intra-governmental transactions processed in FY 2004 and reported to Treasury.
- **Financial System Controls.** Last year, we reported that controls over the Delphi accounting system needed to be improved. Important security measures had not been implemented, system changes were not properly tested, and contingency planning was not adequate. DOT has made significant progress to correct these problems, but for most of FY 2004 the vulnerabilities continued to exist. This year, both Clifton Gunderson and KPMG identified other security issues affecting other financial systems that provide financial data to Delphi. These deficiencies increase the risk that erroneous financial transactions could occur, either intentionally or inadvertently, resulting in unreliable information being included in financial reports without being detected in a timely manner by management.

Reportable Conditions

Reportable conditions in internal controls, although not considered material weaknesses, represent significant deficiencies in the design or operation of internal controls that could adversely affect the DOT consolidated financial statements.

- **Cost-Reimbursable Contracts at FAA.** Last year we reported a material weakness in FAA's management of cost-reimbursable contracts. During FY 2004, FAA management took aggressive actions to implement better controls by identifying all cost-reimbursable contracts and closing most old completed contracts. FAA also obtained \$3 million to audit cost-reimbursable contracts and used the funds to request 185 audits. A reportable condition continues because FAA still has about \$1.5 billion associated with overage contracts that it must close. FAA is continuing to review and close these old contracts and is taking other steps to strengthen its oversight of cost-reimbursable contracts.
- **DOT's Information Security Program.** Last year, based on audits of the Department's overall information system security program, we reported DOT's information security program as a material internal control weakness. The most noteworthy improvements made during FY 2004 include increased oversight of information technology investment management and security controls, strengthened protection of DOT's network infrastructure against attacks, and enhanced security protection of individual computer systems. Continued action is needed to improve security certification reviews, configure computers according to security standards, and develop and test system contingency and continuity plans.
- **MARAD's Oversight of Title XI Loan Guarantees.** Last year, we reported that the Maritime Administration (MARAD) needed to better ensure that inventory, property, and environmental liabilities are reported properly. This year, we found that MARAD has corrected those problems. Last year we also reported that MARAD needed to improve its oversight of the Title XI loan guarantee program. During FY 2004, MARAD designed procedures to strengthen its oversight process for Title XI loan guarantees. What remains to be done is to aggressively and effectively implement the new procedures. This will be critical to ensure that MARAD's \$3.6 billion loan guarantee portfolio is properly managed. This is of considerable importance because MARAD has determined that over 25 percent of its portfolio is at an elevated risk of default.
- **Accounting for Loans in Delphi.** In FY 2003, we reported that DOT needed to improve how it accounts for the direct loans it provides to grantees in Delphi, and this condition still exists as of September 30, 2004. The Delphi accounting system does not include a process to account for expected loan

repayments from grantees, which were valued at \$604 million on September 30, 2004. Instead, DOT relied on information from outside the accounting system (such as commercial banks) to track loan transactions, and some Operating Administrations did not routinely reconcile their loan balances. This year, the Department established a task force to identify a corrective action plan.

We provided a draft of this report to the DOT Assistant Secretary for Budgets and Programs/Chief Financial Officer, who concurred with the findings and agreed to implement the recommendations. DOT and its Operating Administrations have also initiated corrective actions to address the internal control and compliance issues identified by KPMG and Clifton Gunderson in their reports.

We appreciate the cooperation and assistance of DOT, KPMG, and Clifton Gunderson representatives. If we can answer any questions, please call me at (202) 366-1959 or Ted Alves, Assistant Inspector General for Financial and Information Technology Audits, at (202) 366-1496.

Attachment

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**DEPARTMENT OF TRANSPORTATION
INSPECTOR GENERAL'S INDEPENDENT AUDIT REPORT
ON THE DEPARTMENT OF TRANSPORTATION
CONSOLIDATED FINANCIAL STATEMENTS
FOR FISCAL YEARS 2004 AND 2003**

To the Secretary

The Department of Transportation (DOT), Office of Inspector General (OIG), audited the DOT Consolidated Financial Statements for the years ended September 30, 2004, and September 30, 2003. In our audit "DOT Consolidated Financial Statements for Fiscal Years 2004 and 2003," we found:

- Financial statements that are fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles.
- Four material internal control weaknesses: financial management and reporting for Highway Trust Fund agencies,¹ oversight of highway and transit grants, reconciling transactions within DOT and with other Federal agencies, and financial system controls; and four reportable conditions: cost reimbursable contracts at the Federal Aviation Administration (FAA), DOT's information security program, the Maritime Administration's (MARAD) oversight of Title XI loan guarantees, and accounting for loans in Delphi.
- Instances of noncompliance with the Federal Financial Management Improvement Act of 1996, the Anti-Deficiency Act, the Federal Managers' Financial Integrity Act, the Single Audit Act, and the Government Performance and Results Act.
- Financial information in the Management Discussion and Analysis was materially consistent with the financial statements.
- Supplementary and stewardship information was consistent with management representations and the financial statements.

We performed our work in accordance with Government Auditing Standards and Office of Management and Budget (OMB) Bulletin 01-02, "Audit Requirements for Federal Financial Statements." The following sections discuss these

¹ Federal Highway Administration, National Highway Traffic Safety Administration, Federal Transit Administration, Federal Railroad Administration, Federal Motor Carrier Safety Administration, and the Bureau of Transportation Statistics.

conclusions. Our audit objectives, scope, and methodology are in Exhibit A. We believe that our audit provides a reasonable basis for our opinion.

A. UNQUALIFIED OPINION ON FINANCIAL STATEMENTS

In our opinion, the consolidated financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, the DOT assets, liabilities, and net position; net costs; changes in net position; budgetary resources; and reconciliation of net costs to budgetary obligations as of September 30, 2004, and September 30, 2003 and for the years then ended.

Under contract with OIG and under our supervision, KPMG LLP audited the financial statements of FAA as of and for the years ended September 30, 2004, and September 30, 2003. KPMG rendered an unqualified opinion on the FAA financial statements. Also under contract with OIG and under our supervision, Clifton Gunderson LLP audited the financial statements of the Highway Trust Fund (HTF) as of and for the years ended September 30, 2004, and September 30, 2003. Clifton Gunderson rendered an unqualified opinion on the HTF financial statements. We performed a quality control review of the work performed by KPMG and Clifton Gunderson and relied on their results in performing our work on the FYs 2004 and 2003 DOT Consolidated Financial Statements.

As discussed in Note 17, the accompanying financial statements reflect actual excise tax revenues deposited in the HTF and the Airport and Airways Trust Fund through March 31, 2004, and excise tax receipts estimated by the Department of the Treasury Office of Tax Analysis for the two quarters ended June 30, 2004, and September 30, 2004.

As discussed in Note 17, DOT restated the FY 2003 Balance Sheet, Statement of Net Costs, Statement of Changes in Net Position, and Statement of Financing to properly report transactions with the Department of Agriculture related to MARAD's administration of the Cargo Preference Program. As discussed in Note 18, DOT also restated the FY 2003 Statement of Budgetary Resources to properly report its FY 2003 budget authority and unobligated balances. We audited these adjustments and concluded that they were appropriate and properly applied.

B. CONSIDERATION OF INTERNAL CONTROLS

In planning and performing our audit, we considered DOT's internal controls over financial reporting and compliance with laws and regulations. We do not express an opinion on internal controls and compliance because the purpose of our work was to determine our procedures for auditing the financial statements and to comply with OMB Bulletin 01-02 audit guidance, not to express an opinion on internal controls.

For the controls we tested, we found four material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce, to a relatively low level, the risk that errors, fraud, or noncompliance that would be material to the financial statements, may occur and not be detected promptly by employees in the normal course of performing their duties.

Our work identified four reportable conditions in internal controls. Reportable conditions in internal controls, although not considered material weaknesses, represent significant deficiencies in the design and operation of internal controls that could adversely affect the amounts reported in the DOT Consolidated Financial Statements. Our internal control work would not necessarily disclose all material weaknesses or reportable conditions.

MATERIAL WEAKNESSES

The following sections describe the material weaknesses that we identified.

HTF Agencies' Financial Management and Reporting Activities

Material deficiencies continue to exist in internal controls over financial management and reporting activities in the HTF agencies. Last year we reported that HTF agencies, in particular the Federal Highway Administration (FHWA), lacked basic accounting and financial management policies and procedures needed to generate reliable financial statements in a timely manner. Management agreed to implement a series of recommendations to correct these deficiencies and has begun doing so. However, because of the severity of the problems that existed and the limited time available to design and implement corrective actions, FHWA was not able to correct the underlying process deficiencies.

As a result, FHWA continued to encounter significant problems generating reliable financial information. To illustrate, the financial statements submitted for audit had not been fully analyzed and were not reliable. Over \$18 billion of adjustments to the financial statements were needed to correct errors and

omissions. To a large extent, these errors and omissions occurred because FHWA did not have time to implement more disciplined practices to compile financial information, reconcile conflicting or incomplete information, and analyze and review the financial statements to ensure that they were reliable. FHWA, with support from the Department's Office of Financial Management, needs to continue aggressive efforts to correct these deficiencies.

Last year we reported that HTF agencies lacked adequate accounting and financial management policies, procedures, and processes. Problems caused by those longstanding deficiencies were compounded last year because two major HTF agencies (FHWA and the Federal Motor Carrier Safety Administration) had not adequately planned or implemented their conversions to the Department's new accounting system, Delphi. HTF agencies and DOT officials recognized the significance of the deficiencies and committed to take timely corrective actions. However, because the audited financial statements were not issued until January 30, 2004 (almost 6 months into this fiscal year), HTF agencies got a late start implementing changes. The timeframe was further reduced because audited financial statements had to be completed earlier than usual this year, by November 15, 2004. As a result, while they made progress, material deficiencies still exist in financial management and reporting activities in HTF agencies, particularly in FHWA.

Even though the audit of the FY 2004 financial statements was completed by the November 15, 2004 OMB deadline, the HTF agencies expended a tremendous amount of manual effort to "clean up" their accounting records to prepare auditable financial statements as of September 30, 2004. Required accounting processes, including processes to prepare and analyze financial statements and to reconcile accounting transactions, did not operate effectively during the year. These problems were compounded at FHWA because it was still cleaning up unreliable data that had been converted to the new accounting system in February 2003.

To illustrate, FHWA did not automate its financial statement preparation process until the final quarter of FY 2004. As a result, for most of the year, the process used to generate financial statements was labor intensive and prone to error. Rather than using the accounting system to prepare financial statements, HTF agencies manually re-entered data generated by the accounting system into spreadsheets to prepare consolidated agency financial statements. This increased the risk of errors and limited resources available to analyze financial statement presentations. The new financial statement preparation process should alleviate this problem next year.

Further, FHWA was not able to correct unreliable accounting records until the end of the year. As a result, financial statements submitted for audit contained

numerous errors and FHWA had difficulties providing complete and accurate documentation to support its financial statements. For example, 4 weeks after the end of the year, and 2 weeks before audited financial statements were due to OMB, FHWA had to make a number of adjustments to financial statement accounts, increasing costs by \$760 million. FHWA also made several attempts to correct program cost estimates and properly allocate costs among its programs. In one attempt, FHWA incorrectly added about \$2 billion to program costs because it did not understand how to generate program cost numbers. In another, FHWA incorrectly reallocated costs among programs, resulting in a total of \$8 billion in changes to all program line items.

FHWA also did not significantly improve its ability to analyze and understand its financial statements. Management must take responsibility for generating reliable financial statements, understanding how different financial accounts relate to one another, and understanding how program changes affect the financial statements. Although FHWA adopted the financial statement analysis practices that Clifton Gunderson had suggested, the practices were not implemented effectively. As a result, errors that should have been detected from a close reading and analysis of the statements were not detected. For example, costs for the Federal Lands program were identified in the September 30, 2004 financial statements as \$61 million, even though costs had been reported to be \$221 million in June 2004. Reported program costs changed several times during the audit process and ultimately totaled \$222 million, indicating that the June 2004 statements were not reliable.

Clifton Gunderson made a series of recommendations to improve financial management and reporting activities in its financial statement audit report, dated November 8, 2004. DOT agreed to implement the recommendations. Therefore, we are not making additional recommendations in this report.

Financial Oversight of Highway and Transit Grants

FHWA and the Federal Transit Administration (FTA) must establish stronger financial and cost controls to better ensure that grant funds are protected from fraud, waste, and abuse. This is especially important in a time of increasing demands for transportation investments and large Federal deficits. FHWA, however, currently provides little financial oversight of the billions of dollars it provides to states and municipalities each year. Over the last year, there has been a major shift in direction, and the Department now recognizes the need to improve oversight of these resources. As a result, plans are underway to implement much improved oversight processes to provide the needed oversight. Follow-through to ensure the reforms are implemented effectively will be the key to sustained improvement in this area. FTA has systems in place to monitor resources

provided to transit authorities and municipalities, but it too could improve its oversight of Federal funds disbursed to grantees.

We previously reported that FHWA frequently did not perform financial management reviews of grantees. This year, we identified additional issues that raise further questions about the adequacy of FHWA's oversight. First, FHWA does not have an effective process to require its Division Offices to assess grantee financial management risks, and does not require them to review grantee payment controls, or spot check a sample of actual payments for reasonableness. For grant projects examined during the HTF financial statement audit, FHWA did not provide this financial management oversight for 41 of 45 projects, with obligations totaling \$113 million. This is significant because, as we pointed out in June 2003, controls over highway grant payments were not effective. We reviewed a random sample of construction payments and determined that 7 percent of the payments were not adequately supported (\$7 million of \$98 million reviewed). FHWA also reported that its electronic payment system was modified to automatically pay grantees without any review by an FHWA official. Fourteen Division Offices made payments of about \$4 billion this year using this method. FHWA management discontinued the practice as soon as they discovered it.

We have testified that FTA provides more oversight of how grantees use Federal resources than FHWA, but it too can do a better job. For example, FTA uses project management oversight and financial management oversight contractors to provide early warnings of cost, schedule, and quality problems. However, the quality of this oversight can be improved, particularly in the areas of spot-checking grantee cost and schedule estimates. To illustrate, in the case of Puerto Rico's Tren Urbano, costs almost doubled from \$1.25 billion to \$2.25 billion and the project encountered a 3-year delay in opening the system to passengers. Although FTA required Tren Urbano to prepare a plan to address the issues, the plan was not adequate because it did not identify actions or establish timeframes to address all safety-critical issues. In addition, we recently found that FTA oversight did not take action on significant irregularities in change orders on a \$2.25 billion project until they had accumulated to several hundred million dollars.

We also continue to handle significant numbers of fraud cases. Over the last 5 years, our investigations have yielded 128 convictions (29 in FY 2004 alone) and more than \$90 million in recoveries from fraud on highway and transit projects.

DOT is undertaking two efforts to improve FHWA grant oversight. The FHWA Administrator plans to establish a new policy in FY 2005 that will require its 52 Division Offices to perform much more stringent oversight, including reviewing state payment processes and testing a sample of actual payments. The policy has not been approved or implemented. It represents a good first step—a

commitment and a plan. After it is approved, it will take time to implement and, as with any major change, FHWA will face a significant challenge implementing the policy in its 52 Division Offices. When fully implemented, the new policy will go a long way to reducing the risk of losses to fraud, waste, or abuse. Second, we worked with the Office of the Secretary and OMB to establish a pilot project in one state to estimate the extent of improper payments in the Federal aid highway program. That project should provide an estimate of the amount of improper payments in the Highway program.

Reconciling Transactions Within DOT and With Other Federal Agencies

Last year, we reported that DOT had not implemented effective processes to reconcile its transactions with other Federal agencies. Although DOT has initiated improvements and made progress during FY 2004, as of September 30, 2004, it had not corrected the problem. In addition, DOT does not have an effective process to reconcile transactions among its Operating Administrations.

To prepare DOT's financial statements, transactions among DOT's Operating Administrations must be tracked and eliminated to avoid overstating DOT's financial results. Although DOT is implementing improved processes, during FY 2004, it did not adequately track these transactions. To illustrate, DOT's Operating Administrations reported to the Department's Office of Financial Management a total of \$17 million in accounts receivable, or amounts due from other Operating Administrations. The same organizations, however, reported \$582 million in accounts payable, or amounts owed to other Operating Administrations. Because these amounts should reflect all transactions within DOT, the amount due should match the amount owed. Management had to perform extensive research and make manual adjustments to balance the books in order to prepare reliable financial statements.

Similarly, Federal agencies' inability to account for and eliminate transactions with other Federal agencies is a major impediment to a clean audit opinion on the Financial Report of the United States Government. For example, when the Volpe National Transportation Systems Center performs reimbursable work for the Department of Defense, both agencies need to track the value of the work performed and report similar amounts to Treasury. Treasury then needs to eliminate the transactions from the Government-wide financial statement to avoid overstating financial results on the Financial Report of the United States Government. OMB Bulletin 01-09, "Form and Content of Agency Financial Statements," requires agencies to reconcile asset, liability, and revenue amounts with other agencies by confirming the balances with those agencies on a quarterly basis.

During FY 2004, DOT partially confirmed or reconciled transactions with other Federal agencies. A new reporting tool within the financial management system helped facilitate these reconciliations. However, at the end of September 2004, DOT still had not identified the other agency associated with about \$27 billion, or about half, of the \$55 billion of transactions with other Federal agencies that were processed and reported to Treasury in FY 2004. The large amount associated with unknown trading partners demonstrates that DOT does not yet have an effective process to reconcile and eliminate these transactions. Until DOT is able to automatically track transactions with other Federal agencies, it will not be able to make significant progress reconciling balances with those agencies.

Financial System Controls

Last year, we reported Delphi computer control weaknesses as a reportable condition. We found that important security measures such as password controls and removing terminated employees' access to systems had not been implemented or enforced, system changes were not properly tested, and contingency planning was not adequate. Based on the existence and magnitude of these vulnerabilities, we concluded that financial auditors would need to perform additional testing of financial transactions processed by Delphi. We issued 17 recommendations to correct these weaknesses.

During FY 2004, DOT made good progress in correcting Delphi computer control weaknesses. In June 2004, DOT reported that all but five recommendations had been corrected. As of September 30, 2004 management stated that it had completed corrective actions on all but one recommendation. We have not yet validated that these corrective actions are operating effectively but plan to do so in FY 2005.

Our contractors also found computer security weaknesses in a number of systems that provide financial data to Delphi. KPMG concluded that computer security of systems supporting FAA financial management reporting needed improvement. Control weaknesses included inadequate password controls, missing security patches, inadequate system change controls, lack of separation of duties, and key security positions that were not defined.

Clifton Gunderson found that computer security over systems supporting financial management and reporting for the HTF agencies also needed improvement. Control weaknesses identified in FHWA and/or FTA financial systems include financial system certification and accreditation, risk assessments, system testing and evaluation, background checks for system contractors, user profile management, logical access controls, financial systems access for separated employees, backup tape management, and alternate processing facilities. Clifton

Gunderson also found problems with grant approval and payment edit features, and insufficient documented procedures for managing user accounts and sensitive information produced by the systems.

KPMG and Clifton Gunderson provided a series of recommendations to DOT, FAA, FHWA, and FTA for improving these areas. Management concurred with all findings and recommendations and has taken or has initiated corrective actions.

REPORTABLE CONDITIONS

Reportable conditions in internal controls, although not considered material weaknesses, represent significant deficiencies in the design or operation of internal controls that could adversely affect the DOT consolidated financial statements.

FAA Oversight of Cost-Reimbursable Contracts

Last year, we reported a material weakness with FAA's management of cost-reimbursable contracts. During FY 2004, FAA implemented a corrective action plan to strengthen its management of cost-reimbursable contracts. As a result of actions taken and controls put in place, we have downgraded the material weakness to a reportable condition. It remains a reportable condition because FAA still has about \$1.5 billion associated with overage contracts that must be closed to identify allowable costs and excess obligated balances.

As part of its corrective actions, FAA identified all completed and ongoing cost-reimbursable contracts; obtained \$3 million in funding that it used to initiate 185 requests for incurred cost audits of reimbursable contracts; established an internal control procedure to reconcile, on a quarterly basis, amounts billed by contractors to amounts recorded as contract expenses; modified performance measures for contracting officers to ensure that cost-reimbursable contracts are audited in accordance with FAA's audit policy; established a quarterly internal control procedure to verify whether contractor staff met contractual requirements; and revised procedures to ensure that officials consider cost-effective alternatives before requesting new acquisition baselines.

FAA is continuing to review and close old contracts valued at about \$1.5 billion. In addition, FAA is in the process of analyzing the results of an Activity Value Analysis of its contracting activities, which recommended additional changes in contract administration procedures. FAA will need to take actions to implement the proposed changes.

DOT Information Security Program

Last year, we reported DOT's information technology security program as a material internal control weakness for the third year in a row. In October 2004, we issued our fourth annual report on DOT's Information Security Program as required by the Federal Information Security Management Act. Based on the progress the Department has made and the current status of the security program, we are of the opinion that the DOT's information security program should be considered a reportable condition.

The most noteworthy improvements DOT has made since we began the annual information security review in FY 2001 include increased oversight of information technology investment management and security controls, strengthened protection of DOT's network infrastructure against attacks from both outside and inside of the Department, and increased percentage of computer systems completing the security certification review. For example, during FY 2004, the Department increased the number of systems having completed a security certification review from 33 percent to over 90 percent. The office of the departmental Chief Information Officer also issued guidelines for configuring computers in a secure manner to prevent vulnerabilities.

Although DOT has made significant progress, we identified security issues that require continued management attention. Specifically, DOT needs to improve the quality of security certification reviews and better ensure that planned corrective actions are implemented. Our review of 20 systems that had been certified as having adequate security protection found deficiencies in the certification review process. Deficiencies included inadequate assessments of the risks facing the system; lack of evidence that tests were performed—in one case, a test item that had been listed as passed failed when we re-tested it; incomplete presentations of remaining weaknesses to responsible senior officials; and flaws in approving systems for operations.

Because we have made recommendations in other reports to help the Department further enhance its information security protection and oversight of its multi-billion dollar annual information technology investment, we are not including recommendations in this report.

MARAD Oversight of Title XI Loan Guarantees

Last year, we reported that MARAD needed to better ensure that inventory, property, and environmental liabilities are reported properly. This year, we found that MARAD corrected those problems.

Last year we also reported that MARAD needed to improve its oversight of the Title XI loan guarantee program loan application process; borrowers; vessels and shipyards constructed under loan guarantees; and foreclosed assets. The loan guarantees are designed to assist private companies to obtain financing for constructing ships or modernizing U.S. shipyards—with the Government holding a mortgage on the equipment or facilities financed.

During FY 2004, MARAD designed procedures to strengthen its oversight process for Title XI loan guarantees but needs to do more. In particular, effective and aggressive implementation of the new procedures will be critical to ensure that its \$3.6 billion loan portfolio is properly managed. Effectively implementing these improvements is of considerable importance because MARAD has determined that over 25 percent of its portfolio is at an elevated risk of default.

In September 2004, we issued a follow-up audit report that identified three related issues that need to be fixed to ensure that MARAD's oversight is effective. First, MARAD was not sufficiently enforcing the requirements that borrowers establish and maintain specified financial reserves to mitigate the risks of noncompliant loans. Second, MARAD lacked the expertise or resolve to effectively address troubled loans. Third, MARAD's rudimentary financial monitoring system was not yet adequate to effectively manage its \$3.6 billion loan portfolio.

Establishing good procedures is just the first step; fully implementing them is the next one. While MARAD has worked to get satisfactory procedures in place, the proof will be in the follow through and implementation with respect to specific loan guarantee applications. Strong leadership and a staff committed to implementing the strengthened procedures will be critical to realize the intended benefits and reduce risks to the Title XI loan guarantee portfolio. The Department will also need to monitor MARAD's progress to assure appropriate actions are taken to mitigate risks to the existing \$3.6 billion loan guarantee portfolio and to any new loan guarantees. We plan to conduct a follow-up audit of MARAD's implementation progress.

Accounting for Loans in Delphi

In FY 2003, we reported that DOT needed to improve the accounting for loans receivable in Delphi, and this condition still existed on September 30, 2004. The new DOT accounting system, Delphi, does not include a module or subsidiary ledger system to accurately account for anticipated loan repayments from borrowers, valued at \$1 billion on September 30, 2003, and \$604 million on September 30, 2004. FHWA and the Federal Railroad Administration recorded loan activity at a summary level directly into the Delphi accounting system and relied on information from outside the accounting system (such as from

commercial banks) to maintain detailed loan transaction information. Those two Administrations also did not periodically reconcile their recorded balances to the detailed transaction level information during the year.

In FY 2003, we recommended that DOT establish a module or subsidiary system in Delphi to improve accounting for loans receivable and require FHWA and the Federal Railroad Administration to routinely reconcile loans receivable balances. DOT agreed and, in FY 2004, established a Credit Reform Workgroup to discuss how best to account for loan activity.

C. COMPLIANCE WITH LAWS AND REGULATIONS

In planning and conducting our audit, we performed limited tests of DOT's compliance with laws and regulations as required by OMB guidance. It was not our objective to express, and we do not express, an opinion on compliance with laws and regulations. Our work was limited to testing selected provisions of laws and regulations that would be reportable under Government Auditing Standards or under OMB guidance. Our work disclosed the following instances of noncompliance with laws and regulations.

FEDERAL FINANCIAL MANAGEMENT IMPROVEMENT ACT OF 1996 (FFMIA)

Under FFMIA, we are required to report whether DOT's financial management system substantially complies with (1) Federal financial management system requirements, (2) applicable Federal accounting standards, and (3) the U.S. Government Standard General Ledger at the transaction level. DOT's financial management system includes the core accounting system and supporting financial management systems that provide financial data to the core accounting system.

FFMIA requires agencies to produce auditable financial statements based on data from the agency's financial system on a timely basis. Given the problems HTF agencies, and FHWA in particular, encountered in generating reliable financial statements in a timely manner and the difficulties they encountered with their accounting and reporting systems, Clifton Gunderson concluded that the systems did not substantially comply with Federal financial management system requirements for the year ended September 30, 2004.

- **Preparation of Financial Statements.** The process used by HTF agencies, primarily FHWA, was not adequate to prepare reliable and timely financial

statements during the year ended September 30, 2004. In order to prepare the HTF financial statements, an extensive number of adjustments were made to the accounting records. Even though some of these adjustments are considered “normal clean-up” entries, many were the result of manually intensive analysis and reconciliations performed outside the system.

- **Use of Standard General Ledger.** Several HTF agencies did not use Delphi to capture all accounting events at the transaction level to meet OMB or Treasury reporting requirements and FHWA suspense account transactions did not follow the posting rules set forth by Treasury.
- **Federal Accounting Standards.** Some HTF agencies were not in full compliance with the Managerial Cost Accounting Concepts and Standards for the Federal Government and the related provisions of the Government Performance and Results Act. The FY 2004 HTF financial statements did not properly reflect full costs or measure the effectiveness of the agencies’ programs. The HTF Statement of Net Cost was not presented by major program and was not comparable to DOT’s major goals and outputs as described in its strategic and performance plans.

Clifton Gunderson also found that certain HTF financial management systems did not have adequate data processing controls, an important component of Federal system requirements. For example, Clifton Gunderson found that FHWA and FTA systems do not have sufficient financial management controls to reasonably ensure that payments to grantees are properly paid.

KPMG also found that the FAA was not in substantial compliance with FFMIA. KPMG found the FAA uses DOT’s core accounting system, Delphi, to process and record financial transactions and FAA’s Prism system to process procurement related activities. However, after the implementation of Delphi and Prism, FAA encountered a number of conversion-related challenges that prevented it from recording a significant number of transactions in Delphi. This situation interfered with the FAA’s ability to produce accurate and complete financial and budgetary reports. KPMG also noted deficiencies in FAA’s application of managerial cost accounting standards, since FAA was not able to provide accurate and timely cost information on its programs in FY 2004. In addition, KPMG found that six of FAA’s key financial systems that feed financial data into Delphi do not comply substantially with some categories of FFMIA requirements. For example, four of the six feeder systems did not adhere to the Computer Security Act requirements and lacked adequate internal controls.

KPMG recommended that FAA continue to work aggressively to fully integrate its financial management systems and to produce accurate, timely, and reliable management cost reports using the Cost Accounting System. Also, DOT should

address and resolve the weaknesses noted in the six key financial systems used to compile financial statements for FAA.

ANTI-DEFICIENCY ACT

Title 31, United States Code, Section 1517 provides that an officer or employee of the U.S Government may not make or authorize an expenditure or obligation exceeding an amount available in an allotment. In our report on the FY 2003 DOT Financial Statements, we reported that a total of five instances of noncompliance had been identified in DOT. Of the five violations, the two identified for FAA were reported and resolved during FY 2004; the one potential violation identified in FHWA was researched and found to not be a violation; and the remaining two violations, first reported in 2002, have not been fully resolved.

Clifton Gunderson reported that, during FY 2004, FHWA was reviewing four potential violations, in which obligations may have exceeded budget authority by about \$600,000 as of September 30, 2004.

FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT (FMFIA)

The FMFIA requires agencies to implement formal procedures to identify, assess, and monitor management controls to provide management with reasonable assurance that controls remain effective. Our report on the FY 2003 DOT Financial Statements concluded that the HTF agencies did not have formal procedures in place to identify, assess, and monitor management controls over their programs and resources, including their financial management systems. Management controls—which include organization, policies, procedures, and practices—are tools to help program and financial managers achieve results and safeguard the integrity of their programs.

During FY 2004, Clifton Gunderson reported that the HTF agencies, except the Federal Motor Carrier Safety Administration, have still not formalized procedures to identify, assess, and monitor management controls. In addition, we found that two other DOT agencies, the Office of the Secretary and the Research and Special Programs Administration, have not fully assessed the effectiveness of their management controls under FMFIA.

SINGLE AUDIT ACT

Our report on the FY 2003 DOT Financial Statements found that DOT has not effectively implemented certain provisions of the Single Audit Act, including tracking the receipt of reports, distributing reports on time, and ensuring that management makes timely decisions to implement report recommendations. During FY 2004, Clifton Gunderson reported that the HTF agencies began establishing procedures to monitor Single Audit Act activity and comply with provisions related to OMB requirements. However, those procedures were not fully implemented in FY 2004. Emphasis needs to be placed on ensuring that management decisions are issued within the required 6 months.

GOVERNMENT PERFORMANCE AND RESULTS ACT (GPRA)

GPRA requires agencies to manage their programs in an efficient and effective manner based on reliable financial and performance information. To comply with GPRA, agencies need to have a system to track costs and allocate them to individual programs and activities. This information is needed for management to measure the efficiency and effectiveness of operations. Clifton Gunderson reported that because HTF agencies have not fully implemented managerial cost accounting systems, they were not able to present the full cost of each program in the Statement of Net Cost for FY 2004. Further, as described below, because DOT does not have systems in place to allocate costs by major program, the performance measures presented in the Management Discussion and Analysis did not provide information about cost effectiveness and were not linked to the cost of achieving targeted results or to the Statement of Net Cost.

D. CONSISTENCY OF OTHER INFORMATION

The Management Discussion and Analysis, required supplementary information (including stewardship information), and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements. We are not required to, and we do not, express an opinion on this information. As required by OMB guidance, we compared this information for consistency with the DOT Consolidated Financial Statements and discussed the methods of measurement and presentation with DOT officials. Based on this work, we found no material inconsistencies with the DOT Consolidated Financial Statements or nonconformances with OMB guidance. Further, because DOT does not have systems in place to allocate costs by major program, the performance measures did not provide information about cost effectiveness and were not linked to the cost of achieving targeted results or to the Statement of Net Cost.

E. PRIOR AUDIT COVERAGE

Our report on the DOT Consolidated Financial Statements for FYs 2003 and 2002 expressed an unqualified opinion and made two recommendations. They were: (1) that MARAD establish and implement procedures to improve the accounting for inventory, property, and environmental liabilities, and (2) that DOT establish a module or subsidiary ledger system in Delphi to improve the accounting for loans receivable. Our report on the DOT Consolidated Financial Statements for FYs 2002 and 2001 made one recommendation: that DOT confirm and reconcile intra-governmental balances with trading partners. As discussed in Section B, MARAD has improved its accounting for inventory, property, and environmental liabilities; but additional work is needed to implement the other recommendations.

Since we issued our report on the DOT Consolidated Financial Statements for FYs 2003 and 2002, we issued 12 reports related to the DOT Consolidated Financial Statements. The reports are listed in Exhibit B.

The Assistant Secretary for Budgets and Programs/Chief Financial Officer provided comments on a draft of the report (See Appendix). The response agreed with the material weaknesses and reportable conditions in this report and stated that corrective actions have already been initiated. Management agreed to provide a detailed action plan addressing each finding by December 15, 2004.

This report is intended for the information of and use by DOT, the Office of Management and Budget, the Government Accountability Office, and Congress. This report is a matter of public record, and its distribution is not limited.



Kenneth M. Mead
Inspector General

EXHIBIT A. OBJECTIVES, SCOPE, AND METHODOLOGY

Our audit objectives for the DOT Consolidated Financial Statements for FYs 2004 and 2003 were to determine whether: (1) principal DOT Consolidated Financial Statements and accompanying notes are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles; (2) DOT has adequate internal controls over financial reporting, including safeguarding assets; (3) DOT has complied with laws and regulations that could have a direct and material effect on the DOT Consolidated Financial Statements or that have been specified by OMB, including FFMIA; (4) financial information in the Management Discussion and Analysis is materially consistent with the information in the principal DOT Consolidated Financial Statements; (5) internal controls ensured the existence and completeness of reported data supporting performance measures; and (6) supplementary, stewardship, and other accompanying information is consistent with management representations and the DOT Consolidated Financial Statements.

DOT is responsible for (1) preparing the DOT Consolidated Financial Statements for FYs 2004 and 2003 in conformity with U.S. generally accepted accounting principles; (2) establishing, maintaining, and assessing internal controls to provide reasonable assurance that broad control objectives of FMFIA are met; (3) ensuring that DOT financial management systems substantially comply with FFMIA requirements; and (4) complying with other applicable laws and regulations.

We are responsible for obtaining reasonable assurance whether the DOT Consolidated Financial Statements for FY 2004 and FY 2003 are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles. DOT is responsible for preparing financial statements in conformity with U.S. generally accepted accounting principles and establishing and maintaining an effective system of internal controls. The objectives of these controls are explained below.

- Financial reporting. Transactions are properly recorded, processed, and summarized to permit the preparation of financial statements and stewardship information in conformity with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.
- Compliance with laws and regulations. Transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the

financial statements and any other laws, regulations, and Government-wide policies identified by OMB audit guidance.

- Performance measures. Transactions and other supporting data are properly recorded and summarized.

We are also responsible for (1) obtaining sufficient understanding of internal controls over financial reporting and compliance to plan the audit, (2) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and (3) performing limited procedures with respect to certain other information appearing in the DOT Consolidated Financial Statements for FYs 2004 and 2003.

To fulfill these responsibilities, we (1) examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements; (2) assessed the accounting principles used and significant estimates made by management; (3) evaluated the overall presentation of the financial statements; (4) obtained an understanding and performed limited tests of internal controls related to financial reporting, compliance with laws and regulations, and performance measures reported in the Management Discussion and Analysis; and (5) tested compliance with selected provisions of certain laws, including FFMIA.

Under contract with OIG and under our supervision, KPMG audited the financial statements of FAA as of and for the years ended September 30, 2004, and September 30, 2003. KPMG rendered an unqualified opinion on the FAA financial statements. Also under contract with OIG and under our supervision, Clifton Gunderson audited the financial statements of the HTF as of and for the years ended September 30, 2004, and September 30, 2003.² Clifton Gunderson rendered an unqualified opinion on the HTF financial statements. We reviewed the work of KPMG on the FAA financial statements and Clifton Gunderson on the HTF financial statements and determined that the work was performed in accordance with Government Auditing Standards. We relied on their work.

The Government Accountability Office performed agreed upon procedures at the Internal Revenue Service on the excise taxes distributed to the HTF and the Airport and Airway Trust Fund during FY 2004. The Treasury Office of Inspector General reported on the effectiveness of controls placed in operation over the Bureau of Public Debt Trust Fund Management Branch and Federal Investments Branch for the period October 1, 2003, to July 31, 2004, and attained management's assurance on the effectiveness of the controls through

² Clifton Gunderson also performed audit procedures related to Appropriated accounts and balances in the FY 2004 and FY 2003 DOT consolidated financial statement related to HTF agencies, which we relied on.

September 30, 2004. The Treasury Office of Inspector General also reported on selected schedule of assets and liabilities of the HTF and the Airport and Airway Trust Fund prepared by the Bureau of Public Debt Trust Fund Management Branch.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FMFIA, such as those controls relevant to ensuring that programs achieve their intended results and resources are used consistent with agency missions. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal controls, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. We also caution that our internal control testing may not be sufficient for other purposes and that projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that compliance with controls may deteriorate.

We did not test compliance with all laws and regulations applicable to DOT. We limited our tests of compliance to those laws and regulations required by OMB audit guidance that we deemed applicable to the DOT Consolidated Financial Statements for the years ended September 30, 2004, and September 30, 2003. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

The Chief Financial Officers of DOT and each Administration have been assigned the responsibility to address the weaknesses identified in this report. Management's response to the findings and recommendations in this report is contained in the Appendix.

We performed our work in accordance with Government Auditing Standards and OMB Bulletin 01-02, "Audit Requirements for Federal Financial Statements."

EXHIBIT B. FINANCIAL-RELATED REPORTS

<u>TITLE</u>	<u>REPORT NUMBER</u>	<u>DATE ISSUED</u>
Inactive Obligations, FHWA	FI-2004-039	March 31, 2004
Cargo Preference Billing and Payment Process, MARAD	FI-2004-057	May 5, 2004
Audit of Financial Controls for Cost Accounting and Billing Practices, Volpe National Transportation Systems Center, RSPA	FI-2004-076	August 4, 2004
Independent Accountant's Report on the Application of Agreed-Upon Procedures: Selected Personnel Related Cost Items	FI-2004-096	September 28, 2004
FAA's Administration and Oversight of Regionally Issued Contracts	AV-2004-094	September 28, 2004
Title XI Loan Guarantee Program, MARAD	CR-2004-095	September 28, 2004
Audit of the Tren Urbano Rail Transit Project, Federal Transit Administration	MH-2004-098	September 29, 2004
Inactive Obligation, MARAD	FI-2004-099	September 30, 2004
Information Security Program, Department of Transportation	FI-2005-001	October 1, 2004
Quality Control Review of Audited Financial Statements for FY 2004 and FY 2003, Saint Lawrence Seaway Development Corporation	QC-2005-004	November 9, 2004
Quality Control Review of Audited Financial Statements for FY 2004 and FY 2003, Federal Aviation Administration	QC-2005-006	November 10, 2004
Quality Control Review of Audited Financial Statements for FY 2004 and FY 2003, Highway Trust Fund	QC-2005-006	November 10, 2004

APPENDIX. Assistant Secretary for Budget and Programs/Chief Financial Officer Response to Audit Report



**U.S. Department of
Transportation**
Office of the Secretary
of Transportation

Assistant Secretary
for Budget and Programs
and Chief Financial Officer

400 Seventh St., S.W.
Washington, D.C. 20590

NOV 10 2004

MEMORANDUM TO: Kenneth M. Mead
Inspector General

FROM: Linda M. Combs *Linda M. Combs*
Assistant Secretary for Budget and Programs/CFO

SUBJECT: Management Response – Report of the Inspector
General (IG) on the Consolidated Financial
Statements for Fiscal Years (FY) 2004 and 2003

The Department is pleased to respond to your audit report on the Consolidated Financial Statements for FY 2004 and 2003. For the fourth consecutive year we have achieved an unqualified audit on the Consolidated Financial Statements.

We concur with the four material weaknesses and four reportable conditions contained in the report. Corrective actions have already been initiated to address these items. The Department will submit a detailed Action Plan to your Office by December 15 to address the findings contained in the report. Our Action Plan will also address the findings contained in the Audit of the Highway Trust Fund and the Audit of the Federal Aviation Administration. We generally agree with the recommendations listed in these reports and will utilize them to develop corrective action measures.

The achievement of an unqualified audit opinion was accomplished through the joint efforts of your staff, contract auditors and the financial staffs of the Operating Administrations. In several cases extraordinary efforts were required to compensate for financial management weaknesses. We will work with our Operating Administrations, and the various audit groups to ensure that the steps we are taking will result in measurable improvements in Financial Management throughout the Department.

I would like to express my appreciation for the cooperation and professionalism displayed by your staff and your contractors during the course of the audit.