Department of Homeland Security
Office of Inspector General

Independent Auditors' Report on DHS' FY 2012 Financial Statements and Internal Control over Financial Reporting

OIG-13-20

November 2012

OFFICE OF INSPECTOR GENERAL
Department of Homeland Security

Washington, DC 20528 / www.oig.dhs.gov

November 14, 2012

MEMORANDUM FOR: The Honorable Janet Napolitano
Secretary

FROM: Charles K. Edwards
Acting Inspector General

SUBJECT: *Independent Auditors' Report on DHS' FY 2012 Financial Statements and Internal Control over Financial Reporting*

The attached report presents the results of the U.S. Department of Homeland Security's (DHS) financial statements audit for fiscal year (FY) 2012 and the results of an examination of internal control over financial reporting of those financial statements. These are mandatory audits required by the *Chief Financial Officers Act of 1990,* as amended by the *Department of Homeland Security Financial Accountability Act of 2004*. This report is incorporated in the Department's FY 2012 *Annual Financial Report*. We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the integrated audit.

The Department continued to improve financial management in FY 2012 and has achieved a significant milestone. This is the first year the Department has completed a full scope audit on all financial statements. The independent auditors issued a qualified opinion on the financial statements. Nevertheless, the Department still has work to do to meet the goal of becoming fully auditable in FY 2013. KPMG was unable to perform procedures necessary to form an opinion on DHS' internal control over financial reporting of the FY 2012 financial statements. Further, as stated in the Secretary's Assurance Statement, the Department has material weaknesses in internal control over financial reporting. In order to sustain or improve upon the qualified opinion, the Department must continue remediating the remaining control deficiencies.

Summary

KPMG expressed a qualified opinion on the Department's balance sheet as of September 30, 2012, and the related statements of net cost, changes in net position, and custodial activity, and combined statement of budgetary resources for the year then ended (referred to as the "fiscal year (FY) 2012 financial statements"). DHS was unable to represent that property, plant, and equipment (PP&E) account balances were correct and was unable to provide sufficient evidence to support these balances in the financial statements. Additionally, as stated in the Secretary's Assurance Statement, the Department has material weaknesses in internal control over financial reporting, thus

KPMG was unable to opine on DHS' internal control over financial reporting of the financial statements as of September 30, 2012.

The report discusses eight significant deficiencies in internal control, five of which are considered material weaknesses, and four instances of noncompliance with laws and regulations, as follows:

Significant Deficiencies That Are Considered To Be Material Weaknesses

- Financial Reporting
- Information Technology Controls and Financial System Functionality
- Property, Plant, and Equipment
- Environmental and Other Liabilities
- Budgetary Accounting

Other Significant Deficiencies

- Entity-Level Controls
- Grants Management
- Custodial Revenue and Drawback

Non-compliance with Laws and Regulations

- *Federal Managers' Financial Integrity Act of 1982* (FMFIA),
- *Federal Financial Management Improvement Act of 1996* (FFMIA)
- *Single Audit Act Amendments of 1996*
- *Anti-deficiency Act* (ADA)

Moving DHS' Financial Management Forward

Although the Department continued to remediate material weaknesses and reduce the number of conditions contributing to the material weaknesses, all five material weakness conditions identified in FY 2011 were repeated in FY 2012. DHS made some progress in remediating two of the material weaknesses. Specifically, USCG properly stated environmental liability balances, which resulted in the auditors retroactively removing the qualification related to this area in FY 2011. Also USCG was able to remediate a number of internal control weakness related to IT scripting, and continues to make progress in PP&E with the goal of being able to assert to the entire PP&E balance by January 2013. In previous years, the DHS Secretary has issued a statement of no assurance on the Department's internal controls over financial reporting. However, in FY 2012 the Department provided qualified assurance that internal control over financial reporting was operating effectively at September 30, 2012, and acknowledges that material weaknesses continue to exist in key financial processes. Consequently, the independent auditors were unable to render an opinion on DHS' internal controls over financial reporting in FY 2012.

While the Department continues to make progress, there are also some concerns that should be addressed in 2013, to avoid losing momentum, and slipping backwards. The Department must continue remediation efforts, and stay focused, in order to achieve its goal of a full clean opinion in 2013. The goal is in reach, and is achievable in 2013.

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KPMG is responsible for the attached Independent Auditors' Report dated November 14, 2012, and the conclusions expressed in the report. We do not express opinions on financial statements or internal control or conclusions on compliance with laws and regulations.

Consistent with our responsibility under the *Inspector General Act*, we are providing copies of this report to appropriate congressional committees with oversight and appropriation responsibilities over the Department. In addition, we will post a copy of the report on our public website.

We request that the Office of the Chief Financial Officer provide us with a corrective action plan that demonstrates progress in addressing the report's recommendations.

We appreciate the cooperation extended to the auditors by the Department's financial offices. Should you have any questions, please call me, or your staff may contact Anne L. Richards, Assistant Inspector General for Audits, at 202-254-4100.

Attachment

Excerpts from the DHS Annual Financial Report

Table of Contents

Appendixes

KPMG LLP
Suite 12000
1801 K Street, NW
Washington, DC 20006

Independent Auditors' Report

Secretary and Inspector General
U.S. Department of Homeland Security:

We have audited the accompanying balance sheet of the U.S. Department of Homeland Security (DHS or Department) as of September 30, 2012, and the related statements of net cost, changes in net position, and custodial activity, and combined statement of budgetary resources for the year then ended (referred to as the "fiscal year (FY) 2012 financial statements"). We have also audited the accompanying balance sheet of DHS as of September 30, 2011, and the related statement of custodial activity for the year then ended (referred to as the "FY 2011 financial statements"). We were also engaged to audit the Department's internal control over financial reporting of the FY 2012 financial statements. The objective of our audits was to express an opinion on the fair presentation of the FY 2012 and 2011 financial statements (referred to as the financial statements), and the effectiveness of internal control over financial reporting of the FY 2012 financial statements.

In connection with our audit, we tested DHS's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on the FY 2012 financial statements. We were not engaged to audit the accompanying statements of net cost, changes in net position, and budgetary resources, for the year ended September 30, 2011 (referred to as "other FY 2011 financial statements").

Summary

Except as discussed in our Opinion on the Financial Statements, we concluded that DHS's FY 2012 and 2011 financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles.

As discussed in our Opinion on the Financial Statements, the Department changed its financial reporting presentation of the statement of net cost, and statement of budgetary resources, in FY 2012; changed its method of accounting for repairable spare parts, and certain user fees, in FY 2012; and restated its environmental liability balances as presented in the FY 2011 financial statements.

Also, as discussed in our Opinion on the Financial Statements, the Department has intergovernmental debt of approximately $17.8 billion used to finance the *National Flood Insurance Program* (NFIP). The Department has determined that future insurance premiums and other anticipated sources of revenue may not be sufficient to repay this debt. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As stated in the Internal Control over Financial Reporting section of this report:

We were unable to perform procedures necessary to form an opinion on DHS's internal control over financial reporting.

Material weaknesses in internal control over financial reporting have been identified in the following areas:

- Financial Reporting
- Information Technology Controls and Financial System Functionality
- Property, Plant, and Equipment
- Environmental and Other Liabilities
- Budgetary Accounting

Significant deficiencies in internal control over financial reporting have been identified in the following areas:

- Entity-Level Controls
- Grants Management
- Custodial Revenue and Drawback

As discussed in the Compliance and Other Matters section of this report, the results of our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements disclosed the following instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended:

- *Federal Managers' Financial Integrity Act of 1982*
- *Federal Financial Management Improvement Act of 1996*
- *Single Audit Act Amendments of 1996*
- *Anti-deficiency Act*

We also reported other matters related to compliance with the *Anti-deficiency Act* at U.S. Coast Guard (Coast Guard), and Intelligence & Analysis.

The following sections discuss our opinion on the accompanying DHS FY 2012 and 2011 financial statements; why we were unable to express an opinion on internal control over financial reporting; our tests of DHS's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements and other matters; and management's and our responsibilities.

Opinion on the Financial Statements

We have audited the accompanying balance sheet of the U.S. Department of Homeland Security as of September 30, 2012, and the related statements of net cost, changes in net position, and custodial activity, and combined statement of budgetary resources for the year then ended. We have also audited the accompanying balance sheet of DHS as of September 30, 2011, and the related statement of custodial activity for the year then ended.

In FY 2012, Coast Guard continued an extensive project to reconcile its financial statement accounts, obtain sufficient evidence to support historical transactions, and prepare auditable financial statements. While substantial progress was made in FY 2012, Coast Guard was unable to complete certain reconciliations or provide evidence supporting certain components of general property, plant, and equipment (PP&E), and heritage and stewardship assets, as presented in the accompanying FY 2012 financial statements and notes. Accordingly, we were unable to complete our audit procedures over these components of the PP&E balance. The unaudited PP&E balances, as reported in the accompanying balance sheet are $8.3 billion or approximately 40 percent of total PP&E net book value at September 30, 2012.

In our opinion, except for the effects on the FY 2012 financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to apply adequate audit procedures to certain PP&E balances and heritage and stewardship assets, as discussed in the preceding paragraph, the FY 2012 financial statements referred to above present fairly, in all material respects, the financial position of DHS as of September 30, 2012, and its net costs, changes in net position, custodial activities, and budgetary resources, for the year ended September 30, 2012, in conformity with U.S. generally accepted accounting principles.

In our report dated November 12, 2011, we expressed an opinion on the Department's FY 2011 financial statements qualified for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence supporting general PP&E balances, heritage and stewardship assets, and environmental liabilities, at September 30, 2011. Since that date, the Department has provided us with evidence supporting the environmental liability balances, and has restated such liabilities in the accompanying September 30, 2011 balance sheet. Accordingly, our present opinion on the FY 2011 financial statements is different from that expressed in our previous report.

In our opinion, except for the effects on the FY 2011 financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to apply adequate procedures to general PP&E, and heritage and stewardship assets, as discussed in the preceding paragraph, the FY 2011 financial statements referred to above present fairly, in all material respects, the financial position of DHS as of September 30, 2011 and its custodial activity for the year then ended, in conformity with U.S. generally accepted accounting principles. Coast Guard PP&E, as reported in the accompanying balance sheet is $9.9 billion, or approximately 50 percent of total PP&E net book value, as of September 30, 2011.

KPMG

We were not engaged to audit the accompanying statements of net cost, changes in net position, and budgetary resources for the year ended September 30, 2011 and accordingly, we do not express an opinion on these other FY 2011 financial statements.

As discussed in Notes 1B and 23 of the financial statements, the Department changed its presentation of the statement of net cost for the year ended September 30, 2012 to present costs and revenues by major mission, to conform to its strategic plan issued during FY 2012, as required by OMB Circular No. A-136, *Financial Reporting Requirements*, as amended. The statement of net cost for the year ended September 30, 2011 has not been adjusted to conform to the current year presentation.

As discussed in Note 1B of the financial statements, the Department changed its presentation for reporting the statement of budgetary resources in FY 2012, based on new reporting requirements under OMB Circular No. A-136, *Financial Reporting Requirements*, as amended. The statement of budgetary resources for FY 2011 has been reclassified to conform to the current year presentation.

As discussed in Note 32 of the financial statements, the Department changed its method of accounting for repairable spare parts maintained by the Coast Guard, and for certain user fees collected by Customs and Border Protection. These accounting changes were reflected in the FY 2012 financial statements.

As discussed in Note 34 of the financial statements, the Department has restated environmental liabilities as presented in the September 30, 2011 balance sheet.

As discussed in Notes 1T and 15 of the financial statements, the Department has intergovernmental debt of approximately $17.8 billion used to finance the *National Flood Insurance Program*. Due to the subsidized nature of the NFIP, the Department has determined that future insurance premiums, and other anticipated sources of revenue, may not be sufficient to repay this debt. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

U.S. generally accepted accounting principles require that the information in the Management's Discussion and Analysis (MD&A), Required Supplementary Information (RSI), and Required Supplementary Stewardship Information (RSSI) sections of the DHS FY 2012 Annual Financial Report (AFR) be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Federal Accounting Standards Advisory Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We were unable to complete limited procedures over MD&A, RSSI, and RSI information presented in the AFR as prescribed by professional standards because of the limitations on the scope of our audit described in the second and fourth paragraphs of this section of our report. We did not audit the MD&A, RSSI, and RSI information presented in the AFR and accordingly, we express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements as a whole. The information in the Other Accompanying Information section of the AFR and the information on pages 189 through 289 are presented for the purposes of additional analysis and are not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on them.

Internal Control Over Financial Reporting

We were engaged to audit the Department's internal control over financial reporting of the FY 2012 financial statements based on the criteria established in OMB Circular No. A-123, *Management's Responsibility for Internal Control* (OMB Circular No. A-123), Appendix A. DHS management is responsible for establishing and maintaining effective internal control over financial reporting, and for its assertion on the effectiveness of internal control over financial reporting, included in the FY 2012 DHS *Secretary's Assurance Statement*, included in MD&A on pages 34-35 of the AFR, as required by OMB Circular No. A-123. We did not test all controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*.

The FY 2012 DHS *Secretary's Assurance Statement* states that the Department provides qualified assurance that internal control over financial reporting was operating effectively at September 30, 2012, and acknowledges that material weaknesses continue to exist in key financial processes. This conclusion is based on the Department's limited-scope evaluation of internal control over financial reporting conducted in FY 2012 and previous years.

Because of the limitation on the scope of our audit described in the second paragraph of the Opinion on the Financial Statements section, and the nature of managements assertion on the effectiveness of internal control over financial reporting described in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express an opinion on the effectiveness of DHS's internal control over financial reporting.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. Material weaknesses in internal control over financial reporting have been identified in the following areas:

- Financial Reporting
- Information Technology Controls and Financial Systems Functionality
- Property, Plant, and Equipment
- Environmental and Other Liabilities
- Budgetary Accounting

Deficiencies identified that contribute to a material weakness at the consolidated level are presented in Exhibit I.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. Our consideration of internal control was for the purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in DHS's internal control that might be significant deficiencies. However, in accordance with *Government Auditing Standards*, we are required to report significant deficiencies in internal control identified during our audit. Significant deficiencies have been identified in the following areas:

- Entity-Level Controls
- Grants Management
- Custodial Revenue and Drawback.

Deficiencies identified that contribute to a significant deficiency at the consolidated level are presented in Exhibit II.

Other deficiencies in internal control, potentially including additional material weaknesses and significant deficiencies, may have been identified and reported had we been able to apply sufficient audit procedures to general property, plant, and equipment including heritage and stewardship assets, as described in the second paragraph of the Opinion on the Financial Statements; and had we been able to perform all procedures necessary to express an opinion on DHS's internal control over financial reporting of the FY 2012 financial statements.

A summary of the status of material weaknesses and significant deficiencies reported in FY 2011 is included as Exhibit IV. We also noted certain additional deficiencies involving internal control over financial reporting and its operation that we will report to the management of DHS in a separate letter.

Compliance and Other Matters

The results of certain of our tests of compliance as described in the Responsibilities section of this report, exclusive of those referred to in the *Federal Financial Management Improvement Act of 1996* (FFMIA), disclosed the following four instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 07-04, and are described in Exhibit III:

- *Federal Managers' Financial Integrity Act of 1982*
- *Federal Financial Management Improvement Act of 1996*

- *Single Audit Act Amendments of 1996*
- *Anti-deficiency Act*

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

The results of our tests of FFMIA disclosed instances described in Exhibits I, and II where DHS's financial management systems did not substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level.

Other instances of noncompliance with laws, regulations, contracts, and grant agreements may have been identified and reported, had we been able to apply sufficient audit procedures to general property, plant, and equipment including heritage and stewardship assets as described in the second paragraph of our Opinion on the Financial Statements, and perform all procedures necessary to complete our audit of internal control over financial reporting.

Other Matters: We also reported other matters related to compliance with the *Anti-deficiency Act* at the Coast Guard and Intelligence & Analysis in Exhibit III.

* * * * * * *

Responsibilities

Management's Responsibilities. Management is responsible for the financial statements; establishing and maintaining effective internal control over financial reporting; and complying with laws, regulations, contracts, and grant agreements applicable to the Department.

Auditors' Responsibilities. Our responsibility is to express an opinion on the financial statements of DHS based on our audits. Except as discussed in the second and fourth paragraphs of our Opinion on Financial Statements above, we conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Bulletin No. 07-04. Those standards and OMB Bulletin No. 07-04 require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit also includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall financial statement presentation.

We believe that our audits provide a reasonable basis for our opinion.

As part of obtaining reasonable assurance about whether DHS's FY 2012 financial statements are free of material misstatement, we performed tests of DHS's compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of the FY 2012 financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 07-04, including the provisions referred to in Section 803(a) of FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to DHS. However, providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our audit, and accordingly, we do not express such an opinion.

DHS's written response to the deficiencies in internal control, instances of noncompliance or other matters identified in our audit is presented attached to our report, and was not subjected to the auditing procedures applied in the audit of the DHS's financial statements and, accordingly, we express no opinion on it.

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

KPMG LLP

November 14, 2012

Our report on internal control over financial reporting and compliance and other matters is presented in accordance with *Government Auditing Standards,* issued by the Comptroller General of the United States. The internal control weaknesses and findings related to compliance with certain laws, regulations, contracts, and grant agreements presented herein were identified during our audit of the U.S. Department of Homeland Security (Department or DHS)'s financial statements as of, and for the year ended, September 30, 2012, and our engagement to audit internal control over financial reporting of those financial statements. Our findings and the status of prior year findings are presented in five exhibits:

Exhibit I Significant deficiencies in internal control identified throughout the Department. All of the significant deficiencies reported in Exhibit I are considered material weaknesses at the DHS consolidated level. Beginning in FY 2012 internal control findings identified at the Coast Guard are presented with all other DHS components in Exhibit I, whereas previously Coast Guard findings were presented separately.

Exhibit II Significant deficiencies identified throughout the Department that are not considered a material weakness at the DHS consolidated financial statement level.

Exhibit III Instances of noncompliance with certain laws, regulations, contracts, and grant agreements that are required to be reported under *Government Auditing Standards* or Office of Management and Budget (OMB) Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*, as amended.

Exhibit IV The status of our findings reported in FY 2011.

Criteria *Index of Financial Reporting and Internal Control Criteria*

As stated in our Independent Auditors' Report, the scope of our work was not sufficient to enable us to express an opinion on the effectiveness of DHS' internal control over financial reporting as of September 30, 2012. Consequently, additional deficiencies in internal control over financial reporting, potentially including additional material weaknesses and significant deficiencies may have been identified and reported, had we been able to perform all procedures necessary to express an opinion on DHS' internal control over financial reporting.

The determination of which findings rise to the level of a material weakness is based on an evaluation of how deficiencies identified in all components, considered in aggregate, may affect the DHS financial statements as of September 30, 2012 and for the year then ended.

We have also performed follow-up procedures on findings identified in previous engagements to audit the DHS financial statements. To provide trend information for the DHS components, Exhibits I and II contain Trend Tables next to the heading of each finding. The Trend Tables in Exhibits I and II depict the severity and current status of findings, by component that has contributed to that finding from FY 2010 through FY 2012. Listed in the title of each material weakness and significant deficiency included in Exhibits I and II, are the DHS components that contributed to the finding in FY 2012.

The criteria supporting our findings, such as references from technical accounting standards, various rules and regulations, including requirements issued by the Office of Management and Budget and the U.S. Treasury, and internal Departmental and component directives, is presented in the *Index of Financial Reporting and Internal Control Criteria* behind Exhibit IV.

A summary of our findings in FY 2012 and FY 2011 are presented in the Tables below:

Table 1 Presents a summary of our internal control findings, by component, for FY 2012.
Table 2 Presents a summary of our internal control findings, by component, for FY 2011.

We have reported five material weaknesses and three significant deficiencies at the Department level in FY 2012, shown in Table 1.

TABLE 1 – SUMMARIZED DHS FY 2012 INTERNAL CONTROL FINDINGS
(Full-Scope Financial Statement Audit)

Comments / Financial Statement Area		DHS Consol.	CG	CBP	USCIS	FEMA	FLETC	ICE	MGMT	NPPD	TSA
Material Weakness:			Exhibit I								
A	Financial Reporting	MW									
B	IT Controls and System Functionality	MW									
C	Property, Plant, and Equipment	MW									
D	Environmental and Other Liabilities	MW									
E	Budgetary Accounting	MW									
Significant Deficiencies:			Exhibit II								
F	Entity-Level Controls	SD									
H	Grants Management	SD									
I	Custodial Revenue and Drawback	SD									

TABLE 2 – SUMMARIZED DHS FY 2011 INTERNAL CONTROL FINDINGS
(Balance Sheet and Statement of Custodial Activity Audit)

Comments / Financial Statement Area		DHS Consol.	CG	CBP	USCIS	FEMA	FLETC	ICE	MGMT	TSA
			Military	Civilian						
Material Weakness:			Exhibit I	Exhibit II						
A	Financial Reporting	MW								
B	IT Controls and System Functionality	MW								
C	Property, Plant, and Equipment	MW								
D	Environmental and Other Liabilities	MW								
E	Budgetary Accounting	MW								
Significant Deficiencies:			Exhibit III							
F	Entity-Level Controls	SD								
G	Fund Balance with Treasury	SD								
H	Grants Management	SD								
I	Custodial Revenue and Drawback	SD								

	Control deficiency findings are ***more significant*** to the evaluation of effectiveness of controls at the Department-Level
	Control deficiency findings are ***less significant*** to the evaluation of effectiveness of controls at the Department-Level
MW	Material weakness at the Department level exists when all findings are aggregated
SD	Significant deficiency at the Department level exists when all findings are aggregated

All components of DHS, as defined in Note 1A – *Reporting Entity,* to the financial statements, were included in the scope of our audit of the DHS financial statements as of September 30, 2012, and our engagement to audit internal control over financial reporting of those financial statements. Accordingly, our audit and engagement to examine internal control considered significant account balances, transactions, and accounting processes of other DHS components not listed above. Control deficiencies identified in other DHS components that are not identified in the table above did not individually, or when combined with other component findings, contribute to a material weakness or significant deficiency at the DHS consolidated financial statement level.

I-A Financial Reporting (USCG, TSA, ICE)

Background: The U.S. Coast Guard (Coast Guard or USCG) continued to make financial reporting improvements in fiscal year (FY) 2012, by completing its planned corrective actions over selected internal control deficiencies, as described in the *Financial Strategy for Transformation and Audit Readiness* (FSTAR). These remediation efforts allowed management to make new assertions in FY 2012 related to the auditability of its financial statement balances, including approximately $500 million of environmental liabilities and $3 billion of real property. The FSTAR calls for continued remediation of control deficiencies and reconciliation of balances in FY 2013. Consequently, some financial reporting control weaknesses that we reported in the past remain uncorrected at September 30, 2012.

Trend Table

	2012	2011	2010
USCG			
TSA			
ICE		N/A	N/A
USCIS	C		N/A

Key – Trend Table

C	Deficiencies are corrected
N/A	No deficiencies reported
	Deficiencies are less severe*
	Deficiencies are more severe*

* See Introduction

Transportation Security Administration (TSA) continued to make progress in strengthening internal controls. However, we noted that deficiencies remain in some financial reporting processes throughout the component.

Immigration and Customs Enforcement (ICE) financial reporting deficiencies were identified primarily as a result of expanded audit procedures for the full-scope financial statement audit.

USCIS substantially completed corrective actions in financial reporting processes in FY 2012.

Conditions: We noted the following internal control weaknesses related to financial reporting at Coast Guard, TSA, and ICE.

1. The Coast Guard does not have properly designed, implemented, and effective policies, procedures, processes, and controls surrounding its financial reporting process to:

   - Ensure that all non-standard adjustments (i.e., journal entries, top side adjustments, and scripts) impacting the general ledger are adequately researched, supported, and reviewed prior to their recording in the general ledger, or identify and document the financial statement impact of all "non-GAAP" policies.

   - Completely support beginning balance and year-end close-out related activity in its three general ledgers.

   - Ascertain that intra-governmental activities and balances are identified and coded to the correct trading partner. Additionally, differences, especially with agencies outside DHS, are not consistently investigated and resolved in a timely manner in coordination with the Department's Office of Financial Management (OFM).

   - Maintain general ledger activity in compliance with the United States Standard General Ledger (USSGL) at the transaction level.

2. TSA:

   - Has weak or ineffective controls affecting some key financial reporting processes. The control deficiencies noted included weaknesses in transactional and supervisory reviews over capital acquisitions including internal use software, expenses, budgetary accounts, and lease reporting.

   - Controls are not functioning within an acceptable degree of precision over management's quarterly review of financial statements and supervisory reviews over journal vouchers, including understanding the business events that trigger a financial reporting event.

- Has not fully engaged certain program and operational personnel and data into the financial reporting process.
- Is not fully compliant with the USSGL requirements at the transaction level.

3. ICE:

- Has not fully developed its agency-specific financial reporting process with sufficient policies, procedures, and internal controls. The control deficiencies contributed to the need for corrective adjustments in the financial statements. For example, we noted that ICE:
  - Does not have effective controls over the accrual and subsequent reversal of payroll expense; and
  - Does not have an effective process to identify material subsequent events that may impact year-end financial statement balances or note disclosures.
- Has not dedicated adequate resources to effectively respond to audit inquiries in a timely manner, with accurate information, and to identify potential technical accounting issues. Specifically, we noted ICE:
  - In some instances, was unable to provide documentation in a timely manner to support some journal entry transactions and prior period adjustments. Journal entry activity represented a substantial portion of the transactions in the general ledger detail for certain accounts including undelivered orders and operating expenses;
  - In some instances, was unable to timely respond to audit requests for accounts payable and undelivered order general ledger detail, and adjustments of prior year unpaid undelivered orders; and
  - Was unable to effectively identify potential technical accounting issues, analyze the relevant facts and circumstances, and respond to auditor inquiries on a timely basis.
- Is not fully compliant with the USSGL requirements at the transaction level.

Cause/Effect: The Coast Guard does not have an effective general ledger system. The Coast Guard uses three general ledgers, developed over a decade ago. This legacy system has severe functional limitations contributing to the Coast Guard's challenge of addressing systemic internal control weaknesses in financial reporting, strengthening the control environment, and complying with relevant Federal financial system requirements and guidelines, notably Comment **III-J**, *Federal Financial Management Improvement Act of 1996* (FFMIA). The Coast Guard has installed a shadow general ledger system to duplicate transaction postings as a control over financial reporting. See information technology (IT) system functionality issues described at Comment **I-B**, *Information Technology Controls and Financial Systems Functionality.* The conditions supporting our findings collectively limit the Coast Guard's ability to process, store, and report financial data in a manner that ensures accuracy, confidentiality, integrity, and availability of data without substantial manual intervention. These conditions contribute to the Coast Guard's continuing challenges with preparing auditable general property, plant, and equipment balances as further described in Comment **I-C**, *Property, Plant, and Equipment*.

In recent years, TSA has implemented several new procedures and internal controls to correct known deficiencies. However, some procedures still require modest improvements to fully consider all circumstances or potential errors that could occur in the process. The control deficiencies contributed to substantive and classification errors in the financial statements, discovered during our audit.

ICE faces challenges in developing and maintaining adequate lines of communications both within the ICE OFM and amongst its various and decentralized program offices. Communication between financial managers and personnel responsible for contributing to financial reports was not sufficient to consistently generate clear and usable information. In addition, ICE does not have sufficient coordination with IT personnel, including contractors, who are responsible for generating certain financial reports. Also see Comment **II-F,** *Entity-Level Controls*.

Because of the conditions noted above, and described throughout Exhibits I and II, the Department was unable to provide full assurance that internal controls over financial reporting were operating effectively at September 30, 2012, and has acknowledged in the Secretary's Assurance Statement presented in *Management's, Discussion, and Analysis* section of the FY 2012 Annual Financial Report that material weaknesses and other internal control deficiencies continue to exist in some key financial processes.

Criteria: Presented in *Index of Financial Reporting and Internal Control Criteria,* after Exhibit IV.

Recommendations: We recommend that:

1. USCG:
   a. Continue the implementation of the FSTAR as planned in FY 2013;
   b. Implement accounting and financial reporting processes including an integrated general ledger system that is FFMIA compliant; and
   c. Establish new or improve existing policies, procedures, and related internal controls to ensure that:
      i) All non-standard adjustments (i.e., journal entries, top side adjustments, and scripts) impacting the general ledger are adequately researched, supported, and reviewed prior to their recording in the general ledger;
      ii) All "non-GAAP" policies are identified and their quantitative and qualitative financial statement impacts have been documented;
      iii) 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; and
      iv) All intra-governmental activities and balances are reconciled on a timely basis, accurately reflected in the financial statements, and differences are resolved in a timely manner in coordination with the Department's OFM.
2. TSA:
   a. Emphasize and train employees on the critical aspects of key transactional and supervisory review controls including the precision of the review, the need for supporting documentation, and impact to the financial statements;
   b. Work with the TSA leasing office to implement formal and effective processes for identification, evaluation, and recording of cancellable, non-cancellable, and capital leases;
   c. Expand the monthly financial statement review process to incorporate operational and business activities into the evaluation and assessment process; and
   d. Continue to analyze alternatives, including evaluation of systems, to enable FFMIA compliance.
3. ICE:
   a. Develop and implement agency-specific financial reporting policies, procedures, supporting sub-processes, and internal controls to ensure that accruals and subsequent reversals are correct, and subsequent event reviews are effective in identifying material transactions that affect the financial statements;
   b. Implement procedures to involve financial management, and others as needed, when making accounting policy decisions to ensure that adopted accounting policies are technically correct, supported, and properly reflect the business transaction in the financial statements;
   c. Assess resource needs and assign sufficient staff to respond to audit inquiries with accurate and complete information in a timely manner; and
   d. Develop formal policies and procedures to ensure compliance with the USSGL requirements at the transaction level.

I-B Information Technology Controls and Financial System Functionality (USCG, CBP, USCIS, FEMA, ICE)

	2012	2011	2010
USCG			
CBP			
USCIS			
FEMA			
ICE			

See page I.1 for table explanation

Background: During DHS' financial statement integrated audit, we evaluated select general Information Technology (IT) controls (GITC) using the objectives defined by U.S. Government Accountability Office (GAO)'s *Federal Information System Controls Audit Manual* (FISCAM), in five key control areas: security management, access control, configuration management, segregation of duties, and contingency planning. In addition to GITCs, we evaluated select application controls, which are controls supporting the structure, policies, and procedures that apply to the use, operability, interface, edit, and monitoring controls of a financial application.

During our FY 2012 assessment of IT general and application controls, we noted that the DHS components made progress in the remediation of IT findings we reported in FY 2011. We closed approximately 70 (46 percent) of our prior year IT findings.

New findings in FY 2012 resulted primarily from additional IT systems and business processes that came within the scope of our audit this year, and were noted at all DHS components. CBP and FEMA had the greatest number of new findings. We also considered the effects of financial system functionality when testing internal controls and evaluating findings. Many key DHS financial systems are not compliant with FFMIA and OMB Circular Number A-127, *Financial Management Systems,* as revised. DHS financial system functionality limitations add substantially to the Department's challenges of addressing systemic internal control weaknesses, and limit the Department's ability to leverage IT systems to effectively and efficiently process and report financial data.

Conditions: Our findings, which are a cross-representation of common general IT control deficiencies identified throughout the Department's components, related to IT general and application controls and financial systems functionality follow:

Related to IT general and application controls:

1. *Access Controls*:

   - Deficiencies in management of application and/or database accounts, network, and remote user accounts.
   - Ineffective safeguards over logical and physical access to sensitive facilities and resources.
   - Lack of generation, review, and analysis of system audit logs and adherence to DHS requirements.
   - Excessive access of authorized personnel to sensitive areas containing key financial systems, and data center access controls were not properly enforced.

2. *Configuration Management*

   - Lack of documented policies and procedures.
   - Script management test plans were not documented to meet the minimum DHS requirements.
   - Security patch management and configuration deficiencies were identified during the vulnerability assessment on the platforms supporting the key financial applications and general support systems.
   - Evidence to support authorized modifications to key financial systems was not maintained.
   - Internal requirements to conduct Functional Configuration Audits (FCAs) and Physical Configuration Audits (PCAs) were not followed at one component.

3. *Security Management:*
   - Systems certification and accreditation were not completed and documented.
   - IT Security personnel lack mandatory role-based training or compliance was not documented and monitored, and computer security awareness training was not monitored.
   - Background investigations of federal employees and contractors employed to operate, manage and provide security over IT systems were not being properly conducted, nor consistently tracked and monitored.
4. *Contingency Planning:*
   - Service continuity plans were not tested nor updated to reflect the current environment, and an alternate processing site has not been established for high risk systems.
   - Authorized access to backup media was not periodically reviewed and updated; at one component procedures to periodically test backups was not implemented.
5. *Segregation of Duties:*
   - Lack of evidence to show that least privilege and segregation of duties controls exist, including policies and procedures to define conflicting duties and access rights.

These control findings, including other significant deficiencies and criteria are described in greater detail in a separate *Limited Official Use* letter provided to DHS management.

Related to financial system functionality:

Coast Guard (some conditions impact TSA as a user of Coast Guard's IT accounting systems):

- The core financial system configuration management process relies on an IT script process as a solution primarily to compensate for system functionality and data quality issues.
- The component is unable to routinely query its various general ledgers to obtain a complete population of financial transactions, and consequently must create many manual custom queries that delay financial processing and reporting processes.
- A key financial system is limited in processing overhead cost data and depreciation expenses in support of the property, plant and equipment financial statement line item.
- Production versions of financial systems are outdated and do not provide the necessary core functional capabilities (e.g., general ledger capabilities).
- The budgetary module of the core financial system is not activated. As a result, key attributes (e.g., budget fiscal year) are missing and potential automated budgetary entries (e.g., upward adjustments) are not used. This has created the need for various manual workarounds and non-standard adjustments (i.e., topsides) to be implemented.
- 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:
  - Receipt of goods and services upon delivery. As a result, the Coast Guard records a manual estimate of potential receipted goods and services at year end in the general ledger;
  - Ensuring proper segregation of duties and access rights, such as automating the procurement process to ensure that only individuals who have proper contract authority can approve transactions or setting system access rights within the fixed asset subsidiary ledger;

- Maintaining adequate posting logic transaction codes to ensure that transactions are recorded in accordance with generally accepted accounting principles (GAAP); and
- Tracking detailed transactions associated with intragovernmental business and eliminating the need for default codes such as Trading Partner Identification Number that cannot be easily researched.

Other Department Components:

We noted many cases where financial system functionality is inhibiting DHS' ability to implement and maintain internal controls, notably IT application controls supporting financial data processing and reporting. Financial system functionality limitations also contribute to other control deficiencies reported in Exhibits I and II, and compliance findings presented in Exhibit III. We noted persistent and pervasive financial system functionality conditions at all of the significant DHS components in the following general areas:

- Inability of financial systems to process, store, and report financial and performance data to facilitate decision making, safeguarding and management of assets, and prepare financial statements that comply with GAAP.

- Technical configuration limitations, such as outdated systems that are no longer fully supported by the software vendors, impaired DHS' ability to fully comply with policy in areas such as IT security controls, notably password management, audit logging, user profile changes, and the restricting of access for off-boarding employees and contractors.

- System capability limitations prevent or restrict the use of applications controls to replace less reliable, more costly manual controls. Or in some cases, require additional manual controls to compensate for IT security or control weaknesses.

Cause/Effect: DHS management recognizes the need to upgrade its financial systems. Until serious legacy IT issues are addressed, and updated IT solutions implemented, compensating controls and other complex manual workarounds must support its IT environment and financial reporting. As a result, DHS' difficulty in attesting to a strong control environment, to include effective general IT controls and reliance on key financial systems, will continue.

The conditions supporting our findings collectively limit DHS' ability to process, store, and report financial data in a manner to ensure accuracy, confidentiality, integrity, and availability. Some of the weaknesses may result in material errors in DHS' financial data that are not detected in a timely manner through the normal course of business. In addition, because of the presence of IT control and financial system functionality weaknesses; there is added pressure on mitigating controls to operate effectively. Because mitigating controls are often more manually focused, there is an increased risk of human error that could materially affect the financial statements.

Recommendation: We recommend that the DHS Office of the Chief Information Officer (OCIO), in coordination with the Office of the Chief Financial Officer (OCFO) continue the *Financial Systems Modernization* initiative, and make necessary improvements to the Department's financial management systems and supporting IT security controls. Specific recommendations are provided in a separate *Limited Official Use* letter provided to DHS management.

I-C Property, Plant, and Equipment (USCG, CBP, ICE)

	2012	2011	2010
USCG			
CBP			
ICE		N/A	C
TSA	C		
MGMT	C		N/A

See page I.1 for table explanation

Background: The Coast Guard maintains approximately 50 percent of all DHS general property, plant, and equipment (PP&E). 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. The Coast Guard categorizes PP&E as personal property (i.e., aircraft, vessels, vehicles, leasehold improvements, software, information technology, and other equipment), real property (i.e., land, improvements to land, buildings, other structures, and facilities), or construction-in-process (CIP).

DHS stewardship PP&E primarily consists of Coast Guard 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. Coast Guard heritage assets consist 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.

In FY 2012, the Coast Guard continued to perform remediation to address PP&E process and control deficiencies, specifically those associated with land, buildings and other structures, vessels, small boats, aircraft, and CIP. However, remediation efforts were not fully completed in FY 2012, and consequently, most of the conditions cited below have been repeated from our FY 2011 report.

Customs and Border Protection (CBP) has acquired substantial new technology, facilities, and other assets in recent years through purchase and construction. CBP's new assets include construction of border fencing (both physical and virtual), purchase of inspection equipment at ports of entry, and new construction at port of entry facilities.

ICE underwent a process to identify assets that had been inappropriately expensed in prior fiscal years, resulting in corrective adjustments made to the financial statements in FY 2012.

The Management Directorate (MGMT) implemented new processes to remediate PP&E control deficiencies in FY 2012.

TSA substantially completed corrective actions in property, plant, and equipment accounting processes in FY 2012. Remaining control deficiencies affecting PP&E are broadly related to financial reporting, and have been grouped with conditions cited at Comment **I-A**, *Financial Reporting*

Conditions: We noted the following internal control weaknesses related to PP&E at USCG, CBP, and ICE:

1. USCG:

- Has not fully established accurate and auditable PP&E balances as of September 30, 2012 for personal property and CIP balances reported in the financial statements and related disclosures and supplementary information. For example, USCG has not:
  - Implemented sufficient internal controls and related processes to accurately, consistently, and timely record additions to PP&E, (including all costs necessary to place the asset in service e.g., other direct costs), transfers from other agencies, disposals, and CIP activity.
  - Sufficiently supported its methodologies, assumptions, and underlying data, for indirect costs allocated to PP&E projects.
  - 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 personal property assets to the fixed assets system.
  - Properly accounted for improvements and impairments to personal property assets, capital leaseholds, selected useful lives for depreciation purposes, and capitalization thresholds, consistent with GAAP.

- Has not implemented policies, procedures, and effective controls to ensure the accuracy of all underlying data elements and assumptions used to record real property balances, such as land, buildings and other structures.
- Has not implemented a process to identify and evaluate all lease agreements to ensure that they are appropriately categorized as operating or capital, and properly reported in the financial statements and related disclosures.
- Has not 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.

2. CBP:

- Does not always adhere to procedures and processes to properly account for asset purchases and transfers, construction, depreciation, or disposal of assets in a timely manner. For example, CBP did not:
  - Ensure all asset additions are recorded accurately and timely, and are correctly valued in the financial statements.
  - Transfer certain assets from CIP to "in-use" assets in a timely manner.
  - Record some asset disposals timely and in accordance with policy.
  - Maintain complete documentation supporting the timely and accurate accounting for asset transactions, so that it is available for audit.

3. ICE:

- Does not have adequate processes and controls in place to identify internal-use software projects that should be considered for capitalization. After a project has been identified for capitalization, ICE did not have adequate processes to capitalize costs associated with the software project. Similar control weaknesses exist for other types of PP&E and indirect costs at ICE.
- Does not have adequate policies and procedures to ensure that assets acquired are recorded in the general ledger in a timely manner. The majority FY 2012 additions to PP&E that we tested were purchased in previous years, but not recorded in the general ledger until the current year.

Cause/Effect: The Coast Guard has had difficulty establishing its opening PP&E balances and accounting for leases, primarily because of poorly designed policies, procedures, and processes implemented more than a decade ago, combined with ineffective internal controls, and IT system functionality difficulties, See Comment **I-B,** *Information Technology Controls and Financial System Functionality.* Additionally, due to limited resources, the Coast Guard deferred corrective actions associated with personal property and stewardship PP&E to FY 2013. As a result, the Coast Guard is unable to accurately account for personal property, CIP, stewardship PP&E, and leases, and provide necessary information to DHS OFM for consolidated financial statement purposes.

CBP does not have fully implemented policies and procedures, or does not have sufficient oversight of its adherence to policies and procedures, to ensure that all PP&E transactions are recorded timely and accurately, or to ensure that all assets are recorded and properly valued in the general ledger.

ICE had not incurred substantial costs for internal use software until recent years, and previously treated capital expenditures as period costs as incurred. When ICE increased spending on capital projects, appropriate systems and processes were not established to properly account for the costs, or identify costs that qualify for capitalization as internal use software. In FY 2012, ICE completed a review of past and current projects, and recorded an adjustment to the financial statements to properly reflect capitalized internal use software.

Criteria: Presented in *Index of Financial Reporting and Internal Control Criteria,* after Exhibit IV.

Recommendations: We recommend that:

1. USCG:

   a. Continue remediation efforts to establish PP&E balances in the financial statements and related disclosures and supplementary information, including appropriate controls and related processes to accurately and timely record additions to PP&E, transfers from other agencies, improvements, impairments, capital leases, indirect costs, and disposals. Additionally, continue to implement controls over the completeness, existence, accuracy, and valuation of all CIP related balances and activity;

   b. Establish new or improve existing policies, procedures, and related internal controls to sufficiently support methodologies, assumptions, and underlying data, for indirect costs allocated to PP&E projects;

   c. Implement processes and controls to facilitate identification and tracking, and to ensure that the status of assets is accurately tracked in the subsidiary ledger;

   d. Implement internal controls to ensure the accuracy of underlying data elements, calculations, and assumptions used to support real property balances;

   e. Develop and implement a process to identify and evaluate lease agreements to ensure that they are appropriately classified as operating or capital, and are properly reported in the financial statements and related disclosures; and

   f. Develop and implement policies, procedures, and internal controls to support the completeness, existence, accuracy, and presentation and disclosure assertions related to supplementary information for stewardship PP&E.

2. CBP:

   a. Ensure that existing policies and procedures for recording asset additions, reclassifications, and retirements are followed, and properly communicated throughout CBP;

   b. Enhance supervisory and monitoring controls to review PP&E transactions in a timely manner; and

   c. Maintain complete documentation supporting asset transactions recorded in the general ledger.

3. ICE:

   a. Develop and implement sustainable processes and controls to identify internal-use software projects at the time of project inception, and to timely record capitalized software costs and associated indirect costs; and

   b. Develop and implement policies and procedures to ensure that assets acquired are recorded in a timely manner.

I-D Environmental and Other Liabilities (USCG)

	2012	2011	2010
USCG			
See page I.1 for table explanation			

Background: The Coast Guard's environmental liabilities represent approximately $500 million or 75 percent of total DHS environmental liabilities. During FY 2012, the Coast Guard completed the final phases of a multi-year remediation plan to address process and control deficiencies related to environmental liabilities.

The Coast Guard estimates accounts payable by adjusting the prior year accrual estimate based on an analysis of actual payments made subsequent to September 30 of the prior year.

Conditions: We noted the following internal control weaknesses related to environmental liabilities and other liabilities at the Coast Guard:

Regarding Environmental Liabilities:

The Coast Guard did not:

- Implement policies and procedures to develop, record, and periodically review environmental liability estimates until later in FY 2012.
- Implement effective controls to ensure the completeness and accuracy of all underlying data components used in the calculation of environmental liability balances.
- Have documented policies and procedures to update, maintain, and review schedules tracking environmental liabilities where Coast Guard is not the primary responsible party (e.g., Formerly Used Defense Sites) at the headquarters level.

By the end of FY 2012, management implemented new internal controls that they believe will address these deficiencies.

Regarding Other Liabilities:

The Coast Guard did not effectively implement existing policies and procedures associated with the:

- Validation (i.e., "look back") performed over the prior year accounts payable estimate. Specifically, the Coast Guard did not consider all of the relevant factors contributing to the variance identified in the analysis and determine the impact on the current year estimate.
- Consideration of potentially relevant current year data on the accounts payable estimate. As a result, current year data that may have a significant impact on the estimate could be overlooked and not identified until a true-up is performed in the subsequent year.
- Statistical calculation of the accounts payable estimate. Errors were identified in the treatment of sample items that impacted the extrapolation of the statistical results and related accounts payable estimate.

Cause/Effect: The Coast Guard did not fully complete its remediation plans to develop, document, and implement policies and procedures to prepare and record environmental liability estimates in accordance with applicable accounting standards until the fourth quarter of FY 2012. As a result, internal control weaknesses existed throughout the year, environmental liability balances were misstated until the fourth quarter of FY 2012, and $478 million in adjustments to the prior period financial statements were identified and recorded.

The Coast Guard did not fully implement and document their existing accounts payable accrual procedures. Additionally, the management review controls over samples used in the accounts payable estimate were not operating effectively. Without consideration of applicable look back results and current year data and effective review of underlying data used in the calculation of accounts payable, a misstatement in the accounts payable estimate may occur and not be identified in a timely manner (i.e., until validation is performed in a subsequent period).

Criteria: Presented in *Index of Financial Reporting and Internal Control Criteria,* after Exhibit IV.

Recommendations: We recommend that the Coast Guard:

Regarding Environmental Liabilities:

1. Ensure that existing policies and procedures over the completeness and accuracy of underlying data used in the calculation of environmental liability balances are properly followed and performed; and
2. Develop and implement policies and procedures to update, maintain, and review schedules tracking environmental liabilities where Coast Guard is not the primary responsible party (e.g., Formerly Used Defense Sites) at the headquarters level.

Regarding Other Liabilities:

3. Improve the enforcement of existing policies and procedures related to the accounts payable estimate. In particular, emphasize the importance of the consideration and documentation of applicable look back results and current year data, and effective review of underlying data, used in the calculation of the accounts payable estimate.

I-E Budgetary Accounting (USCG, FEMA, ICE, MGMT, FLETC)

	2012	2011	2010
USCG			
FEMA			
ICE		N/A	N/A
MGMT		N/A	N/A
FLETC		N/A	N/A
See page I.1 for table explanation			

Background: DHS has numerous sources and types of budget authority, including annual, multi-year, no-year and permanent and indefinite appropriations, as well as several revolving, special, and trust funds. Accounting for budgetary transactions in a timely and accurate manner is essential to managing the funds of the Department and preventing overspending of allotted budgets.

Coast Guard implemented corrective actions plans over various budgetary accounting processes in FY 2012; however, some control deficiencies reported in FY 2011 remain, and new deficiencies were identified.

In FY 2012, FEMA continued to improve its processes and internal controls over the obligation and monitoring process; however, some control deficiencies remain.

As the financial service reporting provider, ICE is responsible for recording budgetary transactions and administering budgetary processes across different types of funds at NPPD, Science and Technology Directorate (S&T), MGMT, and Office of Heath Affairs (OHA). In FY 2011, ICE identified and began remediating deficiencies in the system posting logic related to downward and upward adjustments of prior year unpaid undelivered orders. In FY 2012, ICE continued to address these issues with certain types of obligations.

The Management Directorate is responsible for the operations and financial oversight of several programs including the DHS Working Capital Fund. The Working Capital Fund provides shared services to DHS agencies. In FY 2012, MGMT recorded several corrective adjustments that were indicative of deficiencies in internal controls over financial reporting at the process level.

The Federal Law Enforcement Training Center (FLETC) budgetary reporting process came within the scope of our audit this year, and as a result new control deficiencies were identified.

Conditions: We noted the following internal control weaknesses related to budgetary accounting at USCG FEMA, ICE, MGMT, and FLETC:

1. USCG:

   - Has not fully implemented existing policies, procedures, and internal controls to ensure that obligations are reviewed and approved and undelivered order balances are monitored to ensure their timely deobligation when appropriate.
   - Does not have fully implemented policies, procedures, and internal controls over the monitoring of reimbursable agreements, and related budgetary unfilled customer orders, to ensure activity, including closeout and de-obligation, as appropriate, is recorded timely and accurately.
   - Does not have sufficient policies and procedures for recording the appropriate budgetary entries upon receipt of goods, and prior to payment.

2. FEMA:

   - Did not effectively certify the status of its obligations to ensure validity prior to fiscal year end.

- Could not readily provide all supporting documentation for obligations and deobligations made during the year and for undelivered orders we audited at June 30, 2012 and September 30, 2012.
- Did not properly review budgetary funding transactions recorded in the general ledger.
- Did not timely and effectively complete management reviews over the monthly reconciliations of the SF-132, *Apportionment and Reapportionment Schedule,* to the SF-133, *Report on Budget Execution and Budgetary Resources.*

3. ICE

- Lacks effective controls over the verification and validation (V&V) of undelivered orders which resulted in substantive errors (invalid obligations) identified through our audit. Specifically, we noted that:
  - V&V reviews performed by the ICE financial managers indicate reliance on responses from field office personnel to determine the validity of open obligations which are sometimes inaccurate, or do not provide sufficient information for the ICE financial managers to make an informed decision about the balance, rendering the V&V process ineffective.
  - Controls were not operating effectively to consistently produce documentation to support the underlying events that support a downward and upward adjustment of prior year unpaid, undelivered orders. We identified errors in total downward and upward adjustments posted in FY 2012 of 20 percent and 50 percent, respectively. In addition, adjustments were not recorded correctly against certain types of obligations in the general ledger.
- Does not have an effective process to match advances to obligations at the transaction level.

4. MGMT:

- Lacks effective controls to effectively monitor undelivered order balances to appropriately de-obligate or adjust undelivered order balances on a timely basis.
- Internal controls are not properly designed to adequately monitor unfilled customer order balances, related to both Working Capital Fund and non-Working Capital Fund activity. Specifically, we noted:
  - Multiple adjustments to MGMT's unfilled customer order balances as well as to component undelivered order balances were recorded and subsequently reversed; and
  - Unfilled customer orders whose period of performance had expired were not properly drawn down to the outstanding obligation balance.

5. FLETC:

- Management did not have controls in place to perform a thorough review of the FY 2012 unfilled customer order beginning balances, related to reimbursable construction, to ensure beginning balances were properly recorded.

Cause/Effect: The Coast Guard's decentralized structure enables obligations to be made throughout the country by various authorized personnel, contributes to the challenge of enforcing existing policies, procedures, and internal controls surrounding budgetary accounting and has caused various control gaps in the internal control environment. Additionally, financial system functionality issues prohibit the Coast Guard from implementing and maintaining automated internal controls to supplement their existing manual controls. For example, the Coast Guard relies on manual workarounds to identify undelivered orders and recoveries since the budgetary module of the financial system is not active. Also see Comment **I-B,** *Information Technology Controls and Financial System Functionality.* Lastly, remediation efforts associated with unfilled customer orders and reimbursable agreements are not scheduled to be completed until after FY 2012. Weak controls in budgetary accounting increase the risk that the Coast Guard will misstate budgetary balances, and may unintentionally lead to a violation of the *Anti-deficiency Act* by overspending its budget authority.

FEMA's annual undelivered order certification process was not effectively designed. Also, FEMA's administrative functions are geographically separated from programmatic operations which make consistent enforcement of policy challenging. Certain offices within FEMA do not have effective document maintenance policies and procedures, making the location of certain supporting documentation difficult. We noted that for certain undelivered order balances significant effort was required to coordinate and identify the responsible parties, to access certain files, locate files, or to provide information in a form that clearly supported the balances reported in the financial statements. Without adequate documentation, FEMA is unable to support the validity of obligation status. In addition, In addition, FEMA personnel have not fully adhered to the existing procedures for the recording of funding transactions because of lack of oversight by management. As a result, FEMA's financial information submitted to DHS for financial statement purposes may contain significant budgetary account errors if they are not detected

ICE's validation and verification process was not adequate to identify invalid undelivered orders, resulting in an overstatement of undelivered orders as obligations are not closed out in a timely manner. In addition, ICE recorded erroneous upward and downward adjustments of prior year obligations that were not correct or identified during OFM's review of current year activity. ICE implemented a review of downward and upward adjustments of prior year obligations in the current year, however the review control was not designed effectively to detect and correct material invalid recoveries. In some instances, the financial system configuration contributed to these errors. This deficiency is also related to the conditions described in Comment **II-F,** *Entity Level Controls*, and Comment **III-J,** *Federal Financial Management Improvement Act of 1996* (FFMIA).

The Management Directorate conducted an internal review of undelivered order and unfilled customer order balances in FY 2012. The results of the review indicated that Management's validation and verification process did not consistently result in the timely deobligation of undelivered orders. In addition, Management was not updating the status of its customer agreements, in a timely manner to prevent a misstatement to its account balances, and that the controls in place to address this risk at the process level are not operating effectively.

FLETC did not have effective management review controls over funding received from the ordering agency, and matching those funds to the proper type of funds available to it, resulting in a misstatement in beginning balances.

Criteria: Presented in *Index of Financial Reporting and Internal Control Criteria,* after Exhibit IV.

Recommendations: We recommend that:

1. USCG:
    a. Continue to improve the enforcement of existing policies and procedures related to processing obligation transactions and the periodic review and validation of undelivered orders. In particular, emphasize the importance of performing effective reviews of open obligations, obtaining proper approvals, and retaining supporting documentation; and
    b. Continue with current remediation efforts to develop and implement policies, procedures, and internal controls over the monitoring of reimbursable agreements and unfilled customer orders to ensure activity, including closeout and de-obligation, is recorded timely and accurately.
    c. Implement sufficient policies and procedures for recording the appropriate budgetary entries timely upon receipt of goods, and prior to payment.
2. FEMA:
    a. Revise the established annual undelivered order certification process to ensure that outstanding obligations are properly certified for validity prior to fiscal year end;
    b. Continue to improve procedures for storing and locating documentation supporting undelivered order information, including points of contact, so that supporting information is readily available for management review and audit purposes;

c. Implement improved review procedures for budgetary funding transactions recorded in the general ledger; and

d. Develop and implement monitoring controls to ensure that management reviews of the monthly SF-132 to SF-133 reconciliations are completed timely and effectively.

3. ICE:

a. Improve controls over the verification and validation of undelivered orders to identify outstanding obligations that need to be closed out and/or adjusted for financial statement presentation;

b. Implement policies and procedures to ensure that financial managers work with field office personnel to perform a rigorous review of the open obligations and maintain appropriate documentation of these reviews; and

c. Improve the process of recording recoveries and upward adjustments of prior year obligations, including identification and adjustment for offsetting transactions.

d. Implement an effective process to match advances to obligations at the transaction level.

4. MGMT:

a. Develop and implement changes to current policies and procedures to ensure timely review and accurate reporting of budgetary balances.

5. FLETC:

a. During FY 2012, FLETC corrected this condition, by establishing multi-year and annual funds to match the funds of the ordering agency, and implemented an enhanced process to review unfilled customer orders related to construction.

II-F Entity-Level Controls (Department-wide, and TSA, FEMA, ICE, NPPD)

Background: Entity-level controls encompass the over-all control environment throughout the entity. This includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance, and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people. Entity-level controls are often categorized as environmental controls, risk assessment, monitoring or communications, as defined by the *Committee of Sponsoring Organizations* of the Treadway Commission (COSO), and the Government Accountability Office. These controls must be effective, to create and sustain an organizational structure that is conducive to reliable financial reporting.

	2012	2011	2010
Ethics Division		N/A	N/A
TSA			C
FEMA			
ICE		N/A	N/A
NPPD		N/A	N/A

See page I.1 for table explanation

In the past three years, DHS has undertaken and completed several steps designed to strengthen its entity and process level internal controls, and thereby improve the reliability of financial reporting. These steps are documented in the *Internal Control over Financial Reporting Playbook.* The Office of Management and Budget (OMB) Circular No. A-123, *Management's Responsibility for Internal Control,* (OMB Circular No. A-123) assessment is also designed to assist with the remediation of control deficiencies, in accordance with an OMB approved plan.

The conditions below should be read in conjunction with Comment **I-B**, *Information Technology Controls and Financial System Functionality,* which describes entity-level control weaknesses related to Department and component IT systems.

The DHS Office of Ethics manages the Department's ethics programs, and provides liaison to the U.S. Office of Government Ethics, and administers the DHS financial disclosure program. DHS requires certain employees whose duties involve the exercise of discretion in sensitive areas to file a confidential financial disclosure report, known as the Office of Government Ethics (OGE) 450. Certain other senior DHS officials may be required to file a public financial disclosure report, known as the OGE 278. The forms are reviewed by an ethics official to determine whether any potential conflicts exist between the official duties and private financial interests and affiliations.

Conditions:

1. Headquarters Ethics Division and Components: We noted that pervasive process and internal control deficiencies exist throughout the Department related to compliance with Federal requirements over financial disclosure forms. Specifically, the Department and components have ineffective controls to ensure proper and timely filing, review, and certification of public financial disclosure (OGE 278 and 450) forms. At every component selected for testwork, including, CBP, USCIS, Coast Guard, FEMA, ICE, NPPD, and TSA we noted at least one of the following deficiencies:

   - Untimely submission of the financial disclosure form (either OGE 278 or OGE 450).
   - Untimely review and/or certification of the financial disclosure form by the designated Ethics Official.
   - The financial disclosure form was not submitted by the individual.
   - The filing status of the individual was undetermined, or a listing of disclosure filers was not complete.

In addition to the conditions cited above we noted the following entity-level control deficiencies at DHS components:

2. TSA:

    - Lacks formalized documented policies and procedures to ensure that new IT systems are properly developed and reviewed, by the appropriate offices and levels of management prior to implementation.
    - Lacks organizational policies and procedures outside of the TSA OFM needed to ensure timely, accurate, and valid responses to auditor requests of information and inquiries.

3. FEMA:

    - Has not certified its policies and procedures on a biennial basis to validate they are accurate and current, as required by FEMA Directive No. 112-1.
    - Did not formalize a process to ensure that personnel attend required ethics training.
    - Has not developed sufficient policies and procedures to properly conduct and track the status of background investigations and maintain related documentation.

4. ICE:

    - Does not effectively communicate financial reporting roles and responsibilities within ICE OFM, between program offices and with DHS customer components.
    - Does not have effective financial systems contractor oversight to ensure that financial information provided by contractors for use by management and the financial statement auditor is adequately prepared and reviewed.
    - Has not fully developed processes to identify and manage risks through the annual risk assessment process, and to monitor adherence to financial management policies and procedures of staff that reside outside ICE OFM.

5. NPPD:

    - Lacks policies and procedures to ensure a central accounting infrastructure is in place that is able to support a strong system of internal controls, including areas with technical requirements.
    - Does not effectively monitor financial activities across the organization to ensure transactions are recorded completely, accurately, and timely.
    - Lacks communication and review processes between the NPPD OFM and its service provider to ensure the accuracy of financial information.

Cause/Effect: The DHS headquarters Ethics Division does not have adequate policies and procedures to ensure required financial disclosure reports are received and the final review and certification is completed within the timelines established by the United States Office of Government Ethics. In addition, the Ethics Division and human resources do not have adequate communication to accurately identify those individuals who are required to file financial disclosure forms. Untimely filing and review of OGE Form 278 and OGE Form 450 forms may lead to undetected conflicts of interest that undermine the public trust of high-level Federal officials and certain executive branch employees.

TSA has not yet fully developed its processes, controls, and training throughout the agency to ensure that important programmatic matters that may affect financial reporting are communicated to TSA's OFM. Consequently, TSA was at times dependent on the external financial statement audit process to identify business process changes with financial reporting impact and the associated risks of misstatement or account balance errors in the financial statements.

FEMA has not fully developed and implemented processes to certify all policies and procedures and to ensure compliance with relevant ethics training requirements. In addition, FEMA has not dedicated sufficient resources to ensure that the appropriate minimum investigative or re-investigative requirements specified by DHS are fulfilled and documented within the system of record for agency personnel security data prior to granting a Personal Identity Verification card, which is a pre-condition for granting system access.

ICE OFM devotes a significant portion of its resources to other agencies within the Department as a financial reporting service provider. In addition, ICE' own internal operations are decentralized. As such, a reliable system of communications including internal policies and procedures, and service level agreements with DHS customers that clearly define roles and responsibilities for internal control and data integrity are needed. Difficulties with IT financial systems are partially due to ICE's use of a proprietary financial system and do not currently have the ability to extract usable information without the aid of the system contractor.

NPPD's organization has grown to include a diverse set of operations including cyber security, infrastructure protection, the Federal Protective Service (FPS), and the US-VISIT program, creating communication and information challenges. NPPD does not have sufficient central accounting infrastructure that is able to support a strong system of internal controls, especially for transactions that require unique understanding of technical requirements such as accounting for internal use software.

Criteria: Presented in *Index of Financial Reporting and Internal Control Criteria,* after Exhibit IV.

Recommendations: We recommend that:

1. Office of Ethics and Various Components:
   a. Review existing policies, including processes involving review and enforcement of required procedures, and implement updated polices and controls as necessary to ensure compliance with applicable regulations over filing and review of financial disclosure forms.
2. TSA:
   a. Develop formalized, documented, policies and procedures to ensure systems are properly evaluated for basics requirements by the appropriate offices and levels of management prior to implementation.
   b. Develop policies and procedures, including monitoring and training for employees both inside and outside the TSA OFM on the importance to maintain accurate, valid supporting documentation, available for audit.
3. FEMA:
   a. Complete the efforts underway to ensure that formal policies and procedures are reviewed and certified on a biennial basis in accordance with FEMA Directive No. 112-1;
   b. Complete development and implementation of procedures to track compliance with and monitor the completion of the annual and new hire ethics training requirements; and
   c. Review, revise as needed, and implement policies and procedures to properly initiate, process, and track background investigations and maintain related documentation.
4. ICE:
   a. Develop and implement policies and procedures to bolster the communication between ICE OFM and program offices, and within the ICE OFM.
5. NPPD:
   a. Further the development of the accounting infrastructure through the implementation of standardized processes;
   b. Develop and implement policies and procedures to foster communication between NPPD's OFM and the program offices, and;
   c. Develop and implement policies and procedures to facilitate communication between NPPD OFM and the accounting service provider.

II-G Grants Management (FEMA only)

	2012	2011	2010
FEMA			
See page I.1 for table explanation			

Background: FEMA is recognized as the primary grant-making component of DHS, managing multiple Federal disaster and non-disaster grant programs.

Conditions: We noted the following internal control weaknesses, many of which are repeat findings, related to grants management.

FEMA:

- Did not compile a complete list of grantees requiring single audits to fully comply with the *Single Audit Act Amendments of 1996* (*Single Audit Act*) and related OMB Circular No. A-133, *Audits of States, Local Governments, and Nonprofit Organizations* (OMB Circular A-133) (see Comment **IV-K**, *Single Audit Act Amendments of 1996*).
- Did not issue Management Decision Letters timely for OMB Circular A-133 audit reports available in the Federal Audit Clearinghouse.
- Did not maintain accurate and timely documentation related to reviews performed of grantees' OMB Circular A-133 audit reports.
- Did not maintain accurate and timely documentation related to site visits/desk reviews performed for grantees.
- Did not consistently follow-up with grantees who have failed to submit quarterly financial reports timely.
- Did not consistently maintain documentation necessary to support grant-related activities.
- Did not consistently and effectively reconcile grantee quarterly financial reports to FEMA systems.
- Did not have a process in place to create and track comprehensive lists of FEMA grants that are eligible for close-out, and has not completed the close-out process in a timely manner.

Cause/Effect: FEMA has not fully implemented policies and procedures over its grant program in order ensure compliance with the *Single Audit Act* and OMB Circular A-133. In addition, FEMA has not implemented effective monitoring procedures over certain grant activities and the maintenance of related documentation. As a result, misreported grantee expenses may not be detected, which may impact the fair presentation of FEMA's grant accrual balances, undelivered orders, and expenses. Further, the diversity of grant programs and systems within FEMA causes difficulty in assembling a comprehensive status of grants eligible for close-out, which could result in untimely closure of grants and an overstatement of undelivered orders.

Criteria: Presented in *Index of Financial Reporting and Internal Control Criteria,* after Exhibit IV.

Recommendations: We recommend that FEMA:

1. Complete the implementation of policies and procedures to ensure full compliance with the *Single Audit Act* and the related OMB Circular No. A-133 related to receipt and review of grantees' single audit reports;
2. Implement monitoring procedures over completing financial site visits/desk reviews; obtaining, timely reviewing and reconciling required quarterly grantee reports; and maintaining related documentation;
3. Develop and implement procedures to create and track comprehensive lists of FEMA grants that are eligible for close-out; and
4. Implement a continuous quality assurance and grants monitoring process to include review of corrective actions resulting from implementation of the recommendations in 1 – 3 above.

II-H Custodial Revenue and Drawback (CBP Only)

	2012	2011	2010
CBP			
See page I.1 for table explanation			

Background: Customs and Border Protection (CBP) collects approximately $35.5 billion in annual import duties, taxes, and fees on merchandise arriving in the United States from foreign countries (identified below as the Entry Process). Receipts of import duties and related refunds are presented in the statement of custodial activity in the DHS financial statements.

Drawback is a remittance, in whole or in part, of duties, taxes, or fees previously paid by an importer. Drawback typically occurs when the imported goods on which duties, taxes, or fees have been previously paid, are subsequently exported from the United States or destroyed prior to entering the commerce of the United States.

Our findings over the Entry Process include conditions identified in In-bond, Bonded Warehouse and Foreign Trade Zones. In-bond entries occur when merchandise is transported through one port; however, the merchandise does not officially enter U.S. commerce until it reaches the intended port of destination. Bonded Warehouses (BW) are facilities, under the joint supervision of CBP and the Bonded Warehouse Proprietor, used to store merchandise that has not made entry into the United States commerce. Foreign Trade Zones (FTZ) are secured areas under CBP supervision that are used to manufacture goods that are considered outside of the United States commerce for duty collection.

The conditions cited below have existed for several years. Management has stated that the time-frame for remediation of these conditions is dependent on funding for IT system upgrades. In FY 2012 CBP deployed a new system to replace the existing in-bond oversight functions, called the In-Bond Compliance Module. This module was implemented in early September 2012 and is intended to create a more effective in-bond monitoring system. However, for the majority of the period under audit, CBP was following policies and procedures that led to ineffective and inefficient processes in in-bond and CBP was using a system with limitations that restricted CBP's ability to accurately monitor the in-bond process, both at the Headquarters and port levels.

For the remaining conditions in Drawback, BW, and FTZ, a systems fix is currently unfunded. However, improvements have been made in the controls surrounding BWs and FTZs, specifically at the BW and FTZ facilities. Furthermore, in FY 2012 CBP continued its review efforts to reassess the Drawback process as a whole.

Conditions: We noted the following internal control weaknesses related to custodial activities at CBP:

Related to Drawback:

- The Automated Commercial System (ACS) lacks the controls necessary to prevent, or detect and correct excessive drawback claims. The programming logic in ACS does not link drawback claims to imports at a detail level. In addition, ACS does not have the capability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries and export documentation upon which the drawback claim is based. Further, ACS has not been configured to restrict drawback claims to 99 percent of each entry summary.

- Drawback review policies do not require drawback specialists to review all, or a statistically valid sample, of prior drawback claims against a selected import entry to determine whether, in the aggregate, an excessive amount was claimed against import entries.

Related to the Entry Process:

- During the audit period, CBP was unable to determine the status of the in-bond shipments and lacked policies and procedures that required monitoring the results of in-bond audits and review of overdue air in-bonds. CBP did not formally analyze the rate and types of violations found, to determine the effectiveness of the in-bond program, and did not identify a projected total amount of uncollected duties and fees on in-bond merchandise that has physically entered U.S. commerce without formal entry to ensure there was not a potentially significant loss of revenue.

- Headquarters has developed national databases which contain an inventory of all BWs and FTZs; however, these databases were not designed to document the assessed risk of each BW or FTZ, scheduled compliance reviews, or the results of compliance reviews. CBP headquarters cannot verify the results of the compliance reviews to determine overall program effectiveness.

Cause/Effect: IT system functionality and outdated IT systems contribute to the weaknesses identified above, in Comment **I-B**, *Information Technology Controls and Financial System Functionality*. For example, under the system in place for the majority of FY 2012 CBP was unable to determine the status of the in-bond shipments with the information available within ACS, and CBP did not have the ability to run an oversight report to determine if ports completed all required audits. CBP could not perform a comprehensive analysis to determine the overall compliance rate of the in-bond program. For drawback, much of the process is manual until IT system functionality improvements are made, placing an added burden on limited resources.

The inability to effectively and fully monitor the in-bond process and verify the arrival of in-bond merchandise at the ports could lead to loss of revenue due to uncollected duties and fees on in-bond merchandise that has physically entered U.S. commerce without formal entry.

CBP does not have the ability to perform a complete analysis over the effectiveness of the BW and FTZ programs. CBP headquarters cannot effectively monitor the BW/FTZ program if a complete population of all BWs and FTZs is not compiled.

Criteria: Presented in *Index of Financial Reporting and Internal Control Criteria,* after Exhibit IV.

Recommendations: We recommend that CBP:

1. *Related to Drawback*:

   a. Since the incorporation of drawback processing is not scheduled for the Automated Commercial Environment production, CBP should continue to pursue alternative compensating controls and measures that may ultimately identify the potential revenue loss exposure to CBP. These alternative internal controls over drawback claims may lead to the ability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries and export documentation for which the drawback claim is based, and identify duplicate or excessive drawback claims;

   b. Develop and implement automated controls, where feasible, to prevent overpayment of a drawback claim; and

   c. Continue to analyze current policies and procedures performed at the Drawback Centers. Determine the benefit of current procedures and revise as necessary.

2. *Related to the Entry Process:*

   a. With the new In-Bond Compliance Module implementation, certain monitoring reports no longer exist; therefore, CBP should ensure the new in-bond compliance system is properly functioning, timely address systemic issues that may arise, and provide additional policy and direction, if necessary;

   b. CBP headquarters should provide oversight and assistance to the field to ensure ports are following procedures and monitor and review the in-bond process to ensure a high in-bond compliance rate;

   c. Continue the implementation of a national database of BWs and FTZs and develop procedures to ensure completeness of the compliance review results submitted to CBP headquarters; and

   d. Increase CBP headquarters monitoring over the BW and FTZ compliance review program by developing a method to determine the program's overall effectiveness.

All of the compliance and other matters described below are repeat conditions from FY 2011.

III-I *Federal Managers' Financial Integrity Act of 1982* (FMFIA)

DHS' implementation of OMB Circular No. A-123, facilitates compliance with the FMFIA. The *DHS Financial Accountability Act of 2004* requires DHS to submit an annual audit opinion of internal control over financial reporting. DHS has an OMB approved plan to correct existing material weaknesses in internal control, before fully implementing the requirements of OMB Circular No. A-123 on all business processes. Accordingly, the DHS Secretary's Assurance Statement dated November 12, 2012, as presented in Management's Discussion and Analysis of the Department's 2012 *Annual Financial Report* (AFR), acknowledges the existence of material weaknesses and the limited scope assessment, and therefore provides qualified assurance that internal control over financial reporting was operating effectively as of September 30, 2012, based on the testwork performed to date. Management's findings are similar to the control deficiencies we have described in Exhibits I and II.

While we noted the Department overall has taken positive steps toward full compliance with FMFIA, OMB Circular No. A-123, and the *DHS Financial Accountability Act* of 2004, the Department has not fully established effective systems, processes, policies, and procedures to ensure that internal controls are operating effectively throughout the Department.

Recommendation: We recommend that the Department continue its corrective actions to address internal control deficiencies, in order to ensure full compliance with FMFIA and its OMB Circular No. A-123 approved plan in future years. We also recommend that DHS continue to follow and complete the actions defined in the *Internal Control Playbook*, to ensure that audit recommendations are resolved timely and corrective action plans addressing all DHS audit findings are developed and implemented together with appropriate supervisory review in FY 2013.

III-J *Federal Financial Management Improvement Act of 1996* (FFMIA)

FFMIA Section 803(a) requires that agency Federal financial management systems comply with (1) applicable Federal accounting standards; (2) Federal financial management system requirements; and (3) the United States Government Standard General Ledger (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.

While we noted the Department overall has taken positive steps toward full compliance with FFMIA, the Coast Guard, U.S. Customs and Border Protection, the Federal Emergency Management Agency (FEMA), U.S. Immigration and Customs Enforcement, and Transportation Security Administration did not fully comply with at least one of the requirements of FFMIA. The reasons for noncompliance are reported in Exhibits I and II. The Secretary of DHS has stated in the Secretary's Assurance Statements dated November 14, 2012 that the Department's financial management systems do not substantially conform to government wide requirements mandated by FFMIA. The Department's remedial actions and related timeframes are also presented in the FY 2012 AFR.

An element within FFMIA, Federal system requirements is ensuring security over financial management information. This element is addressed further in the *Federal Information Security Management Act of 2002* (FISMA), which was enacted as part of the *E-Government Act of 2002.* FISMA requires the head of each agency to be responsible for (1) providing information security protections commensurate with the risk and magnitude of the harm resulting from unauthorized access, use, disclosure, disruption, modification, or destruction of (i) information collected or maintained and (ii) information systems used or operated; (2) complying with the requirements of the Act and related policies, procedures, standards, and guidelines, including (i) information security standards under the United States Code, Title 40, Section 11331, and (ii) information security standards and guidelines for national security systems; and (3) ensuring that information security management processes are integrated with agency strategic and operational planning processes.

We also noted weaknesses in financial systems security, reported by us in Comment **I-B**, *Information Technology Controls and Financial System Functionality*, which impact the Department's ability to fully comply with FISMA.

Recommendation: We recommend that DHS improve its financial management systems to ensure compliance with the FFMIA, and implement the recommendations provided in Exhibits I and II in FY 2013.

III-K *Single Audit Act Amendments of 1996* (*Single Audit*)

FEMA is the only DHS component that has a significant grant making operation. The *Single Audit Act Amendments of 1996*, as implemented by OMB Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* requires agencies awarding grants to monitor their grantees, ensure they receive grantee reports timely, and follow-up on Single Audit findings to ensure that grantees take appropriate and timely action. Although FEMA has implemented a system to monitor grantees and their audit findings, FEMA did not fully comply with provisions in OMB Circular No. A-133 in FY 2012. We noted that FEMA's monitoring efforts were inconsistent and FEMA did not obtain and review all grantee *Single Audit* reports in a timely manner.

Recommendation: We recommend that FEMA implement the recommendations in Comment **II-G**, *Grants Management*.

III-L *Anti-deficiency Act* (ADA)

Various management reviews and OIG investigations are on-going within the Department and its components that may identify ADA violations, as follows:

- The Coast Guard management continues to work to resolve two potential ADA violations relating to (1) funds used in advance of an approved apportionment from OMB and (2) the improper execution of the obligation and disbursement of funds for the lease of passenger vehicles.
- National Protection and Programs Directorate (NPPD) management has completed the review, initiated in FY 2007, over the classification and use of certain funds that resulted in an ADA violation. NPPD is in the process of responding to the OIG report and transmitting notifications of the violation.
- The Management Directorate has completed its investigation of whether rental charges at the Office of the Federal Coordinator for Gulf Coast Rebuilding (OFCGCR) incurred in FY 2009 were not properly committed or obligated and determined that the OFCGCR committed a violation in FY 2009. MGMT is in the process of developing the notification package.
- Intelligence and Analysis (I&A) is investigating the potential ADA violation due to a difference in calculation of apportionments while under continuing resolution in FY 2012.

Recommendation: We recommend that the Department, along with the OIG and the other components, complete the internal reviews currently planned or being performed, and properly report the results in compliance with the ADA, where necessary.

FY 2011 Control Deficiencies As Reported	Summary of Significant Changes in FY 2012	FY 2012 Control Deficiencies As Reported
Material Weaknesses:		
A – Financial Management and Reporting (USCG, TSA, USCIS)	• USCIS substantially corrected financial reporting deficiencies reported in previous years. • The Coast Guard made progress by correcting financial reporting control deficiencies in accounts receivable, and improving their ability to provide accurate and timely information to DHS OFM for financial statement reporting. No new financial reporting deficiencies were identified at USCG in FY 2012. • The Coast Guard's most significant remaining financial reporting deficiencies include supporting non-standard adjustments, supporting certain year-end close-out balances, and reconciling intergovernmental transactions. • TSA is in an advanced stage of remediation of its financial reporting deficiencies. The remaining issues involve the need for incremental but important improvements to strengthen its internal controls over several financial reporting processes. Deficiencies previously reported in budgetary accounting are similar to, and therefore combined with, other financial reporting issues. • New financial reporting control weaknesses were identified at ICE related to year end close process, accounting for accrued payroll, ability to timely support transactions and identify potential accounting issues.	**Repeated** (Exhibit I-A) (USCG, TSA, ICE)
B – Information Technology Controls and Financial Systems Functionality (USCG, CBP, FEMA, USCIS, ICE)	• DHS components made progress in the remediation of IT findings we reported in FY 2011. We closed approximately 70 (46 percent) of our prior year IT findings. CBP, FEMA, and TSA made the most progress in closing IT findings from the prior year. • However, at end of FY 2012, over 175 IT findings existed, of which approximately 75 (43 percent) were repeat findings identified in prior years, and 100 (57 percent) were new findings. New findings resulted primarily from new IT systems and business processes that came within the scope of our audit this year, and were noted at all DHS components. CBP and FEMA had the greatest number of new findings. • Financial systems functionality continues to be a significant contributor to the IT material weakness, and is impairing DHS's ability to install application controls, and leverage IT systems to improve cost effectiveness and provide reliable management information.	**Repeated** (Exhibit I-B) (USCG, CBP, FEMA, USCIS, ICE)
C – Property, Plant, and Equipment (USCG, CBP, TSA, MGMT)	• The Coast Guard continued to execute remediation efforts to address PP&E process and control deficiencies; however, remediation efforts were not complete as of September 30, 2012. Consequently, many of the control weaknesses reported in FY 2011 have been repeated in our FY 2012 report. • The Coast Guard made progress in reconciling real property balances, and was able to fully assert to the reliability of approximately $3 billion of real property balances. We were able to complete audit procedures over real property as of September 30, 2012, narrowing our scope limitation to other PP&E	**Repeated** (Exhibit I-C) (USCG, CBP, ICE)

FY 2011 Control Deficiencies As Reported	Summary of Significant Changes in FY 2012	FY 2012 Control Deficiencies As Reported
	balances, such as personal property and construction in process. Real property represents approximately 25 percent of total Coast Guard property. • TSA substantially corrected PP&E control deficiencies reported in previous years. • CBP made modest progress in correcting PP&E control deficiencies by implementing policies and procedures in FY 2012, however, personnel did not always follow the new policies. • Management Directorate implemented new processes to correct some deficiencies, allowing for downgrade in severity of our findings in FY 2012. • New control weaknesses were identified at ICE primarily related to accounting for internal use software, and a lack of adequate policies and procedures.	
D – Environmental and Other Liabilities (USCG)	• During FY 2012, the Coast Guard completed the final phases of a multi-year remediation plan to inventory, value, and properly state environmental liabilities. As a result, the Coast Guard restated the FY 2011 financial statements, to present the correct environmental liability balance as of September 30, 2011. An adjustment totaling $478 million was recorded to restate and reduce environmental liabilities. • Because the Coast Guard's remediation procedures were not completed until late in FY 2012, many of process and control deficiencies related to environmental liabilities reported in FY 2011 continued to exist during of FY 2012, and have been repeated in our FY 2012 report.	**Partially Repeated** (Exhibit I-D) (USCG)
E – Budgetary Accounting (USCG, FEMA)	• Budgetary accounting control deficiencies at USCG were repeated FY 2012. • FEMA continued to improve its processes and internal controls over the obligation and monitoring process; however, some control deficiencies remain in FY 2012. • New budgetary control deficiencies were identified at ICE primarily in processes intended to validate obligations. In addition, controls over upward and downward adjustments were not effective at ICE. • New budgetary control deficiencies were identified at Management Directorate over accounting for undelivered orders and unfilled customer orders. • New budgetary control deficiencies were identified at FLETC over accounting for unfilled customer orders, at the beginning of the year, that were remediated by September 30, 2012. • The new budgetary control findings cited above are attributable primarily to the increase in the scope of our audit in FY 2012, to include the Statement of Budgetary Resources.	**Repeated** (Exhibit I-E) (USCG, FEMA, ICE, MGMT, FLETC)
Significant Deficiencies:		
F –Entity Level Controls (FEMA, TSA)	• FEMA continued to improve its entity level internal controls, however some control deficiencies reported in FY 2010 remain. • TSA continued to make progress in remediating entity level control deficiencies, however further improvement is needed to fully correct all conditions.	**Repeated** (Exhibit II-F) (Ethics Division, TSA, FEMA, ICE, NPPD)

FY 2011 Control Deficiencies As Reported	Summary of Significant Changes in FY 2012	FY 2012 Control Deficiencies As Reported
	• Throughout the Department and within the Ethics Division, we noted pervasive control weaknesses over administration of financial disclosure process for Department employees and executives, as mandated by regulation. We noted deficiencies related to this process in every component selected for testwork. • New higher-level control weaknesses involving communications, contractor oversight, annual risk assessment processes, and personnel training were noted at ICE. • New higher-level control weakness, were identified at NPPD, primarily related to communications to / from their service provider (ICE) and the DHS Office of Financial Management.	
G – Fund Balance with Treasury (USCG)	• The Coast Guard substantially corrected fund balance with Treasury control deficiencies reported in previous years.	**Corrected**
H – Grants (FEMA)	• Grant accounting control deficiencies identified at FEMA in previous years were substantially repeated FY 2012.	**Repeated** (Exhibit II-G) (FEMA)
I – Custodial Revenue (CBP)	• Deficiencies related to custodial revenue – entry and drawback were repeated in FY 2012.	**Repeated** (Exhibit II-H) (CBP)
Compliance and Other Matters:		
I – *Federal Managers' Financial Integrity Act of 1982*	• The Department overall has taken positive steps toward full compliance with FMFIA, OMB Circular No. A-123, and the *DHS Financial Accountability Act* of 2004. However, the Department has not fully established effective systems, processes, policies, and procedures to ensure that internal controls are operating effectively throughout the Department.	**Repeated** (Exhibit IV – I)
J – *Federal Financial Management Improvement Act of 1996*	• The Department overall has taken positive steps toward full compliance with FFMIA. The USCG, CBP, FEMA, ICE, and TSA did not fully comply with at least one of the requirements of FFMIA. The reasons for noncompliance are reported in Exhibits I and II.	**Repeated** (Exhibit IV – J)
K – *Single Audit Act Amendments of 1996*	• FEMA did not fully comply with provisions in OMB Circular No. A-133 in FY 2012.	**Repeated** (Exhibit IV – K)
L – *Chief Financial Officers Act of 1990*	• DHS was compliant with the Chief Financial Officers Act in FY 2012, by completing a full-scope financial statement audit.	**Corrected**
M – *Anti-deficiency Act*	• Various management reviews and OIG investigations are on-going within the Department and its components that may identify ADA violations.	**Repeated** (Exhibit IV – L)

FY 2011 Control Deficiencies As Reported	Summary of Significant Changes in FY 2012	FY 2012 Control Deficiencies As Reported
N – *Government Performance and Results Act of 1993*	• DHS completed the Quadrennial Homeland Security Review (QHSR) and released and updated strategic plan in FY 2012. In addition, DHS has presented its net cost of operations by major program that relates to major goals described in the strategic plan. DHS' Statement of Net Cost and related disclosures for FY 2012 are now in compliance with OMB Circular A-136, *Financial Reporting Requirements*.	**Corrected**

Department of Homeland Security
Index of Financial Reporting and Internal Control Criteria
(Listed Alphabetically by Criteria Source)

Criteria	Reference	Report Exhibit
Bonded Warehouse Manual for Customs and Border Protection Officers and Bonded Warehouse Proprietors (HB 3500-11, January 2012)	Section 1.1	II-H
CBP Directive 5320-028D, *Commitment, Obligation, and Expenditure Procedures for Goods and Services*	Section 7.5.1	I-C
CBP *Personal Property Management Handbook, HB 5200-13B*	Chapter 8	I-C
CBP's *Real Property Inventory Procedures*		I-C
Coast Guard Financial Reporting Management Manual	Sections 9.B, 9.C.4	I-C
Coast Guard Intragovernmental Reimbursable Agreement Procedural Handbook	Section D	I-E
Coast Guard's Standard Operating Procedure: *Financial Reporting of Personal Property Categorized as Stewardship (Heritage) Asset Footnoted, dated April 20, 2012*	Section 3: Scope	I-C
Code of Federal Regulations, Title 5	Part 2634, 2638	II-F
Code of Federal Regulations, Title 19	§ 19.4, § 191.51, § 18.2, § 18.6, § 18.8, § 146.3	II-H
Compliance Review Handbook for Bonded Warehouses (HB 3500-09, December 2007)		II-H
Compliance Review Handbook for Foreign Trade Zones (HB 3500-10, July 2008)		II-H
DHS Component Requirements Guide for Financial Reporting	Section 4, 34	I-E, II-F
	Section 30, 22	I-A
	Section 43	I-C
DHS Financial Accountability Act, dated Oct. 16, 2004	Section 4	I-A, II-F
DHS Management Directives System MD Number: 0480.1	Section V	II-F
DHS Instruction 121-01-007, DHS Personnel Suitability and Security Program	Chapter 2, Section E	II-F
DHS Sensitive Systems Policy Directive 4300A v. 9.0.2, updated March 19, 2012	Sections 3.7, 3.9, 3.15.1, and 4.1.1	II-F
Ethics in Government Act of 1978	Title I, various sections	II-F
Federal Financial Accounting And Auditing Technical Release 2: *Determining Probable and Reasonably Estimable for Environmental Liabilities in the Federal Government*	Sections 1 and 2	I-D
Federal Financial Management Improvement Act of 1996	Section 803	I-A, I-C, I-E
Federal Managers' Financial Integrity Act of 1982	Section 2	I-A, I-C, I-E, II-F
FEMA Budget Procedures Memorandum 10-02	Section 4 Subsections (d), (g), (h), (j)	I-E
FEMA OCFO SF-132/133, *Reconciliation Process SOP*	Sections VII and VIII	I-E
GAO's *Standards for Internal Control in the Federal Government*	Control Activities	I-A, I-D, I-E, II-G
	Examples of Control Activities (Accurate and Timely Recording of Transactions and Events)	I-E, II-G

Criteria	Reference	Report Exhibit
	Examples of Control Activities (Appropriate Documentation of Transactions and Internal Control)	I-A, I-D, I-E, II-G
	Information and Communications	I-C
	Presentation of the Standards	I-A, I-D
GAO's *Principles of Federal Appropriations Law, Third Edition, Volume II*	Chapter 7	I-E
Grants Programs Directorate, *Financial Monitoring Plan*	Section 3.1	II-G
Memorandum: In-Bond Guidance, dated April 7, 2010		II-H
Mission Assignment Standard Operating Procedure 2600-007, *Financial Reporting of Mission Assignments*, updated March 20, 2012		I-E
National Institute of Standards and Technology (NIST) Special Publication (SP) 800-53, *Recommended Security Controls for Federal Information Systems*	Appendix F, sections CM-1 and CM-3	II-F
Office of Federal Financial Management, *Core Financial System Requirements*	Accounts Payable Process	I-D
Office of Field Operations, Cargo and Conveyance Security's *General Order Merchandise Procedures; In-Bond Oversight,* August 24, 2011		II-H
Office of Field Operations, *Guide for In-Bond Cargo, Version 1.0,* March 31, 2006		II-H
OMB Bulletin No. 07-04, *Audit Requirements for Federal Financial Statements*	Compliance with FFMIA (footnote 16)	I-E
OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget, August 2012*	Sections 20, 20.5 (a), 130.9 Appendix B, Section 1	I-E
OMB Circular No. A-123, *Management's Responsibility for Internal Control,* Revised	1. Purpose	I-A, II-F
	3. Policy	I-C, I-E, II-H
	I. Introduction	I-A, I-C, I-E, II-F, II-H
	II. Standards	I-A, I-E, II-F
	III. Integrated Internal Control Framework	I-E
	IV. Assessing Internal Control	II-H
	Appendix A Section III. Assessing Internal Control Over Financial Reporting	I-A
OMB Circular No. A-127, *Financial Management Systems,* Revised	Section 6 (subpart K) Section 8 (subpart C)	I-A
Office of Management and Budget (OMB) Circular A-130, *Management of Federal Information Resources*	3. Analysis	II-F
Office of Management and Budget (OMB) Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations, Revised to show changes published in the Federal Register of June 27, 2003 and June 26, 2007*	Subparts B, D	II-G
OMB Circular No. A-136, *Financial Reporting Requirements*, Revised	Section V.3	I-A

Criteria	Reference	Report Exhibit
Single Audit Act Amendments of 1996	31 USC §§7502 and 7504	II-G
Statement of Federal Financial Accounting Standards (SFFAS) No. 1, *Accounting for Selected Assets and Liabilities*	Paragraph 77	I-E
Statement of Federal Financial Accounting Standards (SFFAS) No. 5, *Accounting for Liabilities of the Federal Government*	Paragraph 19	I-D
Statement of Federal Financial Accounting Standards (SFFAS) No. 6, *Accounting for Property, Plant, and Equipment*	Paragraph 13, 20, 26, 34, 35, 38, 39, 77, 84 End Note 8	I-C
	Paragraph 85, 94	I-D
Statement of Federal Financial Accounting Standards (SFFAS) No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*	Paragraph 78, 79	I-E
Statement of Federal Financial Accounting Standards (SFFAS) No. 10, *Accounting For Internal Use Software*	Executive Summary (Paragraph 5) Paragraphs 16, 20	I-A, I-C
Statement of Federal Financial Accounting Standards (SFFAS) No. 14, *Amendments to Deferred Maintenance Reporting*	Paragraph 1	I-C
Statement of Federal Financial Accounting Standards (SFFAS) No. 21, *Reporting Correction of Errors and Changes in Accounting Principles*	Paragraph 10 & 11	I-C
Statement of Federal Financial Accounting Standard (SFFAS) No. 23, *Eliminating the Category National Defense Property, Plant and Equipment*,	Paragraphs 11, 12, 13	I-C
Statement of Federal Financial Accounting Standards (SFFAS) No. 29, *Heritage Assets and Stewardship Land*	Summary paragraph Paragraph 26	I-C
Statement of Federal Financial Accounting Standards (SFFAS) No. 35, *Estimating the Historical Cost of General Property, Plant, and Equipment: Amending Statements of Federal Financial Accounting Standards 6 and 23*	Paragraph 12	I-C
Statement of Federal Financial Accounting Standards No. 39: *Subsequent Events: Codification of Accounting and Financial Reporting Standards Contained in the AICPA Statements on Auditing Standards*	Paragraph 8, 12, 13	I-A
Treasury Financial Manual, Volume 1 *T/L 684 Bulletin No. 2012-09*	Part 2, Chapter 4700 Appendix 10	I-A
US Code Title 31, Chapter 15	Sections 1501, 1535, 1554	I-E
US Code Title 44, Chapter 31	Section 3101	I-C, I-D
US Code Title 44, Chapter 35	Section 3544	II-F
USSGL	Transaction A714	I-E

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

Homeland Security

November 14, 2012

MEMORANDUM FOR: Charles K. Edwards
Acting Inspector General

FROM: Peggy Sherry
Peggy Sherry
Chief Financial Officer

SUBJECT: Fiscal Year (FY) 2012 Financial and Internal Controls Audit

I am pleased to accept your audit report on the Department's Consolidated Financial Statements and internal controls for FY 2012 and Consolidated Balance Sheet, related Consolidated Statement of Custodial Activity, and internal controls for FY 2011. We agree with the Independent Public Accountant's conclusions.

Although the report indicates that DHS still faces financial management challenges, the auditor noted the Department's continuing progress in improving the quality and reliability of our financial reporting. During FY 2012, our Components implemented corrective actions that significantly improved key financial management and internal control areas. This year's audit opinion on all financial statements demonstrates that the Department is committed to being a responsible steward of taxpayer dollars.

The FY 2012 audit results show that our corrective actions are working, and we are already focusing our efforts on remediating the remaining issues as we prepare for an unqualified audit opinion on a full-scope audit in FY 2013. I want to thank you for your efforts and the continued dedication by your staff to work collaboratively in addressing our challenges. As we continue our steadfast progress, I look forward to working with the Office of Inspector General and the Independent Public Accountant.

Appendix A
Report Distribution

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