DEPARTMENT OF HOMELAND SECURITY

Office of Inspector General

Independent Auditors' Report on DHS' FY 2007 Financial Statements

OIG-08-12 **November 2007**

Office of Inspector General

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

Homeland Security

November 15, 2007

Preface

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

The attached report presents financial information excerpted from DHS' *Annual Financial Report* (AFR) and the results of the DHS financial statement audits for fiscal year (FY) 2007 and FY 2006. We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the audits. The contract required that KPMG perform its audits according to generally accepted government auditing standards and guidance from the Office of Management and Budget and the Government Accountability Office. KPMG was unable to provide an opinion on DHS' balance sheet as of September 30, 2007 and 2006. The FY 2007 auditor's report discusses eight significant deficiencies, seven of which are considered material weaknesses in internal control, and eight instances of noncompliance with laws and regulations. KPMG is responsible for the attached auditor's report dated November 15, 2007, and the conclusions expressed in the report. We do not express opinions on DHS' financial statements or internal control or conclusions on compliance with laws and regulations.

The recommendations herein have been discussed in draft with those responsible for implementation. It is our hope that this report will result in more effective, efficient, and economical operations. We express our appreciation to all of those who contributed to the preparation of this report.

Richard L. Skinner

Richard L. Skinner
Inspector General

Independent Auditor's Report on
DHS' FY 2007 Financial Statements

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

Homeland Security

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MEMORANDUM FOR: The Honorable Michael Chertoff
Secretary

FROM: Richard L. Skinner
Inspector General

SUBJECT: *Independent Auditors' Report on DHS' FY 2007 Balance Sheet and Statement of Custodial Activity*

The attached report presents the results of the Department of Homeland Security's (DHS or Department) financial statement audits for fiscal year (FY) 2007 and FY 2006. These audits were required by the *Chief Financial Officers Act of 1990*. This report is incorporated into the *Department's FY 2007 Annual Financial Report*. We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the audits.

Generally the corrective action plans for DHS's non-military components, except for FEMA, have started to show results of improving financial reporting during FY 2007, although overall the department still has much work remaining. For the fourth year, KPMG was unable to provide an opinion on the department's balance sheet; although elements and conditions of prior year weaknesses have been corrected, material weaknesses exist in the same processes as in prior years.

Summary

KPMG was unable to express an opinion on the Department's balance sheets as of September 30, 2007 and 2006 and on the related statements of custodial activity for the years then ended, because DHS was unable to represent that certain financial statement balances were correct, and unable to provide sufficient evidence to support its financial statements. In connection with the audits, DHS' internal controls over financial reporting and compliance with certain provisions of laws and regulations were considered. As a result, the FY 2007 Independent Auditors' Report discusses seven material weaknesses, one other significant deficiency in internal control, and eight instances of non-compliance with laws and regulations, as follows:

Significant Deficiencies That Are Considered To Be Material Weaknesses

A. Financial Management and Entity-level Controls
B. Financial Reporting
C. Financial Systems Security
D. Fund Balance with Treasury

E. Capital Assets and Supplies
F. Actuarial and Other Liabilities
G. Budgetary Accounting

Other Significant Deficiency

H. Custodial Revenue and Drawback

Non-compliance with Laws and Regulations

I. Federal Managers' Financial Integrity Act of 1982 (FMFIA)
J. Federal Financial Management Improvement Act of 1996 (FFMIA)
K. Single Audit Act Amendments of 1996, and laws and regulations supporting OMB Circular No. A-50, Audit Follow-up, as revised
L. Improper Payments Information Act of 2002 (IPIA)
M. Chief Financial Officers Act of 1990
N. Government Performance and Results Act of 1993 (GPRA)
O. Debt Collection Improvement Act of 1996 (DCIA)
P. Anti-deficiency Act

Moving DHS' Financial Management Forward

While the auditors' noted improvement toward correction of internal control weaknesses, the Department was unable to represent that its financial statements as of, and for the year ended, September 30, 2007, were presented in conformity with U.S. generally accepted accounting principles. The U.S. Coast Guard, (USCG), DHS-HQ / Office of Financial Management (OFM), and Federal Emergency Management Agency (FEMA), were unable to provide sufficient evidence to support account balances presented in the financial statements and collectively contributed to the auditors' inability to render an opinion.

However, OFM has fully corrected its material weakness in *Financial Management and Entity Level Controls* reported in FY 2006. Additionally, in FY 2007 OFM, Immigration and Customs Enforcement (ICE), Customs and Border Protection (CBP), US-Visit and the Federal Law Enforcement Training Center (FLETC) mitigated the severity of their financial systems security material weaknesses through corrective actions implemented during 2006 and 2007, but have not completely resolved their financial systems security control weaknesses as of September 30, 2007.

The Coast Guard began FY 2007 with a focus on financial management oversight, financial reporting, and fund balance with Treasury. However, the Coast Guard was not able to fully remediate prior year control weaknesses, and the auditors again reported that the Coast Guard contributed to all seven material weaknesses, and did not have an organizational structure that fully supported the development and implementation of effective policies, procedures, and internal controls. Management officials within the Coast Guard acknowledged to the auditors that longstanding procedural, control, personnel, and cultural issues existed and had impeded their progress in installing an effective financial management structure. The auditors' reported that the Coast Guard's personnel rotation policy, among other issues, made it difficult for the Coast Guard's Chief Financial Officer to institutionalize internal controls related to financial management and reporting.

Conditions at FEMA deteriorated in FY 2007 with FEMA now contributing to six material weaknesses instead of two material weaknesses in FY 2006. The auditors identified that FEMA has not established a financial management organizational structure, with clear oversight and supervisory review functions that support the development and implementation of effective policies, procedures, and internal controls over financial reporting, to ensure that accounting principles are correctly applied, and accurate financial data is submitted to OFM for consolidation in a timely manner. The auditors also noted that the FEMA Chief Financial Officer does not have clearly defined and complete authority and responsibility for all financial accounting policy, processes and control functions throughout the agency.

Many of the DHS' difficulties in financial management and reporting can be attributed to the original stand-up of a large, new, and complex executive branch agency without adequate organizational expertise in financial management and accounting. Although the Department made strides in remediating weaknesses during FY 2007, it has committed to focusing on remediation efforts at USCG and FEMA, while sustaining progress made throughout FY 2007. Additionally, the department remains committed to obtaining additional human resources and other critical infrastructure necessary to develop reliable financial processes, policies, procedures, and internal controls that will enable management to represent that financial statements are complete and accurate. These resources and infrastructure are critical to the implementation of effective corrective actions and to establishing an effective financial management oversight function. During the past year, the Department and its components continued the extensive effort to develop meaningful corrective action plans to address specific material internal control weaknesses. We are evaluating the effectiveness of those corrective action plans in a separate series of audits.

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KPMG is responsible for the attached independent auditor's report dated November 15, 2007, 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 each of the Department's chief financial officers provide us with a corrective action plan that demonstrates their 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 Richards, Assistant Inspector General for Audits, at 202-254-4100.

Attachment

KPMG

KPMG LLP
2001 M Street, NW
Washington, DC 20036

INDEPENDENT AUDITORS' REPORT

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

We were engaged to audit the accompanying balance sheets of the U.S. Department of Homeland Security (DHS or Department) as of September 30, 2007 and 2006, and the related statements of custodial activity for the years then ended (referred to herein as "financial statements"). In connection with our fiscal year 2007 audit, we also considered DHS' internal controls over financial reporting, and DHS' compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on these financial statements. We were not engaged to audit the accompanying statements of net cost, changes in net position, and budgetary resources, for the years ended September 30, 2007 and 2006 (referred to herein as "other fiscal year 2007 and 2006 financial statements").

Summary

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the DHS balance sheets as of September 30, 2007 and 2006, or the related statements of custodial activity for the years then ended.

In fiscal year 2007, DHS changed its method of reporting the reconciliation of budgetary resources obligated to the net cost of operations, and changed its method of reporting certain mixed funding budgetary authority.

Our consideration of internal control over financial reporting resulted in the following conditions being identified as significant deficiencies:

A. Financial Management and Entity Level Controls
B. Financial Reporting
C. Financial Systems Security
D. Fund Balance with Treasury
E. Capital Assets and Supplies
F. Actuarial and Other Liabilities
G. Budgetary Accounting
H. Custodial Revenue and Drawback

We consider significant deficiencies A through G, above, to be material weaknesses.

We noted that DHS did not present five years of Required Supplemental Stewardship Information (RSSI) information, as required by U.S. generally accepted accounting principles.

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*:

I. *Federal Managers' Financial Integrity Act of 1982* (FMFIA)
J. *Federal Financial Management Improvement Act of 1996* (FFMIA)

K. *Single Audit Act Amendments of 1996*, and Laws and Regulations Supporting OMB Circular No. A-50, *Audit Follow-up,* as revised
L. *Improper Payments Information Act of 2002*
M. *Chief Financial Officers Act of 1990*
N. *Government Performance and Results Act of 1993*
O. *Debt Collection Improvement Act of 1996*
P. *Anti-deficiency Act*

We also reported other matters related to compliance with the *Anti-deficiency Act* at the National Protection and Programs Directorate (NPPD) and at the Federal Law Enforcement Training Center (FLETC).

Other internal control matters and other instances of non-compliance may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS balance sheets as of September 30, 2007 and 2006, and the related statements of custodial activity for the years then ended, and had we been engaged to audit the other fiscal year 2007 and 2006 financial statements.

The following sections discuss the reasons why we are unable to express an opinion on the accompanying DHS balance sheets as of September 30, 2007 and 2006, and on the statements of custodial activity for the years then ended; our consideration of DHS' internal control over financial reporting; our tests of DHS' compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements and other matters; and management's and our responsibilities.

Report on the Financial Statements

We were engaged to audit the accompanying balance sheets of the U.S. Department of Homeland Security as of September 30, 2007 and 2006, and the related statements of custodial activity for the years then ended. We were not engaged to audit the accompanying statements of net cost, changes in net position, and budgetary resources for the years ended September 30, 2007 and 2006.

The United States Coast Guard (Coast Guard) was unable to provide sufficient evidential matter or make knowledgeable representations of facts and circumstances, that support transactions and account balances of the Coast Guard, as presented in the DHS balance sheets at September 30, 2007 and 2006; particularly with respect to fund balance with Treasury, accounts receivable, inventory and related property, certain categories of property, plant and equipment, actuarially-derived liabilities, environmental and other liabilities, undelivered orders and changes in net position, and adjustments, both manual and automated, made as part of Coast Guard's financial reporting process. The Coast Guard was unable to complete corrective actions, and make adjustments, as necessary, to these and other balance sheet amounts, prior to the completion of the DHS 2007 *Annual Financial Report* (AFR). Because of the significance of these account balances and/or transactions and conditions noted above, Coast Guard management was unable to represent that the Coast Guard's balance sheets as of September 30, 2007 and 2006, were fairly stated in conformity with U.S. generally accepted accounting principles. The total assets of Coast Guard, as reported in the accompanying DHS balance sheet, were \$15.9 billion and \$12.5 billion, or 20 percent and 16 percent of total DHS consolidated assets as of September 30, 2007 and 2006, respectively.

DHS Office of Financial Management (OFM) and certain DHS components were unable to reconcile intragovernmental transactions and balances with other Federal trading partners totaling approximately \$1.5 billion as of September 30, 2007, prior to the completion of the DHS 2007 AFR. In addition, DHS was unable to provide sufficient evidential matter to support its recording of \$1.5 billion in both fund balance with Treasury and undelivered orders at September 30, 2007, resulting from a budgetary allocation transfer made by the Office of Health Affairs (OHA), a DHS component, to another Federal agency, in fiscal year 2007. Because of the significance of this allocation transfer, DHS management was unable to represent that the balance sheet of OHA is fairly stated in conformity with U.S. generally accepted accounting principles at September 30, 2007. The total assets of OHA, as reported in the accompanying DHS balance sheet as of September 30, 2007, were $3.3 billion or 4 percent of total DHS consolidated assets. In fiscal year 2006, OFM and certain DHS components were unable to provide sufficient evidential matter supporting the completeness and accuracy of the Department's accrued legal liability totaling $71 million as of September 30, 2006, and related contingent legal liabilities as disclosed in Note 21 to the financial statements; reconcile intragovernmental transactions and balances with other Federal trading partners totaling $3.5 billion, as of September 30, 2006; or provide sufficient evidential matter or make knowledgeable representations of the facts and circumstances that support its implementation of Statement of Federal Financial Accounting Standard (SFFAS) No. 27, *Identifying and Reporting Earmarked Funds*, prior to the completion of DHS' 2006 *Performance and Accountability Report* (PAR).

Federal Emergency Management Agency (FEMA) was unable to fully support the accuracy and completeness of certain stockpiled supplies, unpaid obligations related to mission assignments, and certain grants payable/advances, and the related effects on net position, if any, prior to the completion of the DHS 2007 AFR. The stockpiled supplies, as reported in the accompanying DHS balance sheet as of September 30, 2007 were $243 million or 38 percent of DHS' consolidated inventory and related property. FEMA's unpaid obligations related to mission assignments, as reported in the accompanying DHS balance sheet as of September 30, 2007, were $2.6 billion or 5 percent of DHS' consolidated unexpended appropriations. FEMA's net grants payable/advances, as reported in the DHS balance sheet as of September 30, 2007, were $149 million or 3 percent of DHS' consolidated accounts payable. The total net position of FEMA as reported in the accompanying DHS balance sheet as of September 30, 2007, was $10.1 billion or 12.8 percent of DHS' consolidated liabilities and net position. In fiscal year 2006, FEMA was unable to fully support the accuracy and completeness of certain unpaid obligations and accounts payable, and the related effect on net position, if any, prior to the completion of DHS' 2006 PAR. FEMA's unpaid obligations, as reported in the accompanying DHS balance sheet as of September 30, 2006, were $22.3 billion or 46 percent of DHS' consolidated unexpended appropriations. FEMA's accounts payable, as reported in the DHS balance sheet as of September 30, 2006, were $1.5 billion or 33 percent of DHS' consolidated accounts payable. The total net position of FEMA as reported in the accompanying DHS balance sheet as of September 30, 2006, was $11.2 billion or 14 percent of DHS' consolidated liabilities and net position.

In fiscal year 2006, Transportation Security Administration (TSA) was unable to provide sufficient evidential matter or make knowledgeable representations of facts and circumstances that support certain transactions and account balances of TSA, as presented in the DHS balance sheet at September 30, 2006, particularly with respect to property and equipment, accounts payable, accrued unfunded employee leave, and the components of net position. Because of the significance of these account balances and/or transactions and conditions noted above, TSA management was unable to represent that TSA's balance sheet as of September 30, 2006, was fairly stated in conformity with U.S. generally accepted accounting principles. The total assets of TSA as reported in the accompanying DHS balance sheet as of September 30, 2006, were $4.1 billion or 5 percent of DHS consolidated assets.

In fiscal year 2006, Immigration and Customs Enforcement (ICE), was unable to fully support the accuracy and completeness of certain accounts payable and undelivered orders, and the related effect on net position, if any, prior to the completion of the DHS 2006 PAR. ICE's accounts payable and undelivered orders, as reported in the accompanying DHS balance sheet as of September 30, 2006, were $319 million or 7 percent of DHS' consolidated total accounts payable, and $1.2 billion or 2.5 percent of DHS' consolidated unexpended appropriations, respectively.

In fiscal year 2006, the Management Directorate was unable to fully support the accuracy and completeness of certain accounts payable and undelivered orders, and the related effect on net position, if any, prior to the completion of the DHS 2006 PAR. The Management Directorate's accounts payable and undelivered orders, as reported in the accompanying DHS balance sheet as of September 30, 2006, were $60 million or 1.3 percent of consolidated total accounts payable, and $527 million or 1.1 percent of DHS consolidated unexpended appropriations, respectively.

In addition, we were unable to obtain appropriate representations from DHS management, regarding the matters described above, including certain representations as to compliance with U.S. generally accepted accounting principles, with respect to the accompanying DHS balance sheets and related statements of custodial activity as of and for the years ended September 30, 2007 and 2006, and were unable to determine the effect of the lack of such representations on the 2007 and 2006 DHS' financial statements.

It was impractical to extend our procedures sufficiently to determine the extent, if any, to which the DHS balance sheets as of September 30, 2007 and 2006, and the related statements of custodial activity for the years then ended, may have been affected by the matters discussed in the seven preceding paragraphs. Accordingly, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

We were not engaged to audit the accompanying statements of net cost, changes in net position, and budgetary resources for the years ended September 30, 2007 and 2006, and accordingly, we do not express an opinion on these financial statements.

As discussed in Note 34, DHS restated its fiscal year 2006 financial statements to correct multiple errors identified by TSA, ICE, NPPD, United States Citizenship and Immigration Services, Science and Technology Directorate, FLETC, and Management Directorate that required adjustment of balances previously reported in DHS' fiscal year 2006 financial statements. Because of the matters discussed above regarding our fiscal year 2006 audit, and the control deficiencies described in our report on internal control over financial reporting, we were unable to audit the restatements discussed in Note 34, and accordingly, we have not concluded on the appropriateness of this accounting treatment or the restatement of the DHS balance sheet as of September 30, 2006.

As discussed in Notes 35 and 36 to the financial statements, in fiscal year 2007, DHS changed its method of reporting the reconciliation of budgetary resources obligated to the net cost of operations and changed its method of reporting certain mixed funding budgetary authority.

The information in the Management's Discussion and Analysis (MD&A), RSSI, and Required Supplementary Information (RSI) sections of the DHS AFR is not a required part of the financial statements, but is supplementary information required by U.S. generally accepted accounting principles and OMB Circular A-136. We were unable to complete limited procedures over MD&A, RSSI, and RSI as prescribed by professional standards, because of the limitations on the scope of our audit described in the previous paragraphs of this section of our report. Certain information presented in the MD&A, RSSI, and RSI is based on fiscal year 2007 and 2006 financial statements on which we have not expressed an opinion. We did not audit the MD&A, RSSI, and RSI and, accordingly, we express no opinion on it. However, in fiscal year 2007, we noted that DHS did not present five years of RSSI information that U.S. generally accepted accounting principles has determined is necessary to supplement, although not required to be part of, the financial statements.

The information in pages 12 through 23, Section II – Performance Achievements and Key Performance Measures, Section IV – Other Accompanying Information, and Section V – Appendices, of DHS' 2007 AFR are presented for purposes of additional analysis, and are not a required part of the financial statements. This information has not been subjected to auditing procedures, and accordingly, we express no opinion on it.

Internal Control over Financial Reporting

Our consideration of the internal control over financial reporting was for the limited purpose described in the Responsibilities section of this report and would not necessarily identify all deficiencies in the internal control over financial reporting that might be significant deficiencies or material weaknesses.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects DHS' ability to initiate, authorize, record, process, or report financial data reliably in accordance with U.S. generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of DHS' financial statements that is more than inconsequential will not be prevented or detected by DHS' internal control over financial reporting. A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by DHS' internal control.

Significant deficiencies in internal control over financial reporting and its operation are described in Exhibits I, II, and III. Deficiencies that are considered to be material weaknesses at the Coast Guard, when aggregated at the consolidated level, are presented in Exhibit I. Deficiencies that are considered to be material weaknesses at DHS-Headquarters (HQ), OFM, and all other DHS components, when aggregated at the consolidated level, are presented in Exhibit II. Exhibit III presents other significant deficiencies that are not considered to be material weaknesses. As discussed in the Report on the Financial Statements section, the scope of our work was not sufficient to express an opinion on the balance sheets as of September 30, 2007 and 2006, and the related statements of custodial activity for the years then ended, and accordingly, other internal control matters may have been identified and reported had we been able to perform all procedures necessary to express an opinion on those financial statements, and had we been engaged to audit the other fiscal year 2007 and 2006 financial statements. A summary of the status of fiscal year 2006 reportable conditions is included as Exhibit V.

We also noted certain additional matters 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

Our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, as described in the Responsibilities section of this report, exclusive of those referred to in the FFMIA, disclosed eight instances of noncompliance that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 07-04, and are described in Exhibit IV.

The results of our tests of compliance exclusive of those referred to in FFMIA, disclosed no other 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, II and III where DHS' financial management systems did not substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level.

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the balance sheets as of September 30, 2007 and 2006, and the related statements of custodial activity for the years then ended, and accordingly, other instances of non-compliance with laws, regulations, contracts, and grant agreements may have been identified and reported, had we been able to perform all procedures necessary to express an opinion on those financial statements, and had we been engaged to audit the other fiscal year 2007 and 2006 financial statements.

Other Matters. NPPD management has initiated a review of the classification and use of certain funds that may identify a violation of the *Anti-deficiency Act*, or other violations of appropriation law in fiscal year 2007 or in previous years. In addition, FLETC management has initiated a review of the classification of certain liabilities, recorded in their accounting records that may identify a violation of the *Anti-deficiency Act,* or other violations of appropriation law that may have occurred during fiscal year 2007 or during previous years.

Management's Response to Internal Control and Compliance Findings

DHS management has indicated, in a separate letter immediately following this report, that it concurs with the findings presented in Exhibits I, II, III, and IV of our report. We did not audit DHS's response and, accordingly, we express no opinion on it.

Responsibilities

Management's Responsibilities. The United States Code, Title 31, Sections 3515 and 9106 require agencies to report annually to Congress on their financial status and any other information needed to fairly present their financial position and results of operations. To meet these reporting requirements, DHS prepares and submits financial statements in accordance with OMB Circular No. A-136.

Management is responsible for the financial statements, including:

- Preparing the financial statements in conformity with U.S. generally accepted accounting principles;
- Preparing the MD&A (including the performance measures), RSI, and RSSI;
- Establishing and maintaining effective internal control; and
- Complying with laws, regulations, contracts, and grant agreements applicable to DHS, including FFMIA.

In fulfilling this responsibility, management is required to make estimates and judgments to assess the expected benefits and related costs of internal control policies.

Auditors' Responsibilities. As discussed in the report on the financial statements section, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the DHS balance sheets as of September 30, 2007 and 2006, or on the related statements of custodial activity for the years then ended; and we were not engaged to audit the accompanying statements of net cost, changes in net position, and budgetary resources for the years ended September 30, 2007 and 2006.

In connection with our fiscal year 2007 engagement, we considered DHS' internal control over financial reporting by obtaining an understanding of DHS' internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our procedures. We limited our internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards* and OMB Bulletin No. 07-04. We did not test all internal controls relevant to operating objectives as broadly defined by the FMFIA. The objective of our engagement was not to provide an opinion on the effectiveness of DHS' internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of DHS' internal control over financial reporting. Further, other matters involving internal control over financial reporting may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS balance sheet as of September 30, 2007, and the related statement of custodial activity for the year then ended, and had we been engaged to audit the other fiscal year 2007 financial statements.

In connection with our fiscal year 2007 engagement, we performed tests of DHS' 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 balance sheet amounts as of September 30, 2007, and the related statement of custodial activity for the year then ended, and certain provisions of other laws and regulations specified in OMB Bulletin No. 07-04, including certain provisions referred to in 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 the DHS. However, providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our engagement and, accordingly, we do not express such an opinion. In addition, other matters involving compliance with laws, regulations, contracts, and grant agreements may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS balance sheet as of September 30, 2007, and the related statement of custodial activity for the year then ended, and had we been engaged to audit the other fiscal year 2007 financial statements.

Under OMB Bulletin No. 07-04 and FFMIA, we are required to report whether DHS' financial management systems 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. To meet this requirement, we performed tests of compliance with FFMIA Section 803(a) requirements. However, as discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the balance sheet as of September 30, 2007, and the related statement of custodial activity for the year then ended, and accordingly, other instances of non-compliance may have been identified and reported, had we been able to perform all procedures necessary to express an opinion on the those financial statements, and had we been engaged to audit the other fiscal year 2007 financial statements.

Restricted Use

This report is intended solely for the information and use of DHS management, DHS Office of Inspector General, OMB, 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 15, 2007

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, contacts, and grant agreements presented herein were identified during our engagement to audit the Department of Homeland Security (DHS or Department) balance sheet and related statement of custodial activity as of and for the year ended September 30, 2007. We were not engaged to audit the Department's fiscal year 2007 statements of net cost, changes in net position, and budgetary resources (referred to as other fiscal year 2007 financial statements). Our findings and the status of prior year findings are presented in five exhibits:

Exhibit I Significant deficiencies in internal control identified at the Coast Guard. All of the significant deficiencies reported in Exhibit I are considered material weaknesses that individually, or when combined with other significant deficiencies reported in Exhibit II, are considered material weaknesses at the DHS consolidated financial statement level.

Exhibit II Significant deficiencies in internal control identified at other DHS components and the Office of the Chief Financial Officer (collectively referred to as DHS Civilian Components). All of the significant deficiencies reported in Exhibit II are considered material weaknesses that individually, or when combined with other significant deficiencies reported in Exhibit I, are considered material weaknesses at the DHS consolidated financial statement level.

Exhibit III A significant deficiency that is not considered a material weakness at the DHS consolidated financial statement level.

Exhibit IV 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.*

Exhibit V The status of our findings reported in fiscal year 2006.

As stated in our Independent Auditors' Report, our consideration of internal control over financial reporting would not necessarily disclose all matters that might be significant deficiencies or instances of noncompliance. We were not engaged to audit the other 2007 financial statements. In addition, the scope of our work was not sufficient to express an opinion on the financial statements that we were engaged to audit; consequently, other internal control matters and instances of noncompliance may have been identified and reported had we been engaged to audit all of the FY 2007 financial statements, and had we been able to perform all procedures necessary to express an opinion on those financial statements.

The determination of which findings rise to the level of a material weakness is based on an evaluation of how all component conditions, considered in aggregate, may affect the DHS balance sheet as of September 30, 2007 or the related statement of custodial activity for the year then ended.

We have also performed follow-up procedures on findings identified in previous engagements to audit the DHS financial statements. All of the material weaknesses identified and reported in Exhibit I for the Coast Guard are repeated from our FY 2005 and FY 2006 report, and include updates for new findings resulting from our 2007 audit procedures. To provide trend information for the DHS Civilian Components, Exhibit II contains a Trend Table next to the heading of each finding, except Exhibit II-C, *Financial Systems Security.* The Trend Table depicts the level and current status of findings, by component, that have contributed to that finding from 2005 through

2007. Significant deficiencies and material weaknesses, by component, included in the Exhibit II trend tables, are presented below.

The table below presents a summary of our internal control findings, by component, for fiscal year 2007. We have reported seven material weaknesses at the Department level in 2007, which is reduced from ten reported in 2006. While the DHS Civilian Components have made substantial progress in correcting control deficiencies, as shown in the Trend Tables in Exhibit II, the reduction in material weaknesses at the Department level in 2007 is due to a consolidation of findings into fewer, but broader categories for reporting purposes.

SUMMARIZED DHS FY 2007 INTERNAL CONTROL FINDINGS

		Coast Guard	DHS HQ	CBP	FEMA	ICE	US - Visit	TSA	FLETC
Material Weaknesses		**Exhibit I**	**Exhibit II**						
A	Financial Management & ELC	MW			MW				
B	Financial Reporting	MW	MW		MW			SD	
C	Financial Systems Security	MW	SD	SD	MW	SD		MW	SD
D	Fund Balance With Treasury	MW							
E	Capital Assets and Supplies	MW			MW		SD	SD	
F	Actuarial and Other Liabilities	MW			MW			SD	
G	Budgetary Accounting	MW			MW			MW	
Significant Deficiencies			**Exhibit III**						
H	Custodial Revenue and Drawback			SD					

SD Significant Deficiency (SD's in Exhibit II contribute to Department level material weakness)

MW Material Weakness (individually, or when combined with other findings, result in Department level material weakness)

All components of DHS, as defined in Note 1A – *Reporting Entity,* to the financial statements, were included in the scope of our engagement to audit the consolidated balance sheet of DHS as of September 30, 2007 and the related statement of custodial activity for the year then ended. Accordingly, our audit considered significant account balances and transactions 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 reportable control deficiency at the DHS consolidated financial statement level.

I-A Financial Management and Entity-Level Controls

Background: In FY 2006, we reported that significant weaknesses in financial management oversight hindered the United States Coast Guard's (Coast Guard) ability to prepare accurate, complete, and timely financial information. Those conditions have not been corrected and continue to affect Coast Guard's financial management and reporting processes. During FY 2007, the Coast Guard developed a Corrective Action Plan (CAP) called the *Financial Strategy for Transformation and Audit Remediation* (FSTAR) to address the conditions described below, and throughout this Exhibit. However, significant steps to correct the conditions that cause the material weaknesses in internal control are not planned until after 2007.

Conditions: Many of the conditions described below are indicators of a weak control environment or entity-level controls. The control environment begins at the top with the Commandant, and permeates the organization with a mindset of quality, care, and commitment of resources to reasonably ensure the integrity of the Coast Guards' financial processes, controls, and information technology (IT) systems. We noted the following conditions related to the control environment which existed in prior years, and have been updated for this report.

The Coast Guard has not fully implemented a financial management organizational structure where:

- U.S. generally accepted accounting principles (GAAP) are applied and financial statement balances are appropriately supported, resulting in the Coast Guard not being able to assert to the completeness, existence (validity), accuracy, valuation, or presentation of their financial data.
- Appropriate and clear internal reporting relationships have been established resulting in effective financial guidance and oversight over internal and external distribution of financial information, particularly related to the *Federal Managers' Financial Integrity Act of 1982* (FMFIA).
- Clear and complete authority and responsibility for all financial accounting policy, processes, and control functions vests with the Coast Guard Chief Financial Officer (CFO).
- Financial management oversight functions, complete with an organizational chart, job descriptions, roles and responsibilities, and skill sets required, are defined.
- The financial management infrastructure is appropriately staffed with experienced financial managers and staff, to expeditiously identify and address control weaknesses, and develop and implement effective policies, procedures, and internal controls to ensure that data supporting financial statement assertions are complete and accurate.
- The objectives of sound fiscal management, as defined by various government sources, described in the criteria section below, are embraced by all officers and personnel of the Coast Guard.

Cause/Effect: The Coast Guard's management has acknowledged that longstanding procedural, control, personnel, and cultural issues have impeded progress toward installing an effective financial management structure. In addition, the Coast Guard's CFO must coordinate with heads of various divisions who have a role in the accounting and financial reporting processes, but who otherwise have limited exposure to financial statement audits. Further, these division heads change regularly as part of the Coast Guard military assignment and rotation polices, making it difficult for the CFO to institutionalize internal controls related to financial management and reporting that are outside the CFO's direct organization. The conditions described above continue to prevent the Coast Guard and DHS from timely preparation of accurate financial information and reports and have also contributed to the conditions reported in Exhibit I-B, *Financial Reporting*, as well as other material weaknesses described in this Exhibit.

Criteria: OMB Circular No. A-123, Revised, *Management's Responsibility for Internal Control*, defines internal controls as the organization, policies, and procedures used by agencies to reasonably ensure that (i) programs achieve their intended results; (ii) resources are used consistent with agency mission; (iii) programs and resources are protected from waste, fraud, and mismanagement; (iv) laws and regulations are followed; and (v) reliable and timely information is obtained, maintained, reported, and used for decision making.

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

The GAO *Standards* identify the control environment, as one of the five key elements of control, which emphasizes the importance of control conscientiousness in management's operating philosophy and commitment to internal control. These standards cover controls such as human capital practices, supervisory reviews, and segregation of duties, policies, procedures, and monitoring.

OMB Circular No. A-50, *Audit Follow-up*, as revised, states that corrective action taken by management on audit findings and recommendations is essential to improving the effectiveness and efficiency of Government operations. Each agency shall establish systems to assure the prompt and proper resolution and implementation of audit recommendations. These systems shall provide for a complete record of action taken on both monetary and nonmonetary findings and recommendations.

Recommendations: We recommend that the Coast Guard:

1. Initialize the CAP/FSTAR process with an assessment of the control environment (entity-level controls), develop effective corrective actions, and implement improved financial processes and systems;
2. Delegate responsibility for sound fiscal management centrally with the CFO who has full authority to implement change as needed, including new policies, procedures, controls and IT systems requirements, to have the ability, and appropriate resources for Coast Guard financial management and reporting functions;
3. Engage an expert from outside the organization to evaluate the existing financial management organizational and internal control structure. The organizational specialist should conduct an assessment of the financial management organizational structure to consider the conditions cited above. In addition, the organizational specialist should consider other conditions identified in Exhibit I-B, *Financial Reporting,* below, such as the number and type of personnel and resources needed, along with the requisite skills and abilities necessary, to provide effective guidance and oversight to program offices that are significant to financial management and reporting, and make recommendations to senior management for appropriate changes; and

4. Ensure that its CAP/FSTAR actions as designed and performed are:
   a) Effective in addressing all of the material weakness described in this Exhibit; and
   b) Coordinated and prioritized with the input from Departments CFO to address matters that are preventing the Department from preparing reliable financial statements and executing its fiscal management responsibilities.

I-B Financial Reporting

Background: In FY 2006, we reported that the Coast Guard had numerous internal control weaknesses that led to a material weakness in financial reporting. While the Coast Guard developed FSTAR to address the control weaknesses, they were not able to make substantial progress in execution of their corrective actions, and, consequently, many of the conditions reported in prior years are repeated below.

Conditions: The Coast Guard:

- Has not developed and implemented an effective general ledger system. The Core Accounting System (CAS), Aircraft Logistics Management Information System (ALMIS), and Naval Engineering Supply Support System (NESSS) general ledgers are significantly noncompliant with the requirements of the *Federal Financial Management Improvement Act* (FFMIA). Specifically:
  - The general ledgers are not compliant with the United States Standard General Ledger (USSGL) at the transaction level, include noncompliant chart of account definitions, invalid accounts, improper posting logic codes and inconsistent crosswalks to the Coast Guard *Treasury Information Executive Repository* (TIER) database. The general ledgers also have static balances related to a legacy general ledger conversion and unsubstantiated automated changes to CAS financial data through the use of hundreds of scripts, implemented without effective controls to correct system problems;
  - The Coast Guard's TIER submissions to the Department's Office of Financial Management (OFM) are from a database that does not have detail at the transactional level, and is not reconciled or supported by the transaction level detail in the Coast Guard's three general ledgers; and
  - The financial reporting process is overly complex and labor intensive, and requires a significant number of "on-top" adjustments (adjustments made outside the core accounting system for presentation of financial information given to the Department for consolidation). These topside adjustments are not supported at the transaction level and are not recorded to the respective general ledgers at a detailed transactional level. Thus, period-end and opening balances are only supported by the Coast Guard TIER database, and the three general ledgers do not support the financial statements.
- Has significant deficiencies in its policies, procedures, and controls surrounding its financial reporting process. For example, the Coast Guard does not have
  - Effective procedures to support beginning balance, year-end close out and the cumulative results of operation analysis;
  - A process to record all financial transactions, in detail at the transactional level, to the general ledger systems;

- Effective policies and procedures to identify the cause and resolve abnormal balances and account relationship discrepancies, e.g., budgetary to proprietary reconciliations, and identified potential errors in its financial data;
- Effective procedures and internal controls over the process of preparing and reviewing adjustments to account balances, and financial statement disclosures, and uses high-level analytical comparisons to identify adjusting entries;
- Effective procedures to assess potential financial system problems, such as potential posting logic errors and automated changes to financial data through scripts (system modifications);
- Fully effective and accurate reporting tools for financial data analysis (Facts & Figures Quick Report Tool);
- An effective process to record, review, and monitor accounts receivable activity;
- Effective policies, procedures, and internal controls to compile, support, review, and report financial statement disclosures submitted for incorporation in the DHS financial statements, to include the effective completion the GAO Disclosure Checklist and valid support for the preparation of statement of net cost disclosure; and
- A validated, comprehensive process, to include effective internal controls, to fully track and reconcile intragovernmental transactions with its Federal trading partners, especially those outside DHS, and to determine that Coast Guard intragovernmental balances, as reported in the DHS financial statements, are complete, accurate, appropriately valued, belong to Coast Guard, and presented properly in the financial statements.

Cause/Effect: Many of the issues mentioned above stem from the conditions described in Exhibit I-A *Financial Management and Entity-Level Controls.* At the Coast Guard, the accuracy of financial information is highly dependent on the knowledge and experience of a limited number of key financial personnel rather than on clearly documented procedural manuals and process-flow documentation. In addition, the Coast Guard has serious general ledger structural and IT system functionality deficiencies that make the financial reporting process more complex and difficult. Consequently, the Coast Guard can not be reasonably certain that its financial statements are complete or accurate at any time. In its annual Assurance Statement provided to the DHS Secretary in September 2007, the Coast Guard was unable to provide reasonable assurance that internal controls over financial reporting are operating effectively, and was unable to represent to us that any significant balance sheet line items are fairly stated at September 30, 2007.

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

FMFIA requires that agencies establish internal controls according to standards prescribed by the Comptroller General and specified in the GAO *Standards*. These standards define internal control as an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.

The GAO *Standards* require that internal controls be documented in management directives, administrative policies or operating manuals; transactions and other significant events be clearly documented; and information be recorded and communicated timely with those who need it within a timeframe that enables them to carry out their internal control procedures and other responsibilities.

Recommendations: We recommend that the Coast Guard:

1. Conduct an assessment of its current financial reporting process, including a review of its three general ledger systems, with the goal of establishing a general ledger that is FFMIA compliant at the transaction level, e.g., all financial transactions are recorded in the general ledger at the detail USSGL level as they occur, all financial statement line items are fully reconciled and supported by transactional detail contained in the general and subsidiary ledgers, reducing complexity, implementing appropriate internal controls, improving financial systems integration and automating manual processes;

2. Establish new or improve existing policies, procedures, and related internal controls to ensure that:

   a) The year-end, close-out process; reconciliations; and financial data and account analysis procedures are supported by documentation, including evidence of effective management review and approval, and beginning balances in the following year are determined to be reliable and auditable;

   b) On-top adjustments to account balances and abnormal balances and account relationship discrepancies, e.g., budgetary to proprietary reconciliations are identified, reviewed and documented;

   c) Account reconciliations, for each of the three general ledgers and the monthly TIER submission, are performed timely and completely each month, and differences are researched and resolved before the next month's reporting cycle. Reconciliations should include all funds maintained by the Coast Guard, including revolving, special, and trust funds;

   d) The Coast Guard identifies all accounts receivables and then implements comprehensive Coast Guard-wide policies and procedures, including internal controls, at a sufficient level of detail to determine that the accounts receivable process is effective to support management assertions, in compliance with generally accepted accounting principles, for the accounts receivable balance reported on the Coast Guard balance sheet; and

   e) The Coast Guard develops and implements effective policies, procedures and internal controls to compile, support, review, and report financial statement disclosures submitted for incorporation in the DHS financial statements, to include the effective completion the GAO Disclosure Checklist and valid support for the preparation of statement of net cost disclosure;

3. Investigate potential financial system problems such as potential posting logic errors and automated changes to financial data through scripts (system modifications); and

4. Establish a formal documented review and approval process over reconciliation activities performed by Coast Guard to ensure that all intragovernmental activity and balances are identified and differences are being resolved in a timely manner in coordination with the OFM (see Exhibit II-B, *Financial Reporting*). Procedures should also include obtaining positive confirmation of balances with DHS trading partners and make appropriate system

changes to include updating and validating the information in the vendor tables for trading partner data, and correct known errors.

I-C Financial Systems Security

Background: The Coast Guard maintains three general ledger systems that support its financial statements and other financial data provided to DHS OFM for consolidation, which are CAS, ALMIS, and NESSS – described in Exhibit I-B, *Financial Reporting*. Our audit included a review of the Coast Guard's IT general control (ITGC), and specifically in six key control areas: entity-wide security program planning and management, access control, application software development and change control, system software, segregation of duties, and service continuity. During FY 2007, the Coast Guard took actions to improve aspects of its ITGC to address our prior year findings; however, the Coast Guard did not make all of the necessary improvements that they had planned to make during the year. The Coast Guard also serves as Transportation Security Administration's (TSA)'s accounting service provider; therefore, some financial accounting system and process weaknesses at the Coast Guard may affect the TSA's accounting records, as well.

Conditions: During our 2007 ITGC testing, we identified 42 findings, of which 36 are repeat findings and 6 are new findings. The ITGC and other financial system control weaknesses were identified at Coast Guard Headquarters and its components. We noted control deficiencies in all six general control areas that when combined, present more than a remote possibility of materially impacting financial data integrity. The significant deficiencies identified included: 1) excessive access to key Coast Guard financial applications, 2) application change control processes that are not adequately designed nor operating effectively, 3) entity-wide security program issues involving personnel background checks, 4) system software weaknesses involving patch management and configuration management, 5) segregation of duties involving lack of policies and procedures and excessive privilege access issues, and 6) service continuity issues involving the lack of testing of disaster recovery testing. Significant deficiency Nos. 1 and 2, above, are considered to be material weaknesses impacting the DHS consolidated financial statements. In addition, the significant deficiencies in application change control processes are among the principle causes of Coast Guard's inability to support their financial statement balances. See Exhibit I-B, *Financial Reporting,* for a discussion of the related conditions causing significant noncompliance with the requirements of FFMIA. Our ITGC findings are described in greater detail in a separate *Limited Official Use* (LOU) letter provided to the Coast Guard and DHS management.

Cause/Effect: The Coast Guard has made some progress correcting certain ITGC weaknesses identified in previous years. However, the Coast Guard was not able to effectively prioritize and implement CAPs to remediate the root cause of the ITGC weaknesses in 2007. Consequently, the corrective actions taken more often address the symptom of the problem and not the root cause. For example, workarounds are sometimes implemented so that the system can continue functioning, while more permanent solutions are developed.

Many of these weaknesses were inherited from system development activities that did not incorporate strong security controls during the initial implementation of the system more than five years ago, and will take several years to fully address. These weaknesses exist both in the documentation of processes and the implementation of adequate security controls over processes and within financial systems. Specifically, policies and procedures supporting the operation of various processes within control areas such as change control and access controls were developed without taking into account required security practices. Consequently, as policies and procedures are updated, many Coast Guard components are challenged to move away from previous methodologies and fully implement and enforce these new controls in unison with other components.

The effect of these ITGC weaknesses limits Coast Guard's ability to ensure that critical financial data is reliable and is maintained in a manner to ensure confidentiality, integrity, and availability. In addition, as a result of the presence of IT weaknesses, there is added dependency on the other mitigating manual controls to be operating effectively at all times. Because mitigating controls often require more human involvement, there is an increased risk of human error that could materially affect the financial statements.

Criteria: The *Federal Information Security Management Act* (FISMA) passed as part of the *Electronic Government Act of 2002,* mandates that Federal entities maintain IT security programs in accordance with National Institute of Standards and Technology (NIST) guidance.

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

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

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

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

The GAO's *Federal Information System Controls Audit Manual* (FISCAM) provides a framework and recommended audit procedures that are used to conduct the IT general control test work.

Recommendations: We recommend that the DHS Office of Chief Information Officer in coordination with the Office of the Chief Financial Officer (OCFO) make the following improvements to the Coast Guard's financial management systems:

1. Implement the recommendations in our LOU letter provided to the Coast Guard and DHS management, to effectively address the deficiencies identified including: 1) access to key Coast Guard financial applications, 2) application change control processes, 3) entity-wide security program issues, 4) system software weaknesses involving patch management and configuration management, 5) segregation of duties involving lack of policies and procedures and excessive privilege access issues, and 6) service continuity issues involving the lack of testing of disaster recovery;
2. Design and implement plan of action and milestones that address the root cause of the weakness, to migrate away from excessive workarounds and reliance on manual mitigating controls; and
3. Develop and implement policies and procedures that appropriately consider required security practices when supporting the operation of various processes within control areas such as change control and access controls.

I-D Fund Balance with Treasury

Background: In fiscal year 2006, we reported the existence of a material weakness in Fund Balance with Treasury (FBwT) at the Coast Guard. The Coast Guard has not yet developed or implemented comprehensive FBwT CAPs, and consequently, we are repeating and expanding the conditions cited in last year's report. FBwT at the Coast Guard totaled approximately $5 billion, or approximately 10 percent of total DHS FBwT, at September 30, 2007. The majority of these funds represented appropriated amounts that were obligated, but not yet disbursed, at September 30, 2007.

Conditions: The Coast Guard:

- Did not maintain adequate supporting documentation that validated the accuracy of all of its FBwT reconciliations and the clearing of suspense items, to include posting unsupported adjustments to the Coast Guard reported general ledger activity submitted to the Treasury, and to agree Coast Guard balances to Treasury records without supporting documentation.
- Did not have an effective process for accounting for suspense account transactions related to FBwT. The Coast Guard lacks documented and effective policies and procedures, to include internal controls, to support the completeness, existence, and accuracy of recorded and subsequently posted suspense account transactions. The Coast Guard continues to be unable to produce complete and accurate populations of suspense transactions.
- Was unable to provide validated military and civilian payroll data to support payroll transactions processed through the Coast Guard's FBwT, USSGL account No. 1010. The Coast Guard did not properly report and reconcile these transactions or maintain appropriate supporting documentation.

Cause/Effect: The Coast Guard has not designed and implemented accounting processes, including a financial system that complies with federal financial system requirements, as defined in OMB Circular No. A-127 and the requirements of the *Joint Financial Management Improvement Program* (JFMIP), now administered by the *Financial Systems Integration Office* (FSIO), to fully support the fiscal year 2007 FBwT activity and balance at September 30, 2007. Failure to implement timely and effective reconciliation processes could increase the risk of fraud, abuse, undetected violations of appropriation laws, including instances of undiscovered

Anti-deficiency Act violations, and mismanagement of funds, which could lead to inaccurate financial reporting and affects DHS' ability to effectively monitor its budget status.

Criteria: The *Treasury Financial Manual* (TFM) states, "Federal agencies must reconcile their USSGL account No.1010, and any related subaccounts, on a monthly basis (at minimum). Federal agencies must research and resolve differences between the balances reported on their general ledger FBwT accounts and balances reported in the *Government-wide Accounting* system (GWA). In addition, Section 803(a) of FFMIA requires that Federal financial management systems comply with 1) Federal accounting standards, 2) Federal system requirements, and 3) the USSGL at the transaction level. FFMIA emphasizes the need for agencies to have systems that can generate timely, reliable, and useful information with which to make informed decisions to ensure ongoing accountability.

According to OMB Circular No. A-123, transactions should be promptly recorded, and properly classified and accounted for, in order to prepare timely and reliable financial and other reports. Documentation for transactions, management controls, and other significant events must be clear and readily available for examination.

Recommendations: We recommend that the Coast Guard:

1. Establish policies, procedures, and internal controls, including effective reconciliations and the use of a financial system that complies with federal financial system requirements, as defined in OMB Circular A-127, and the requirements of the JFMIP, to fully support the fiscal year 2007 FBwT activity and balance at September 30, 2007. These policies and procedures should allow the Coast Guard to:
   a) Perform complete and timely FBwT reconciliations using the tools provided by Treasury GWA;
   b) Better manage its suspense accounts to include researching and clearing items carried in suspense clearing accounts in a timely manner during the year, and maintaining documentation of periodic reconciliations of FBwT; and
   c) Ensure payroll data, supporting payroll transactions processed through FBwT (account 1010), is properly maintained and available for audit testwork, as needed.

I-E Capital Assets and Supplies

Background: Property, plant, and equipment (PP&E) represents approximately 15.5 percent of total DHS assets, and the Coast Guard maintains more than 60 percent of all DHS PP&E, including a large fleet of boats and vessels. Many of the Coast Guard's assets are constructed over a multi-year period, have long useful lives, and undergo extensive routine servicing that may increase their value or extend their useful lives. Comprehensive policies and procedures are necessary to accurately and timely account for and report these assets. We reported in prior years that the Coast Guard has been unable to provide auditable documentation for certain categories of PP&E, due to a number of policy, control, and process deficiencies that will require several years to correct, and consequently, most of the conditions cited below have been repeated from our 2006 report, and have existed since the Department's inception in 2003.

Operating Materials and Supplies (OM&S) are maintained by the Coast Guard in significant quantities, and consist of tangible personal property to be consumed in normal operations to service marine equipment, aircraft, and other operating equipment. The majority of the Coast Guard's OM&S is physically located at either two Inventory Control Points (ICPs) or in the field.

The Coast Guard's policy requires regularly scheduled physical counts of OM&S, which are important to the proper valuation of OM&S and its safekeeping. The conditions cited below for OM&S are based on findings reported in fiscal 2006, updated as necessary to reflect the conditions noted in fiscal year 2007.

Conditions: Coast Guard has not:

Regarding PP&E:

- Consistently applied policies and procedures to ensure appropriate documentation supporting PP&E acquisitions, and their existence, is maintained to support capitalized PP&E. In cases where original acquisition documentation has not been maintained, the Coast Guard has not developed and documented methodologies and assumptions to support the value of PP&E.
- Implemented appropriate controls and related processes to accurately, consistently, and timely record additions to PP&E and construction in process (CIP), transfers from other agencies, disposals in its fixed asset system, and valuation and classification of repairable PP&E.
- Implemented accurate and complete asset identification, system mapping, and tagging processes that include sufficient detail, e.g., serial number, to clearly differentiate and accurately track physical assets to those recorded in the fixed asset system.
- Properly accounted for some improvements and impairments to buildings and structures, capital leases, and selected useful lives for depreciation purposes, consistent with GAAP.

Regarding OM&S:

- Implemented policies, procedures, and internal controls to support the completeness, accuracy, existence, valuation, ownership, and presentation assertions related to the fiscal year 2007 OM&S and related account balances.
- Fully designed and implemented policies, procedures, and internal controls over physical counts of OM&S to remediate conditions identified in previous years.
- Properly identified (bar-coded or tagged) recorded OM&S.
- Established processes and controls to fully support the calculated value of certain types of OM&S to approximate historical cost.

Cause/Effect: PP&E policies and procedures are not appropriately designed, consistently followed, or do not include sufficient controls to ensure compliance with policy or to ensure complete supporting documentation is maintained and available for audit testwork. The fixed asset module of the Coast Guard's CAS is not updated for effective tracking and reporting of PP&E. The effect of these conditions is that the Coast Guard is unable to accurately account for its PP&E, and provide necessary information to DHS OFM for consolidated financial statement purposes.

Coast Guard management deferred correction of most OM&S weaknesses reported in previous years, and acknowledged that the conditions we reported in prior years remained throughout fiscal year 2007. Lack of comprehensive and effective policies and controls over the performance of physical counts, and appropriate support for valuation, may result in errors in the physical inventory process or inventory discrepancies that could result in financial statement misstatements.

Criteria: Statement of Federal Financial Accounting Standard (SFFAS) No. 6, *Accounting for Property, Plant, and Equipment*, requires that:

- PP&E is recorded at historical cost with an adjustment recorded for depreciation. In the absence of such information, estimates may be used based on a comparison of similar assets with known values or inflation-adjusted current costs; and
- PP&E accounts should be adjusted for disposals, retirements, and removal of PP&E, including associated depreciation.

According to OMB Circular No. A-123, transactions should be promptly recorded, and properly classified and accounted for, in order to prepare timely and reliable financial and other reports. Documentation for transactions, management controls, and other significant events must be clear and readily available for examination.

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

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

Recommendations: We recommend that the Coast Guard:

Regarding PP&E:

1. Improve controls and related processes and procedures to ensure that documentation supporting PP&E acquisitions, to include the CIP process and existence, including additions, transfers, and disposals, is maintained to support capitalized PP&E;
2. Implement processes and controls to record PP&E transactions accurately, consistently, and timely in the fixed asset system; record an identifying number in the fixed asset system at the time of asset purchase to facilitate identification and tracking; and ensure that the status of assets is accurately maintained in the system;
3. Revise procedures for performing physical inventories of repairable items, to include procedures for resolving differences, and reporting results, to ensure that repairable PP&E is accurately and completely classified and recorded. Support the pricing methodology used to value repairable PP&E to ensure that balances, as presented in the financial statements, approximate amortized historical cost; and
4. Review policies and procedures to account for improvements and impairments to buildings and structures, capital leases, and identify proper useful lives for depreciation purposes in accordance with GAAP.

Regarding OM&S:

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

I-F Actuarial and Other Liabilities

Background: The Coast Guard maintains pension, medical, and postemployment travel benefit programs that require actuarial computations to record related liabilities for financial reporting purposes. The Military Retirement System (MRS) is a defined benefit plan that covers both retirement pay and health care benefits for all active duty and reserve military members of the Coast Guard. The medical plan covers active duty, reservists, retirees/survivors and their dependents that are provided care at Department of Defense (DoD) medical facilities. The postemployment travel benefit program pays the cost of transportation for uniformed service members upon separation from the Coast Guard. Annually, participant and cost data is extracted by the Coast Guard from its records and provided to an actuarial firm as input for the liability calculations. The accuracy of the actuarial liability as reported in the financial statements is dependent on the accuracy and completeness of the underlying participant and cost data provided to the actuary. A combined unfunded accrued liability of approximately $30 billion for the plans is reported in the DHS consolidated balance sheet at September 30, 2007.

The Coast Guard estimates accounts payable as a percentage of undelivered orders (UDOs) based on historical trends. As described in Exhibit I-G, *Budgetary Accounting*, reliable accounting processes surrounding the recording of obligations and disbursements, and tracking of UDOs, are key to the accurate reporting of accounts payable in the Coast Guard's financial statements.

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

The Coast Guard estimates its legal liabilities to include Oil Spill Liability Trust Fund claims, that are incorporated, and recorded, as part of the DHS legal liability on DHS financial statements.

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

- Have effective policies, procedures, and controls to ensure the completeness and accuracy of participant data, medical cost data, and trend and experience data provided to, and used by, the actuary for the calculation of the MRS pension, medical, and postemployment benefit liabilities. Reconciliations between subsidiary and general ledger amounts for medical expenditures are not effective.
- Have effective policies, procedures and internal controls over the Coast Guard's process for reconciling military payroll recorded in the CAS general ledger to detail payroll records. Military personnel data changes, including changes in leave balances and payroll corrections, are not processed in the appropriate payroll and/or reporting periods, and

consequently impact the completeness and accuracy of leave and payroll accruals as well as data used for actuarial projections.

- Use a reliable methodology to estimate accounts payable. The method used was not supported as to the validity of data, assumptions, and criteria used to develop and subsequently validate the reliability of the estimate for financial reporting.
- Support the completeness, existence, and accuracy assertions of the data utilized in developing the estimate for the FY 2007 recorded environmental liability account balance. The Coast Guard has not fully developed, documented, and implemented the policies and procedures in developing, preparing, and recording the environmental liability estimates related to vessels, shore facilities projects, lighthouses, and SAFRs.
- Use a reliable methodology to estimate their legal liabilities, to include Oil Spill Liability Trust Fund claims that are incorporated and recorded as part of the DHS contingent legal liability on DHS consolidated financial statements. The Coast Guard did implement corrective actions to support the completeness of their oil spill legal claims. However, Coast Guard policies, procedures, and internal controls were not fully effective to accurately estimate liabilities for oil spill claims.

Cause/Effect: Much of the data required by the actuary comes from personnel and payroll systems that are outside of the Coast Guard's accounting organization and are instead managed by Coast Guard's Personnel Service Center (PSC). The PSC has not substantiated the completeness and accuracy of the basic pay information provided to the actuary. Consequently, the Coast Guard management is unable to provide assurance on the completeness and accuracy of actuarially determined liabilities as stated in the DHS consolidated balance sheet at September 30, 2007. In addition, the Coast Guard does not have sufficient controls to prevent overpayments for medical services, and inaccurate medical costs submitted to the Coast Guard actuary could result in a misstatement of the actuarial medical liability and related expenses. Also, the conditions noted exist, in part, because of ineffective entity-level controls, in particular, with regard to financial management oversight – see Exhibit I-A, *Financial Management and Entity Level Controls.*

The Coast Guard has not yet developed comprehensive policies and procedures or corrective action plans to address the conditions above, and consequently, management is unable to assert to the accuracy and completeness of accounts payable, and payroll accruals recorded as of September 30, 2007.

The Coast Guard has not developed consistent, written, agency-wide policies to define the technical approach, cost estimation methodology, and overall financial management oversight of its oil spill claims and environmental remediation projects, resulting in the inability to support the completeness of the estimate and possible misstatement of the liability in its financial statements.

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

GAO *Standards* hold that transactions should be properly authorized, documented, and recorded accurately and timely. OMB Circular No. A-123 states that "transactions should be promptly recorded, properly classified, and accounted for in order to prepare timely accounts and reliable financial and other reports." SFFAS No. 1, *Accounting for Selected Assets and Liabilities*, states, "When an entity accepts title to goods, whether the goods are delivered or in transit, the entity should recognize a liability for the unpaid amount of the goods. If invoices for those goods are not available when financial statements are prepared, the amounts owed should be estimated."

Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates,* states "An entity's internal control may reduce the likelihood of material misstatements of accounting estimates. Specific relevant aspects of internal control include the following: Accumulation of relevant, sufficient, and reliable data on which to base an accounting estimate, and comparison of prior accounting estimates with subsequent results to assess the reliability of the process used to develop estimates."

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

Recommendations: We recommend that the Coast Guard:

Regarding actuarial liabilities:

1. Establish and document policies, procedures, and effective controls to ensure the completeness and accuracy of the actuarial pension, medical, and postemployment travel benefit liabilities;
2. Establish and document policies, procedures, and effective controls to ensure the completeness and accuracy of participant data, medical cost data, and trend and experience data provided to, and used by, the actuary for the calculation of the MRS pension, medical, and postemployment travel benefit liabilities; and
3. Perform a periodic reconciliation between the medical expenditures recorded in the subsidiary ledger and those recorded in the CAS, and address differences before data is provided to the actuary. This reconciliation should be performed for all significant sources of medical actuarial data, including TriCare, and DoD Military Treatment Facilities (MTFs). In addition, this reconciliation should be reviewed by someone other than the preparer to ensure accuracy.

Regarding accounts payable and payroll:

4. Analyze and make appropriate improvements to the methodology used to estimate accounts payable and support all assumptions and criteria with appropriate documentation to develop and subsequently validate the estimate for financial reporting; and
5. Implement corrective action, including appropriately designed and implemented internal controls, to support the completeness, existence, and accuracy of changes in member personnel data records and military payroll transactions, and to include recorded accrued military leave and payroll liabilities.

Regarding environmental liabilities:

6. Develop consistent written agency-wide policies, procedures, processes, and controls to ensure identification of and recording of all environmental liabilities, define the technical approach, cost estimation methodology, and overall financial management oversight of its environmental remediation projects. The policies should include:
   a) Procedures to ensure the proper calculation and review of cost estimates for consistency and accuracy in financial reporting, including the use of tested modeling techniques, use of verified cost parameters, and assumptions;
   b) Periodically validate estimates against historical costs; and
   c) Ensure that detailed cost data is maintained and reconciled to the general ledger.

Regarding legal liabilities:

7. Develop, document, and implement a reliable methodology as well as formal policies and procedures, to include internal controls, to verify and support the accuracy of the legal liability estimate and related disclosures.

I-G Budgetary Accounting

Background: Budgetary accounts are a category of general ledger accounts where transactions related to the receipt, obligation, and disbursement of appropriations and other authorities to obligate and spend agency resources are recorded. Each Treasury Account Fund Symbol (TAFS), with separate budgetary accounts, must be maintained in accordance with OMB and Treasury guidance. The Coast Guard has over 80 TAFS covering a broad spectrum of budget authority, including annual, multiyear, and no-year appropriations; and several revolving, special, and trust funds. In addition, the Coast Guard estimates accounts payable at year end as a percentage of UDOs based on historical trends. Reliable accounting processes surrounding obligations, UDOs and disbursements are key to the accurate reporting of accounts payable in the DHS consolidated financial statements.

Conditions: We noted the following internal control weaknesses related to budgetary accounting, many of which were repeated from our fiscal year 2006 report.

- The policies, procedures and internal controls over the Coast Guard's process for validation and verification of UDO balances are not effective to ensure that recorded obligations and UDO balances were complete, valid, accurate, and that proper approvals and supporting documentation is maintained.
- Policies were not fully implemented to ensure that contract awards, particularly related to the Deepwater Acquisition Program, were recorded in the general ledger in a timely manner, and as a result, obligations might have been temporarily understated.
- Procedures and controls are not implemented to prevent incurring a commitment/obligation in excess of established targets so that funds are not obligated in excess of the apportioned and allotted amounts. In addition, the Coast Guard did not effectively monitor unobligated commitment activity in its procurement system. As of April 2007, there were over 16,000 unobligated commitment transactions totaling approximately $516 million.
- The Coast Guard's procedures, processes, and internal controls in place to verify the completeness and accuracy of the year-end obligation pipeline adjustment to record all executed obligations were not properly designed and implemented. These deficiencies

affected the completeness, existence, and accuracy of the year-end "pipeline" adjustment that was made to record obligations executed before year end.

- Automated system controls are not effectively used to prevent the processing of procurement transactions by contracting officer's with expired warrant authority, and a manual compensating control was not effective since listings of warranted contracting officers were not complete.

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

Criteria: According to the JFMIP, *Core Financial System Requirements*, an agency's core financial management system must ensure that an agency does not obligate or disburse funds in excess of those appropriated and/or authorized and specific system edits and user notifications related to funds control must be in place. The *Federal Acquisition Regulation* (FAR) Section 1.16 addresses the authorities and responsibilities granted to contracting officers. Treasury's USSGL guidance specifies the accounting entries related to budgetary transactions.

FFMIA Section 803(a) requires that each Agency to implement and maintain a system that complies substantially with Federal financial management system requirements as stipulated by OMB Circular No. A-127.

Recommendations: We recommend that the Coast Guard:

1. Improve policies, procedures, and the design and effectiveness of controls related to processing obligation transactions, including periodic review and validation of UDOs. Emphasize to all fund managers the need to perform effective reviews of open obligations, obtain proper approvals, and retain supporting documentation;
2. Fully implement policies and the design and effectiveness of controls to ensure that contract awards are recorded in the general ledger in a timely manner;
3. Improve segregation of duties for transactions related to the creation and approval of purchase requisitions, certification of funds availability, and the recording of the obligations, and record contracts timely;
4. Revise controls and related policies and procedures to periodically review commitments;
5. Improve procedures, processes, and internal controls to verify the completeness and accuracy of the year-end obligation pipeline adjustment to record all executed obligations for financial reporting; and
6. Establish automated system controls to prevent incurring a commitment/obligation in excess of established targets so that funds are not obligated in excess of the apportioned and allotted amounts and preclude the processing of procurement transactions if the contracting officer's warrant authority had expired.

II-A Financial Management and Entity Level Controls (FEMA)

	2007	2006	2005
FEMA	MW	N/A	N/A
OFM	C	MW	MW
ICE	C	C	MW

Key – Trend Table

C	Corrected
SD	Significant Deficiency*
MW	Material Weakness*

* See Introduction

Background: The Federal Emergency Management Agency (FEMA)'s accounting and financial reporting requirements are very diverse supporting multifaceted operations, such as temporary assistance funds, disaster relief loans, national flood insurance programs, stockpiles of essential supplies, mission assignments to other federal agencies for restoration and reconstruction, and grants to state and local governments. These programs are sometimes subject to complicated accounting rules, as defined by the *Federal Accounting Standards Advisory Board* (FASAB), and require specialized technical knowledge to interpret and apply. FEMA has been subject to significant reorganization efforts during FY 2007 and FY 2006, while also continuing its disaster relief efforts resulting from the 2005 hurricanes affecting the Southern U.S. In addition, FEMA's accounting personnel and systems need to be ready to mobilize and support disaster operations with little advance notice, while also maintaining sound financial management standards. These circumstances place a high demand on financial management and emphasize the need for strong entity level controls throughout FEMA. Some of the conditions cited below contributed to qualifications of our Independent Auditors' Report in previous years. We believe these conditions, which include financial reporting control weaknesses, considered in aggregate, now represent a material weakness in financial management and entity level controls at FEMA.

Until 2007, the DHS OFM, within the OCFO at DHS Headquarters has not been adequately staffed with a sufficient number of management personnel who had the requisite financial accounting background, knowledge, and expertise, to both (i) set up, and (ii) effectively manage the consolidated financial reporting and internal control infrastructure of a large and complex Executive Branch agency. However, late in FY 2006 and throughout 2007, the OCFO executed a staffing plan to fill gaps in OFM skill sets. With the addition of new financial management and staff, restructuring of the OFM, development and issuance of new policies and procedures, and improved internal controls, with a focus on entity level controls, we noted that OFM has fully corrected its material weakness in *Financial Management and Entity Level Controls* reported in our FY 2006 report.

In 2006, we reported that ICE corrected its entity level control weaknesses in financial management and oversight. The corrective actions taken in 2006 continued to be effective in FY 2007.

Conditions: We noted the following internal control weaknesses related to financial management and entity level controls at FEMA, when combined with the conditions existing at the Coast Guard (see Exhibit I-A, *Financial Management and Entity Level Controls*), rise to a material weakness at the DHS consolidated financial statement level.

FEMA:

- Has not established a financial management organizational structure, with clear oversight and supervisory review functions that supports the development and implementation of effective policies, procedures, and internal controls over financial reporting, to ensure that accounting principles are correctly applied and accurate financial data is submitted to OFM for consolidation in a timely manner. For example, we noted:

  - The FEMA CFO does not have clearly defined and complete authority and responsibility for all financial accounting policy, processes, and control functions throughout the agency;
  - Financial management oversight functions have not been clearly defined, complete with an organizational chart, job descriptions, roles and responsibilities, training requirements, and skill sets required;
  - A lack of segregation of duties in financial reporting roles; and
  - A lack of supervisory review in financial functions, especially over complex, nonroutine accounting estimates and adjustments, such as credit reform subsidies.

- Does not have a sufficient number of experienced financial managers and staff to expeditiously address nonroutine accounting issues. A lack of skilled accounting resources has contributed to FEMA's inability to perform important accounting functions timely. For example, we noted that FEMA did not:
  - Fully integrate certain Grants and Training (G&T) accounting processes;
  - Perform necessary procedures to completely and accurately present stockpile inventory balances in the consolidated financial statements;
  - Reevaluate the reasonableness of its allowance rates for disaster relief accounts receivable; and
  - Prepare and record adjustments for its National Flood Insurance Program accurately or timely. A material error was identified after submission of FEMA's year-end financial information to OFM.
- Has not completed and implemented a comprehensive CAP to correct internal control weaknesses that are contributing to Department-level material weaknesses, as required by OMB Circular No. A-50, *Audit Follow-up*, as revised.
- Has not documented and/or updated formal policies and procedures (including desk manuals) for many of the roles, responsibilities, processes, and functions performed within FEMA. For example, in FY 2007, we noted that improvements are needed in the formal documentation of policies and procedures related to *Anti-deficiency Act* compliance, preparation and review of the quarterly and annual financial statements; identification of and adherence to GAAP and OMB statements and guidance; policies for timely de-obligation of outstanding grant and non-grant obligations that should be closed related to the former G&T office; policies for monitoring and responding to OMB Circular No. A-133 reports, Office of Inspector General (OIG) reports, and GAO report findings and recommendations; and the quarterly process for estimating accruals (including accrual validation).
- Has not completed the placement of sufficient financial and accounting resources in its regional offices, which contributes to certain issues in Mission Assignment accounting. For example, Mission Assignment obligations are not closed out timely, and in a sample of 216 Mission Assignment payments selected for testwork, we noted that approximately 10% of the payments were not properly reviewed and approved in accordance with FEMA policy.

Cause/Effect: FEMA maintains a relatively small headquarters infrastructure and accounting staff, compared to its diverse programmatic and mission focused objectives. In addition, FEMA is dependent on timely information from other federal agencies, state governments, and grantees to account for some transactions. FEMA's evaluation of internal control over financial reporting conducted pursuant to OMB Circular No. 123, *Managements Responsibility for Internal Control*, and representations made to the Secretary pursuant to the *DHS Financial Accountability Act*, stated that FEMA could not provide reasonable assurance that its internal controls over financial reporting are operating effectively to achieve desired objectives during FY 2007.

Criteria: FMFIA requires that agencies establish internal controls according to standards prescribed by the Comptroller General and specified in the GAO *Standards*. The GAO defines internal control as an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. The GAO *Standards* identify the control environment, as one of the five key elements of control, which emphasizes the importance of control conscientiousness in management's operating philosophy and commitment to internal control. These standards cover controls such as human capital practices, supervisory reviews, and segregation of duties, policies, procedures, and monitoring.

Recommendations: We recommend that FEMA:

a) Provide its CFO with clear authority to develop and implement accounting and financial reporting policies, procedures, and internal controls throughout the agency. Program offices should be required to adhere to policies;

b) Evaluate the existing financial management organizational and internal control structure to determine the number of personnel and resources needed, along with the requisite skills and abilities necessary, to ensure that all significant transactions and account balances are accurately and completely recorded in FEMA's general ledger in a timely manner;

c) Assign accounting functions and responsibilities to staff to ensure proper segregation of duties;

d) Establish clear management oversight responsibilities and processes to effectively review adjustments to account balances and complex, nonroutine accounting transactions;

e) Develop and implement a comprehensive CAPs to correct conditions that contribute to the Department-level material weaknesses in internal controls, and prevented FEMA management from providing reasonable assurance on the effectiveness of internal control;

f) Fully implement plans to place comptrollers in each regional office; and

g) Ensure that procedures are in place to maintain all job-related training, and other critical personnel actions.

II-B Financial Reporting (DHS-HQ, FEMA, and TSA)

	2007	2006	2005
DHS-HQ	MW	MW	MW
FEMA*	MW	N/A	MW
TSA	SD	MW	MW
ICE	C	C	MW

* FEMA Financial Reporting conditions are combined with Comment II-A in 2007

Background: DHS-HQ (or DHS Management and Operations) is comprised of various programs, reporting entities, and offices including, the OCFO. The OCFO is primarily responsible for the financial accounting and reporting infrastructure of the Department, together with other responsibilities as defined in the *Chief Financial Officers Act of 1990*, as amended by *DHS Financial Accountability Act of 2004*. DHS' OFM is responsible for preparing the *Annual Financial Report* (AFR), including the consolidated financial statements, footnote and supplementary data, from trial balances and other financial data submitted by the components to OFM through the TIER system. DHS components are responsible for providing OFM complete, accurate, and timely submission of monthly financial data and reports. The DHS CFO has authority to establish accounting policy that must be followed by components when submitting data used in the DHS consolidated financial statements, and has established *Standard Operating Procedures* (SOP)s, to perform oversight and monitoring controls over financial data submitted by the components that are properly designed and effective when fully completed. During FY 2007, the OCFO issued a component guide that describes component reporting procedures and requirements, as well as other policy memoranda, and several additional DHS-wide policies are scheduled for release in 2008.

FEMA identified a material weakness in internal control over financial reporting in its FY 2007 assurance statement sent to the Secretary, in accordance with Departmental policies requiring self evaluation of internal controls pursuant to FMFIA and OMB Circular No. A-123. The financial reporting internal control weaknesses at FEMA are included in Exhibit II-A, *Financial Management and Entity Level Controls.*

The TSA began using the Coast Guard's *Core Accounting System* (CAS) for its primary general ledger in FY 2005. The transition to a new accounting system required the development and implementation of many new accounting processes and procedures, some of which were needed to mitigate material weaknesses in internal controls that existed prior to TSA's migration to CAS and that currently exist at the Coast Guard. This process of setting up a financial accounting and reporting process interfered with TSA's ability to prepare timely and accurate financial statements through 2006, and contributed to a material weakness in internal controls over financial reporting. In FY 2007, TSA developed and implemented a CAP to address its financial reporting and other accounting internal control weaknesses. TSA has made progress toward correction of control weaknesses in financial reporting in FY 2007.

In 2006, we reported that ICE corrected its internal control weaknesses over financial reporting. The corrective actions taken in 2006 continued to be effective in FY 2007.

Conditions: We noted the following internal control weaknesses related to financial reporting at DHS-HQ and TSA:

1. DHS-HQ:

   - Has made significant progress toward the performance of responsibilities related to the consolidated financial reporting at DHS, however additional improvements are needed to fully implement a consolidated financial reporting process. This condition is supported, in part by these observations:

     - As part of the Post-Katrina reorganization, the Office of Health Affairs (OHA) was established. The accounting, reporting, and data gathering responsibilities for the new entity, including a new reporting requirement affecting the presentation of a transfer appropriation account and related activity conducted by another Federal agency and reimbursed by OHA, were not clearly established and delegated in time to be effective during the year. OHA does not have the administrative infrastructure in place to facilitate (i.e., user controls) financial reporting functions provided by its service provider (i.e., service provider controls) which changed during FY 2007. Consequently, DHS management was unable to support its implementation of a new reporting requirement of OMB Bulletin No. A-136, *Financial Reporting Requirements*, affecting the accounting and presentation of budgetary allocation transfers that occurred at OHA, and was unable to represent that the balance sheet of

OHA is fairly stated in conformity with U.S. generally accepted accounting principles at September 30, 2007. Specifically, OHA did not obtain assurance that $1.4 billion of fund balance with Treasury and undelivered orders recorded as result of a budget allocation to another Federal agency, was properly stated at September 30, 2007. The total assets of OHA, as reported in the accompanying DHS balance sheet as of September 30, 2007, were $3.2 billion or 4 percent of total DHS consolidated assets.

- DHS was not able to timely or completely reconcile intragovernmental balances with other Federal entities, particularly the Department of Defense. Consequently, the DHS' *Material Difference/Status of Disposition Certification Report*, submitted to the Treasury for September 30, 2007, showed material differences attributable to accounting/reporting errors in excess of $1.5 billion FEMA, Coast Guard, TSA and CBP are DHS components that have significant intragovernmental transactions throughout the year. These conditions also impacted DHS' ability to accurately report transactions with Federal government trading partners in the financial statements as required; and
- Instances were noted where DHS components routinely provided OFM incomplete or inaccurate information, and/or did not respond timely to OFM' inquires. Consequently, OFM was often unable to fully complete its own procedures for timely review of component financial data and, therefore, are unable to resolve potential errors before the financial statements were prepared.

- Has not fully implemented recently issued policies, and we noted weaknesses in the operating effectiveness of the following established policies:
  - Beginning of the year balance reconciliations that ensure opening balances agree to the prior year ending balances. These weaknesses resulted in several material errors in the financial statements that were not identified by OFM, until questioned during our audit;
  - Interim financial statement preparation and support. During our review of the June 30, 2007, draft financial statements, we noted some errors and discrepancies that were not corrected prior to submission to the auditor. In some cases, we noted that erroneous entries were recorded to correct out-of-balance conditions in data submitted by components, without support or follow-up, and resolution with the component; and
  - Computation of abnormal or unusual account balances, including proprietary to budgetary account relationship analysis performed at the consolidated level. Currently, there is still a reliance on the external auditor to identify potential errors through proprietary to budgetary reconciliations, and refer the differences to components and OFM for investigation and resolution. Although upgrades to the existing analytical tools have been developed by OFM, they are not yet being fully utilized, with full implementation scheduled for FY 2008.
- Did not always perform key supervisory and monitoring control procedures over work prepared by accounting staff during the year. In some cases, we noted that supervisory reviews were performed and documented on incomplete information, without evidence of closure on open issues. Some reviews were not effective, e.g., did not identify material errors in the financial data. For example, some top-side (manual) adjustments to financial statements, and fluctuation and variance analysis, were not always reviewed and approved by a supervisor. In some cases, we noted that these manual adjustments also created misstatements of the financial statement balances, which were identified during our audit.

- Has not established Strategic Goals and the financial information systems or sufficiently documented processes to accumulate cost data by DHS strategic goal when the goals are established, as required by SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards*, and does not have a current strategic plan, as required by the *Government Performance and Results Act* (GPRA) (see Exhibit III-N).

2. TSA has improved its financial reporting process in FY 2007. While TSA has made progress in addressing the conditions we identified and reported in 2006, its financial reporting CAP has not been fully implemented by the end of FY 2007. We noted that TSA:

   - Made a number of restatements to its prior year financial statements, primarily as a result prior-year data that was not previously reconciled to its general ledger.
   - Did not have certain policies and procedures in place all fiscal year.
   - Required numerous other on-top adjustments to properly close and report its monthly and annual financial results, did not consistently reverse all on-top adjustments that required reversal, and did not record all on-top adjustments properly.
   - Required significant additional human resources, to perform its year-end general ledger close, prepare financial statements, and respond to audit inquiries in a timely manner.

Cause/Effect: The OCFO adopted CAPs to address the conditions cited above; however, we continue to report that the OCFO has a material weakness in financial reporting, primarily because the OCFO has not yet fully implemented policies designed to ensure timely, accurate, and complete periodic reporting throughout the year, and developed tools to ensure that component agencies routinely respond to inquiries and actively investigate and resolve potential accounting and reporting errors in a timely manner. In some cases, newly designed centralized policies and procedures, together with effective internal controls over financial reporting, have not been fully implemented as of September 30, 2007. In addition, challenges remain in obtaining consistently complete and accurate data from DHS components, affecting OFM's ability to completely perform its responsibilities in a timely manner.

Intragovernmental out-of-balances exist in many Federal agencies and DHS is dependent on other Federal agencies maintaining accurate account balances in order to fully reconcile its balances. No government-wide system currently exists to allow for this reconciliation to be done independently by DHS. Although OFM undertook numerous corrective actions in FY 2007, including initiating a consolidated confirmation process, holding workshops to instruct components how to reconcile balances, assisting components in implementing procedures to support balances with external trading partners, and meeting with OMB and other agencies to directly reconcile differences, DHS was not able to fully reconcile its balances. OFM's process does demonstrate progress; for instance, it recently reconciled a $350 million difference with the Department of Defense.

TSA's CAP is a two-year plan to fully remediate the process and control weaknesses in financial reporting, which is not scheduled for completion until FY 2008. TSA invested substantial resources to reconcile its beginning balance sheet accounts, as necessary, to obtain an external audit of those accounts. FY 2007 was a "catch-up" year, intended to establish more efficient and effective accounting and financial reporting processes which will benefit FY 2008 and beyond.

Criteria: OMB Circular No. A-136, *Financial Reporting Requirements*, revised July 24, 2006, changed the financial reporting requirements for transferring, or allocating, budget authority from one entity to another within or to another Federal department (i.e., parent/child reporting). OMB Memorandum M-07-12 clarified the reporting requirements and emphasized that the two Federal departments may need to coordinate to ensure that parent's reporting and auditing requirements are met.

The *Treasury Federal Intragovernmental Transactions Accounting Policies Guide,* dated August 18, 2006, and OMB Circular No. A-136, require Federal CFO Act and non-CFO Act entities identified in the Treasury Financial Manual (TFM) 2006, Vol. I, Part 2-Chapter 4700, *Agency Reporting Requirements for the Financial Report of the United States Government,* to perform quarterly reconciliations of intragovernmental activity/balances. TFM, Section 4706, *Intragovernmental Requirements,* requires reporting agencies to reconcile and confirm intragovernmental activity and balances quarterly for specific reciprocal groupings. TFM Bulletin 2007-03 *Intragovernmental Business Rules*, also provides guidance to Federal agencies for standardizing the processing and recording of intragovernmental activities.

OMB Circular No. A-123 defines management's responsibility and provides guidance to Federal managers on improving the accountability and effectiveness of Federal programs and operations by establishing, assessing, correcting, and reporting on internal control. Within the organizational structure, management must clearly: define areas of authority and responsibility; appropriately delegate the authority and responsibility throughout the agency; establish a suitable hierarchy for reporting; support appropriate human capital policies for hiring, training, evaluating, counseling, advancing, compensating, and disciplining personnel; and uphold the need for personnel to possess and maintain the proper knowledge and skills to perform their assigned duties as well as understand the importance of maintaining effective internal control within the organization.

FMFIA requires that agencies establish internal controls according to standards prescribed by the Comptroller General and specified in the GAO *Standards.* The GAO defines internal control as an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. The GAO *Standards* identify the control environment, as one of the five key elements of control, which emphasizes the importance of control conscientiousness in management's operating philosophy and commitment to internal control. These standards cover controls such as human capital practices, supervisory reviews, and segregation of duties, policies, procedures, and monitoring.

OMB Circular No. A-50 states that corrective action taken by management on audit findings and recommendations is essential to improving the effectiveness and efficiency of Government operations. Each agency shall establish systems to assure the prompt and proper resolution and implementation of audit recommendations. These systems shall provide for a complete record of action taken on both monetary and nonmonetary findings and recommendations.

Recommendations: We recommend that:

1. DHS-HQ (with OCFO and OFM):
    a) Develop a strategy to quickly provide full accounting and reporting services to newly created reporting entities. Identify a full-service accounting provider for OHA, that will address the allocation transfer accounting matters early in FY 2008, and make appropriate adjustments to the financial statements to accurately reflect activity and balances. Consider creating a permanent group within OCFO that will proactively identify and resolve accounting issues before they develop into significant problems, similar to the process used to assist US-Visit in FY 2007. When appropriate, and needed, this group should be directly involved in development and implementation of long-term accounting solutions, either within the Directorate or at an existing component;
    b) Fully implement a comprehensive proprietary to budgetary account analysis that is performed each month with TIER submissions, and require component entities to

investigate and resolve differences in a timely manner. Monthly certifications received from component CFOs should specifically state the completion of this procedures, together with recording of correcting entries to the general ledger;

c) Direct component CFO leadership to improve communication and coordination on unique accounting and transactional matters, and to improve the accuracy of routine monthly data submissions. Problems with timeliness, completeness and accuracy of component data submissions, and/or responsiveness to OFM may need the support of the CFO to resolve;

d) In coordination with other DHS components, further develop policies, procedures and controls that will result in the timely reconciliation of intragovernmental activity and balances. Differences should be reconciled in a timely manner. This may involve setting up special arrangements with some trading partners, such as work OFM has begun with the Department of Defense. Procedures should include positive confirmation at least on a quarterly basis, all intragovernmental activity and balances with their intragovernmental trading partners, including other DHS component entities, as prescribed by Treasury guidance;

e) Continue with implementation of the financial reporting management directives scheduled for release in FY 2008. Once implemented, the policies should be tested for effectiveness, and when necessary, make improvement to addresses weaknesses identified;

f) Improve supervisory and monitoring control procedures over work prepared by accounting staff during the year, to ensure that they will reliably identify errors for correction, in a timely manner. Consider additional training for component accountants to improve the quality of submitted financial data, and for desk officers to improve the effectiveness of their initial reviews; and

g) OCFO and applicable component entities should develop financial information systems and document processes to accumulate and present cost data by DHS strategic goal, as required by SFFAS No. 4.

2. TSA:

   a) Consistently adhere to policies and perform procedures for the preparation and approval of on-top adjustments for submission to its accounting services provider;

   b) Develop and implement procedures to properly identify all on-top adjustments that require reversal in the subsequent period and to ensure the timely reversal of those adjustments; and

   c) Once accounting and reporting processes stabilize in FY 2008, perform a financial organization and human resource needs assessment in coordination with its accounting services provider to determine the optimum number of accounting personnel and skill sets required and the most effective organizational structure to sustain efficient accounting operations. TSA's accounting operations should be designed and staffed to most efficiently support timely responses to auditor inquiries during the year, without also causing significant disruption to on-going accounting operations.

II-C Financial Systems Security

Background: Financial systems security is essential to achieving effective, reliable reporting of financial and performance data. As a part of the financial statement audit, we perform an evaluation of the general controls over significant DHS financial IT systems. Effective general controls are typically defined by the GAO's FISCAM, in six key control areas: entity-wide security program planning and management, access control, application software development and change control, system software, segregation of duties, and service continuity. In addition to general controls, financial systems contain application controls, which are the structure, policies, and procedures that apply to use, operability, interface, edit and monitoring controls of an application. We tested various application controls of key DHS financial systems as part of our IT audit test work.

The primary IT systems evaluated as a part of our audit are the component general ledger and subsidiary/feeder subledger or modules that support the financial statements and specific accounting processes such as grants, loans, excise tax receipts, etc.

During FY 2007, DHS Civilian Components took significant steps to improve their financial systems security, particularly the FISCAM general control areas entity-wide security program planning and management, and system software, which resulted in the closure of more than 30% of our prior year IT control findings.

Conditions: The FISCAM IT general control areas that continue to present a risk to financial systems security and data integrity include: 1) excessive access to key DHS financial applications; 2) application change control processes that are inappropriate in other locations not fully defined, followed, or effective; and 3) service continuity issues impacting DHS' ability to ensure that DHS financial data is available when needed. The conditions supporting our findings collectively limit DHS' ability to ensure that critical financial and operational data is kept secure and is maintained in a manner to ensure confidentiality, integrity, and availability. Our findings, including significant deficiencies that do not rise to the level of being a material weakness, are described in greater detail in a separate *Limited Official Use* letter provided to DHS management.

Regarding access controls – we noted:

- Excessive access existed within financial applications at two DHS components. Specifically, instances of generic shared accounts exist on the financial applications. These accounts have every privilege within the application, including the ability to create/delete/modify user accounts.
- Account management documentation did not exist, and user account lists were not periodically reviewed for appropriateness, resulting in inappropriate authorizations and excessive user access privileges across two DHS components.
- Accounts were not configured to disable upon personnel termination across two DHS components.
- Two DHS components had a large number of instances of inadequate or weak passwords that existed on key servers and databases that house financial data.
- Instances where workstations, servers, or network devices were configured without necessary security patches, inactivity time-outs, and proactive/appropriate vulnerability scanning not occurring.
- Audit logs were not reviewed at one DHS component, and the most restrictive security settings for the audit logging of highly privileged accounts and the protection of data sets were not enabled for a financial application at another DHS component.

Regarding application software development and change control – we noted:

- Instances where changes made to the configuration of the system were not always documented or performed for test plans, test results, approvals or software modifications at two DHS components. Additionally, documented approval did not exist, or was not always retained, for emergency enhancements, "bug" fixes, and data fixes, and in some cases, audit logs for tracking changes to the data or systems were not activated.
- One DHS component had implemented a separate and secondary change control process outside of and conflicting with the established change control process. In another instance, changes were made prior to management approval. Instances where changes made to the configuration of the system were not always documented or performed through System Change Requests (SCRs), test plans, test results, approvals, or software modifications at two DHS components also existed.
- The contract that a DHS component has with the software vendor does not include security configuration requirements that must be adhered to during the configuration management process.
- Instances where policies and procedures regarding change controls were not in place to prevent users from having concurrent access to the development, test, and production environments of the system, or for restricting access to application system software and system support files.
- Policies and procedures surrounding the system development life cycle (SDLC) process have not been documented or adopted a finalized SDLC.

Regarding service continuity – we noted:

- The Continuity of Operations Plan (COOP) does not include an accurate listing of critical information technology systems, did not have critical data files and an alternate processing facility documented, and was not adequately tested for DHS one component. An alternate processing site is not operational for DHS one component.
- Backup tapes are not rotated off site or are not periodically tested. One DHS component did not have policy and procedures developed for testing of backups.
- Rules of Behavior forms are not consistently signed prior to gaining local area network (LAN) access for one DHS component.

Cause/Effect: Many of these weaknesses were inherited from the legacy agencies that came into DHS or system development activities that did not incorporate strong security controls from the outset and will take several years to fully address. A contributing cause to repeated findings is that DHS lacks an effective component-wide prioritization of IT systems issues, including the development of a stable centralized IT platform for the Department. Several attempts have been made, such as eMerge and eMerge 2, to centralize the financial IT platform; however, each has been halted or delayed. In addition, we found that focus is also placed on the tracking of response to audit recommendations, instead of on developing the most effective method of addressing the actual control weakness; and when weaknesses in controls or processes are identified, the corrective actions address the symptom of the problem and do not the correct root cause – amounting to a temporary fix.

The effect of the IT weaknesses identified during our testing impacts the reliability of DHS' financial data. Many of these weaknesses, especially those in the area of change controls, may result in material errors in DHS' financial data that are not detected, in a timely manner, in the normal course of business. In addition, as a result of the presence of IT weaknesses there is added pressure on the other mitigating manual controls to be operating effectively at all times. Because mitigating controls often require more human involvement, there is an increased risk of human error that could materially affect the financial statements.

Criteria: The FISMA passed as part of the *E-Government Act of 2002,* mandates that Federal entities maintain IT security programs in accordance with NIST guidance.

OMB Circular No. A-130 describes specific essential criteria for maintaining effective general IT controls.

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

DHS' *Sensitive Systems Policy, 4300A*, documents policies and procedures adopted by DHS intended to improve the security and operation of all DHS IT systems.

The FISCAM provides a framework and recommended audit procedures that are used to conduct the IT general control test work.

Recommendations: We recommend that the DHS Office of Chief Information Officer in coordination with the OCFO make the following improvements to the Departments financial management systems:

For access controls:

a) Implement an account management certification process within all the components to ensure the periodic review of user accounts for appropriate access and to ensure that generic accounts do not exist on the system;

b) Implement and appropriately implement an access authorization process that ensures that a request is completed and documented for each individual prior to granting him/her access to a financial application or database;

c) Implement a process to ensure that all accounts of terminated individuals from the system are immediately removed/end-dated/disabled upon their departure. This includes both terminated employees and contractors;

d) Enforce password controls that meet DHS' password requirements on all key financial systems. Conduct periodic vulnerability assessments, whereby systems are periodically reviewed for access controls not in compliance with DHS and Federal guidance and ensure that action is taken to remediate any security weaknesses identified;

e) Implement a patch and security configuration process, and enforce the requirement that systems are periodically tested by DHS components and the DHS Office of Chief Information Officer; and

f) Develop and implement detailed procedures requiring the review of operating system logs for suspicious activity and conduct audit log reviews of the operating system on a consistent and timely basis.

For application software development and change control:

a) Further develop and enforce policies that require changes to the configuration of the system are approved and documented, and audit logs are activated and reviewed on a periodic basis;

b) Implement a single, integrated change control process over the DHS components' financial systems with appropriate internal controls to include clear lines of authority to the components' financial management personnel and to enforce responsibilities of all participants in the process and documentation requirements. Further develop and enforce policies that require changes to the configuration of the system are approved and documented, and audit logs are activated and reviewed on a periodic basis;

c) Reevaluate and revise the contract between DHS and the software vendor or otherwise ensure that the security configurations associated with the application changes and software patches are in compliance with DHS and NIST standards for financial applications;

d) Develop and implement formal policies and procedures for restricting access to DHS system software, and promulgate it to all needed personnel, to be in compliance with DHS *Sensitive Systems Policy*, 4300A;

e) Develop and implement procedures to perform a periodic review of access to financial application software and support files to determine whether access is valid, consistent with job responsibilities, and according to the least privilege principle; and

f) Remove excessive access to the all DHS financial application software and support files. Develop, document and implement a formalized SDLC process.

For service continuity:

a) Update the COOP to document and prioritize an accurate listing of critical IT systems;

b) Perform testing of key service continuity capabilities, including contingency planning;

c) Ensure that the alternate processing site is made operational;

d) Rotate backups off-site on a regular basis, implement policies and procedures developed to enforce testing of backups, and Test backups at least annually;

e) Revise the COOP to incorporate critical data files and alternate processing facility; and

f) Ensure that all employees and contractors acknowledge and sign a Rules of Behavior prior to being granted LAN access.

II-D Not Used

II-E Capital Assets and Supplies (FEMA, TSA and US-Visit)

	2007	2006	2005
FEMA	MW	N/A	N/A
TSA	SD	MW	MW
US-Visit	SD	MW	MW

Background: FEMA maintains a stockpile of inventory (e.g., blankets, bottled water, cots, tarps, plastic sheeting, Meals Ready to Eat, and ice), to be used for disaster relief if the need arises. After the 2005 hurricane season, FEMA substantially increased the amount of supplies that are stockpiled. The large increase in supplies has also increased the asset's carrying value on FEMA's and DHS' financial statements. FEMA policies require the agency to conduct an annual inventory of the supplies.

TSA maintains extensive capital assets used at airports to screen passengers and their baggage. In FY 2006, we reported accounting process and control weaknesses at TSA related to, among other things, the unreconciled Property, Plant and Equipment (PP&E) balances, and the lack of supporting documentation needed to perform our audit. These conditions also prevented TSA from asserting that its September 30, 2006 PP&E was fairly stated. During FY 2007, TSA executed a CAP to correct these deficiencies. We noted that TSA corrected the deficiencies we reported in prior years by September 30, 2007.

The mission of US-Visit is to collect, maintain, and share information on foreign nationals traveling to and from the United States in order to enhance national security, facilitate legitimate trade and travel, and contribute to the integrity of our immigration system, while deploying the program in accordance with existing privacy laws and policies. Customized software is being developed to assist with this objective.

Conditions: We noted the following internal control weaknesses related to capital assets and supplies at FEMA, TSA and US-Visit:

1. FEMA:

   - Did not fully adhere to its policies when performing its annual physical count of supplies inventory. We noted that:

     - Inventory counts were not fully reconciled to FEMA's Logistics Information Management System (LIMS), which is used to track inventory;

     - Inventory counts were not conducted in a well-controlled environment. We noted numerous weaknesses in how the procedures were conducted, which increased the likelihood of error; and

     - In some cases inventory that was in LIMS could not be located.

   - Adjustments to the stockpile inventory were not recorded in FEMA's general ledger system as they occurred throughout FY 2007.

2. TSA:

   - Did not reconcile its PP&E subsidiary ledger to its general ledger consistently and timely throughout FY 2007. However, TSA was reconciling timely by year-end.

   - Has not recorded depreciation on certain explosive detection equipment, using a method that is consistent with generally accepted accounting principles. Specifically, TSA began recording depreciation expense prior to the date the equipment was placed in service. Consequently, TSA has recorded excessive depreciation expense during FY 2007 and in previous years totaling approximately $80 million. TSA recomputed the depreciation expense, using the correct date placed in service, and adjusted its PP&E, depreciation expense, and net position balances to correct the error in its FY 2007 financial statements. The adjustment also resulted in a restatement of TSA's 2006 financial statements.

   - Uses USSGL Account No. 1890 (Other PP&E) to record all PP&E purchases, which is not compliant with the USSGL requirements of FFMIA.

   - Improperly capitalized certain advance payments to vendors as construction in progress.

3. US-Visit:

   - Did not consistently apply procedures to identify and capitalize software development costs or to reclassify software placed into production from software in development; and
   - Does not have a reliable financial accounting and reporting process or system in place to routinely account for its software expenditures, capitalize appropriate amounts, and report those balances to OFM to report in the consolidated financial statements.

Cause/Effect: FEMA personnel performing the physical count of supplies lacked training in proper inventory count procedures and failed to reconcile results to the LIMS database. Without accurate physical counts and reconciliations to the perpetual records, FEMA cannot be sure supplies exist, listings of available supplies are complete, and the financial statements accurately reflect the asset values. FEMA was unable to devote sufficient human resources to properly account for its stockpile during FY 2007 (see Exhibit II-A, *Financial Management and Entity Level Controls*).

TSA personnel considered that the date of purchase and receipt of the explosive detection equipment was a reasonable approximation of the date the asset was placed in service. Verification of the reasonableness of this accounting practice was not performed, and consequently the discrepancy was not discovered until our audit of capital assets this year. Because of insufficient accounting code details on purchase orders and related system configurations, TSA's accounting services provider (Coast Guard) records PP&E purchases that do not have sufficient accounting code details to USSGL Account No. 1890 until information is available to record such purchases in the appropriate capitalized PP&E or expense account.

US-Visit has developed adequate accounting policies for tracking software development costs, these policies are not fully or adequately implemented during FY 2007. With assistance from OFM, US-Visit was able to manually compute an estimated balance, which was reclassified to capitalized software at year end for financial statement presentation purposes. A lack of sufficient personnel assigned to the financial reporting areas of US-Visit appear to have contributed to implementation delays.

Criteria: SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, requires that PP&E is recorded at historical cost with an adjustment recorded for depreciation. Depreciation expense should be recognized in the financial statements beginning on the date that the asset is placed in service for its intended use.

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

Per FEMA Manual 6150.1 Section 4-4g, *Annual Inventory of Accountable Property*, the designated Property Management Officers (PMO) will ensure that a complete physical inventory of FEMA property with acquisition cost of $5,000 or more, sensitive items, serialized equipment, and loaned equipment is made annually, discrepancies reconciled, and the results maintained on file for one year. The annual inventory of accountable property may be wall-to-wall (closed), cyclic (open), or special (when directed). A wall-to-wall inventory is a complete counting of all items located within the organization as of a scheduled date. A cyclic inventory is the counting of a portion of the organization's property during a given period of time (monthly, quarterly, or semiannually) to cover the entire account in a one-year period. A special inventory is the counting of selected items for a specific reason.

SFFAS No. 10, *Accounting for Internal Use Software*, provides requirements for the capitalization and reporting of software development costs. GAO *Standards* require that internal control and all transactions and other significant events be clearly documented and readily available for examination. The JFMIP, *Property Management Systems Requirements,* state that the agency's property management system must create a skeletal property record or have another mechanism for capturing information on property in transit from the providing entity (e.g., vendor, donator, lender, grantor, etc.).

Recommendations: We recommend that:

1. FEMA:
   a) Devote necessary personnel to develop and implement proper accounting policies and procedures and related internal controls to ensure that its stockpiled inventory is accurately and completely accounted for in its general ledger throughout the year;
   b) Establish and implement a plan to perform a closed annual inventory count as required by FEMA Manual 6150.1 Section 4-4g, Section g., *Annual Inventory of Accountable Property*;
   c) Provide more training and detailed instruction to Logistics Center staff on performing inventory counts, including the completion of count sheets and the performance of recounts; and
   d) Reconcile the physical inventory counts, including the annual physical inventory, to the perpetual counts recorded in LIMS, and resolve related discrepancies.
2. TSA:
   a) Formally modify its policy to define the placed in service date, which then begins the process of recording periodic depreciation expense;
   b) Implement needed IT system changes to properly account for and maintain placed in service dates;
   c) Work with its accounting services provider to discontinue the use of USSGL Account No. 1890 and record PP&E to the proper general ledger account upon purchase; and
   d) Develop and implement management review controls over equipment purchase contracts to ensure that amounts advanced to vendors are properly accounted for given the terms of the underlying contract.
3. US-Visit implement procedures for developers to track and notify accounting personnel when software has been placed into production so that accounting personnel can properly classify and amortize the software costs, and appropriate and sufficient evidence is maintained to document management's decisions that lead to significant accounting transactions.

II-F Other Liabilities (FEMA, G&T, and TSA)

Background: In 2006, we reported that OFM and DHS General Counsel had not implemented adequate policies and procedures to accurately estimate and report an accrual for contingency legal liabilities. OFM, DHS General Counsel, and each of the DHS

	2007	2006	2005
OFM	C	MW	N/A
FEMA	MW	MW	MW
G&T*	MW	MW	MW
TSA	SD	SD	MW

* G&T grants merged with FEMA in 2007

component entities implemented a corrective action plan in 2007, and have successfully remediated the control deficiencies we reported last year.

For the first two fiscal quarters of FY 2007, the G&T was a component of the Preparedness Directorate within DHS. During this time, accounting services for G&T were provided by the Department of Justice through an interagency agreement. These accounting services included the development and implementation of a grant accrual methodology to be used in G&T's quarterly reporting financial reporting. Effective March 31, 2007, G&T's operations were transferred to FEMA as a result of the *Post-Katrina Emergency Management Reform Act of 2006*. The financial and grant data of G&T was fully transferred to FEMA on May 15, 2007. Accordingly, FEMA is now responsible for providing accounting services for G&T, including the grant accrual methodology, and prepares its monthly financial submissions used by OFM to prepare the DHS consolidated financial statements.

A part of TSA's employee compensation package includes annual leave, which accrues at varying rates and is based on years of service, and related benefits. The annual leave liability and related benefit accruals in TSA's financial statements at September 30, 2007, totaled approximately $193 million.

Conditions: We noted the following internal control weaknesses related to other liabilities:

1. FEMA:

   - Did not establish a reliable method, including validation of data and assumptions made, to estimate G&T grants payable [or advances] for accrual in the financial statements at September 30, 2007. FEMA management was unable to provide assurance that the accrued liability related to former G&T grants, was accurate, and complete at September 30, 2007.

   - Did not have sufficient policies and procedures in place to fully comply with the *Single Audit Act Amendments of 1996* and related OMB Circular No. A-133, *Audits of States, Local Governments, and Nonprofit Organizations* (see Exhibit IV-K, *Single Audit Act Amendments of 1996*).

2. TSA:

   - Has not maintained all of the necessary supporting documentation for us to complete our audit procedures over accrued annual leave. From a sample of 75 items, 13 items could not be supported and 5 contained errors.

   - Has not reconciled annual leave balances earned by employees per the payroll provider's output records to the data submitted by TSA and with the general ledger on a routine basis, which likely contributed to the errors identified in our sample.

Cause/Effect: FEMA did not have sufficient resources to perform all accounting functions related to the transfer of G&T grant administration and accounting that occurred in FY 2007. FEMA accounting staff used FEMA's historical methodology for estimating the grant liability for FEMA's grant portfolio to compute and record a grant liability at year end for the former G&T grant portfolio. However, FEMA was unable to validate this application of its methodology as appropriate and plans to perform its validation during FY 2008. Consequently, we were unable to complete our audit procedures over the accrued grant liability presented in the DHS consolidated balance sheet at September 30, 2007. Additionally, without effective procedures to timely resolve and close audit reports with identified questioned costs or other findings, the circumstances leading to the findings may continue to exist and amounts due to the government may not be received timely.

The portion of TSA's annual leave liability that is in question relates to a balance that was transferred from a payroll system that has been replaced. Supporting information is not readily available to determine the correct liability at September 30, 2007.

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

SAS No. 57, *Auditing Accounting Estimates*, states "An entity's internal control may reduce the likelihood of material misstatements of accounting estimates. Specific relevant aspects of internal control include the following: Accumulation of relevant, sufficient, and reliable data on which to base an accounting estimate and comparison of prior accounting estimates with subsequent results to assess the reliability of the process used to develop estimates."

OMB Circular No. A-133 states that grants should be monitored by the grant making organization.

Recommendations: We recommend that:

1. FEMA:
    a) Develop, test (e.g., validation of data and assumptions made), and implement a reliable method to periodically estimate G&T grants payable [or advances] for accrual in the financial statements during the year; and
    b) Implement policies and procedures to ensure full compliance with OMB Circular No. A-133.
2. TSA:
    a) Develop and perform procedures to enable management to assert to the appropriateness of the "beginning" accrued leave balance at a point in time (e.g., October 1, 2007). For example, these procedures may involve validating leave balances for all TSA employees at the selected point in time. These procedures should require that sufficient documentation be retained for purposes of the annual financial statement audit; and
    b) Develop and implement policies and procedures to reconcile annual leave balances per its payroll provider output records to input records submitted by TSA and to the TSA general ledger each pay period. These reconciliations should be documented, reviewed by an appropriate supervisor, and maintained.

II-G Budgetary Accounting (FEMA and TSA)

	2007	2006	2005
FEMA	MW	MW	MW
TSA	MW	MW	MW
ICE	C	SD	MW
MGMT	C	MW	N/A
US-Visit	C	SD	N/A

Background: Budgetary accounts are a category of general ledger accounts where transactions related to the receipt, obligation, and disbursement of appropriations and other authorities to obligate and spend agency resources are recorded. Combined, DHS has over 300 separate Treasury fund symbols (TAFS), each with separate budgetary accounts that must be maintained in accordance with OMB and Treasury guidance. The TAFS cover a broad spectrum of budget authority, including annual, multiyear, and no-year appropriations; and several revolving, special, and trust funds. Accounting for budgetary transactions in a timely and accurate manner is essential to manage the funds of the Department and prevent overspending of allotted budgets.

Immigration and Customs Enforcement (ICE), Management Directorate, and U.S.-Visit each developed and implemented corrective action plans during FY 2007, to address the internal control weaknesses in budgetary accounting that we reported in our 2006 report.

The National Response Plan (NRP) calls for use of Other Federal Agencies (OFA) to provide goods and services to assist FEMA with its response to a disaster, as needed. The NRP defines a Mission Assignment as the vehicle used by FEMA to support Federal operations during a major disaster or emergency declaration covered under the *Stafford Act*. These work orders are issued by FEMA to OFAs to direct completion of a specific task and represent the primary documentation maintained by FEMA to support its obligations for disaster relief operations/programs being performed by OFAs.

TSA has substantial obligations and undelivered orders at year end, primarily for contract services and purchases of equipment. TSA's Office of Acquisition in coordination with TSA's Office of Financial Management monitors obligation activity and provides key input data needed to properly deobligate funds and prepare an accurate accounts payable estimate.

Conditions: We noted the following internal control weaknesses related to budgetary accounting:

1. FEMA:

    - Did not adequately monitor the status of its obligations and ensure the timely deobligation of mission assignments resulting in a material misstatement of UDOs at the time of our testwork. We noted the following:

        - In a sample of 74 mission assignment obligations, approximately 50 percent were past their projected end dates by more than 120 days, and in some cases more than a year; and

        - Quarterly reviews of open obligations required by FEMA policies were not consistently performed or documented in the supporting records.

    - OFA's did not always provide FEMA with timely progress reports that included sufficient cost/billing data. Sufficient documentary evidence was not obtained and/or documented timely for mission assignment manager follow-up procedures with the OFAs.

2. TSA:

    - Does not have a funds control process in place to monitor outstanding obligation balances on a periodic basis (e.g., quarterly). During our interim testwork we identified 7 errors out of a sample of 75 items, and a projected overstatement undelivered orders of approximately $200 million. During our year-end testwork we identified 26 errors out of a sample of 195 items, and a projected overstatement of undelivered orders of approximately $130 million.

    - Does not have sufficient policies and procedures requiring contract officers to monitor and close-out contracts, and we noted some deficiencies in the effectiveness of TSA's validation and verification process conducted over its obligations during the second half of FY 2007.

- Completed an investigation over certain obligations recorded in previous years and determined that a violation of the *Anti-deficiency Act* occurred in previous years (see Exhibit IV-P, *Anti-deficiency Act*).

Cause/Effect: Although TSA has initiated a validation and verification process over its obligations, TSA was unable to complete the process before September 30, 2007.

FEMA's ability to monitor and manage mission assignments continues to be affected by resource limitations. In addition, FEMA is dependent on OFA's to provide timely information on the status of mission assignment obligations throughout the year. Lacking this information, FEMA is unable to effectively monitor and account for outstanding mission assignments, e.g., recording a proper account payable and deobligating excess funds.

Criteria: FEMA's SOP for *Processing Mission Assignment and Interagency Payments for Fund Code 06*, updated April 2007, establishes the process for mission assignment closeouts. If no activity has been recorded within the last 90 days, the Disaster Finance Branch initiates the closeout process with the Region or Headquarters.

The FEMA Form 90-129, *Mission Assignment Agreement,* states that the OFA is responsible for submitting a Mission Assignment Monthly Progress Report to FEMA to include cost data when mission assignments take more than 60 days to complete, including billing. To assist with this process, OMB issued its Memorandum – *Yearend Accounting Guidance for Disaster Relief Fund Transactions* dated September 17, 2007.

The *Anti-deficiency Act* is a series of statutes prohibiting agencies from obligating or expending funds in advance of appropriation or apportionment, OMB Circular No. A-11 has strict requirements for notification and reporting Anti-deficiency violations. GAO *Standards* hold that transactions should be properly authorized, documented, and recorded accurately and timely.

According to JFMIP's *Core Financial System Requirements*, an agency's core financial management system must ensure that an agency does not obligate or disburse funds in excess of those appropriated and/or authorized and specific system edits and user notifications related to funds control must be in place. The *Federal Acquisition Regulation* Section 1.6 addresses the authorities and responsibilities granted contracting officers. Treasury's USSGL guidance specifies the accounting entries related to budgetary transactions.

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

FFMIA Section 803(a) requires that each Agency implement and maintain a system that complies substantially with Federal financial management system requirements as stipulated by OMB Circular No. A-127.

Recommendations: We recommend that:

1. FEMA:
   a) Require all regional offices to perform a complete UDO review, monitor timely completion of this review, and ensure that all identified mission assignment deobligations are processed in the general ledger promptly;
   b) Ensure that personnel follow the established policy for quarterly obligation reviews prior to the end of each quarter to timely determine whether the remaining balance on a mission assignment is valid, or whether a deobligation of the remaining balance is necessary;
   c) Enforce the requirement that all OFA's submit not only a progress report when the mission assignment takes more than 60 days to complete, but a progress report every additional 30 days that the project remains either programmatically or financially incomplete. The report should include an estimated completion date and, when applicable, Form 90-136 should be submitted for extension of the projected end-date whenever the estimate for programmatic completion is more than 30 days;
   d) Consider involving OMB in a permanent solution, such as Agreed-upon Procedures engagements, to ensure that FEMA receives sufficient and timely information from OFA's to properly account for obligations related to outstanding mission assignments; and
   e) Consider adding additional temporary or permanent accounting staff to improve the deobligation process (our recommendations in I-A, *Financial Management Oversight and Entity Level Controls,* will also help address these conditions).
2. TSA:
   a) Require contracting officers to review and certify whether obligations are valid or require deobligation on a periodic basis (e.g., quarterly);
   b) Refine or develop a new general ledger reporting tool that provides the contracting officers accurate information regarding outstanding obligated balances to include information related to the last activity date to assist in aging the balance;
   c) Refine existing processes by which the Business Management Office periodically examines outstanding obligations and makes recommendations (e.g., deobligation) on outstanding balances; and
   d) Develop formal policies and procedures to assist in expediting deobligations of funds associated with invalid obligations in advance of a formal contract close out.

III-H Custodial Revenue and Drawback

Background: CBP collects approximately $30 billion in annual import duties, taxes, and fees on merchandise arriving in the United States from foreign countries. Receipts of import duties and related refunds are presented in the statement of custodial activity in the DHS financial statements. CBP is the only DHS component with significant custodial responsibilities.

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.

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 considered outside of the CBP territory, upon activation. 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 origin.

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

Related to drawback:

- The Automated Commercial System (ACS) lacked automated controls to detect and prevent excessive drawback claims and overpayments, necessitating inefficient manual processes that do not effectively compensate for these automated controls.
- Drawback review policies did not require drawback specialists to review all or a statistically valid sample of related drawback claims against the underlying consumption entries to determine whether, in the aggregate, an excessive amount was claimed.

Related to the entry process – collection of taxes, duties and fees:

- Policies, procedures, and general guidance provided to field offices related to review procedures, and documentation requirements for the monthly review of the entry process are weak. Consequently, we noted a number of instances of noncompliance with CBP guidelines, inconsistencies in review performance, and a lack of documentation to confirm performance of the monthly reviews.

Related to BW, FTZ, and In-bond:

- We noted inconsistencies in the performance of risk assessments and compliance reviews of BWs, and FTZs, and in-bond entries in various ports. In addition, HQ review of the BW and FTZs assessment results can take up to six months to compile and analyze. Further, no policies or procedures exist to monitor the results of the in-bond audits/reviews.
- CBP is unable to determine the status of the in-bond shipments with the information available within ACS.

Cause/Effect: CBP has been challenged to balance its commitment of limited resources to two important mission objectives – trade compliance, including the collection of taxes, duties and fees owed to the Federal government, and securing the U.S. borders from potential terrorist entry. In FY 2007, CBP made significant improvements in its custodial review controls and measurement processes, procedures, and policies. For drawback, much of the process is manual until planned IT system functionality improvements are made, placing an added burden on limited resources.

Criteria: Under FMFIA, management must implement cost-effective controls to safeguard assets and ensure reliable financial reporting. OMB's *Revised Implementation Guidance for FFMIA,* states that financial systems should "routinely provide reliable financial information consistently, accurately, and reported uniformly" to support management of current operations.

JFMIP publications and OMB Circular No. A-127 outlines the requirements for Federal systems. JFMIP's *Core Financial System Requirements* state that the core financial system must maintain detailed information by account sufficient to provide audit trails and to support billing and research activities. OMB Circular No. A-127 requires that the design of financial systems should eliminate unnecessary duplication of a transaction entry. Wherever appropriate, data needed by the systems to support financial functions should be entered only once, and other parts of the system should be updated through electronic means consistent with the timing requirements of normal business/transaction cycles.

The *Improper Payments Information Act of 2002*, effective in FY 2004, requires agencies to assess the risk of erroneous payments and develop a plan to correct control weaknesses. In addition to the regulatory requirements stated above, CBP's *Drawback Handbook*, dated July 2004, states that management reviews are necessary to maintain a uniform national policy of supervisory review.

Recommendations: We recommend that CBP:

Related to drawback:

a) Implement effective internal controls over drawback claims as part of any new systems initiatives, including 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; and

b) Implement automated controls within ACS to prevent overpayment of a drawback claim that is subject to deem liquidation.

Related to entry:

a) Provide additional detail in the guidelines, specifying the sample size, procedures to perform, and documentation requirements for the CM Coordinator's review of the Import Specialists' review. The guidance should also readdress the timing requirements for the monitoring reports or data queries and documentation retention; and

b) Conduct periodic training to ensure that all port personnel have comprehensive knowledge of the CM program requirements.

Related to BW, FTZ, and In-bond:

a) Ensure adequate communication of the ports requirements related to the annual risk assessments and compliance reviews and provide effective training so that all responsible personnel are aware of and can consistently execute all of the requirements; and

b) Implement a standard procedure to periodically compile the results of all In-bond audit/reviews during the year and develop an analysis function in order to evaluate the importers' compliance with regulations.

(Exhibits I and II include Comments A – G, and Exhibit III presents Comment H)

All of the compliance and other matters described below are repeat conditions except IV-P *Anti-deficiency Act*, which is new finding in FY 2007.

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

Office of Management and Budget (OMB) Circular No. A-123, *Management's Responsibility for Internal Control*, requires agencies and Federal managers to 1) develop and implement management controls; 2) assess the adequacy of management controls; 3) identify needed improvements; 4) take corresponding corrective action; and 5) report annually on management controls. During FY 2007, DHS developed a CAP titled *Internal Controls over Financial Reporting Playbook* to implement corrective actions and support management assurances by performing tests of design and operating effectiveness on entity level controls and other financial accounting and reporting processes. DHS' implementation of OMB Circular No. A-123 also facilitates compliance with FMFIA and the *DHS Financial Accountability Act of 2004*, which requires an annual audit of internal control over financial reporting.

While we noted the Department overall has taken positive steps toward full compliance with FMFIA and OMB Circular No. A-123, the Coast Guard has not fully established effective systems, processes, policies, and procedures to develop and implement internal accounting and administrative controls, and conformance of accounting systems. In addition, TSA and FEMA's control assessment processes require improvement to ensure full compliance with FMFIA.

Recommendations: We recommend that the Coast Guard, FEMA, and TSA fully implement the FMFIA process, as prescribed by the OCFO, to ensure full compliance with FMFIA and its OMB approved plan for Circular No. A-123 implementation in FY 2008. We also recommend that the OCFO consider additional training for its components, to ensure a thorough understanding of requirements.

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

Passage of the *DHS Financial Accountability Act of 2004* made DHS subject to the FFMIA, beginning in FY 2005. FFMIA Section 803(a) requires that agency Federal financial management systems comply with 1) Federal accounting standards, 2) Federal system requirements, and 3) the USSGL at the transaction level. FFMIA emphasizes the need for agencies to have systems that can generate timely, reliable, and useful information with which to make informed decisions to ensure ongoing accountability. Office of Management and Budget (OMB) Circular No. A-123, *Management's Responsibility for Internal Control*, requires agencies and Federal managers to 1) develop and implement management controls; 2) assess the adequacy of management controls; 3) identify needed improvements; 4) take corresponding corrective action; and 5) report annually on management controls. During FY 2007, DHS OCFO continued with its implementation of OMB Circular No. A-123, by performing tests of design and operating effectiveness on entity level controls and other financial accounting and reporting processes as planned. DHS' implementation of OMB Circular No. A-123 also facilitates compliance with the *DHS Financial Accountability Act of 2004*, which requires an annual audit of internal control over financial reporting.

While we noted the Department overall has taken positive steps toward full compliance with FMFIA and OMB Circular No. A-123, the Coast Guard, FEMA, and TSA did not fully comply with at least one of the requirements of FFMIA. The reasons for noncompliance are reported in Exhibits I, II, and III. The Secretary of DHS also has stated in the Secretary's Assurance Statements dated November 15, 2007, as listed in Management's Discussion and Analysis (MD&A) of the Department's 2007 *Annual Financial Report* (AFR), that the Department cannot provide assurance that its financial management systems are in substantial compliance with the requirements of FFMIA. The Department's remedial actions and related timeframes are also presented in that section of the 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 noted weaknesses in financial systems security, reported by us in Exhibits I-C and II-C *Financial Systems Security*, which impact the Department's ability to fully comply with FISMA.

Recommendations: We recommend that DHS improve its financial management systems to ensure compliance with the FFMIA, and implement the recommendations provided in Exhibits I, II, and III in FY 2008.

IV-K *Single Audit Act Amendments of 1996,* and Laws and Regulations Supporting OMB Circular No. A-50, *Audit Follow-up,* as revised

During 2007, DHS' G&T Directorate merged its grants making function with FEMA. FEMA is now the only DHS component that has a significant grant making operation. OMB Circular No. A-133 requires agencies awarding grants to ensure they receive grantee reports timely and to follow-up on grantee Single Audit findings. Although FEMA has adopted procedures to monitor grantees and their audit findings, FEMA did not fully comply with provisions in OMB Circular No. A-133 in FY 2007. We noted that FEMA does not always obtain and review grantee Single Audit reports in a timely manner, and follow up on questioned costs and other matters identified in these reports. Because Single Audits typically are performed by other entities outside of DHS, procedures related to these reports are not always entirely within the control of DHS and its components.

OMB Circular No. A-50, as revised, provides guidance for use by executive agencies when considering reports issued by Inspectors General, other executive branch audit organizations, the GAO, and non-Federal auditors, where follow up is necessary. Corrective action taken by management on findings and recommendations is essential to improve the effectiveness and efficiency of government operations, and to support the objectives of sound fiscal management. The DHS OCFO has developed an extensive corrective action plan that requires each component to develop and execute corrective actions to address all material weaknesses in internal controls. This strategy is documented in the DHS Internal Controls over Financial Reporting (ICOFR) "Playbook." Progress is monitored by the CFO, and regularly reported to OMB and other outside stakeholders, such as Congressional Committees. We noted that each component has complied with the OCFO directive to develop corrective actions, and they have been reviewed and approved by the CFO. All DHS components have made progress toward remediation of material internal control weaknesses; however, as shown in described in Exhibits I, II and III, deficiencies identified in prior years have not been fully corrected in FY 2007.

Recommendations: We recommend that:

Regarding Single Audit Act Amendments of 1996:

1. FEMA develop procedures to ensure compliance with its policy to obtain and review grantee Single Audit reports in a timely manner, and follow up on questioned costs and other matters identified in these reports. We also recommend that FEMA perform the following in FY 2008:
   a) Further develop and implement a tracking system to identify each grantee for which an OMB Circular No. A-133 Single Audit is required, and the date the audit report is due;
   b) Strengthen communication with the cognizant agencies;
   c) Use the tracking system to ensure audit and performance reports are received timely, or to follow-up when reports are overdue; and
   d) Perform reviews of grantee audit reports, issue-related management decisions, and ensure that the grantees take appropriate corrective action, on a timely basis.

Regarding OMB No. A-50, Audit Follow-up, as revised

2. DHS continue to follow and complete the actions defined in its ICOFR "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 2008.

IV-L *Improper Payments Information Act of 2002*

DHS is required to comply with the *Improper Payments Information Act of 2002* (the Act or IPIA). The Act requires agencies to review all programs and activities they administer annually and identify those that may be susceptible to significant erroneous payments. For all programs and activities where the risk of erroneous payments is significant, agencies must estimate the annual amounts of erroneous payments, and report the estimates to the President and Congress with a progress report on actions to reduce them. The agency must report a statistically valid error projection for susceptible programs in its annual Performance and Accountability Report (PAR). To facilitate the implementation of the Act, OMB issued guidance in Memorandum M-03-13, *Implementation Guide for the Improper Payments Information Act of 2002*, and in Appendix C, *Requirements for Effective Measurement and Remediation of Improper Payments*, to OMB Circular No. A-123, *Management's Responsibility for Internal Controls*, which provides a recommended process to meet the disclosure requirements.

In FY 2007, we noted the Department has taken positive steps toward full compliance with IPIA, and Appendix C of OMB Circular No. A-123, including identification of programs subject to IPIA, conducting a comprehensive process to assess the risk of programs susceptible to improper payments, and performing sample testing of programs. However, DHS did not fully comply with the Act in FY 2007. We noted that at DHS and its components:

- Some federal disbursements were excluded from the scope of DHS IPIA testwork performed.
- Some programs identified as high risk of significant improper payments during the assessment process were not tested, and some programs identified as low risk of significant improper payments were selected for testing. Accordingly, this sample testing did not meet the IPIA requirements in FY2007.
- The testing time frames selected for some components were not approved by OMB in advance, and in some cases the testing timeline did not appear to provide enough time to complete testwork over selected programs.

- CAPs were not developed for all programs identified as "high risk" during the risk assessment process, if no statistical sampling was performed to validate those risks during FY2007 due to DHS' multi-year compliance plan.

Recommendation: We recommend that DHS risk assessments be completed earlier in the year so that programs identified as high risk by risk assessments are the programs that are sample tested. DHS needs to strengthen oversight of components' progress in implementing corrective action plans and in recovering improper payments for high-risk programs. Also, DHS should review sample testing procedures and begin to independently validate the results of components' sample testing.

IV-M *Chief Financial Officers Act of 1990*

The *DHS Financial Accountability Act of 2004* made DHS subject to the *Chief Financial Officers Act of 1990*, as amended, which requires DHS to submit to the Congress and OMB audited financial statements annually. DHS' OIG has engaged an independent auditor to audit the September 30, 2007 balance sheet and related statement of custodial activity. Other financial statements, including the statements of net cost, net position, and budgetary resources, are not currently auditable. DHS must be able to represent that its balance sheet is fairly stated, and obtain at least a qualified opinion before it is practical to extend the audit to other financial statements.

Recommendation: We recommend that DHS, and its components continue to implement the corrective action plans described in DHS' ICOFR "Playbook" (see Comment IV – I, *Federal Managers' Financial Integrity Act of 1982*, above) to remediate the FY 2007 material weaknesses and significant deficiencies, and improve its policies, procedures, and processes, as necessary, to allow management to assert that all financial statements are fairly stated in compliance with accounting principles generally accepted in the United States, and are ready for an independent audit.

IV-N *Government Performance and Results Act of 1993* (GPRA)

The *Government Performance and Results Act* requires each agency to develop a strategic plan, that includes a description of how goals and objectives are to be achieved, including a description of the operational processes, skills and technology, and the human, capital, and other resources required to meet those goals and objectives. The Department's annual performance plan and performance reports, that measure progress toward achieving strategic goals and related performance metrics are also integral to compliance with GPRA. We noted that DHS' Strategic Plan expired on October 1, 2006 and the Department has not yet provided an updated Strategic Plan as of September 30, 2007. Consequently, the Department is not in compliance with the requirements of GPRA during FY 2007. In addition, we noted that the existing (expired) strategic plan did not align all strategic objectives to performance objectives as required.

Recommendation: We recommend that DHS ensure full compliance with GPRA by completing its updated Strategic Plan and aligning all performance goals to its strategic objectives in FY 2008.

IV-O *Debt Collection Improvement Act of 1996* (DCIA)

The *DCIA of 1996* (DCIA) is intended to significantly enhance the Federal Government's ability to service and collect debts. Under the DCIA, the Treasury assumes a significant role for improving government-wide receivables management. The DCIA requires Federal agencies to refer eligible delinquent nontax debts over 180 days to U.S. Treasury for the purpose of collection by cross-servicing or the offset program. Our tests of compliance disclosed instances where DHS was not in compliance with certain provisions of the DCIA. Specifically, we noted that due process is not performed in a timely manner to ensure that some eligible debts are forwarded to the Treasury for cross-servicing or the offset program within the timeframes established by DCIA.

Recommendation: We recommend that DHS develop policies and procedures to ensure full compliance with the DCIA in FY 2008.

IV-P *Anti-deficiency Act*

DHS and TSA management notified us of an *Anti-deficiency Act* violation that occurred in the TSA, Expenses Account, Treasury Symbol – 70X0508 in an amount up to $155 million, where expenditures and obligations exceeded available funding in FY 2004. The DHS Secretary has reported the violation to the President of the United States, the President of the Senate, the Speaker of the House of Representatives, and the Comptroller General, as required by 31 U.S.C. Section 1351. After establishing certain budgetary authority within its DHS general ledger through a journal entry, the related individual purchase orders were then recorded and the journal entry reversed in March 2003. A subsequent transaction in May 2003 erroneously reversed the initial journal entry amount again. This second journal entry reversal, which led to the *Anti-deficiency Act* violation, overstated TSA's budget authority by underreporting its existing obligations. A separate notification of the final determination is still required under 31 U.S.C. section 1351.

Recommendation: We recommend that TSA continue to implement the remedial actions resulting from its internal investigation of this matter.

	Summary of Conditions As Reported in 2006 DHS Performance and Accountability Report	Fiscal Year 2007 Status/ Disposition
	Material Weaknesses:	
A.	**Financial Management and Oversight**	
A.1	The Coast Guard had not fully implemented a financial management organizational structure that supports the development and implementation of effective policies, procedures, and internal controls to ensure data supporting financial statement assertions are complete and accurate. The Coast Guard had not established clear management oversight responsibilities and processes to review adjustments to account balances, identify the cause of abnormal balances, and account relationship discrepancies, e.g., budgetary to proprietary reconciliations, and investigate potential financial system concerns such as potential posting logic errors. The Coast Guard had not fully established management oversight functions to ensure that accounting principles are correctly applied, and to provide accounting operational guidance to other offices and facilities within the Coast Guard. The Coast Guard has not completed a comprehensive Corrective Action Plan to correct longstanding internal control weaknesses.	**Repeated** (Exhibit I-A)
A.2	The OFM did not have a sufficient number of management personnel with the requisite financial accounting background to both (i) set-up, and (ii) effectively manage the financial reporting and internal controls infrastructure of a large Executive Branch agency. The OFM had not provided effective management and oversight throughout the year to monitor the operations of DHS components to promptly identify and raise issues to the CFO that may affect the quality of the financial statements. OFM had not established a process to support the timely completion of the annual financial statement audit.	**Corrected**
B.	**Financial Reporting** *(This finding has been combined with finding J below and reported as Financial Reporting in 2007)*	
B.1	The OFM continued to have significant difficulty coordinating delivery of financial data from components and preparing financial statements and disclosures throughout the year. The OFM had not established Departmental policies and procedures, or issued timely guidance to ensure that financial statements are accurate and complete during the year. Fully documented policies and procedures for many critical activities necessary to adequately manage financial reporting processes, and monitoring controls to ensure monthly TIER submissions received from the components were prepared timely and accurately.	**Partially Repeated** (Exhibit II-B)

	Summary of Conditions As Reported in 2006 DHS Performance and Accountability Report	Fiscal Year 2007 Status/ Disposition
B.2	The Coast Guard had not developed and implemented an effective general ledger system. The general ledgers are not compliant with the USSGL, and TIER submissions to OFM were from a database that did not have detail back-up support for some on-top adjustments at the transaction level. The Coast Guard's financial reporting process was complex and labor-intensive, and required a significant number of "on-top" adjustments (adjustments made outside the core accounting system for presentation of financial information given to DHS for consolidation). The Coast Guard had serious deficiencies in its policies, procedures, and controls surrounding its financial reporting process, and did not record all financial transactions to the general ledger systems or have adequate beginning balance and year-end close out procedures. The Coast Guard routinely used analytical comparisons to identify adjusting entries to the financial statements, without verifying that the ending balances were properly supported at the transaction level, e.g., budgetary accounts were adjusted to equal proprietary accounts, without verifying that the underlying transactional detail supported the ending balances. The Coast Guard did not have adequate procedures and internal controls over the process of preparing and reviewing the financial statement disclosures and did not have an adequate process to record, review, and monitor accounts receivable activity.	**Repeated** (Exhibit I-B)
B.3	TSA continued to experience difficulties related to financial reporting. Specifically, we noted that certain accrual amounts were not posted and certain property amounts were misstated in the final financial data submission for the June 30, 2006 hard-close; numerous other on-top adjustments were made thereafter, account reconciliations were not performed timely or completely throughout the year, and material abnormal balances and analytical account variances were not resolved timely throughout the year. TSA did not have sufficient processes and procedures established to enable the successful completion of a financial statement audit. TSA could not provide complete supporting documentation for numerous journal vouchers.	**Corrected**
B.4	OFM and certain components did not have effective financial information systems, or sufficiently documented processes, to accumulate cost data by DHS strategic goal, as required by SFFAS No. 4, *Managerial Cost Accounting Concepts and Standards*.	**Partially Repeated** (Exhibit II-B)
C.	**Financial Systems Functionality**	
	OCFO and DHS bureaus have IT and financial system security control weaknesses in entity-wide security program planning and management, access controls, application software development and change controls, system software, segregation of duties, and service continuity.	**Partially Repeated** (Exhibits I-C and II-C)

	Summary of Conditions As Reported in 2006 DHS Performance and Accountability Report	Fiscal Year 2007 Status/ Disposition
D.	**Fund Balance with Treasury (FBwT)**	
	The Coast Guard did not effectively manage its suspense accounts to include accurately aging and clearing items carried in suspense clearing accounts in a timely manner during the year, and did not maintain adequate supporting documentation that validated the accuracy of the FBwT reconciliations and the clearing of suspense items.	**Repeated** (Exhibit I-D)
E.	**Property, Plant, and Equipment** *(This finding has been combined with finding F below and reported as Capital Assets and Supplies in 2007)*	
E.1	The Coast Guard had not implemented appropriate controls and related processes to accurately, consistently, and timely record PP&E, to include additions, transfers from other agencies and disposals in its fixed asset system. The Coast Guard had not consistently applied policies and procedures to ensure appropriate documentation supporting PP&E acquisitions is maintained, and readily available for audit. The Coast Guard lacked methodologies and assumptions to support the value of PP&E that is not supported by original acquisition or other documentation. The Coast Guard needed an asset identification, system mapping, and tagging processes that included sufficient detail, e.g., serial number, to clearly differentiate and accurately track assets in the fixed asset system. The Coast Guard lacked an effective physical inventory process and appropriate support for the valuation method and classification of repairable PP&E to ensure accounting and reporting for PP&E is consistent with generally accepted accounting principles.	**Repeated** (Exhibit I-E)
E.2	US-Visit did not consistently apply procedures to identify and capitalize software development costs or to reclassify software placed into production from software in development. Consequently US Visit was unable to fully support the accuracy and completeness of certain property, plant, and equipment balances, to allow us to complete our testwork, prior to the completion of DHS' 2006 PAR.	**Partially Repeated** (Exhibit II-E)
E.3	TSA did not implement adequate policies and procedures to properly account for and support property balances. Subsidiary records has not been reconciled to the general ledger timely, a sub component of the general ledger had not been updated for depreciation, additions, and disposals related to certain property and equipment, and TSA was unable to provide adequate supporting documentation to support valuation of its property.	**Corrected**

	Summary of Conditions As Reported in 2006 DHS Performance and Accountability Report	Fiscal Year 2007 Status/ Disposition
F.	**Operating Materials and Supplies** *(This finding has been combined with finding E above and reported as Capital Assets and Supplies in 2007)*	
F.1	At the Coast Guard, internal controls over physical counts at field locations were not designed and implemented to remediate conditions identified during fiscal year 2003 and 2004. OM&S items were not always properly bar-coded or tagged, on-hand quantities frequently did not agree to the perpetual inventory records, and procedures did not sufficiently address whether all inventory on hand was properly recorded in the perpetual records or require discrepancies to be resolved timely. Processes and controls were not in place to fully support the calculated value of field-held and ICP OM&S to approximate historical cost. Policies, procedures and controls designed to remediate conditions related to conducting physical inventories of OM&S at the ICPs were not completely implemented.	**Repeated** (Exhibit I-E)
G.	**Legal and Other Liabilities** *(This finding has been combined with finding H below and reported as Actuarial and Other Liabilities in 2007)*	
G.1	OFM, in association with OGC, had not implemented adequate policies and procedures to ensure that OFM is provided with sufficient information to accurately and completely present legal liabilities and related disclosures in the financial statements throughout the year.	**Corrected**
G.2	The Coast Guard did not use a reliable methodology to estimate accounts payable. The method used was not supported as to the validity of data, assumptions, and criteria used to develop and subsequently validate the reliability of the estimate for financial reporting. Did not have adequate policies, procedures and internal controls over Coast Guard's process for reconciling military payroll recorded in the CAS general ledger to detail payroll records. Military personnel data changes, including changes in leave balances and payroll corrections, are not processed to be reflected in the appropriate payroll and/or reporting periods, and consequently impact the completeness and accuracy of leave and payroll accruals as well as data used for actuarial projections. Did not have documented policies and procedures, including appropriately designed internal controls, to ensure that the Coast Guard legal liabilities, included with the Department's accrued and disclosed contingent liabilities in the balance sheet at September 30, 2006, are accurate and complete. In addition, information is not prepared on a quarterly basis as necessary to prepare accurate timely financial statements throughout the year.	**Repeated** (Exhibit I-F)
G.3	G&T did not establish a reliable method, including validity of data and assumptions made, to estimate its grants payable [or advances] for accrual in the financial statements until the end of the fourth quarter of fiscal year 2006. (G&T grants merged with FEMA during 2007)	**Repeated** (Exhibit II-F)

	Summary of Conditions As Reported in 2006 DHS Performance and Accountability Report	Fiscal Year 2007 Status/ Disposition
G.4	TSA did not implement a new grant accrual methodology until August 2006, and the new methodology did not consider non-reporters. Therefore, the underlying expenditure data used in the accrual percentage and the actual expenditure data subsequently used for comparison/validation purposes may not be complete (corrected). Was unable to reconcile its annual leave subsidiary ledger to the general ledger during the year, creating an out-of-balance condition in July (repeated).	**Partially Repeated** (Exhibit II-F)
G.5	FEMA did not estimate and accrue accounts payable for all material open mission assignments at year-end. FEMA only accrued for mission assignments for which a payable confirmation had been received from the other Federal agency. Did not have fully effective policies and procedures to ensure that insurance company financial data collected through a third-party service provider was accurate and complete, affecting the reliability of its accounts payable balance as of September 30, 2006.	**Partially Repeated** (Exhibit II-F)
G.6	FEMA and TSA did not have sufficient policies and procedures in place to fully comply with the OMB Circular No. A-133, *Audits of States, Local Governments, and Non-profit Organizations*, and laws and regulations supporting OMB Circular No. A-50, *Audit Follow-up*, as revised.	**Partially Repeated** (Exhibit II-F)
H.	**Actuarial Liabilities** *(This finding has been combined with finding G above and reported as Actuarial and Other Liabilities in 2007)*	
H.1	The Coast Guard was unable to fully support its assertions relating to accuracy and completeness of the underlying participant data, medical cost data, and trend and experience data provided to, and used by, the actuary for the calculation of the MRS, and post employment travel benefits liabilities. The Coast Guard did not follow established policies and procedures to accumulate data for the actuary to compute post-employment travel benefits. The Coast Guard did not perform periodic reconciliations between the medical expenditures subsidiary ledger and the general ledger. The Coast Guard did not have effective policies, procedures, and controls to monitor the expenditures for medical services to ensure they were billed at proper rates and for valid participants only, e.g., service members and their families, and retiree/survivors.	**Repeated** (Exhibit I-F)

	Summary of Conditions As Reported in 2006 DHS Performance and Accountability Report	Fiscal Year 2007 Status/ Disposition
I.	**Budgetary Accounting**	
I.1	Coast Guard did not have effective policies, procedures and internal controls over Coast Guard's process for validation and verification of UDO balances to ensure that recorded obligations were valid, obligations incurred were recorded timely, and that proper approvals and supporting documentation is maintained. Coast Guard has not designed or implemented a comprehensive internal control program across all components of the organization to prevent or detect and correct misstatements to UDO balances reported on the financial statements. In addition, programming logic and transaction codes used to record advances for which an obligation was not previously recorded are not operating effectively to ensure the obligation and UDO are properly recorded. Procedures and controls are not adequate to prevent a commitment or obligation of funds in excess of established appropriations. Obligations were recorded in FPD, but were not properly interfaced with the CAS, and were not supported by adequate documentation. Obligations related to post-employment permanent changes of station (PCS) were not recorded at the time orders were approved and issued. Automated system controls are not effectively used to prevent the processing of procurement transactions by contracting officer's with expired warrant authority, and a manual compensating control was not effective since listings of warranted contracting officers were not complete.	**Repeated** (Exhibit I-G)
I.2	TSA did not maintain, documentation supporting UDOs and related purchase information in a manner that is readily available to management and the auditors. Consequently, TSA was unable to provide sufficient documentation to support a sample of UDO balances at year-end prior to the completion of the DHS' 2006 PAR. Has developed, but not fully implemented, IT system programming logic which allows the accounting system to record obligations recovered at the transaction level in accordance with SGL requirements.	**Partially Repeated** (Exhibit II-G)
I.3	FEMA did not have adequate resources to monitor the status and ensure the timely deobligation of mission assignments, resulting in an overstatement of UDOs at the time of our testwork. Did not maintain adequate communications with its grants disbursements service provider regarding the reliability of its internal controls. In fiscal year 2006, FEMA's grant disbursement service provider received a qualified opinion over the effectiveness of its internal controls for the period October 1, 2005, to June 30, 2006. However, FEMA was not aware of these control deficiencies until late October 2006, and consequently, payment information from the third-party service provider used to reduce obligations in its general ledger may not be accurate	**Partially Repeated** (Exhibit II-G)
I.4	ICE has not completed its validation and verification of FPS prior year obligations, in order to determine the propriety of the completeness, existence, and accuracy of those obligations.	**Corrected**

	Summary of Conditions As Reported in 2006 DHS Performance and Accountability Report	Fiscal Year 2007 Status/ Disposition
I.5	Management Directorate had not established policies and procedures to ensure that obligations are recorded timely. Had not established policies and procedures to ensure that all key attributes of an obligation and purchase are recorded in the financial accounting system.	**Corrected**
I.6	US-Visit has not established policies and procedures to ensure that documentation supporting obligations and subsequent disbursements is filed and readily available for management and auditor review.	**Corrected**
J.	**Intragovermental and Intradepartmental Balances** *(This finding has been combined with finding B above and reported as Financial Reporting in 2007)*	
	OFM has not been able to reconcile intragovernmental asset, liability, and revenue amounts with trading partners, as required by OMB Circular No. A-136. OFM did not coordinate a DHS-wide reconciliation throughout the year of all intragovernmental balances. We noted that DHS, in cooperation with its components, have not developed and adopted effective policies and procedures, or established systems, to completely track, confirm, and reconcile intra-governmental balances and/or transactions with trading partners in a timely manner, which contributed to the material differences, cited below in 2006. The *Material Differences Reports* submitted to Treasury identified accounting/reporting errors of approximately $1.4 billion in both the first and second quarter 2006. These differences were primarily related to activity with the following trading partners: 96-U.S. Army Corps of Engineers and 97-Office of the Secretary of Defense-Defense Agencies. These differences were not fully reconciled/ resolved by the following quarter.	**Repeated** (Exhibit II-B)
Other Reportable Conditions:		
K.	**Environmental Liabilities**	
K.1	At the Coast Guard consistent policies or procedures have not been developed for the identification, evaluation, and estimation of potential environmental remediation of Coast Guard sites, thereby resulting in different approaches by shore facility commands and ultimately varying liability estimates.	**Repeated** (Exhibit I-F)

	Summary of Conditions As Reported in 2006 DHS Performance and Accountability Report	Fiscal Year 2007 Status/ Disposition
K.2	FLETC had not Implemented effective policies and procedures to accurately and completely estimate its liabilities. Consequently, FLETC's liability for lead contamination at its SAFRs was substantially understated and required an adjustment to the financial statements at year-end. Implemented a process to completely identify the existence of lead-paint and asbestos contamination, and to accurately estimate the cost of clean-up for financial statement purposes. The estimation process used in fiscal year 2006 was not supported by a detailed analysis that, among other things, considered the actual square footage of the contaminated area and the type of asbestos contamination.	**Corrected**
L.	**Custodial Revenue and Drawback**	
	At CBP related to drawback the ACS lacked automated controls to detect and prevent excessive drawback claims and over-payments, necessitating inefficient manual processes that do not effectively compensate for these automated controls. ACS did not have the capability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries or export documentation upon which the drawback claim was based. ACS lacked controls to prevent overpayment of drawback claims at the summary line level that were subject to the new deem liquidation process put in place during fiscal year 2006. CBP drawback review policy and procedures allowed drawback specialists, with supervisory approval, to judgmentally decrease the number of ACS selected underlying consumption entries randomly selected for review, thus decreasing the review's effectiveness. Related to the entry process – collection of taxes, duties and fees - policies, procedures, and general guidance provided to CMP coordinators related to sampling, review procedures, and documentation requirements for the monthly review of CM results are weak. The National Analysis Specialist Division port audits were no longer performed during FY 2006. CBP lacks formal policies and procedures to ensure the CM data used for analysis and to compute the revenue gap is accurately and completely input into the IT system. Related to BW, FTZ, and In-bond we noted inconsistencies in the performance of risk assessments and compliance reviews of BWs, and FTZs, and in-bond entries in various ports.	**Repeated** (Exhibit III-H)

	Summary of Conditions As Reported in 2006 DHS Performance and Accountability Report	Fiscal Year 2007 Status/ Disposition
	Compliance and Other Matters:	
M.	*Federal Managers' Financial Integrity Act of 1982* DHS management's FMFIA report did not contain corrective action plans for all material weaknesses identified in the PAR. In addition, DHS and its components have not established effective systems, processes, policies and procedures to evaluate and report on FMFIA compliance.	**Repeated** (Exhibit IV-I)
N.	*Federal Financial Management Improvement Act of 1996* We noted that DHS and each significant component did not fully comply with at least one of the requirements of FFMIA.	**Partially Repeated** (Exhibit IV-J)
O.	*Federal Information Security Management Act (Electronic Government Act of 2002)* We noted instances of non-compliance with FISMA that have been reported by us in the material weakness on *Financial Systems Security*.	**Combined with FFMIA** (Exhibit IV-J)
P.	***Single Audit Act Amendments of 1996*, and Laws and Regulations Supporting OMB Circular No. A-50, *Audit Follow-up*, as revised** DHS did not have procedures in place to fully comply with provisions in OMB Circular No. A-133 that require them to timely obtain and review grantee Single Audit reports and follow up on questioned costs and other matters identified in these reports. DHS and its components did not fully develop and implement corrective action plans to address all material weaknesses and reportable conditions identified by previous financial statement audits within the time-frames established in OMB Circular No. A-50. We also noted that some corrective action plans lack sufficient detail, such as clearly defined roles and responsibilities, actions to be taken, time-table for completion of actions, and documented supervisory review and approval of completed actions.	**Partially Repeated** (Exhibit IV-K)
Q.	*Improper Payments Information Act of 2002* DHS did not properly define programs and activities, institute a systematic method of reviewing all programs and identifying those at risk of significant erroneous payments, and properly sample or compute the estimated dollar amount of improper payments.	**Repeated** (Exhibit IV-L)

Summary of Conditions As Reported in 2006 DHS Performance and Accountability Report	Fiscal Year 2007 Status/ Disposition
R. ***DHS Financial Accountability Act of 2004 (Chief Financial Officers Act of 1990)***	
Section 3 of Public Law 108-330, *DHS Financial Accountability Act of 2004,* states that the President of the United States shall appoint a Chief Financial Officer of DHS not later than 180 days after the date of the enactment of this Act signed in October 2004, to be confirmed by the U.S. Senate. At September 30, 2005 DHS was operating with an Acting CFO, while no waiver or amendment to this law has been obtained by DHS management. The *DHS Financial Accountability Act of 2004* also made DHS subject to the *Chief Financial Officers Act of 1990*, as amended, which requires DHS to submit to the Congress and OMB audited financial statements annually. DHS engaged an independent auditor to audit the September 30, 2006, consolidated balance sheet and statement of custodial activity only.	**Repeated** (Exhibit IV-M)
S. ***Government Performance and Results Act of 1993***	
The validation and verification section of the fiscal year 2006 DHS *Annual Performance Plan* was incomplete and included erroneous data. In addition, no performance goals or measures were established or aligned to two of the Department's strategic objectives in the *Annual Performance Plan*. GPRA states that an agency may not omit or minimize the significance of any program activity constituting a major function or operation for the agency.	**Repeated** (Exhibit IV-N)
T. ***The Debt Collection Improvement Act of 1996***	
DHS was not in compliance with certain provisions of the DCIA. Specifically, we noted that due process is not performed in a timely manner to ensure that some eligible debts are forwarded to Treasury for cross-servicing or the offset program within the timeframes established by DCIA.	**Repeated** (Exhibit IV-O)

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

Homeland Security

November 15, 2007

MEMORANDUM FOR: Richard L. Skinner, Inspector General

FROM: David L. Norquist, Chief Financial Officer

SUBJECT: FY 2007 Financial Statement Audit

This memo is our response to the Independent Public Accountant's audit of our balance sheets as of September 30, 2007 and 2006, and the related statement of custodial activities for the years then ended. We agree with the Independent Public Accountant's conclusions.

I would like to thank you for your efforts and the dedication shown by your staff and the Independent Public Accountant in working with the Department to improve financial management. Although the auditor's report on internal controls and compliance indicates that DHS still faces serious financial management challenges, I am encouraged to note that significant progress was made this year. This progress has been made possible through the tireless effort of many throughout the Department to implement meaningful corrective actions and develop strong processes and internal controls.

We are currently updating our plans to address the challenges identified by the auditors, as well as those noted by management during our A-123 assessment. Our plans will focus on sustaining progress at the components that have corrected weaknesses, as well as supporting corrective action plans in areas where weaknesses remain. Two particular challenges for the upcoming year will be the U.S. Coast Guard and the Federal Emergency Management Agency.

Financial management at DHS has come a long way. I am inspired by the extraordinary efforts of the Department's dedicated staff, and am most appreciative of the partnership we have forged with your office. Together we will continue to improve financial management and grow a cadre of leaders ready to address the mission challenges of the next decade.

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