Department of Homeland Security
Office of Inspector General

Independent Auditors' Report on DHS' FY 2010 Financial Statements and Internal Control over Financial Reporting

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Preface

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

The attached report presents the results of the DHS financial statements audits for fiscal years (FY) 2010 and 2009 and the results of an examination of internal control over financial reporting of the balance sheet as of September 30, 2010, and the statement of custodial activity for FY 2010. We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the audits. The contract required that KPMG perform its audits according to generally accepted government auditing standards and guidance from the Office of Management and Budget and the Government Accountability Office. KPMG was unable to provide an opinion on DHS' balance sheets as of September 30, 2010 and 2009, or on DHS' internal control over financial reporting of the FY 2010 balance sheet and statement of custodial activity. The FY 2010 auditors' report discusses eight significant deficiencies in internal control, of which six are considered material weaknesses, and five instances of noncompliance with laws and regulations. KPMG is responsible for the attached draft auditors' report and the conclusions expressed in the report. We do not express opinions on DHS' financial statements or provide conclusions on compliance with laws and regulations.

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

Richard L. Skinner

Richard L. Skinner
Inspector General

U.S. DEPARTMENT OF HOMELAND SECURITY

Excerpts from the DHS Annual Financial Report

Table of Contents

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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, 2010 and 2009, and the related statements of custodial activity for the years then ended (referred to herein as "financial statements"). We were also engaged to examine the Department's internal control over financial reporting of the balance sheet as of September 30, 2010, and statement of custodial activity for the year then ended. In connection with our audit engagement, we also considered DHS' compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on the balance sheet as of September 30, 2010 and the related statement of custodial activity for the year 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, 2010 and 2009 (referred to herein as "other fiscal year (FY) 2010 and 2009 financial statements"), or to examine internal control over financial reporting over the other FY 2010 financial statements.

Summary

As stated 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, 2010 and 2009, or the related statements of custodial activity for the years then ended.

As discussed in Notes 1V and 1N, DHS adopted Statement of Federal Financial Accounting Standard (SFFAS) No. 33, *Pensions, Other Retirement Benefits, and Other Post-employment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates,* and SFFAS No. 35, *Estimating the Historical Cost of General Property, Plant, and Equipment* (SFFAS No. 35) as of October 1, 2009.

As stated in our Report on Internal Control over Financial Reporting, we were unable to perform procedures necessary to form an opinion on DHS' internal control over financial reporting of the FY 2010 balance sheet and statement of custodial activity.

Material weaknesses in internal control over financial reporting, as defined in the Report on Internal Control over Financial Reporting section of this report, have been identified in the following areas:

- Financial Management and Reporting
- Information Technology Controls and Financial System Functionality
- Fund Balance with Treasury
- Property, Plant, and Equipment
- Actuarial and Other Liabilities
- Budgetary Accounting.

Significant deficiencies, as defined in the Report on Internal Control over Financial Reporting section of this report, have been identified in the following areas:

- Certain Entity Level Controls
- Custodial Revenue and Drawback.

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

- *Federal Managers' Financial Integrity Act of 1982* (FMFIA), and Laws and Regulations Supporting OMB Circular No. A-50, *Audit Follow-up*, as revised
- *Federal Financial Management Improvement Act of 1996* (FFMIA)
- *Single Audit Act Amendments of 1996*
- *Chief Financial Officers Act of 1990*
- *Anti-deficiency Act*
- *Government Performance and Results Act of 1993.*

We also reported other matters related to compliance with the *Anti-deficiency Act* at the National Protection and Programs Directorate (NPPD), U.S. Secret Service (USSS), U.S. Coast Guard (Coast Guard), and the Management Directorate.

Other deficiencies in internal control, potentially including additional material weaknesses and significant deficiencies, 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 DHS' balance sheets as of September 30, 2010 and 2009, and the related statements of custodial activity for the years then ended, had we been able to perform all procedures necessary to express an opinion on DHS' internal control over financial reporting of the balance sheet as of September 30, 2010, and statement of custodial activity for the year then ended, and had we been engaged to audit the other FY 2010 and 2009 financial statements, and to examine internal control over financial reporting of the other FY 2010 financial statements.

The following sections discuss the reasons why we are unable to express an opinion on the accompanying DHS financial statements; why we were unable to express an opinion on internal control over financial reporting of the balance sheet as of September 30, 2010, and statement of custodial activity for the year then ended; 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, 2010 and 2009, and the related statements of custodial activity for the years then ended. These financial statements are the responsibility of DHS management.

The Coast Guard was unable to provide sufficient evidential matter that support transactions and certain balance sheet accounts including fund balance with Treasury, accounts receivable, inventory and related property, general property, plant and equipment including heritage assets and stewardship land, certain actuarially-derived liabilities, environmental and other liabilities, and net position, as reported in the accompanying DHS balance sheets as of September 30, 2010 and 2009. The total assets and liabilities of the Coast Guard, as reported in the accompanying DHS balance sheets, were $20.3 billion and $18.7 billion, or 23 and 22 percent of total DHS consolidated assets, and were $46.4 billion and $37.8 billion, or 56 and 51 percent of total DHS consolidated liabilities as of September 30, 2010 and 2009, respectively.

The Transportation Security Administration (TSA) was unable to provide sufficient evidential matter that supports certain general property, plant, and equipment balances and related effects on net position, as reported in the accompanying DHS balance sheets as of September 30, 2009. The TSA general property, plant, and equipment balances reported in the accompanying DHS balance sheets were $997 million as of September 30, 2009, or 6 percent of DHS' consolidated general property, plant, and equipment as of September 30, 2009.

It was impractical to extend our procedures sufficiently to determine the extent, if any, to which the DHS balance sheets as of September 30, 2010 and 2009, and the related statements of custodial activity for the years then ended, may have been affected by the matters discussed in the two 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 and the related notes thereto.

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, 2010 and 2009, and accordingly, we do not express an opinion on these other FY 2010 and 2009 financial statements.

As discussed in Note 32, DHS restated its FY 2009 financial statements to correct multiple errors identified by U.S. Citizenship and Immigration Services, TSA, Coast Guard, Federal Law Enforcement Training Center, and Federal Emergency Management Agency that required adjustment of balances previously reported in DHS' FY 2009 financial statements. Because of the matters discussed in the second and third paragraphs of the Report on the Financial Statements regarding our audits at the Coast Guard and TSA, we were unable to audit the restatements identified by the Coast Guard and TSA, 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, 2009. In addition, DHS did not present the Statements of Net Cost as of September 30, 2010 and 2009 by major program, goals and outputs as described in a strategic and performance plan, and also omitted certain related financial statement disclosures, required by OMB Circular No. A-136, *Financial Reporting Requirements*, as amended.

As discussed in Notes 1V and 1N, DHS adopted Statement of Federal Financial Accounting Standard (SFFAS) No. 33, *Pensions, Other Retirement Benefits, and Other Post-employment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates*, and SFFAS No. 35, *Estimating the Historical Cost of General Property, Plant, and Equipment* (SFFAS No. 35) as of October 1, 2009.

The information in the Management's Discussion and Analysis (MD&A), Required Supplementary Stewardship Information (RSSI), and Required Supplementary Information (RSI) sections of the DHS FY 2010 AFR is not a required part of the financial statements, but is supplementary information required by U.S. generally accepted accounting principles. 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 second and third paragraphs of this section of our report. Certain information presented in the MD&A, RSSI, and RSI is based on other FY 2010 and 2009 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, we noted that DHS did not include summary performance information that is aligned with its FY 2010 strategic goals and other information, within the MD&A section of the FY 2010 AFR, as required by OMB Circular No. A-136, *Financial Reporting Requirements*, as amended. DHS recently completed a quadrennial review for the purpose of developing an updated strategic plan around new priorities established by the Secretary.

The information in the Other Accompanying Information section of DHS' FY 2010 AFR is 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.

Report on Internal Control over Financial Reporting

We were engaged to examine the Department's internal control over financial reporting of the balance sheet as of September 30, 2010, and statement of custodial activity for the year then ended, based on the criteria established in OMB Circular No. A-123, *Management's Responsibility for Internal Control* (OMB Circular No. A-123), Appendix A. DHS management is responsible for establishing and maintaining effective internal control over financial reporting, and for its assertion on the effectiveness of internal control over financial reporting, included in the FY 2010 DHS *Secretary's Assurance Statement*, included in MD&A on page 29 of the DHS FY 2010 AFR, as required by OMB Circular No. A-123. We were not engaged to examine and report on internal control over financial reporting at the DHS component level.

The FY 2010 DHS *Secretary's Assurance Statement*, states that the Department was unable to provide assurance that internal control over financial reporting was operating effectively at September 30, 2010. This conclusion is based on the Department's evaluation and analysis of control deficiencies in the Coast Guard, TSA, Federal Emergency Management Agency, U.S. Customs and Border Protection, and U.S. Immigration and Customs Enforcement that in combination represent Departmental material weaknesses. In addition, the Coast Guard was unable to provide documentation of key processes, risk assessments, or evidence supporting the existence of internal controls, and Management acknowledges that pervasive material weaknesses exist in key financial processes, and is therefore unable to make an assertion on the effectiveness of internal control over financial reporting in key financial statement processes.

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

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

- Financial Management and Reporting
- Information Technology Controls and Financial Systems Functionality
- Fund Balance with Treasury
- Property, Plant, and Equipment
- Actuarial and Other Liabilities
- Budgetary Accounting.

Deficiencies at the Coast Guard that are considered to be material weaknesses at the consolidated level, when aggregated with deficiencies existing at other components, are presented in Exhibit I. Deficiencies at other DHS components that contribute to material weaknesses at the consolidated level, when aggregated with deficiencies existing at the Coast Guard, are presented in Exhibit II.

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

- Other Entity Level Controls
- Custodial Revenue and Drawback.

Exhibit III presents significant deficiencies at the consolidated level.

Because of the limitation on the scope of our examination described in the second paragraph of the Report on the Financial Statements section, and the second paragraph of the Report on Internal Control over Financial Reporting section, the scope of our work was not sufficient to enable us to express, and we do not express an opinion on the effectiveness of DHS' internal control over financial reporting of the balance sheet as of September 30, 2010, and related statement of custodial activity for the year then ended. It was impractical to extend our procedures sufficiently to determine the extent, if any, to which the FY 2010 balance sheet and statement of custodial activity may have been affected by these circumstances. We were not engaged to examine internal controls over financial reporting of the accompanying statements of net cost, changes in net position, and budgetary resources, for the year ended September 30, 2010. Additional deficiencies in internal control over financial reporting, potentially including additional material weaknesses and significant deficiencies, may have been identified and reported had we been able to perform all procedures necessary to express an opinion on DHS' internal control over financial reporting of the FY 2010 balance sheet and statement of custodial activity, and had we been engaged to audit the other FY 2010 and 2009 financial statements, and to examine internal control over financial reporting over the other FY 2010 financial statements.

The FY 2010 DHS *Secretary's Assurance Statement*, states that the Department identified five material weaknesses in internal control over financial reporting, which differs from the number of material weaknesses indentified by us during our FY 2010 audit. The reasons for this difference are provided in Exhibit IV, Comment I.

A summary of the status of FY 2009 material weaknesses and significant deficiencies is included as Exhibit V. We also noted certain additional deficiencies involving internal control over financial reporting and its operation that we will report to the management of DHS in a separate letter.

Report on Compliance and Other Matters

In connection with our engagement to audit of the balance sheet of DHS as of September 30, 2010, and statement of custodial activity for the year then ended, 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, 2010, 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, as amended, including the provisions referred to in Section 803(a) of FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to DHS. However, providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our engagement, and accordingly, we do not express such an opinion.

Management is responsible for complying with laws, regulations, contracts and grant agreements applicable to DHS.

The results of certain of our tests of compliance exclusive of those referred to in the FFMIA, disclosed the following six instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 07-04, as amended, and are described in Exhibit IV:

- *Federal Managers' Financial Integrity Act of 1982* (FMFIA), and Laws and Regulations Supporting OMB Circular No. A-50, *Audit Follow-up*, as revised
- *Federal Financial Management Improvement Act of 1996* (FFMIA)
- *Single Audit Act Amendments of 1996*
- *Chief Financial Officers Act of 1990*
- *Anti-deficiency Act*
- *Government Performance and Results Act of 1993.*

The results of our other 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, as amended.

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 (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level.

As discussed in our Reports on the Financial Statements and Internal Control over Financial Reporting, the scope of our work was not sufficient to express an opinion on the balance sheets as of September 30, 2010 and 2009, and the related statements of custodial activity for the years then ended, or to express an opinion on the effectiveness of internal control over financial reporting of the balance sheet as of September 30, 2010 and the related statement of custodial activity for the year then ended. Accordingly, other instances of noncompliance with laws, regulations, contracts, and grant agreements may have been identified and reported, had we been able to perform all procedures necessary to complete our audit of the financial statements and examination of internal control over financial reporting of the balance sheet as of September 30, 2010 and the related statements of custodial activity for the year then ended, and had we been engaged to audit the other FY 2010 and 2009 financial statements and to examine internal control over financial reporting over the other FY 2010 financial statements. In addition, because of the matters discussed in the second paragraph of our report on the financial statements, we were unable to complete tests of compliance over the Prompt Payment Act and Titles 10, 14, 31 (as related to the *Anti-deficiency Act*), and 37 of the United States Code at the Coast Guard.

Other Matters: Management of the NPPD, USSS, Coast Guard, and the Management Directorate have initiated reviews of certain collections, classification and use of funds, expenditures and/or obligations recorded that may identify a violation of the *Anti-deficiency Act*, or other violations of appropriation law in FY 2010 or in 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' response, and accordingly, we express no opinion on it.

KPMG

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 12, 2010

Our report on internal control over financial reporting and compliance and other matters is presented in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. The internal control weaknesses and findings related to compliance with certain laws, regulations, contracts, and grant agreements presented herein were identified during our engagement to audit the U.S. Department of Homeland Security (Department or DHS)'s the balance sheet as of September 30, 2010, and statement of custodial activity for the year then ended (financial statements), and to examine internal control over financial reporting of those financial statements. We were not engaged to audit the Department's fiscal year (FY) 2010 statements of net cost, changes in net position, and budgetary resources (referred to as other FY 2010 financial statements), or to examine internal controls over financial reporting of the other FY 2010 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 United States Coast Guard (Coast Guard). All of the significant deficiencies reported in Exhibit I are considered material weaknesses at the DHS consolidated level when combined with other significant deficiencies reported in Exhibit II.

Exhibit II Significant deficiencies in internal control identified throughout the Department or at other DHS components (components other than Coast Guard are collectively referred to as DHS Civilian Components). All of the significant deficiencies reported in Exhibit II are considered material weaknesses at the DHS consolidated level when combined with other significant deficiencies reported in Exhibit I.

Exhibit III Significant deficiencies that are 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*, as amended.

Exhibit V The status of our findings reported in FY 2009.

As stated in our Independent Auditors' Report, the scope of our work was not sufficient to enable us to express an opinion on the effectiveness of DHS' internal control over financial reporting of the balance sheet as of September 30, 2010, and related statement of custodial activity for the year then ended. 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, additional deficiencies in internal control over financial reporting, potentially including additional material weaknesses and significant deficiencies, may have been identified and reported had we been able to perform all procedures necessary to express an opinion on DHS' internal control over financial reporting of the financial statements, and had we been engaged to audit the other FY 2010 financial statements, and to examine internal control over financial reporting of the other FY 2010 financial statements.

The determination of which findings rise to the level of a material weakness is based on an evaluation of how deficiencies identified in all components, considered in aggregate, may affect the DHS balance sheet as of September 30, 2010, 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 significant deficiencies identified and reported in Exhibit I for the Coast Guard are repeated from our FY 2009 and FY 2008 report, and include updates for new findings resulting from our 2010 procedures. To provide trend information for the DHS Civilian Components, Exhibits II and III contain Trend Tables next to the heading of each finding. The Trend Tables in Exhibits II and III depict the severity and current status of findings by component that has contributed to that finding from FY 2008 through FY 2010.

A summary of our findings in FY 2010 and FY 2009 are presented in the Tables below:

Table 1 Presents a summary of our internal control findings, by component, for FY 2010.
Table 2 Presents a summary of our internal control findings, by component, for FY 2009.

We have reported six material weaknesses and two significant deficiencies at the Department level in FY 2010, shown in Table 1.

TABLE 1 – SUMMARIZED DHS FY 2010 INTERNAL CONTROL FINDINGS

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

TABLE 2 – SUMMARIZED DHS FY 2009 INTERNAL CONTROL FINDINGS

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

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

All components of DHS, as defined in Note 1A – *Reporting Entity*, to the financial statements, were included in the scope of our engagement to audit the consolidated balance sheet of DHS as of September 30, 2010, and the related statement of custodial activity for the year then ended, and to examine internal control over financial reporting of those financial statements Accordingly, our engagement to audit and examine internal control considered significant account balances, transactions, and accounting processes of other DHS components not listed above. Control deficiencies identified in other DHS components that are not identified in the table above did not individually, or when combined with other component findings, contribute to a significant deficiency at the DHS consolidated financial statement level.

I-A Financial Management and Reporting

Background: In fiscal year (FY) 2010, we were engaged to perform an examination of internal controls over financial reporting. The auditors' objective in an examination of internal control is to form an opinion on the effectiveness of internal control. When planning our examination, we gave appropriate emphasis to testing entity-level controls, such as management's risk assessment and monitoring processes, and other control environment elements that exist throughout the Department. Four Department-wide control environment conditions were identified through our examination procedures that have a pervasive influence on the control environment and effectiveness of control activities at the United States Coast Guard (Coast Guard). This Exhibit should be read in conjunction with the Department-wide conditions and recommendations described in Comment **II-A**, *Financial Management and Reporting*.

In previous years, we reported that the Coast Guard had several internal control deficiencies that led to a material weakness in financial reporting. In response, the Coast Guard developed its *Financial Strategy for Transformation and Audit Readiness* (FSTAR), which is a comprehensive plan to identify and correct conditions that are causing control deficiencies, and in some cases preventing the Coast Guard from preparing auditable financial statements.

The Coast Guard made progress in FY 2010, by completing its planned corrective actions over selected internal control deficiencies. Specifically, remediation efforts associated with accrued payroll, pension, and medical liabilities allowed management to make assertions on the completeness and accuracy of more than $43 billion of accrued liabilities, which represents more than 50 percent of DHS' total liabilities. The FSTAR calls for continued remediation of control deficiencies and reconciliation of balances in FY 2011.Consequently many of the financial reporting deficiencies we reported in the past remain uncorrected at September 30, 2010.

Conditions:

1 In FY 2010, certain entity-level control weaknesses, that may interfere with the timely completion of corrective actions planned for FY 2011 and beyond, continued to exist. While progress has been made, the Coast Guard has not completed the:

- Development and implementation of effective policies, procedures, internal controls, and information and communication processes to ensure that data supporting financial statement assertions are complete and accurate, that transactions are accounted for consistent with generally accepted accounting principles (GAAP), and that technical accounting issues are identified, analyzed and resolved in a timely manner. For example, the development and implementation of an accounting position over post-employment travel benefits, totaling less than one percent of liabilities took several months to complete. This condition is a potentially serious impediment to the Coast Guard's objective of producing an auditable balance sheet next year:
- Adoption of an on-going Coast Guard-wide risk assessment by financial, IT, and program personnel that addresses all significant financial statement line items; and
- Implementation of adequate monitoring controls over headquarters, units, and areas/districts with significant financial activity, including those controls associated with management override.

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

- Support beginning balances, year-end close-out, and the cumulative results of operations analysis in its general ledgers individually and/or in the aggregate;
- Ensure that transactions and accounting events at Coast Guard headquarters, units, and areas/districts are appropriately supported and accounted for in its general ledgers;
- Ensure that accounts receivable balances exist, are complete and accurate, and properly presented in the financial statements. For example, underlying data supporting accounts receivable balances is not maintained, reimbursable related activity is not identified timely, and accounts receivable activity is not properly recorded in the financial statements on a timely basis;

- Ensure financial statement information and related disclosures submitted for incorporation in the DHS financial statements are accurate and complete; and
- Ascertain that intragovernmental activities and balances are identified and differences, especially with agencies outside DHS, are being resolved in a timely manner in coordination with the Department's Office of Financial Management (OFM).

Cause/Effect: The Coast Guard has thorough and highly procedural processes for identifying and resolving technical accounting issues, and/or responding to auditor inquiries. This process often results in exceptionally long time periods devoted to issue resolution, which can extend to several months or even years, to resolve a single matter. In some cases, the issues are not material to the financial statements, but still require long time periods to resolve. This approach interferes with the timely completion of financial reports, and the availability of auditable accounting positions. In addition, insufficient controls over financial reporting could create an environment where an *Anti-deficiency Act* violation could occur.

The Coast Guard has not developed and implemented an effective general ledger system. The Core Accounting System (CAS), Aircraft Logistics Management Information System (ALMIS), and Naval Engineering Supply Support System (NESSS) general ledgers do not comply with the requirements of the *Federal Financial Management Improvement Act* (FFMIA). The general ledgers do not allow for compliance with the United States Standard General Ledger (USSGL) at the transaction level, and period-end and opening balances are not supported by transactional detail in the three general ledgers. The conditions described below in Comment **I-B**, *Information Technology Controls and Financial Systems Functionality* contribute to the financial reporting control deficiencies, and make correction more difficult.

Because of the conditions noted above, the Coast Guard was unable to provide reasonable assurance that internal controls over all financial reporting processes are operating effectively, and has acknowledged that pervasive material weaknesses continue to exist in some key financial processes. Consequently, the Coast Guard cannot be reasonably certain that its financial statements are reliable, or assert to the completeness, existence, accuracy, valuation, rights and obligations, or presentation of their financial data related to their balances of fund balance with Treasury, accounts receivable, general property, plant, and equipment, including heritage assets and stewardship land, environmental and other liabilities, and net position as reported in the Department's balance sheets as of September 30, 2010 and 2009.

Criteria: FFMIA Section 803(a) requires that each agency shall implement and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. FFMIA is intended to ensure that agencies use financial management systems that provide reliable, timely, and consistent information.

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

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

The Treasury *Federal Intragovernmental Transactions Accounting Policies Guide,* dated August 13, 2010, states that Office of Management and Budget (OMB) Circular No. A-136, *Financial Reporting Requirements,* as revised, require Federal CFO Act and non-CFO Act entities identified in the Treasury

Financial Manual (TFM) 2010, 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 recording and reconciling intragovernmental activities.

Recommendations: We recommend that the Coast Guard:

1. Continue the implementation of the FSTAR, as planned;
2. Develop and implement effective policies, procedures, and internal controls to ensure that technical accounting issues are identified, analyzed, and resolved in a timely manner. The Coast Guard should be able to discuss initial accounting positions with basic rationale and supporting facts within one week of issue identification. Final resolution, may take longer depending on the complexity of the issues and impact on the Department, however even difficult cases should be resolved in substantially less time;
3. Improve entity-level controls by fully implementing a formal risk assessment process, evaluating and updating processes used to communicate policies and ensure that all transactions are recorded completely and accurately, and improve monitoring controls over financial data supporting the general ledger and financial statements;
4. Implement accounting and financial reporting processes including an integrated general ledger system that is FFMIA compliant; and
5. Establish new or improve existing policies, procedures, and related internal controls to ensure that:
   a. The year-end close-out process, reconciliations, and financial data and account analysis procedures are supported by documentation, including evidence of effective management review and approval, and beginning balances in the following year are determined to be reliable and auditable;
   b. All accounting transactions and balances are properly reflected in the financial statements and consistent with GAAP;
   c. Accounts receivable balances exist, are complete and accurate, and properly presented in the financial statements;
   d. Financial statement disclosures submitted for incorporation in the DHS financial statements are accurate and complete; and
   e. All intragovernmental activity and balances are accurately reflected in the financial statements, and differences are being resolved in a timely manner in coordination with the Department's OFM.

I-B Information Technology Controls and Financial Systems Functionality

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

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

In FY 2010, our IT audit work identified 28 IT findings, of which 10 were repeat findings from the prior year and 18 were new findings. In addition, we determined that Coast Guard remediated eight IT findings identified in previous years. Specifically, the Coast Guard took actions to improve aspects of its user recertification process, data center physical security, and scanning for system vulnerabilities. The Coast Guard's remediation efforts have enabled us to expand our testwork into areas that previously were not practical to test, considering management's acknowledgment of the existence of control deficiencies. Most of the new findings relate to IT systems that were added to our examination scope this year.

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

Related to IT controls:

Condition: We noted that Coast Guard's core financial system configuration management process controls are not operating effectively, and continue to present risks to DHS financial data confidentiality, integrity, and availability. Financial data in the general ledger may be compromised by automated and manual changes that are not adequately controlled. For example, the Coast Guard uses an IT scripting process to make updates to its core general ledger software, as necessary, to process financial data. During our FY 2010 testing, we noted that some previously identified control deficiencies were remediated (particularly with the implementation of a new script change management tool in the second half of FY 2010), while other deficiencies continued to exist. The remaining control deficiencies vary in significance. However, three key areas that impact the Coast Guard IT script control environment are:

- Script testing requirements – Limited testing requirements exist to guide Coast Guard staff in the development of test plans and guidance over the functional testing that should be performed;
- Script testing environment – Not all script changes were tested in the appropriate test environments, as required; and
- Script audit logging process – The Coast Guard's core system databases are logging changes to tables as well as successful and unsuccessful logins. However, no reconciliation between the scripts run and the changes made to the database tables is being performed to monitor the script activities and ensure that all scripts run have been approved.

In addition, we noted weaknesses in the script change management process as it relates to the Internal Control over Financial Reporting (ICOFR) process (e.g., the financial statement impact of the changes to FINCEN core accounting system through the script change management process). The Coast Guard has not fully developed and implemented procedures to ensure that a script, planned to be run in production, has been through an appropriate level of review by a group of individuals thoroughly assessing if the script would have a financial statement impact. Furthermore, the rationale documenting the impact of the script, whether deemed as having financial impact or not, is not documented and retained for internal assessment or audit purposes. Internal controls that ensure the reliability of the scripting process must be effective throughout the year, but most importantly during the year-end close-out and financial reporting process.

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

Related to financial system functionality:

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

- As noted above, Coast Guard's core financial system configuration management process is not operating effectively due to inadequate controls over IT scripts. The IT script process was instituted as a solution primarily to compensate for system functionality and data quality issues;

- Financial system audit logs are not readily generated and reviewed, as some of the financial systems are lacking the capability to perform this task efficiently;
- Production versions of operational financial systems are outdated and do not provide the necessary core functional capabilities (e.g., general ledger capabilities); and
- Financial systems functionality limitations are preventing the Coast Guard from establishing automated processes and application controls that would improve accuracy, reliability, and facilitate efficient processing of certain financial data such as:
  - Ensuring proper segregation of duties and access rights such as automating the procurement process to ensure that only individuals who have proper contract authority can approve transactions or setting system access rights within the fixed asset subsidiary ledger;
  - Maintaining sufficient data to support Fund Balance with Treasury related transactions, including suspense activity;
  - Maintaining adequate posting logic transaction codes to ensure that transactions are recorded in accordance with GAAP; and
  - Tracking detailed transactions associated with intragovernmental business and eliminate the need for default codes such as Trading Partner Identification Number that cannot be easily researched.

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

Criteria: The *Federal Information Security Management Act* (FISMA) passed as part of the *E-Government Act of 2002*, provides guidance 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*, establishes policy for the management of Federal information resources.

FFMIA is intended to ensure that agencies use financial management systems that provide reliable, timely, and consistent information. The purpose of FFMIA is to (1) provide for consistency of accounting by an agency from one fiscal year to the next, and uniform accounting standards throughout the Federal Government, (2) require Federal financial management systems to support full disclosure of Federal financial data, including the full costs of Federal programs and activities, (3) increase the accountability and credibility of federal financial management, (4) improve performance, productivity, and efficiency of Federal Government financial management, and (5) establish financial management systems to support controlling the cost of Federal Government.

OMB Circular No. A-123, *Management's Responsibility for Internal Control*, states, "Agency managers should continuously monitor and improve the effectiveness of internal control associated with their programs. This continuous monitoring, and other periodic evaluations, should provide the basis for the agency head's annual assessment of and report on internal control, as required by 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."

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

The GAO's 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), implement the recommendations in our LOU letter provided to the Coast Guard and DHS management. In that letter, we provide more detailed recommendations to effectively address the deficiencies identified in the configuration management process.

Additionally, regarding IT controls, we recommend that the Coast Guard:

1. Develop and implement policies and procedures that address open aspects of script testing, including documentation of test documents;
2. Develop training that addresses all aspects of script testing (including documentation of test documents) and provide training to appropriate CM staff;
3. Develop a resource plan with associated supporting business case(s) to address the database audit logging requirements;
4. Develop procedures and perform regular account revalidation for the script management tool to ensure privileges remain appropriate; and
5. Conduct an assessment over the ICFOR process related to identifying and evaluating scripts that have a financial statement impact. This assessment can be included in the configuration management oversight process as part of USCG's annual A-123 efforts, or performed independent of the A-123 process. We recommend that this assessment (1) be performed early in the FY 2011, in time to remediate deficiencies before the end of the third quarter, and (2) involve process documentation and sufficient testing to fully assess both design and operating effectiveness of controls. The objective being to have a reliable process and internal controls in place that allow the auditor to test, and rely on those controls, during the fourth quarter of FY 2011.

I-C Fund Balance with Treasury

Background: Fund Balance with Treasury (FBWT) at the Coast Guard totaled approximately $6.5 billion, or approximately 10.7 percent of total DHS FBWT at September 30, 2010. The majority of these funds represented appropriated amounts that were obligated, but not yet disbursed, as of September 30, 2010. In FY 2009, we reported a material weakness in internal control over FBWT at the Coast Guard. In FY 2010, the Coast Guard corrected some FBWT control deficiencies; specifically issues associated with payroll related transactions, and revised its remediation plan to include additional corrective actions that are scheduled to occur after FY 2010. Consequently, most of the conditions stated below are repeated from our FY 2009 report.

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

- Did not properly design and implement FBWT monthly activity reconciliations and/or could not provide detail transaction lists reconciled to the general ledger for amounts reported to Treasury for all Coast Guard Agency Location Codes;

- Has not been able to substantiate the completeness and accuracy of all inputs to the SF 224 process;
- Recorded adjustments to the general ledger FBWT accounts or activity reports submitted to Treasury, including adjustments to agree Coast Guard balances to Treasury amounts, that were unsupported;
- Does not have an effective process for clearing suspense account transactions related to FBWT due to over-reliance on vendor-provided data. The Coast Guard lacks documented and effective policies and procedures and internal controls necessary to support the completeness, existence, and accuracy of suspense account transactions. In addition, certain issues persist with industrial service orders (ISOs) and credit cards that preclude a complete and accurate population of suspense detail; and
- Does not have well established procedures to perform routine analytical comparisons between accounts, particularly budgetary accounts that should have a direct relationship with FBWT accounts.

Cause/Effect: The Coast Guard had not designed and implemented accounting processes, including a financial system that complies with federal financial system requirements, as defined in OMB Circular No. A-127, *Financial Management Systems*, as revised, and the requirements of the *Joint Financial Management Improvement Program* (JFMIP), now administered by the FSIO, to fully support the FY 2010 FBWT activity and balance as of September 30, 2010. Failure to implement timely and effective reconciliation processes could increase the risk of undetected errors and/or violations of appropriation laws, including instances of undiscovered *Anti-deficiency Act* violations or fraud, abuse, and mismanagement of funds, which could lead to inaccurate financial reporting and affect DHS' ability to effectively monitor its budget status.

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

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

Section 803(a) of FFMIA requires that each agency shall implement and maintain financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. FFMIA is intended to ensure that agencies use financial management systems that provide reliable, timely, and consistent information.

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

Recommendations: We recommend that the Coast Guard continue to implement remediation efforts associated with establishing policies, procedures, and internal controls to ensure that FBWT transactions are recorded accurately completely, and in a timely manner, and that all supporting documentation is maintained for all recorded transactions. The Coast Guard remediation efforts should include procedures to:

1. Ensure that appropriate supporting documentation is maintained and readily available to support all aspects of appropriation activity (e.g., warrants, transfers, rescissions, etc.) and opening 2011 FBWT balances;
2. Perform complete and timely FBWT reconciliations using the Treasury Government-wide Accounting tools. Adequate documentation should be maintained and readily available for all data (e.g., receipts, disbursements, journal entries, etc.) used in the reconciliation process. Documentation should be sufficient to support items at the transactional level, and enable transactions and balances to be reconciled to the general ledger, as appropriate;
3. Better manage its suspense accounts to include researching and clearing items carried in suspense clearing accounts in a timely manner during the year, and maintaining proper supporting documentation in clearing suspense activity;
4. Perform analytical procedures over budgetary and proprietary activity related to the FBWT process; and
5. Review any IT related application (e.g., system generated reports) or general controls (e.g., change management) associated with the FBWT process.

I-D Property, Plant, and Equipment

Background: The Coast Guard maintains approximately 51 percent of all DHS property, plant, and equipment (PP&E), including a large fleet of boats and vessels. Many of the Coast Guard's assets are constructed over a multi-year period, have long useful lives, and undergo extensive routine servicing that may increase their value or extend their useful lives. In FY 2010, the Coast Guard continued to execute remediation efforts as documented in FSTAR to address the PP&E process and control deficiencies, specifically those associated with vessels, small boats, and aircraft. However, FSTAR procedures are scheduled to occur over a multi-year timeframe. Consequently, many of the conditions cited below have been repeated from our FY 2009 report.

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

Conditions: The Coast Guard has not:

Regarding PP&E:

- Established its opening PP&E balances necessary to prepare a balance sheet as of September 30, 2010. Inventory procedures were performed in 2010 to assist in the substantiation of existence and completeness of PP&E balances; however, they were not performed over all asset classes (e.g., real property). Furthermore, in cases where original acquisition documentation has not been maintained, the Coast Guard has not fully implemented methodologies and assumptions to support the value of all PP&E;
- Implemented appropriate controls and related processes to accurately, consistently, and timely record additions to PP&E and construction in process (CIP), (including all costs necessary to place the asset in service e.g., other direct costs), transfers from other agencies, disposals in its fixed asset system, and support the 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;

- Developed and implemented a process to identify and evaluate all lease agreements to ensure that they are appropriately categorized as operating or capital, and properly reported in the financial statements and related disclosures;
- Properly accounted for improvements and impairments to buildings and structures, capital leaseholds, selected useful lives for depreciation purposes, and appropriate capitalization thresholds, consistent with GAAP; and
- Identified and tracked all instances where accounting is not in compliance with GAAP (usually due to immateriality), and prepare a non-GAAP analysis that supports managements accounting policies. This analysis should be maintained and available for audit.

Regarding Stewardship PP&E:

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

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

The Coast Guard management deferred correction of the Stewardship PP&E weaknesses reported in previous years, and acknowledged that the conditions we reported in prior years remained throughout FY 2010. The lack of comprehensive and effective policies and controls over the identification and reporting of Stewardship PP&E could result in misstatements in the required financial statement disclosures and related supplementary information for Stewardship PP&E.

Criteria: SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, provides the general requirements for recording and depreciating property, plant, and equipment. SFFAS No. 6 was recently amended by SFFAS No. 35, *Estimating the Historical Cost of General Property, Plant, and Equipment: Amending Statements of Federal Financial Accounting Standards 6 and 23*, which clarifies that "reasonable estimates of original transaction data historical cost may be used to value general PP&E…Reasonable estimates may be used upon initial capitalization as entities implement general PP&E accounting for the first time, as well as by those entities who previously implemented general PP&E accounting." Additionally, SFFAS No. 35 "allows the use of reasonable estimates when an entity determines it is necessary to revalue general PP&E assets previously reported."The Federal Accounting Standards Advisory Board (FASAB)'s Federal Financial Accounting Standards Interpretation No. 7, dated March 16, 2007, defines "items held for remanufacture" as items "in the process of (or awaiting) inspection, disassembly, evaluation, cleaning, rebuilding, refurbishing and/or restoration to serviceable or technologically updated/upgraded condition. Items held for remanufacture may consist of: Direct materials, (including repairable parts or subassemblies […]) and Work-in-process (including labor costs) related to the process of major overhaul, where products are restored to 'good-as-new' condition and/or improved/upgraded condition. 'Items held for remanufacture' share characteristics with 'items held for repair' and items in the process of production and may be aggregated with either class. Management should use judgment to determine a reasonable, consistent, and cost-effective manner to classify processes as 'repair' or 'remanufacture'."

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

FFMIA Section 803(a) requires that each agency shall implement and maintain financial management systems that comply substantially with Federal financial management system requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. OMB Circular No. A-127 prescribes the standards for federal agencies' financial management systems.

Recommendations: We recommend that the Coast Guard:

Regarding PP&E:

1. Continue to implement remediation efforts associated with establishing PP&E balances, including designing and implementing inventory procedures over all PP&E categories and implementing methodologies, including the use of SFFAS No. 35, to support the value of all PP&E;
2. Implement appropriate controls and related processes to accurately and timely record additions to PP&E and CIP, transfers from other agencies, improvements, impairments, capital leases, depreciable lives, disposals in its fixed asset system, and valuation and classification of repairable PP&E;
3. Implement processes and controls to record any identifying numbers in the fixed asset system at the time of asset purchase to facilitate identification and tracking; and to ensure that the status of assets is accurately tracked in the subsidiary ledger;
4. Develop and implement a process to identify and evaluate all lease agreements to ensure that they are appropriately categorized as operating or capital, and are properly reported in the financial statements and related disclosures;
5. Ensure that appropriate supporting documentation is maintained and readily available to support PP&E life-cycle events (e.g., improvements, in-service dates, disposals, etc.); and
6. Perform and document a non-GAAP analysis for all instances where accounting policies are not in compliance with GAAP.

Regarding stewardship PP&E:

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

I-E Actuarial and Other Liabilities

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

The Coast Guard estimates accounts payable by adjusting the prior year revised accounts payable accrual estimate by the percentage change in budgetary authority for the current fiscal year. The revised prior year estimate is the mid-point of the range in which the accrual should fall based on an analysis of actual payments made subsequent to September 30 of the prior year. The calculation is based on the results of a statistical sample for a portion of the subsequent disbursement population and a judgmental sample for the other portion.

The Coast Guard's environmental liabilities consist of environmental remediation, cleanup, and decommissioning. The environmental liabilities are categorized as relating to shore facilities or vessels. Shore facilities include any facilities or property other than ships (e.g., buildings, fuel tanks, lighthouses, small arms firing ranges, etc.).

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

Regarding actuarial liabilities:

The Coast Guard had not implemented sufficient internal controls to ensure that information used by the actuary to calculate the pension benefit liability was complete, accurate, and properly used in actuarial valuation calculations until later in FY 2010. In early FY 2010, adjustments to the prior year pension benefit liability were identified by both the actuarial service provider and the Coast Guard, which highlighted this control weakness. During FY 2010, management implemented new internal controls that they believe will address these deficiencies.

The Coast Guard has not:

- Developed and implemented sufficient ongoing internal controls to ensure that information used by the actuary to calculate the actuarial medical benefit liability is complete and accurate. During FY 2010, the Coast Guard implemented various mitigating internal control and substantive procedures to address these conditions, however did not design or implement a sufficient long-term internal control solution; and

- Implemented effective policies, procedures, and controls to ensure the completeness and accuracy of relocation claims provided to, and used by, the actuary for the calculation of the post-employment travel benefit liability.

Regarding accounts payable and payroll estimates:

- Designed a methodology used to estimate accounts payable that considers and uses all applicable current year data. As a result, current year data that may have a significant impact on the estimate could be overlooked;

- Fully implemented effective controls to ensure that services have been provided to qualified Coast Guard members prior or subsequent to the payment of medical related invoices. As a result, medical related year-end accounts payable amounts and data utilized in the calculation of medical incurred but not reported estimates may be misstated, and improper payments may be made to service providers. During FY 2010, the Coast Guard implemented detective procedures to review invoices paid in FY 2010, however they did not review historical invoices (i.e., invoices paid prior to FY 2010) used in the incurred but not reported calculation nor implement a sufficient long-term internal control solution to address these conditions; and

- Designed and implemented a process to properly calculate and record civilian related payroll liabilities until fiscal year-end.

Regarding environmental liabilities:

- Fully supported the completeness, existence, and accuracy assertions of the data utilized in developing the estimate for the FY 2010 environmental liability account balance; and

- Fully developed, documented, and implemented the policies and procedures in developing, preparing, and recording the environmental liability estimates related to shore facilities and vessels.

Cause/Effect: The Coast Guard did not perform a comprehensive review over information provided by actuarial service providers to ensure the completeness and accuracy of their calculation of pension benefit liabilities. Additionally, ineffective policies, procedures, and controls exist to ensure the completeness and accuracy of relocation claims provided to, and used by, the actuary for the calculation of post-employment benefit liabilities.

The Coast Guard's methodology used to estimate accounts payable is based on the prior year estimate, validated via a subsequent payment analysis, and does not consider or use all applicable current year data. Additionally, the information provided by medical service providers is not sufficient for the Coast Guard to perform detailed reviews prior to payment, and as such, modifications may be necessary to existing service agreements.

The Coast Guard has not fully developed, documented, and implemented policies and procedures to develop, prepare, and record environmental liability estimates in accordance with applicable accounting standards.

The process to record civilian related payroll accruals was not designed or operating effectively until fiscal year-end, leading to misstatements in quarterly financial statements.

Criteria: According to SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, paragraph 79, Other Retirement Benefits (ORB) include all retirement benefits other than pension plan benefits. Per paragraph 88, the ORB liability should be reported using the aggregate entry-age normal method. The liability is the actuarial present value of all future benefits less the actuarial future present value of future cost contributions that would be made for and by the employees under the plan.

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

The GAO *Standards* hold that transactions should be properly authorized, documented, and recorded completely and accurately. SFFAS No. 1, paragraph 77 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."

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. Continue to assess the effectiveness of controls implemented during FY 2010 to ensure that information used by the actuary to calculate the pension benefit liability is complete, accurate, and properly used in actuarial valuation calculations;
2. Develop and implement sufficient internal controls to ensure that information used by the actuary to calculate the actuarial medical benefit liability is complete and accurate; and
3. Implement effective policies, procedures, and controls to ensure the completeness and accuracy of information provided to the actuary to develop the post-employment travel benefit liability.

Regarding accounts payable and payroll estimates:

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;
5. Implement effective internal controls to ensure that services have been provided to qualified Coast Guard members prior or subsequent to the payment of medical invoices; and

6. Continue to assess the effectiveness of internal controls implemented over payroll at fiscal year-end.

Regarding environmental liabilities:

7. Develop and implement policies, procedures, processes, and controls to ensure the identification and recording of all environmental liabilities, to define the technical approach, to establish cost estimation methodology, and to develop overall financial management oversight of its environmental remediation projects. Consider the "Due Care" requirements defined in FASAB Technical Release No. 2. The policies should include:

   a. Procedures to ensure the proper calculation and review of cost estimates for consistency and accuracy in financial reporting, including the use of tested modeling techniques, use of verified cost parameters, and assumptions;

   b. Periodically validate estimates against historical costs; and

   c. Ensure that detailed cost data is maintained and reconciled to the general ledger.

I-F Budgetary Accounting

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

Conditions: We noted the following internal control weaknesses related to budgetary accounting, many of which were repeated from our FY 2009 report. The Coast Guard has not:

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

- Finalized and implemented policies and procedures to monitor unobligated commitment activity in CAS throughout the fiscal year. Currently, the Coast Guard only performs a year-end review to reverse commitments that are no longer valid; and

- Designed and implemented effective procedures, processes, and internal controls to verify the completeness and accuracy of the year-end obligation "pipeline" which are obligations executed on or before September 30 but not recorded in the Coast Guard's CAS, and to record all executed obligations. These deficiencies affected the completeness, existence, and accuracy of the year-end "pipeline" adjustment that was made to record obligations executed before year end.

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

Criteria: According to the Office of Federal Financial Management's *Core Financial System Requirements*, dated January 2006, an agency is responsible for establishing a system for ensuring that it does not obligate or disburse funds in excess of those appropriated or authorized, and "the Budgetary Resource Management function must support agency policies on internal funds allocation methods and controls." The *Federal Acquisition Regulation* (FAR) Section 1.602 addresses the authorities and responsibilities granted to contracting officers. Treasury's USSGL guidance at TFM S2 10-02 (dated August 2010) specifies the accounting entries related to budgetary transactions.

FFMIA Section 803(a) requires that each agency shall implement and maintain financial management systems that comply substantially with Federal financial management system requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. OMB Circular No. A-127, as revised, prescribes the standards for federal financial management systems.

Recommendations: We recommend that the Coast Guard:

1. Continue to improve policies, procedures, and the design and effectiveness of controls related to processing obligation transactions, including periodic review and validation of UDOs. Emphasize to all fund managers the need to perform effective reviews of open obligations, obtain proper approvals, and retain supporting documentation;
2. Finalize policies and procedures to periodically review commitments, and make appropriate adjustments in the financial system; and
3. Improve procedures, processes, and internal controls to verify the completeness and accuracy of the year-end obligation "pipeline" adjustment to record all executed obligations for financial reporting.

II-A Financial Management and Reporting

Department-wide Entity-Level Controls affecting Financial Reporting:

Background: We were engaged to perform an integrated audit in fiscal year (FY) 2010, which is an audit of the financial statements integrated with an examination of internal control over financial reporting. The auditors' objective in an examination of internal control is to form an opinion on the effectiveness of internal control. We used the criteria defined in the Office of Management and Budget (OMB) Circular No. A-123, *Management's Responsibility for Internal Control,* to evaluate effectiveness of internal control. OMB Circular No. A-123, and other similar control criteria such as *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), emphasizes the importance of entity-level controls as well as control activities over key financial statement processes. Consequently, when planning our examination, we gave appropriate emphasis to testing entity-level controls, such as management's risk assessment and monitoring processes, and other control environment elements that exist throughout the Department of Homeland Security (DHS or the Department). In FY 2009, we noted that the Department lacked a sufficient number of management personnel with the requisite financial accounting knowledge and background to ensure that its financial statements are prepared accurately and in compliance with generally accepted accounting principles. Throughout FY 2010, the Department executed a staffing plan to fill gaps in Department-wide skill sets, increasing the number of accounting and financial management personnel with essential technical competencies. Four Department-wide control environment conditions were identified through our examination procedures that have a pervasive influence on the effectiveness of controls. Those common themes are described below; however, they also contribute to several of the conditions presented throughout Exhibits I – IV.

Conditions: We identified the following Department-wide control environment weaknesses that have a pervasive effect on the effectiveness of internal controls over consolidated financial reporting:

- Development and implementation of effective information and communication processes to help ensure that technical accounting issues are identified, analyzed and resolved in a timely manner. For example, development of an accounting position and/or responses to our questions at the U.S. Customs and Border Protection (CBP), Federal Emergency Management Agency (FEMA) and Transportation Security Administration (TSA) at various times throughout the audit, is often a time-consuming process, that spans several months, even for some less complex matters;
- Generally, the components continue to be dependent on the external financial statement audit to discover and resolve technical accounting issues;
- Field and operational personnel do not always share responsibilities for, or are not held accountable for, financial management matters that affect the financial statements, including adhering to accounting policies and procedures and performing key internal control functions in support of financial reporting; and
- The Department's financial Information Technology (IT) system infrastructure is aging and has limited functionality, which is hindering the Department's ability to implement efficient corrective actions and produce reliable financial statements that can be audited. Weaknesses in the general control environment are interfering with more extensive use of IT application controls to improve efficiencies in operations and reliability of financial information.

Recommendations: We recommend that the Department's Office of the Chief Financial Officer (OCFO), with the support of the Deputy Secretary and Under Secretary for Management, develop and implement actions to:

1. Design and implement strategies to ensure that technical accounting issues are identified, analyzed, and resolved in a timely manner. DHS components, working with Office of Financial Management (OFM) support, should be able to discuss initial accounting positions, with basic rationale and supporting facts, within one to two days of issue identification. Final resolution, may take longer depending on the complexity of the issues and impact on the Department, however, even difficult matters should be resolved in substantially less time;

2. Consider realignment of some recently hired financial accounting and reporting personnel to devote more resources to technical accounting issue resolution, and reduce reliance on the external audit;

3. Expand the annual risk assessment process to involve field and operational personnel, to identify potential accounting and financial reporting issues, including accounting systems, processes, and infrastructure, where problems are likely to occur due to changing operations and programs; and

4. Continue the assessment of the Department's financial IT system infrastructure, with the objective of improving the effectiveness of IT controls, both general and application, and IT functionality in support of timely and accurate financial reporting. In the interim, consider opportunities to expand use of application controls to help ensure completeness, accuracy, authorization, and validity of financial transactions reported in the financial statements.

Financial Management and Reporting (TSA and FEMA):

	2010	**2009**	**2008**
DHS-HQ	**N/A**	**N/A**	**C**
TSA			
FEMA			
CBP	**C**		**N/A**

Key – Trend Table	
C	Deficiencies are corrected
	Deficiencies are less severe*
	Deficiencies are more severe*
* See Introduction	

Background: The TSA is in the final stages of establishing baseline accounting policies, procedures, and processes, with well-designed and effective internal controls. In FY 2010, TSA made progress by hiring accounting personnel, and completing the reconciliation of its balance sheet accounts. In addition, TSA addressed matters that have led to misstatements in the financial statements in previous years. Again in FY 2010, this progress was achieved through the exceptional efforts of a few people in the OFM, reliance on external contractor expertise, and reliance on the external audit to identify issues. Consequently, some entity-level and financial reporting control weaknesses reported in FY 2009 continued to exist, however measurable progress has been made FY 2010, allowing us to downgrade the severity of this control deficiency.

FEMA's accounting and financial reporting processes must support multi-faceted 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. While FEMA has taken positive steps in FY 2010 to correct control deficiencies that we have reported in the past, certain financial reporting control deficiencies continued to exist throughout the year.

CBP substantially corrected control deficiencies affecting financial reporting that we reported in FY 2009. However, some entity-level control deficiencies continue to exist, and have been reported in Comment **III-G**, *Other Entity-Level Controls*.

Conditions:

1. TSA:

   - Has not fully developed its financial reporting process with sufficient policies, procedures, and internal controls to ensure the reliability of financial statements. For example, we noted that TSA:

     - Has not distributed the financial reporting workload to ensure that skill sets are aligned with tasks, make optimal use of newly hired resources, and improve the financial reporting internal control structure;

     - Lacks effective internal controls, including supervisory reviews and monitoring, at some significant process-level risk points, e.g., where there is a risk of material error within a process;

     - Does not perform sufficient procedures, or have established compensating controls, working in coordination with the Agency's OMB A-123 process, that would identify abnormalities in account balances and correct errors that may occur. Instead, Office of Financial Management (OFM) is dependent on receiving accurate data, from various sources within TSA, some of which may not have fully effective internal controls (see comment **II-D**, *Property, Plant, and Equipment*); and

- Remains dependent on the external financial statement audit process, or outside contractors, to identify risks of misstatement, account balance errors, and provide feedback on corrective action plans.

* Is not fully compliant with the United States Government Standard General Ledger (USSGL) requirements at the transaction level. For example, TSA did not record property-related adjustments into the applicable general ledger accounts at the appropriate fund account symbol to provide an audit trail to the transaction level; and

* Is unable to fully identify and present its intragovernmental balances and transactions by trading partner.

2. FEMA:

* Did not have adequate processes and controls throughout the year to ensure that all adjustments were fully researched, substantiated, documented, and/or appropriately reviewed prior to preparation and submission of financial data to the Department. For example, FEMA performs manual adjustments to correct attributes for certain financial activity, primarily related to the Grants Program Directorate (GPD). These adjustments are not fully substantiated;

* Did not have well designed controls throughout the year over financial reporting to the Department using the Treasury Information Repository System (TIER) system, and did not always maintain evidence of the control procedures performed. For example, we noted that FEMA:

  - Did not properly document its verification that TIER beginning balances were accurate and agreed to prior year TIER ending balances;

  - Did not perform the June TIER to Integrated Financial Management Information System (IFMIS) reconciliation at the Treasury Account Fund Symbol (TAFS) level in June, and investigate discrepancies that existed between the TIER balances on the reconciliation and the submitted TIER trial balance;

  - Did not maintain evidence of supervisory review of the TIER file in the TIER holding area before it was moved to the TIER repository prior to the third quarter of FY 2010; and

  - Did not prepare and review the initial and final TIER to the IFMIS reconciliations prior to submission of the TIER file to the DHS TIER repository prior to the fourth quarter of FY 2010.

* Did not properly complete the Government Accountability Office (GAO) Financial Audit Manual (FAM) 2010 – Checklist for Federal Accounting, and the supervisory review control was not effective in identifying errors in the checklist.

Cause/Effect: TSA continued to devote substantial resources to remediation of control deficiencies and reconciliation of balance sheet accounts in FY 2010, which placed greater than normal demands on the staff. Technical accounting staff were often committed to projects, and TSA was unable to make optimal use of its newly hired resources in a review and monitoring capacity. As a result, in some cases, adjustments to correct errors in accounts were recorded without appropriate supporting analysis, documentation, and reviews.

FEMA's IT systems are outdated and have limited capacity for modification. (See comment **II-B**, *Information Technology Controls and Financial System Functionality.*) Consequently, FEMA must rely more heavily on manual analyses and adjustments to accurately prepare financial statements. With accelerated time-frames for reporting, particularly at year-end, the likelihood that a material error will occur increases. Additionally, prior to the fourth quarter of FY 2010, FEMA had not devoted adequate resources to correct the errors related to GPD. Further, prior to the third quarter of FY 2010, FEMA did not have formal documented processes for various financial reporting activities, including the timely completion and documentation of all TIER-related control activities.

Criteria: OMB Circular No. A-123 defines internal control 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. In particular, management is responsible for establishing and maintaining internal control to achieve the objectives of effective and efficient operations, reliable financial reporting, and compliance with applicable laws and regulations. The documentation for internal control, all transactions, and other significant events should be readily available for examination. Further, relevant, reliable, and timely information should be communicated to relevant personnel at all levels within an organization. It is also crucial that an agency communicate with outside organizations. In addition, the Circular states that management should identify both internal and external risks, and analyze those risks for their potential effect on the agency.

The *Federal Financial Managers Improvement Act of 1996* (FFMIA) Section 803(a) requires that each agency shall implement financial management systems that comply substantially with Federal financial management systems requirements, applicable Federal accounting standards, and the USSGL at the transaction level. FFMIA is intended to ensure that agencies use financial management systems that provide reliable, timely, and consistent information.

OMB Circular No. A-50, *Audit Follow-Up,* states that corrective action taken by management on resolved 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.

Statement of Federal Financial Accounting Concepts No. 1, *Objectives of Federal Financial Reporting*, paragraph 164, states that financial reporting "should help report users make relevant comparisons among similar federal reporting units, such as comparisons of the costs of specific functions or activities. Comparability implies that differences among financial reports should be caused by substantive differences in the underlying transactions or organizations rather than by the mere selection of different alternatives in accounting procedures or practices."

Per Section 18 of the DHS OFM *Component Requirements Guide for Financial Reporting*, each component must "report Component information in accordance with the OMB financial reporting requirements, including OMB Circular No. A-136, *Financial Reporting Requirements* (as updated)."

The Treasury *Federal Intragovernmental Transactions Accounting Policies Guide*, dated August 13, 2010, states that OMB Circular No. A-136, *Financial Reporting Requirements,* as revised, require Federal CFO Act and non-CFO Act entities identified in the Treasury Financial Manual (TFM) 2010, 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 recording and reconciling intragovernmental activities.

Recommendations: We recommend that:

1. TSA:
    a. Consider redistribution of the workload to further integrate newly hired personnel with accounting skills into the financial reporting processes. As restructuring or realignment of staffing is considered, responsibilities can be better matched with technical skills;
    b. Ensure that the annual risk assessment process is fully utilized to identify risk-points where control weaknesses exist and update policies and procedures to mitigate risk of error in the financial statements. This may also involve added supervisory reviews and monitoring controls at significant process-level risk points, particularly where the risk of misstatement exists outside of the OFM;

c. Strengthen monitoring controls, such as account relationship or flux analysis, to help identify and investigate potential errors in financial statements;

d. Develop policies and procedures to ensure compliance with the USSGL requirements at the transaction level. Specifically, the procedures should ensure that adjustments to the general ledger system are recorded at the appropriate fund account symbol and include the correct budgetary and proprietary entries; and

e. Work with its accounting service provider to ensure that the proper trading partner code is recorded for each intragovernmental transaction. Until such time, TSA should continue to perform its manual process for the identification and reporting of intragovernmental activities and balances.

2. FEMA:

a. Fully implement new processes and controls to ensure that manual adjustments are fully researched, substantiated, documented, and/or appropriately reviewed prior to preparation and submission of financial data to the Department;

b. Complete the full implementation of the new TIER to IFMIS reconciliation processes and controls;

c. Formally document and implement policies and procedures for opening and closing funds, including requirements to maintain all supporting documents; and

d. Develop and implement procedures over the preparation and review of the GAO FAM 2010 – Checklist for Federal Accounting.

II-B Information Technology Controls and Financial System Functionality

	2010	2009	2008
CBP			
USCIS			
FEMA			
FLETC			
ICE			N/A
TSA	C		

See page II.2 for table explanation

Background: Effective IT general and application controls and financial systems functionality are essential for achieving accurate and reliable reporting of financial and performance data. As part of the DHS financial statement audit, we evaluated select IT general controls using the objectives defined by GAO's *Federal Information System Controls Audit Manual* (FISCAM), in five key control areas: security management, access control, configuration management, segregation of duties, and business continuity. In addition to IT general controls, we evaluated select application controls, which are controls supporting the structure, policies, and procedures that apply to the use, operability, interface, edit, and monitoring controls of a financial application. We also considered the effects of financial system functionality when testing internal controls. Many key DHS financial systems are not compliant with FFMIA and OMB Circular Number A-127, *Financial Management Systems* (as revised and effective on October 1, 2009). DHS financial system functionality limitations add to the Department's challenges of addressing systemic internal control weaknesses, and limit the Department's ability to effectively and efficiently process and report financial data.

During our FY 2010 assessment of IT general and application controls and financial system functionality, we noted that the DHS Civilian Components made some progress in remediation of IT findings we reported in FY 2009. We have closed approximately 30 percent of our prior year IT findings. In FY 2010, we indentified approximately 140 findings, of which more than 60 percent are repeated from last year. Further, nearly one-third of our repeat findings were for IT deficiencies that management represented were corrected during FY 2010. Disagreements with managements self assessment occurred almost entirely at FEMA, and only occasionally in other components.

The findings identified below are a cross-representation of the nature of IT general control deficiencies identified throughout the Department's components. Many represent a single instance of an indentified deficiency at one component, and may not be representative of the general control environment in other components.

Conditions: Our findings related to IT controls and financial systems functionality follow:

Related to IT controls:

1. *Access controls*:

   - Deficiencies in management of application and/or database accounts, network, and remote user accounts:
     - System administrator root access to financial applications was not properly restricted, logged, and monitored;
     - Strong password requirements were not enforced;
     - User account lists were not periodically reviewed for appropriateness, inappropriate authorizations and excessive user access privileges were allowed at some DHS components, and users were not disabled or removed promptly upon personnel termination;
     - Emergency and temporary access was not properly authorized, and contractor development personnel were granted conflicting access to implement database changes;
     - Initial and modified access granted to application and/or database, network, and remote users was not properly documented and authorized; and
     - The process for authorizing and managing remote virtual private network (VPN) access to external state emergency management agencies, and component contractors, did not comply with DHS and component requirements.
   - Ineffective safeguards over logical and physical access to sensitive facilities and resources:
     - While performing after-hours physical access testing, we identified the following unsecured items: Government credit cards; financial system user IDs and passwords; computer laptops; and server names and IP addresses; and
     - While performing social engineering testing, we identified instances where DHS employees provided their system user names and passwords to an auditor posing as a help desk employee.
   - Ineffective or insufficient use of available audit logs:
     - Logs of auditable events are not being reviewed to identify potential incidents, or were reviewed by those with conflicting roles;
     - Logging of application and/or database events required to be recorded was not enabled;
     - Documented procedures for audit log follow-up do not meet DHS requirements; and
     - Evidence of audit log reviews was not retained.

2. *Configuration management*

   - Lack of documented policies and procedures:
     - To prevent users from having concurrent access to the development, test, and production environments of the system at four DHS components; and
     - Configuration, vulnerability, and patch management plans have not been established and implemented, or did not comply with DHS policy;
   - Vulnerabilities were identified during periodic internal scans and related corrective actions were not reported and tracked in accordance with DHS policy; and

- Security patch management and configuration deficiencies were identified during the vulnerability assessment on hosts supporting the key financial applications and general support systems.

3. *Security management:*

- Systems certification and accreditation:
  - Several component financial and associated feeder systems as well as general support systems, were not properly certified and accredited, in compliance with DHS policy;
  - Compliance with the Federal Desktop Core Configuration (FDCC) security configurations is in progress, but has not been completed; and
  - An instance where Interconnection Security agreements was not documented.
- Roles and responsibilities have not been clearly defined:
  - Instances of security roles and responsibilities are not adequately defined for financial applications and general support systems; and
  - System boundaries have not been adequately and completely defined within the System Security Plan.
- Lack of policies and procedures:
  - One instance of incomplete or inadequate policies and procedures associated with computer incident response capabilities;
  - Procedures for exit processing of transferred/terminated personnel, including contractors, had not been established; and
  - Lack of component policies and procedures for IT-based specialized security training.
- Lack of compliance with existing policies:
  - Several instances where background investigations of federal employees and contractors employed to operate, manage and provide security over IT systems were not being properly conducted;
  - Lack of compliance with DHS computer security awareness training requirements;
  - Non-disclosure agreements were not completed at one DHS component; and
  - A complete and accurate listing of workstations could not be provided at one DHS component and as a result anti-virus protection is not installed on all workstations.

4. *Contingency Planning:*

- Instances where incomplete or outdated business continuity plans and systems with incomplete or outdated disaster recovery plans were noted at four DHS components. Some plans did not contain current system information, emergency processing priorities, procedures for backup and storage, or other critical information;
- Service continuity plans were not consistently and/or adequately tested, and individuals did not receive training on how to respond to emergency situations at four DHS components;
- An alternate processing site has not been established for high risk systems; and
- Appropriate authorization to access backup media was not made available.

5. *Segregation of Duties:*

- Financial system users had conflicting access rights as the Originator, Funds Certification Official, and an Approving Official profile;

- Lack of evidence to show that least privilege and segregation of duties controls exist; and
- Policy and procedures to define and implement segregation of duties were not properly developed and/or implemented.

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

Related to financial system functionality:

We noted that in some cases, financial system functionality is inhibiting DHS' ability to implement and maintain internal controls, notably IT applications controls supporting financial data processing and reporting. Financial system functionality limitations also contributes to other control deficiencies reported in Exhibits I, II and III, and can make compliance with FFMIA and OMB Circular A-127 more difficult. Financial system functionality conditions include:

- Inability to modify IT system core software, and install controls to prevent duplicate payments. The component identified two instances where duplicate payments were made in FY 2009 and FY 2010, and the funds needed to be recovered;
- The financial systems in one component cannot be configured to:
  - Prevent, detect, and correct excessive refunds;
  - Provide summary information of the total unpaid assessments for duties, taxes, and fees by individual importer; and
  - Report information on outstanding receivables, the age of receivables, or other data necessary for management to fully monitor collection actions; and
- Two inventory tracking systems are not fully integrated with the financial system of record; and
- Several financial systems do not have the necessary functionality to enforce DHS-required system security requirements. For example, one system does not have the functionality to enforce policy requirements related to password complexity, account lockout, and profiles changes. In addition, a system does not have the functionality to track new users or user profile changes.

Cause/Effect: The IT control weaknesses have resulted from systemic challenges in complying with DHS security policies, which is complicated by many components' financial systems inability to offer the necessary functionality. One key Department financial system was migrated to a new operating platform during FY 2010, which will help alleviate some control weaknesses and functionality limitations. However, DHS broad and systemic IT weaknesses and financial system functionality limitations will not be fully addressed until the Department implements a stable centralized financial system platform. DHS is currently planning such a platform - the Transformation and Systems Consolidation (TASC) initiative, which is designed to consolidate and integrate mission-essential enterprise financial, acquisition, and asset management systems. However, the time and resources needed to implement TASC and address IT control weaknesses will take several years.

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. Many of these weaknesses, especially those in the area of access and configuration management controls, may result in material errors in DHS' financial data that are not detected in a timely manner and in the normal course of business. In addition, as a result of the presence of IT control weaknesses and financial system functionality weaknesses, there is added pressure on other mitigating controls to be operating effectively at all times. Because mitigating controls often require more manually performed procedures, 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 *E-Government Act of 2002*, provides guidance that Federal entities maintain IT security programs in accordance with National Institute of Standards and Technology (NIST) guidance.

OMB Circular Number A-130, *Management of Federal Information Resources*, establishes policy for the management of Federal information resources.

FFMIA is intended to ensure that agencies use financial management systems that provide reliable, timely, and consistent information. The purpose of FFMIA is to: (1) provide for consistency of accounting by an agency from one fiscal year to the next, and uniform accounting standards throughout the Federal Government; (2) require Federal financial management systems to support full disclosure of Federal financial data, including the full costs of Federal programs and activities; (3) increase the accountability and credibility of federal financial management; (4) improve performance, productivity and efficiency of Federal Government financial management; and (5) establish financial management systems to support controlling the cost of Federal Government. FFMIA requirements are complemented by specific financial system polices and standards contained in OMB Circular Number A-127, as revised on October 1, 2009.

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

Recommendations: We recommend that the DHS Office of the Chief Information Officer, in coordination with the OCFO, make necessary improvements to the Department's financial management systems. Specific recommendations are provided in a separate *Limited Official Use* letter provided to DHS management.

II-C Not Used

II-D Property, Plant, and Equipment (TSA and CBP)

	2010	2009	2008
CBP			
FEMA	N/A	C	
TSA			
USCIS	C		N/A
ICE	C		N/A
NPPD	C		N/A

See page II.2 for table explanation

Background: TSA manages passenger and baggage X-ray, explosives detection, and other equipment as part of its mission. This equipment, which is in every major U.S. airport, is owned and maintained by TSA. The costs required to procure, ship, temporarily store, install, operate, and maintain this equipment are substantial and consume a large portion of TSA's annual operating budget. Unique accounting processes and systems are necessary to track the status and accumulate costs, and to accurately value, account for, and depreciate the equipment. TSA completed the reconciliation of its property, plant and equipment (PP&E) accounts in FY 2010 and was able to assert to that its PP&E balances at September 30, 2010 are fairly stated in the DHS FY 2010 AFR. TSA made some progress remediating controls deficiencies however was not able to fully address all of the conditions that existed in FY 2009.

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

USCIS, ICE and NPPD corrected the PP&E conditions we reported in FY 2009.

Conditions: We noted the following internal control weaknesses related to PP&E:

1. TSA:

   - Has not implemented policies, procedures, and controls to properly identify risks and potential errors related to general property, equipment, and software balances, as necessary, to maintain the accuracy and completeness of those account balances. For example, we noted that TSA did not accurately and completely account for internal use software, other direct costs (ODC) incurred to transport, store, and install screening equipment at airports, and depreciation expense throughout

FY 2010. Several adjustments totaling in excess of $100 million, some of which were auditor-identified adjustments, were required to fairly state PP&E accounts affected by these items;

- Has not fully adopted sufficient procedures to properly document, track, and value capital assets on an on-going basis. For example, we noted that TSA lacks sufficient policies and procedures to:
  - Perform a periodic analysis of idle assets stored in a warehouse and adjust the carrying value of those assets to net realizable value (NRV), if necessary, as required by GAAP;
  - Ensure that assets warehoused are inventoried and reported in the financial statements timely and accurately;
  - Identify and account for assets below the capitalization threshold (i.e., peripheral equipment);
  - Ensure asset additions, disposals, and transfers are recorded in the general ledger timely and accurately; and
- Continues to have weaknesses in coordination and communication (including training, oversight, and monitoring) with personnel outside of the OFM that contribute to control weaknesses in processes dependent on operations.

2. CBP:

- Does not have adequate accounting policies, procedures, processes, and controls to properly account for new equipment purchases and transfers, construction, or disposal of assets in a timely manner. For example, CBP did not:
  - Consistently record construction-in-process (CIP) to its construction projects per the observed percentage of completion (POC);
  - Transfer assets from CIP to "in-use" assets in a timely manner; and
  - Record some asset additions and disposals in accordance with its policy.
- Did not properly perform and/or document several physical annual inventories related to real and personal property.

Cause/Effect: TSA focused primarily on correcting the conditions that prevented management from asserting to the accuracy and completeness of certain PP&E balances as of September 30, 2009, and relatively less time was devoted to correcting related control deficiencies in FY 2010. Further, time constraints caused TSA to record some adjustments before a proper review was performed. These conditions led to a number of errors in the financial statements that were discovered during our audit. In some cases, TSA was dependent on input and feedback from outside contractors, and the auditor for interpretation and application of accounting standards to resolve difficult accounting issues related to the development of its opening balance sheet. This deficiency is also related to the conditions described in Comment **II-A**, *Financial Management and Reporting.*

CBP does not have documented and/or fully implemented policies and procedures, or does not have sufficient oversight of its policies and procedures, to ensure that all PP&E transactions are recorded timely and accurately. As a result, CBP's PP&E balance may be misstated by the recording of transactions, which are incorrect, unsupported, or untimely. Also, CBP IT systems lack functionality to track and account for assets in various stages of completion and deployment leading to increased manual involvement to accurately report assets. This deficiency is also related to the conditions described in Comment **II-A**, *Financial Management and Reporting,* and Comment **II-B**, *Information Technology Controls and Financial System Functionality*.

Criteria: SFFAS No. 10, *Accounting for Internal Use Software*, provides requirements for the capitalization and reporting of internal use software development costs. According to paragraph 16, the capitalizable cost should include "….the full cost (direct and indirect cost) incurred during the software development stage." Per SFFAS No. 10, paragraphs 18-20, "For COTS [Commercial off-the-shelf] software, capitalized cost should include the amount paid to the vendor for the software. For contractor-developed software, capitalized cost should include the amount paid to a contractor to design, program, install, and implement the software. Material internal cost incurred by the federal entity to implement the COTS or contractor-developed software and otherwise make it ready for use should be capitalized […] Costs incurred after final acceptance testing has been successfully completed should be expensed."

SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, paragraph 17, states, "Property, plant, and equipment consists of tangible assets, including land, that meet the following criteria: they have estimated useful lives of 2 years or more; they are not intended for sale in the ordinary course of operations; and they have been acquired or constructed with the intention of being used, or being available for use by the entity." Per paragraph 26, "All general PP&E shall be recorded at cost. Cost shall include all costs incurred to bring the PP&E to a form and location suitable for its intended use." Paragraph 34 requires, "In the case of constructed PP&E, the PP&E shall be recorded as construction work in progress until it is placed in service, at which time the balance shall be transferred to general PP&E." Per paragraph 35, "Depreciation expense is calculated through the systematic and rational allocation of the cost of general PP&E, less its estimated salvage/residual value, over the estimated useful life of the general PP&E. Depreciation expense shall be recognized on all general PP&E, except land and land rights of unlimited duration." Per paragraphs 38, "In the period of disposal, retirement, or removal from service, general PP&E shall be removed from the asset accounts along with associated accumulated depreciation/amortization. Any difference between the book value of the PP&E and amounts realized shall be recognized as a gain or a loss in the period that the general PP&E is disposed of, retired, or removed from service."

GAO's *Standards for Internal Control in the Federal Government (Standards)* requires that internal control and all transactions and other significant events be clearly documented and readily available for examination. The Joint Financial Management Improvement Program (JFMIP), *Property Management Systems Requirements,* states 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. TSA:
    a. Develop and implement policies and procedures to properly identify risks, potential errors, and account for, monitor, and report general property, equipment, and internal use software balances;
    b. Develop and implement sufficient procedures to properly document, track, and value assets on an on-going basis; and
    c. Improve coordination and communication with personnel outside of the Office of Financial Management to ensure that actions regarding updates to the capital asset subsidiary ledger are properly reflected in accordance with GAAP.
2. CBP:
    a. Develop, document, and communicate policies and procedures for classifying, recording, and reviewing all capital transactions, particularly for new construction, to ensure that the financial statements are materially correct and presented in accordance with GAAP. Consideration should be given to the adequacy of policies to account for CIP, including methodologies to apply overhead charges, and establishing an appropriate useful life for annual depreciation charges;
    b. Emphasize the need to record asset additions and disposals in accordance with established policy;
    c. Consider adding supervision and monitoring controls to ensure that all intended corrective actions are effective and functioning properly;
    d. Establish and implement a standardized process that is integrated with its financial system of record in order to facilitate the timely recording of new assets placed into service; and
    e. Improve guidance for the performance and documentation of PP&E inventories.

II-E Actuarial and Other Liabilities (FEMA)

	2010	2009	2008
FEMA			
FLETC	C	C	
ICE	C	C	
S&T	C	C	
TSA	C		C
See page II.2 for table explanation			

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

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

- Does not have sufficient policies and procedures in place to fully comply with the *Single Audit Act Amendments of 1996* (*Single Audit Act*) and related OMB Circular No. A-133, *Audits of States, Local Governments, and Nonprofit Organizations* (OMB Circular A-133) (see Comment **IV-K**, *Single Audit Act Amendments of 1996*);
- Does not maintain accurate and timely documentation related to site visits/desk reviews performed for grantees. Specifically, our control testwork performed over a sample of 60 site visits/ desk reviews performed during the six-month period ended March 31, 2010, identified 35 exceptions related to documentation; and
- Does not consistently follow-up with grantees who have failed to submit quarterly financial and/or programmatic reports timely.

Cause/Effect: FEMA has not implemented policies and procedures over its grant program in order ensure compliance with the *Single Audit Act* and OMB Circular A-133. In addition, while GPD guidance and grant monitoring policies and procedures were disseminated in early FY 2009, all regions have not yet achieved the same level of control conscientiousness when it comes to documentation of grantee monitoring. As a result, misreported grantee expenses may not be detected, which would impact the fair presentation of FEMA's grant accrual balances, undelivered orders, and expenses.

Criteria: OMB Circular No. A-123 states, "Management is responsible for developing and maintaining effective internal control. Effective internal control provides assurance that significant weaknesses in the design or operation of internal control, that could adversely affect the agency's ability to meet its objectives, would be prevented or detected in a timely manner. […] Management should identify internal and external risks that may prevent the organization from meeting its objectives. When identifying risks, management should take into account relevant interactions within the organization as well as with outside organizations."

The *Single Audit Act Amendments of 1996*, Section 7502 (f)(1)(B) states, "Each Federal agency which provides Federal awards to a recipient shall… review the audit of a recipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the recipient by the Federal agency." Chapter 75, Section 7504 requires each federal awarding agency to "monitor non-Federal entity use of Federal awards."

OMB Circular No. A-133, Subpart D, provides for the responsibilities of federal agencies and pass-through entities for audits of states, local governments, and non-profit organizations.

Recommendations: We recommend that:

1. FEMA:

   a. Implement policies and procedures to ensure full compliance with the *Single Audit Act* and the related OMB Circular No. A-133; and

   b. Continue to provide comprehensive financial monitoring plans and expand guidance to regional staff responsible for conducting financial monitoring visits and obtaining and reviewing required quarterly grantee reports.

II-F Budgetary Accounting (FEMA and CBP)

	2010	2009	2008
CBP			
FEMA			
TSA	N/A	N/A	C

See page II.2 for table explanation

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. DHS has over 350 separate TAFS combined, 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, multi-year, and no-year appropriations, and several revolving, special, and trust funds. Accounting for budgetary transactions in a timely and accurate manner is essential to managing the funds of the Department and preventing overspending of allotted budgets.

In FY 2010, FEMA improved its processes and internal controls over the obligation and monitoring process; however, some control deficiencies remain.

CBP has implemented policies and procedures requiring the timely review and deobligation of funds when the contracts have expired or are complete. However, CBP has not been effective in adhering to its policy or in monitoring compliance.

Conditions: We noted the following internal control weaknesses related to budgetary accounting at FEMA and CBP:

1. FEMA:

   - Did not effectively monitor the status of its obligations as part of its normal operations to ensure timely deobligation when appropriate;
   - Could not readily provide all supporting documentation for undelivered orders (UDO)s, other than mission assignments, interagency agreements, and non-disaster grants tested at June 30, 2010 and September 30, 2010. We noted that for certain portions of the population, significant effort was required to coordinate and identify the responsible parties, to access certain files, or to provide information in a form that clearly supported the balances reported in the financial statements; and
   - Was required to correct numerous erroneous entries recorded by the Budget Planning & Analysis Division (BPAD) or to record transactions that should have been recorded by the BPAD but were not.

2. CBP is not enforcing its policies and procedures (Directive 1220-011C) to monitor and deobligate or close-out its obligations in a timely manner. We noted that CBP did not properly deobligate inactive undelivered orders for several items we tested as of September 30, 2010. In addition, when completing its review and certification of UDOs as of December 31, 2009, CBP marked the majority of its UDOs as not yet reviewed.

Cause/Effect: FEMA's administrative functions are geographically separated from programmatic operations which make locating certain UDO documentation difficult. Additionally, FEMA's new UDO annual certification and quarterly validation processes are not fully effective. Without supporting documentation, FEMA is unable to support the validity of certain UDO balances. Certain personnel within the BPAD do not have the necessary skills or training to correctly record budgetary entries in FEMA's general ledger. As a result, FEMA's financial information submitted to DHS may contain significant budgetary account errors if they are not detected by the OCFO.

CBP did not properly monitor all open obligations, and consequently, government funds may be committed and not made available to CBP for other Federal expenditures for longer periods of time than necessary. In addition, CBP's financial statements will not properly reflect the status of obligations.

Criteria: According to GAO *Standards*, "transactions should be promptly recorded to maintain their relevance and value to management in controlling operations and making decisions. This applies to the entire process or life cycle of a transaction or event from the initiation and authorization through its final classification in summary records." Further, "control activities help to ensure that all transactions are completely and accurately recorded." In addition, "internal control and all transactions and other significant events need to be clearly documented, and the documentation should be readily available for examination […] All documentation and records should be properly managed and maintained."

US Code Title 31 Section 1501 states that "an amount shall be recorded as an obligation of the United States Government only when supported by documentary evidence of (1) a binding agreement between an agency and another person (including an agency) that is (a) in writing, in a way and form, and (b) Executed before the end of the period of availability for obligation of the appropriation or fund used for specific goods to be delivered, real property to be bought or leased, or work or service to be provided." Section 1554, Audit, control and reporting states, "The head of each agency shall establish internal controls to assure that an adequate review of obligated balances is performed…"

CBP Directive 1220-011C states that all obligation records must be reconciled to supporting documentation at the close of each quarter and that additionally, a semi-annual review of specific populations of obligations must be performed and the status for each record identified to assure that only valid obligations remain open.

Recommendations: We recommend that:

1. FEMA:
   a. Modify and complete the implementation of the new UDO annual certification and quarterly validation processes to ensure that outstanding obligations are reviewed for validity quarterly;
   b. Continue to improve procedures for storing and locating documentation supporting UDO information, including points of contact, so that supporting information is readily available for management review and audit purposes; and
   c. Dedicate the appropriate resources to adequately staff, train, and supervise BPAD personnel to ensure that the BPAD is properly recording all necessary budgetary transactions.
2. CBP:
   a. Implement improved procedures to ensure full compliance with CBP Directive 1220-011C to ensure that obligations are reconciled to supporting documentation on a quarterly basis and are reviewed for validity on a semi-annual basis.

III-G Other Entity-Level Controls (USCG, FEMA and CBP)

	2010	2009	2008
USCG			
FEMA			
CBP		NA	NA
TSA	C		
See page II.2 for table explanation			

Background: In the past three years, the Department of Homeland Security (DHS or the Department) has undertaken and completed several steps designed to strengthen its entity and process level internal controls, and thereby improve the reliability of financial reporting. These steps are documented in the *Internal Control over Financial Reporting Playbook* and in component level Mission Action Plans (MAPs) prepared annually. The Department's Office of Management and Budget (OMB) Circular No. A-123, *Management's Responsibility for Internal Control*, assessment is also designed to assist with the remediation of control deficiencies.

The comments below should be read in conjunction with Comments **I-B** and **II-B**, *Information Technology Controls and Financial System Functionality*, which describe other entity-level control weaknesses related to Department and Component IT systems. United States Coast Guard (Coast Guard) and Department-wide entity-level control deficiencies that contribute to the Department's material weakness in financial reporting are presented in Comments **I-A** and **II-A**, *Financial Management and Reporting*, respectively.

The Coast Guard continues to make progress in remediation of control deficiencies that are important to its objective of becoming auditable in FY 2011. Some of the conditions cited below are repeated from FY 2009 and remain important to the Coast Guard's continued success in reconciling opening balances, and installing policies and procedures to support sustainable accounting processes and reliable financial reporting. The Coast Guard continues to follow the *Financial Strategy for Transformation and Audit Readiness* (FSTAR) updated in FY 2009. The FSTAR is a comprehensive plan to identify and correct the root causes of control deficiencies.

FEMA made continued progress toward correction of its entity-level control deficiencies in FY 2010. While progress has been made, some entity-level control deficiencies identified at FEMA in previous years continued during FY 2010, and are repeated below.

CBP's investment in accounting and financial reporting infrastructure did not keep pace with its significant expansion in capital assets in prior years, creating an environment where financial statement errors are more likely to occur. In FY 2010, CBP management recognized that its operations continue to experience rapid and large scale growth and took action to bring the resources allocated to its financial management in line with this growth. However, our audit determined that some entity-level control deficiencies continued to exist, which impair CBP's ability to produce timely, reliable financial information throughout the fiscal year.

Conditions: We noted the following internal control weaknesses related to other entity-level controls:

1. Coast Guard:

    - Has not developed adequate policies, procedures, or controls associated with monitoring, training, and continual education courses associated with personnel with financial duties;
    - Does not have standardized job descriptions that include the identification and definition of tasks required, for particular assignments that have financial duties;
    - Does not have policies that are operating effectively for hiring and evaluating financial employees, as management does not maintain adequate documentation for certain hiring requirements and periodic performance evaluations; and
    - Has not developed adequate controls with the Standards of Ethical Conduct to a) ensure that recent changes in the Coast Guard environment are included, and b) track and monitor compliance, including document retention for the investigation of any violation and corrective actions taken to ensure proper filing and review of the Confidential Disclosure Reports and ethics training requirements.

2. FEMA:

- Has not developed sufficiently effective methods of communication to ensure that significant financial-related system development and acquisition projects involve all relevant stakeholders, including the Office of the Chief Financial Officer (OCFO), to ensure the projects meet organizational mission needs and functional and technical requirements;
- Has not provided adequate monitoring and oversight of its National Flood Insurance Program (NFIP) contractor to ensure the implementation and maintenance of required security controls for NFIP information systems;
- Has not completed its documentation and/or update of formal policies and procedures (including desk manuals) for several of the roles, responsibilities, processes, and functions performed within FEMA;
- Has not committed sufficient resources to ensure that personnel attend required ethics training; and
- Has not developed sufficient policies and procedures to properly designate position sensitivity for positions that use, develop, or operate IT systems; track the status of background investigations; and maintain related documentation.

3. CBP:

- Does not timely resolve or have proper oversight of financial management issues, particularly, when the information resides with and/or is controlled and maintained by a contractor, to ensure that policies are followed and transactions are recorded accurately and timely in the general ledger. The lack of oversight contributed to the following conditions:
  - Operating materials and supply purchases were not properly recorded in a timely manner;
  - Financial information received from contractors was not always timely, reliable, and complete;
  - Inaccurate reporting of the percentage of completion of construction projects in the first half of FY 2010; and
  - Ultimate resolution of accounting issues related to SBInet were not finalized until the final weeks of the fiscal year.

Cause/Effect: Coast Guard management has acknowledged that longstanding procedural, control, personnel, IT and cultural issues have impeded progress toward installing an effective financial management structure. Coast Guard has developed, and is in the process of implementing, a multi-year MAP (FSTAR) that addresses entity-level controls, see comment **I-A**, *Financial Management and Reporting*.

In FY 2010, FEMA devoted substantial resources to developing certain policies and procedures, including those related to financial reporting. Consequently, FEMA devoted comparatively less attention to correcting other control deficiencies in FY 2010. Decentralized and informal background investigation processes present potential risks to FEMA's operations and IT systems.

In its FY 2010 representations made to the Secretary pursuant to the *DHS Financial Accountability Act*, the Coast Guard stated that they cannot provide reasonable assurance that internal control over financial reporting are operating effectively.

CBP does not have an effective process in place to timely review and analyze contractor information that could potentially impact the financial statements. As a result, CBP is unable to address changes in its operations that could potentially result in errors or omissions in the financial statements, or misapplication of GAAP may go undetected throughout the year.

Criteria: OMB Circular No. A-123, as revised, states that internal controls are the organization, policies, and procedures that agencies use to help program and financial managers achieve results and safeguard the integrity of their programs.

The *Federal Managers' Financial Integrity Act of 1982 (*FMFIA) requires that agencies establish internal controls according to standards prescribed by the Comptroller General. These standards are established in the GAO's *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 conscientiousness in management's operating philosophy and commitment to internal control. These standards cover controls such as human capital practices, supervisory reviews, policies, procedures, monitoring, and segregation of duties.

DHS 4300A *Sensitive Systems Handbook*, sets forth requirements related to background investigations for federal employees and contractors requiring access to DHS systems.

FEMA Directive Number 112-1, *Directives Management System*, sets forth the procedures for initiating, authorizing and updating FEMA directives. Page 5 of Directive states that the Directives Management System Point-of-Contact (DMS-POC) is responsible for "Establishing a biennial re-certification process for the review of their organization's functional area directives by using FEMA Form 112-1-1-1 Management Directives Review Report, and providing notification to the Directives Management Office."

Recommendations: We recommend that:

1. Coast Guard:
    a. Review and enhance, if necessary, the entity-level planned actions in its FSTAR to include steps to fully assess entity-level controls, develop effective corrective actions, and implement improved financial processes and systems.
2. FEMA:
    a. Develop and implement agency-wide communication protocols to ensure that significant financial-related system development and acquisition projects involve all relevant stakeholders, including the OCFO;
    b. Develop and implement monitoring procedures over the NFIP contractor to ensure the implementation and maintenance of required controls for NFIP information systems;
    c. Complete the efforts underway to ensure that formal policies and procedures (including desk manuals) are documented and current for all significant roles, responsibilities, processes, and functions performed within FEMA;
    d. Complete development and implementation of procedures and dedicate resources to provide, track compliance with, and monitor the annual and new hire ethics training requirements; and
    e. Develop and implement policies and procedures to properly designate position sensitivity for all positions that use, develop, or operate IT systems; track the status and completion of background investigations; and maintain related documentation.
3. CBP:
    a. Executive senior management needs to emphasize the importance of the financial statements to all program offices to ensure they provide the information necessary to identify and address risks and issues related to CBP's operations which could possibly lead to misstatements on CBP's financial statements; and
    b. CBP program offices should conduct an assessment relating to their financial reporting requirements to ensure they have the proper resources and processes to timely and accurately provide the information requested for the CBP Financial Statements.

III-H Custodial Revenue and Drawback (CBP Only)

Background: CBP collects approximately $29.5 billion in annual import duties, taxes, and fees on merchandise arriving in the United States from foreign countries (identified below as the Entry Process). Receipts of import duties and related refunds are presented in the statement of custodial activity in the DHS financial statements.

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

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

TCM is the primary method by which CBP measures risk in the areas of trade compliance and revenue collection. CBP utilizes the TCM program to measure the effectiveness of its control mechanisms deployed, and its execution in collecting revenues rightfully due to the U.S. Department of the Treasury.

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

Related to drawback:

- The Automated Commercial System (ACS) lacks automated controls to detect and prevent excessive drawback claims and overpayments, necessitating inefficient manual processes that do not effectively compensate for these automated controls;
- ACS lacks controls to prevent the overpayment of drawback claims at the summary line level;
- Drawback review policies do not require drawback specialists to review all, or a statistically valid sample, of prior drawback claims against a selected import entry to determine whether, in the aggregate, an excessive amount was claimed;
- Drawback review policy and procedures allow drawback specialists, with supervisory approval, to judgmentally decrease the number of underlying consumption entries (UCEs) randomly selected for review, which decreases the review's effectiveness. Further, CBP's sampling methodology for selecting UCEs is not considered to be statistically valid; and
- The period for document retention related to a drawback claim is only three years from the date of payment, based on statutory requirements set by Congress. However, there are several situations that could extend the life of the drawback claim well beyond three years.

Related to the Entry Process:

- CBP is unable to determine the status of the in-bond shipments and lacks policies and procedures that require monitoring the results of in-bond audits and require the review of overdue air in-bonds. Although port personnel are required to review some overdue in-bonds, there is no requirement to completely resolve overdue items;
- In-bond cargo examinations were not performed at the ports in FY 2010 because CBP failed to manually reset its system that selects in-bond cargo examinations at the beginning of fiscal year;
- CBP does not perform an analysis to determine the overall compliance rate of the in-bond program. CBP does not analyze the rate and types of violations found to determine the effectiveness of the in-bond program, and does not identify a projected total amount of uncollected

duties and fees on in-bond merchandise that has physically entered U.S. commerce without formal entry to ensure there is not a potentially significant loss of revenue;

- TCM oversight guidelines do not provide complete coverage over the TCM program. CBP implemented a consistent set of procedures for performing TCM reviews, during FY 2010, however, there are weaknesses in the oversight and monitoring of the TCM program at the port and CBP headquarter locations; and
- Current BW and FTZ Compliance Review Manuals lack specific guidance for ports to determine the appropriate risk assessment of a BW or FTZ. In addition, HQ review of the BWs and FTZs assessment results does not provide CBP with objective data related to the effectiveness of compliance reviews, common discrepancies found and the risks associated with those discrepancies, and techniques for mitigating risks.

Cause/Effect: IT system functionality and outdated IT systems contribute to the weaknesses identified above, also see Comment **II-B**, *Information Technology Controls and Financial System Functionality*. For example, CBP is unable to determine the status of the in-bond shipments with the information available within ACS, and CBP does not have the ability to run an oversight report to determine if ports have completed all required audits. For drawback, much of the process is manual until IT system functionality improvements are made, placing an added burden on limited resources.

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

The weaknesses in the CM program could result in CBP incorrectly evaluating the effectiveness of its control environment over the collections of duties, taxes, and fees.

It is possible that BWH/FTZ operators and users may be able to operate BWHs and FTZs that contain merchandise that CBP has no or limited knowledge about.

Criteria: Under FMFIA, management must implement cost-effective controls to safeguard assets and ensure reliable financial reporting. OMB's *Implementation Guidance for FFMIA,* dated January 9, 2009, states that financial systems should "routinely provide reliable financial information consistently, accurately, and uniformly."

OMB Circular No. A-127, *Financial Management Systems,* prescribes the standards for Federal agencies' financial management systems. The Office of Federal Financial Management's *Core Financial System Requirements,* dated January 2006, states that the core financial system must maintain detailed information sufficient to provide audit trails and to support reconciliation and research activities.

The *Improper Payments Information Act of 2002* requires agencies to annually review programs and activities and identify any that may be susceptible to significant improper payment. Whenever an agency estimates that improper payments may exceed $10 million, it must also provide a report on what actions are being taken to reduce such payments. In addition to the statutory 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.

OMB Circular No. A-50, *Audit Follow-Up,* states that corrective action taken by management on resolved 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.

CFR 19, Ch.1, Section 111.23, which addresses documents that support import entries, states that: (1) "…records must be retained by a broker in accordance with the provisions of this part and part 163 of this chapter within the broker district that covers the Customs port to which they relate unless the broker chooses to consolidate records at one or more other locations, and provides advance notice of that consolidation to Customs…" and (2) "…the records described in paragraph (a)(1) of this section, other than powers of attorney, must be retained for at least 5 years after the date of entry."

Recommendations: We recommend that CBP:

1. *Related to drawback*:

    a. Implement effective internal controls over drawback claims as part of any new system 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;

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

    c. Pilot statistically valid drawback claim review programs at each Drawback Center. Analyze the results of the pilots and determine the benefit of full implementation of the programs.

2. *Related to the Entry Process:*

    a. Increase headquarters oversight of the in-bond process by (a) analyzing the summary of post-audits conducted and associated results, (b) ensuring the system that selects in-bond cargo examinations is manually reset beginning of the fiscal year;

    b. Develop or re-emphasize formal requirements for all ports to continue to run and completely resolve overdue in-bond items and maintain documentation of the resolution;

    c. Resolve errors related to the universe of overdue air in-bonds. Issue guidance and require ports to and completely resolve overdue air in-bonds;

    d. Analyze the in-bond program annually to determine an overall compliance rate of the in-bond program;

    e. Provide additional detail in the TCM guidelines, specifying the use of the monitoring report, data queries, and any other tools to provide complete coverage over the TCM program;

    f. Develop standard operating procedures for conducting risk assessments for all BWs and FTZs. In addition, develop standardized procedures for HQ or field office oversight to ensure compliance review schedules are being reviewed timely and provide effective training to ensure that all ports are aware of updates and changes to the program and can consistently execute all requirements presented in the compliance review manuals and handbooks; and

    g. Continue the implementation of a national database of BWs and FTZs and develop procedures to ensure completeness.

All of the compliance and other matters described below are repeat conditions from FY 2009, except IV-N - *Government Performance and Results Act of 1993*, which is new in FY 2010.

IV-I *Federal Managers' Financial Integrity Act of 1982* (FMFIA) and Laws and Regulations Supporting OMB Circular No. A-50, *Audit Follow-Up,* as revised

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 internal controls; (2) assess the adequacy of internal controls; (3) separately assess and document internal control over financial reporting; (4) identify needed improvements; (5) take corresponding corrective action; and (6) report annually on internal controls. During fiscal year (FY) 2010 and 2009, the Department of Homeland Security (DHS or the Department) developed an annual *Internal Control Playbook* to implement corrective actions and support management assurances by performing tests of design and operating effectiveness of entity level controls and other financial accounting and reporting processes. DHS' implementation of OMB Circular No. A-123 facilitates compliance with the *Federal Managers' Financial Integrity Act of 1982* (FMFIA). The *DHS Financial Accountability Act of 2004* requires DHS to submit an annual audit opinion of internal control over financial reporting. The Secretary of DHS has stated in the Secretary's Assurance Statement dated November 12, 2010, as presented in Management's Discussion and Analysis (MD&A) of the Department's 2010 *Annual Financial Report* (AFR), that based on the material weaknesses identified from the OMB Circular A-123 assessment, the Department provides no assurance that internal control over financial reporting was operating effectively as of September 30, 2010.

The FY 2010 DHS *Secretary's Assurance Statement*, states that the Department identified five material weaknesses in internal control over financial reporting, which differs from the number of material weaknesses indentified by us during our FY 2010 audit. The reasons for this difference are related to the timing of management's assurance statement, which is as of September 30, 2010. Management believes that they have corrected the control deficiencies related to actuarial liabilities we reported in Exhibit I-E. Further, management has classified the remaining controls deficiencies we identify in Exhibit I-E together with Financial Reporting. Consequently, as reported in the FY 2010 AFR, Other Accompanying Information, management has reassessed, and thereby removed, the material weakness related to Human Resource Management at the U.S. Coast Guard.

In addition, 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 Government Accountability Office (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. As described above, 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 *Internal Control Playbook*. Progress is monitored by the Under Secretary for Management (USM) and the CFO, and regularly reported to OMB and other outside stakeholders, such as Congressional Committees. We noted that each component has complied with the DHS directive to develop corrective actions, and they have been reviewed and approved by the USM and CFO. All DHS components have made progress toward remediation of material internal control weaknesses; however, as shown in Exhibits I, II and III, deficiencies identified in prior years have not been fully corrected in FY 2010.

While we noted the Department overall has taken positive steps toward full compliance with FMFIA, OMB Circular No. A-123, OMB Circular No. A-50, and the *DHS Financial Accountability Act*, the Department has not fully established effective systems, processes, policies, and procedures to ensure that internal controls are operating effectively throughout the Department.

Recommendation: We recommend that the Department continue its corrective actions to address internal control deficiencies, in order to ensure full compliance with FMFIA and its OMB-approved plan for implementation of Circular No. A-123, in future years. We also recommend that DHS continue to follow and complete the actions defined in the *Internal Control Playbook*, to ensure that audit recommendations are resolved timely and corrective action plans addressing all DHS audit findings are developed and implemented together with appropriate supervisory review in FY 2011.

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

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

While we noted the Department overall has taken positive steps toward full compliance with FFMIA, the Coast Guard, US Customs and Border Protection (CBP), the Federal Emergency Management Agency (FEMA), the Federal Law Enforcement Training Center (FLETC), U.S. Immigration and Customs Enforcement (ICE), and TSA did not fully comply with at least one of the requirements of FFMIA. The reasons for noncompliance are reported in Exhibits I, II, and III. The Secretary of DHS has stated in the Secretary's Assurance Statements dated November 12, 2010 that the Department's financial management systems do not substantially conform to government wide requirements mandated by FFMIA. The Department's remedial actions and related timeframes are also presented in that section of the FY 2010 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 Comments **I-B** and **II-B**, *Information Technology Controls and Financial System Functionality*, which impact the Department's ability to fully comply with FISMA.

Recommendation: We recommend that DHS improve its financial management systems to ensure compliance with the FFMIA, and implement the recommendations provided in Exhibits I, II, and III, in FY 2011.

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

FEMA is the only DHS component that has a significant grant making operation. OMB Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* requires agencies awarding grants to ensure they receive grantee reports timely and to follow-up on *Single Audit* findings to ensure that grantees take appropriate and timely action. 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 2010. We noted that FEMA does not always obtain and review grantee *Single Audit* reports in a timely manner, or 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.

Recommendations: We recommend that:

1. FEMA further develop and implement 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 2011:
    a. Further develop and implement a tracking system to identify each grantee for which a *Single Audit* is required, and the date the audit report is due;
    b. Use the tracking system to ensure audit reports are received timely, and follow-up when reports are overdue; and

c. Perform reviews of grantee audit reports, issue-related management decisions, and ensure that the grantees take appropriate corrective action, on a timely basis.

IV-L ***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' Office of the Inspector General (OIG) has engaged an independent auditor to audit the September 30, 2010 balance sheet and related statement of custodial activity. Other financial statements, including the statements of net cost, changes in 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 Mission Action Plans described in DHS' *Internal Control Playbook* (see Comment **IV – I**, *Federal Managers' Financial Integrity Act of 1982*, above) to remediate the FY 2010 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-M ***Anti-deficiency Act*** **(ADA)**

Various management reviews and OIG investigations are on-going within the Department and its components that may identify ADA violations. The Coast Guard management continues to work to resolve four potential ADA violations relating to funds used in advance of an approved apportionment from OMB, funds used for construction and improvement projects, funds that may be been inappropriately administered the funding for modifications to fixed price contracts, and the improper execution of the obligation and disbursement of funds for the lease of passenger vehicles. National Protection and Programs Directorate (NPPD) management is continuing their review, initiated in FY 2007, over the classification and use of certain funds that may identify an ADA violation. The GAO reported that the United States Secret Service (USSS) spending, in one fund, exceeded the amount budgeted in its fiscal year 2009 Presidential Candidate Nominee Protection PPA. The Management Directorate is currently investigating whether rental charges incurred in FY 2008 and FY 2009 were not properly committed or obligated.

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

IV-N ***Government Performance and Results Act of 1993***

The *Government Performance and Results Act of 1993* requires each agency to prepare performance plans that include a description of the operational processes, skills and technology, and the resources required to meet the goals, and a description of the means used to verify and validate the measured results. In addition, the AFR should include performance indicators established in the annual strategic and performance plan, the actual performance achieved compared with the prior year goals, and an evaluation of the current year performance plan with respect to success in achieving the performance goals. DHS recently completed a quadrennial review for the purpose of developing an updated strategic plan around new priorities established by the Secretary. However the Department has not formally revised and adopted a new strategic plan. Since DHS has not updated its strategic plan, the Statements of Net Cost as of September 30, 2010 and 2009 have not been presented by major program, goals and outputs, and certain related financial statement disclosures, required by OMB Circular No. A-136, *Financial Reporting Requirements*, as amended, are not included in the FY 2010 AFR. In addition, DHS is did not include summary performance information that is aligned with its strategic goals and other information, within the MD&A section of the FY 2010 AFR.

Recommendation: We recommend that DHS develop policies and procedures to ensure full compliance with the *Government Performance Results Act of 1993* in FY 2011.

Summary of Conditions As Reported in the 2009 DHS Annual Financial Report		Fiscal Year 2010 Status/ Disposition
Material Weaknesses:		
A.	**Financial Reporting**	
A.1	There are several Department of Homeland Security (DHS or Department) Department-wide control environment weaknesses affecting financial reporting. The Department lacks a sufficient number of accounting and financial management personnel with core technical competencies to ensure financial statements are prepared accurately and in compliance with generally accepted accounting principles. DHS's accounting and financial reporting infrastructure have not received investments in proportion to the Department's rapid growth. The Department's IT infrastructure is aging and has limited functionality.	**Partially Repeated** (Exhibit II-A)
A.2	The Coast Guard had not developed and implemented an effective general ledger system. The general ledgers are not compliant with the United States Government Standard General Ledger (USSGL). The Coast Guard had deficiencies in its policies, procedures, and controls surrounding its financial reporting process, and did not have adequate beginning balance or year-end close out procedures or cumulative results of operations analysis. The Coast Guard did not have adequate policies or procedures to ensure that transactions are appropriately supported and accounted for in its general ledgers. The Coast Guard did not have effective policies and procedures to identify the cause and resolve abnormal balances and account relationship discrepancies, e.g. budgetary to proprietary reconciliations. The Coast Guard did not have a process to reconcile and resolve differences between intragovernmental transactions with its Federal trading partners.	**Partially Repeated** (Exhibit I-A)
A.3	TSA did not have a sufficient number of accounting personnel with technical accounting proficiencies to perform essential accounting and financial reporting functions, ensure segregation of duties, and identify financial reporting issues on a timely basis. TSA had not developed and implemented procedures to fully analyze the effects of its accounting policies to ensure full compliance with GAAP. TSA is not compliant with the USSGL requirements at the transaction level. TSA did not fully reconcile its intragovernmental balances with trading partners.	**Partially Repeated** (Exhibit II-A)
A.4	FEMA did not have sufficient experienced financial managers and staff to ensure segregation of duties in financial reporting roles. FEMA's financial reporting process was complex and required numerous "on-top" adjustments. FEMA did not have effective policies and procedures to identify the cause and resolve abnormal balances and account relationship discrepancies, e.g. budgetary to proprietary reconciliations.	**Partially Repeated** (Exhibit II-A)
A.5	CBP did not have sufficient resources or infrastructure to ensure proper and timely accounting and reporting. CBP did not have effective policies to properly account for and timely report significant new activities. CBP did not have an annual risk assessment process to timely identify and address new accounting standards.	**Corrected**

	Summary of Conditions As Reported in the 2009 DHS Annual Financial Report	Fiscal Year 2010 Status/ Disposition
B.	**Information Technology General and Application Controls**	
	DHS and its components had IT and financial system security control weaknesses in access controls, change controls, and service continuity.	**Repeated** (Exhibits I-B and II-B)
C.	**Fund Balance with Treasury (FBWT)**	
	The Coast Guard had not developed a comprehensive process to ensure all FBWT are recorded in the general ledger timely, completely and accurately. The Coast Guard did not maintain adequate supporting documentation that validated the accuracy for at least three of the six Agency Location Codes FBWT reconciliations. The Coast Guard recorded unsupported adjustments to general ledger FBWT accounts. The Coast Guard did not have an effective process for clearing suspense account transactions. The Coast Guard was unable to provide military payroll data to support payroll transactions processed through the FBWT account and did not have policies for processing and documenting military and civilian payroll transactions.	**Repeated** (Exhibit I-C)
D.	**Property, Plant, and Equipment**	
D.1	The Coast Guard had not consistently applied policies and procedures to ensure appropriate documentation is maintained to support Property Plant & Equipment (PP&E) acquisitions and their existence, and the methodologies and assumptions, to support the value of PP&E where documentation has not been maintained, has not been developed. The Coast Guard has not implemented appropriate controls to accurately, consistently, and timely record additions to PP&E and construction in process, transfers, disposals, and valuation and classification of repairable PP&E. The Coast Guard has not implemented accurate and complete asset identification, system mapping, and tagging processes for fixed assets, and has not properly accounted for some improvements and impairments to buildings and structures, capital leases, and selected useful lives. For Operating Materials and Supplies (OM&S), the Coast Guard had not implemented policies, procedures, and internal controls to support the assertions related to the OM&S account balances, or fully designed and implemented procedures over physical counts of OM&S. The Coast Guard has not properly identified recorded OM&S, or established processes and controls to fully support the calculated value of certain types of OM&S to approximate historical cost. The Coast Guard had not implemented policies, procedures or internal controls to support assertions related to stewardship PP&E.	**Partially Repeated** (Exhibit I-D)
D.2	TSA did not have policies and procedures to properly account for, monitor, and report PP&E related transactions, including other direct costs, idle or impaired assets, or peripheral equipment. TSA did not have policies or procedures to ensure assets are recorded, depreciated, and disposed of on a timely basis, identify heritage assets, or reconcile the subsidiary ledger.	**Repeated** (Exhibit II-D)

	Summary of Conditions As Reported in the 2009 DHS Annual Financial Report	Fiscal Year 2010 Status/ Disposition
D.3	CBP did not have adequate accounting policies, procedures, processes or controls to properly account for equipment purchases, transfers, construction or to allocate indirect costs to construction projects. CBP did not properly perform several physical annual inventories of real and personal property.	**Partially Repeated** (Exhibit II-D)
D.4	USCIS did not have adequate policies, procedures, or internal controls to ensure leasehold improvements, internal use software and software in development.	**Corrected**
D.5	NPPD did not have adequate policies, procedures, or internal controls to ensure hardware purchased by contractors was accurately and timely recorded in the general ledger.	**Corrected**
D.6	ICE did not have policies or procedures to properly account for internal use software or software in development in accordance with applicable accounting standards.	**Corrected**
E.	**Actuarial and Other Liabilities**	
E.1	The Coast Guard did not have an effective process to ensure the completeness and accuracy of data provided to, and used by, the actuary for the calculation of medical and postemployment benefit liabilities, and reconciliations between subsidiary and general ledgers for medical expenditures were not effective. The Coast Guard did not have an effective process to prevent overpayments for medical services. The Coast Guard did not have effective processes to account for military personnel data changes, which impacts the completeness and accuracy of leave and payroll accruals as well as data used for actuarial projections. The Coast Guard did not have a reliable methodology to estimate accounts payable. The Coast Guard did not support the completeness, existence, and accuracy assertions of the data utilized in developing the environmental liability estimate.	**Partially Repeated** (Exhibit I-E)
E.2	FEMA 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.*	**Partially Repeated** (Exhibit II-E)
E.3	TSA had not developed policies or procedures to accurately estimate its OTA accrued liability at year-end. TSA did not have policies or procedures to ensure accounts payable accruals are complete and accurate. TSA did not perform an independent analysis of vendor confirmations for which an accrual is based to determine accuracy of the confirmation.	**Corrected**

	Summary of Conditions As Reported in the 2009 DHS Annual Financial Report	Fiscal Year 2010 Status/ Disposition
F	**Budgetary Accounting**	
F.1	The 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, accurate, recorded timely, and that proper approvals and supporting documentation is maintained. The Coast Guard had not implemented procedures and controls to monitor unobligated commitment activity during the fiscal year. The Coast Guard did not have properly designed and implemented procedures, processes, and internal controls to verify the completeness and accuracy of the year-end obligation pipeline adjustment to record all executed obligations. The Coast Guard did not have controls to ensure procurement transactions are only processed by contracting officers with appropriate warrant authority.	**Repeated** (Exhibit I-F)
F.2	FEMA did not consistently monitor the status of its obligations as part of its normal operations and ensure the timely deobligation of mission assignments and grants. In addition, FEMA could not provide all supporting documentation for the sample of UDOs other than mission assignments and grant UDOs. Significant effort was required to identify the responsible parties and to access certain files or provide information to clearly support the balances reported in the financial statements.	**Partially Repeated** (Exhibit II-F)
F.3	CBP did not enforce its policies and procedures to monitor and deobligate or close-out its obligations in a timely manner.	**Repeated** (Exhibit II-F)
Other Significant Deficiencies:		
G.	**Entity Level Controls**	
G.1	The Coast Guard did not have adequate policies, procedures or controls associated with training for personnel with financial duties. The Coast Guard did not have standardized job descriptions or policies for hiring and evaluating financial employees. The Coast Guard did not have adequate controls with the Standards of Conduct to track and monitor compliance. The Coast Guard did not have an entity-wide policy to address management override of internal controls.	**Repeated** (Exhibit I-A and III-G)

	Summary of Conditions As Reported in the 2009 DHS Annual Financial Report	Fiscal Year 2010 Status/ Disposition
G.2	FEMA had not sufficiently developed effective methods of communication throughout the agency to ensure that significant financial-related events outside of the OCFO are timely communicated, including review and monitoring of its National Flood Insurance Program. FEMA did not complete the placement of sufficient financial and accounting resources related to mission assignments. FEMA had not completed documentation of policies and procedures for several roles, responsibilities, processes and functions within the agency. FEMA had not committed sufficient resources to ensure that personnel attend required ethics training. FEMA had not developed sufficient policies and procedures to designate position sensitivity for positions using, developing, or operating IT systems or track and maintain the status of background investigations.	**Partially Repeated** (Exhibit II-A and Exhibit III-G)
G.3	TSA had not implemented an agency-wide policy to address intervention of management override of internal controls.	**Corrected**
H.	**Custodial Revenue and Drawback**	
	The CBP 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. The CBP's 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. CBP was unable to determine the status of in-bond shipments and lacks policies and procedures that require monitoring of the results of in-bond audits. CBP did not perform an analysis to determine the potential loss of revenue through the in-bond process. CBP Compliance Measurement oversight guidance did not provide complete coverage over the CM program. There were inconsistencies in the performance of risk assessments of Bonded Warehouses and Foreign Trade Zones.	**Repeated** (Exhibit III-H)

Summary of Conditions As Reported in the 2009 DHS Annual Financial Report	**Fiscal Year 2010 Status/ Disposition**
Compliance and Other Matters:	
I. ***Federal Managers' Financial Integrity Act of 1982*** **and Laws and Regulations Supporting OMB Circular No. A-50,** ***Audit Follow-up,*** **as revised**	
The Coast Guard had 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, the Federal Law Enforcement Training (FLETC), National Preparedness Directorate (NPPD), and TSA's control assessment processes require improvement to ensure full compliance with FMFIA.	**Partially Repeated** (Exhibit IV-I)
J. ***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. In addition, we noted weaknesses in financial systems security, which impact the Department's ability to fully comply with FISMA.	**Repeated** (Exhibit IV-J)
K. ***Single Audit Act Amendments of 1996,***	
DHS and its components 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.	**Repeated** (Exhibit IV-K)
L. ***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 engaged an independent auditor to audit the September 30, 2009, consolidated balance sheet and statement of custodial activity only.	**Repeated** (Exhibit IV-L)

Summary of Conditions As Reported in the 2009 DHS Annual Financial Report	Fiscal Year 2010 Status/ Disposition
M. *Anti-deficiency Act*	
FEMA had initiated a preliminary review of certain expenditures in FY 2008 that may have violated the *Anti-deficiency Act* (ADA). The Coast Guard management continued to work to resolve two potential ADA violations. NPPD management continued to review the classification and use of certain funds that may identify an ADA violation as well as certain fees collected for attendance at a DHS-sponsored conference. United States Secret Service (USSS) performed a review of certain salaries and expenses that may identify a violation of ADA. In addition, various other management reviews and OIG investigations are on-going within the Department and its components that may identify ADA violations.	**Repeated** (Exhibit IV-M)

Office of the Chief Financial Officer
U.S. Department of Homeland Security
Washington, DC 20528

Homeland Security

November 12, 2010

MEMORANDUM FOR: Richard L. Skinner
Inspector General

P. Sherry

FROM: Peggy Sherry
Deputy Chief Financial Officer

SUBJECT: Fiscal Year (FY) 2010 Financial and Internal Controls Audit

Thank you for the opportunity to comment on the Independent Public Accountant's audit of our balance sheets, the related statement of custodial activities and internal controls as of September 30, 2010 and 2009. We agree with the Independent Public Accountant's conclusions.

Although the report indicates that DHS still faces financial management challenges, the auditor noted the Department's progress in improving the quality and reliability of our financial reporting. During FY 2010, our Components implemented corrective actions that significantly improved key financial management and internal control areas. As we grow closer to obtaining an audit opinion on the consolidated balance sheet and statement of custodial activities, DHS will discover additional opportunities for financial management improvement and will continue to strengthen internal controls and accountability.

The FY 2010 audit results show that our corrective actions are working, and we are already focusing our efforts on the remaining issues before us. I want to thank you for your efforts and the continued dedication by your staff to work collaboratively in addressing our challenges. As we continue our steadfast progress, I look forward to working with the Office of Inspector General and the Independent Public Accountant.

Appendix A
Management's Response

Office of the Chief Financial Officer
U.S. Department of Homeland Security
Washington, DC 20528

Homeland Security

November 12, 2010

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Inspector General

FROM: P Sherry
Peggy Sherry
Deputy Chief Financial Officer

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Appendix B
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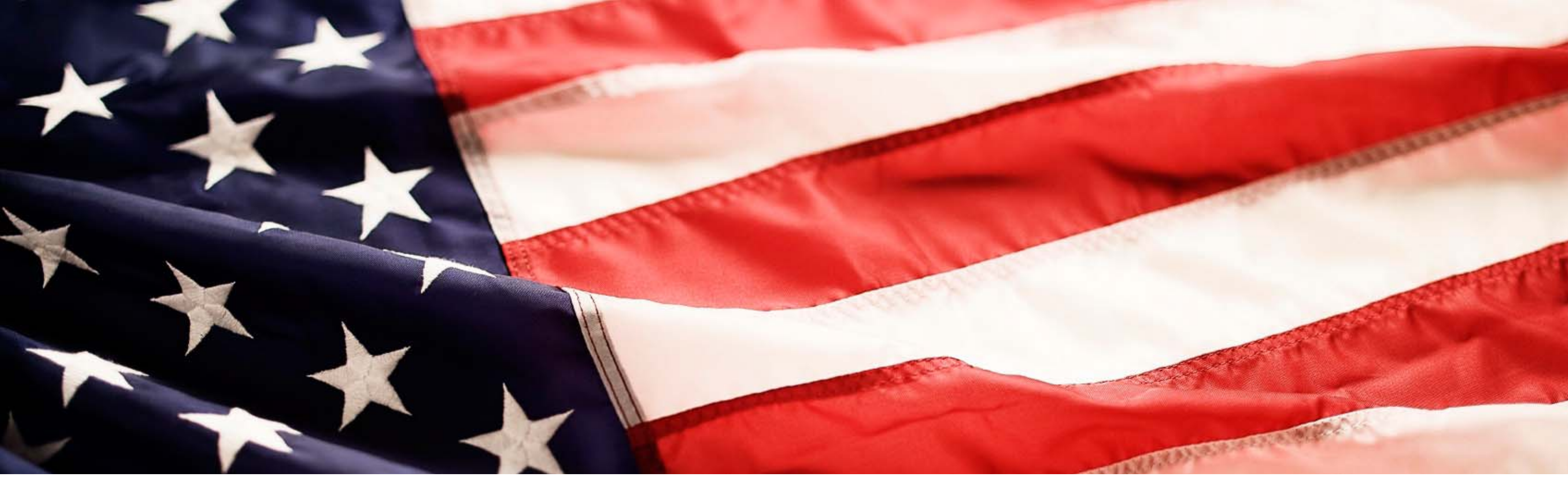

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