DEPARTMENT OF HOMELAND SECURITY

Office of Inspector General

Special Report: Letter on TSA's FY 2005 Financial Statements

Office of Audits

OIG-06-48 **July 2006**

Office of Inspector General

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

July 7, 2006

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 published by our office as part of our oversight responsibilities to promote economy, efficiency, and effectiveness within the department.

This special report presents a letter on TSA's FY 2005 financial statements prepared by the independent public accounting firm KPMG LLP (KPMG). We engaged KPMG to audit TSA's FY 2005 financial statements. This special report marks a significant departure from TSA's past performance in preparing auditable financial statements. For FY 2005, KPMG did not complete their audit because TSA did not provide KPMG with final financial statements on which KPMG could report.

However, during the period of their engagement, KPMG noted certain matters involving internal control and other operational matters that are included in the attached letter. Other matters may have been identified had KPMG been able to perform all procedures necessary to express an opinion on the TSA FY 2005 financial statements. KPMG is responsible for the attached letter dated March 14, 2006. We do not express an opinion on TSA's financial statements or conclusions on internal control or compliance with laws and regulations.

Of the matters identified by KPMG in the attached letter, our office recommends that TSA give prioritized attention to the following: accounting treatment of fees; financial reporting; financial systems security; grants monitoring and year-end accounting; undelivered orders, contract file maintenance, and letters of intent accrual; and obligation recoveries.

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

Richard L. Skinner

Richard L. Skinner
Inspector General

KPMG LLP
2001 M Street, NW
Washington, DC 20036

March 14, 2006

Mr. Richard L. Skinner
Inspector General
U.S. Department of Homeland Security
245 Murray Drive, S.W. Bldg. 410
Washington D.C. 20528

Dear Mr. Skinner:

We were engaged to audit the consolidated balance sheet of the U.S. Department of Homeland Security's Transportation Security Administration (TSA) as of September 30, 2005, and the related consolidated statements of net cost, changes in net position, and financing, and the combined statement of budgetary resources, for the year then ended (hereinafter referred to as the consolidated financial statements). TSA's management is responsible for preparing its consolidated financial statements.

We did not audit, review, or complete procedures related to the consolidated financial statements because management did not present final consolidated financial statements for audit. Accordingly, we are unable to provide an auditors' report on the consolidated financial statements.

In connection with our engagement to audit the consolidated financial statements, we were also engaged to consider TSA's internal control over financial reporting and to test TSA's compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on the consolidated financial statements. Our procedures do not include examining the effectiveness of internal control and do not provide assurance on internal control.

However, we noted certain matters involving internal control and other operational matters that are presented in Attachment A for your consideration. Further, other matters may have been identified had we been able to perform all procedures necessary to express an opinion on the consolidated financial statements. We would be pleased to discuss these comments and recommendations with you at any time.

Very truly yours,

KPMG LLP

Accounting Treatment of Fees

Background: The U.S. Department of Homeland Security's (Department) Transportation Security Administration (TSA) collects fees from passengers and air carriers to offset costs incurred in providing aviation security to the public. The fees collected are not sufficient to fully cover the costs incurred by TSA for aviation security. Accordingly, Congress provides an annual appropriation to fund TSA. TSA and its legal counsel have interpreted its annual appropriations law to state that the passenger and air carrier fees are not available for use without specific authorization from Congress. Accordingly, during the year (as in previous years), TSA accounted for the fees received as though the amounts were not available for use. However, to comply with Treasury's reporting requirements, TSA adjusted its general ledger *at year end* to present the fees collected as a rescission/reduction of appropriations for external reporting purposes – which is different than the accounting treatment used during the year.

Condition: This year-end adjustment results in a presentation of the fees collected that is not consistent with TSA's interpretation of the appropriation law. To resolve this inconsistency, in February 2006, the Department's Office of General Counsel (OGC) reviewed the applicable public law and concluded with a verbal interpretation of the appropriation law that differed from TSA's interpretation, and if followed may result in a change to the year-end adjustment recorded by TSA for FY 2005 and previous years. As of the date of this letter, the Department has not notified us about the resolution of this difference of opinion, and neither the Department nor TSA has completed an analysis to determine the impact of the Department OGC's interpretation on TSA's accounting treatment of these fees.

Recommendation: We recommend TSA in coordination with the Department:

1. Obtain a written opinion from the Department's OGC to support its verbal interpretation that the fees should be used by TSA.

2. Based on the Department OGC's opinion, determine the appropriate accounting treatment of fees from collection through disbursement, complete a year-by-year analysis (since TSA's inception) of the impact of the opinion on the year-end account balances, and prepare appropriate adjusting entries, as necessary. Develop and maintain documentation supporting the analysis and adjustments, including references to appropriate accounting literature.

3. Consult with appropriate personnel within the Department's Office of the Chief Financial Officer, the Office of Management and Budget (OMB), and the U.S. Department of Treasury's Financial Management Service to ensure agreement among all parties on the proposed accounting treatment. Once agreement is reached and documented, record the appropriate adjusting entries.

4. Resubmit the September 30, 2005, financial data with appropriately supported adjustments to the Department.

5. Support Departmental personnel in restating the Department's FY 2005 financial statements, if necessary.

Financial Reporting

Background: Beginning in FY 2005, the United States Coast Guard (Coast Guard) began providing accounting services to TSA. As such, the Coast Guard maintains TSA's general ledger and processes accounting transactions as directed by TSA.

Condition: TSA experienced difficulties in the monthly closing of its general ledger due, in part, to its change in accounting services providers. Specifically, as of June 30, 2005, we noted accruals had not been posted for all accounts, certain account balances had not been updated to reflect activity for the current year, account reconciliations were not performed timely throughout the year, material abnormal balances and analytical account variances were not resolved, and the Statement of Net Cost allocation methodology was not consistent with the methodology to be used at year end.

At year end, we noted accruals and other adjustments had not been posted for all accounts at the agreed upon time for audit, detailed schedules to support financial statement amounts were not provided timely, and material abnormal balances and analytical account variances were not resolved timely.

Recommendations: We recommend that TSA:

1. Implement formal, documented policies and procedures for the monthly and year-end closing processes to ensure that complete and accurate Treasury Information Executive Repository (TIER) financial data and financial statements can be prepared. Such processes must include timely posting of accounts and account reconciliations. Procedures should also identify the responsibilities of the accounting services provider and TSA; allow for adequate time for TSA to review financial information provided; provide for the timely resolution of abnormal balances and analytical variances; and require the documentation of the methodology underlying accounting estimates and any changes to it.

2. Develop and implement a process to identify a complete listing of post-closing adjustments to be provided to the accounting services provider and the Department.

3. Conduct a "lessons learned" session with all parties involved to discuss the closing process and those items that worked well and those that need to be improved.

Financial Systems Security

Background: Controls over information technology (IT) and related financial systems are essential elements of financial reporting integrity. Effective general controls in an IT and financial systems environment are typically defined in six key control areas: entity-wide security program planning and management, access control, application software development and change control, system software, segregation of duties, and service continuity. In addition to general controls, financial systems contain application controls, which are the structure, policies, and procedures that apply to separate, individual application systems, such as accounts payable, inventory, payroll, or grants.

Condition: During FY 2005, the Coast Guard began hosting the financial processing of key TSA financial applications. As such, our procedures over IT controls for TSA included a review of the Coast Guard's procedures, policies, and practices. We noted several actions taken by the Coast Guard to improve its IT general controls environment and to address many prior year IT general control issues. Additionally, the Department issued an update to Policy 4300A, *Sensitive System Handbook.* The purpose of this Handbook update was to provide specific techniques and procedures for implementing the requirements of the Department's IT Security Program for sensitive systems. The improved guidance resulted in the Coast Guard's correction of some conditions identified in prior years.

Despite these improvements, we continued to find IT general and application control weaknesses at the Coast Guard. Collectively, the IT control weaknesses at the Coast Guard limited TSA's ability to ensure that critical financial and operational data is maintained in a manner to ensure confidentiality, integrity, and availability.

Recommendation: Due to the sensitive nature of these findings, we have communicated our specific recommendations separately to management.

Grants Monitoring and Year-End Accounting

Background: FY 2004 was the first year TSA was responsible for preparing its own grant accrual estimate. TSA elected to follow the accrual methodology used by the DHS Office of State and Local Government Coordination and Preparedness (SLGCP). Comparison of the methodology's results with historical records is an important validation technique. Although TSA's grant activity decreased in FY 2005 because many grant programs were transferred to SLGCP in May 2004, TSA continued to issue and maintain certain types of grants.

Condition: TSA has not developed policies and procedures to properly monitor grantees' compliance with OMB Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Specifically, we noted the following procedures were not in place at TSA:

- To ensure that OMB Circular No. A-133 audit reports from grantees were received from the grantees or the Department's Office of Inspector General (OIG).

- To ensure that any findings on TSA grants in such audit reports were resolved and closed in a timely manner.

- For TSA management to issue management decisions on grantee audit findings within the six month timeframe required by OMB Circular No. A-133.

In addition, TSA did not validate its FY 2004 grant accrual to ensure the methodology used provided a reasonable estimate of the actual amount owed at September 30, 2004. Further, TSA had not developed policies and procedures to perform such a validation on an annual basis. This same methodology was to be used to estimate the grant accrual as of September 30, 2005.

We also noted several journal vouchers to record the year-end grant accrual were not posted by TSA's accounting service provider, totaling approximately $93 million.

Recommendation: We recommend that TSA:

1. Develop and implement a tracking system to identify each grantee for which an OMB Circular No. A-133 audit is required and the date that the audit report is due. TSA should then use this system to track the receipt of all completed audit reports, the issuance of TSA's management decision on TSA-related findings (if any), and the completion of appropriate corrective action by the grantee.

2. Establish sufficient and ongoing communication with the Department's OIG to verify the receipt and status of all OMB Circular No. A-133 audit reports for TSA grantees; place higher emphasis on following up with grantees and the Department's OIG for the audit reports that identify questioned costs or other significant findings; and ensure that timely resolution is documented.

3. Perform additional research on grantee spending patterns, including consultation with other grant-making entities for alternative methodologies, and develop and implement an accrual methodology that more closely captures TSA grantee spending activities.

4. Develop and implement formal, documented policies and procedures to ensure the grant accrual methodology is validated, at a minimum, on an annual basis.

Undelivered Orders, Contract File Maintenance and Letters of Intent Accrual

Background: In accordance with Federal appropriations law, entities in the Federal government are required to reserve funds for goods and services ordered but not yet delivered. This reserved amount is commonly referred to as an undelivered order (UDO). The UDO balance is the difference in value between the total order placed and the goods or services received to date. Larger UDO balances are typically associated with larger purchases, where the period of performance or terms of delivery span multiple accounting periods. Accurate UDO balances are essential to maintaining the status of budgetary accounts and estimating TSA's general accounts payable at year-end.

Condition: During the course of our interim and year-end procedures for UDOs, we were unable to obtain documentation in a timely manner to substantiate amounts recorded in the TSA's general ledger, which totaled $1.4 billion at September 30, 2005. With regard to our year-end procedures over a sample of 63 items, TSA did not provide documentation for three items. Further, our procedures identified differences between source documentation and recorded amounts in 32 of the remaining 60 sample items ranging from a few dollars to several million dollars. Further, TSA had to expend substantial effort to locate files, provide missing documentation and substantiate the amount recorded in the general ledger in order to support our required UDO procedures.

Additionally, we noted that at year-end TSA accrued as a payable the entire UDO balance for Letters of Intent[1] (LOI). As a result of certain confirmation procedures we performed as of September 30, 2005, we determined that this accrual policy resulted in the overstatement of payables and the understatement of UDOs in the year-end unadjusted general ledger.

Recommendation: We recommend that TSA develop and implement policies and procedures to:

1. Regularly review contract files and MarkView[2] to ensure all procurement and expense supporting source documentation has been maintained and those amounts are consistent with amounts recorded in the general ledger.

2. Retain all procurement and expense supporting source documentation in a manner that facilitates timely document retrieval.

3. Maintain current procurement contact information in the database.

4. Accrue LOI payables at year-end based on actual or estimated unreimbursed expenses. If the payables are estimated, the related methodology should be documented and periodically validated.

Human Resources

Background: TSA is required to maintain complete and accurate personnel records. These records support employee salaries and deduction calculations.

Condition: During the course of performing procedures related to Human Resources, we noted certain payroll amounts (i.e., employee salaries) did not match the documentation contained in the employee files.

Recommendation: We recommend TSA develop and implement policies and procedures to ensure documentation supporting salary are properly maintained in employee files.

Revenue and Accounts Receivable

Background: TSA's Office of Financial Management (OFM) prepares a Revenue Reconciliation to reconcile the general ledger to Treasury's CashLink reports. The Coast Guard, TSA's accounting services provider, closes TSA's general ledger three to four days before the end of every month. However, TSA receives the majority of its passenger and air carrier fees in the last three to four days of the month through its lockbox, FedWire, and Pay.Gov Cashlink. Because of the early closing, TSA posts an on-top adjustment to its financial statements based on the Revenue Reconciliation.

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[1] Letters of Intent represent agreements entered into by TSA to reimburse certain airports for a percentage of the cost to modify the facility for security purposes.

[2] MarkView is an electronic data warehouse that stores vendor invoices.

Condition: Our review of the June Revenue Reconciliation and the Accounts Receivable Accrual Schedule identified an error of approximately $180 million. This error resulted from an incorrect carry-forward amount and inclusion of an amount that should have been reversed.

Recommendation: We recommend TSA's OFM:

1. Ensure the Revenue Reconciliations and Accounts Receivable Accrual Schedules are reviewed (both the amounts and mathematical accuracy) by an appropriate level of management and contain evidence of the review (e.g., signature).

2. Formalize policies and procedures for reviewing documentation supporting all on-top adjustments to the financial statements and manual journal vouchers posted to the general ledger.

Imputed Financing

Background: Imputed intra-departmental costs are defined by Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards*, and again in Interpretation of Federal Financial Accounting Standards (Interpretation) No. 6, *Accounting for Imputed Intra-departmental Costs: An Interpretation of SFFAS No. 4*, as the unreimbursed portion of the full cost of goods and services received by an entity (whether recognized or not) from a providing entity that is part of the same department or larger reporting entity. SFFAS No. 4 provides the accounting and implementation guidance of these costs in paragraphs 108 through 115. Interpretation No. 6 clarifies the requirement that the accounting applies to both imputed intra-Departmental and inter-Departmental costs.

Condition: TSA does not have procedures in place to capture, record, and report imputed intra-departmental costs and the related imputed financing sources (i.e., related to those bureaus within the Department where the cost of providing goods or services to TSA exceeds the amount charged to TSA).

Recommendation: TSA, with Departmental guidance, should develop and implement policies and procedures to properly recognize the amount of imputed intra-departmental costs in financial reports submitted to the Department on a quarterly basis.

Obligation Recoveries

Background: Recoveries of obligations are cancellations or downward adjustments in the current year for obligations incurred in prior fiscal years that were not yet expended. The United States Standard General Ledger (USSGL) provides a uniform chart of accounts and technical guidance to be used in standardizing Federal agency accounting, which supports the preparation of standard external reports required by central agencies.

Condition: The financial system used by TSA's service provider did not have the ability to process amounts deobligated from prior year obligations (i.e., recoveries) at the transaction level in accordance with Federal financial management system requirements. Accordingly, the prior year recoveries identified during FY 2005 were manually tracked and recorded.

Recommendation: We recommend that TSA work with its accounting service provider to establish the necessary programming logic in the service provider's financial system to capture and report amounts deobligated at the transaction level in accordance with Federal financial management system requirements.

Reporting Supplementary Information

Background: OMB Circular No. A-136, *Financial Reporting Requirements,* requires that Federal financial statements include certain information that is financial in nature or that concerns certain resources entrusted to the reporting agency.

Condition: In performing our procedures related to the accumulation and reporting of Required Supplementary Stewardship Information (RSSI) amounts, TSA provided a schedule supporting RSSI amounts that were to be reported for FY 2005. However, we learned that the RSSI amounts to be reported were not reviewed and approved by someone other than the preparer.

Additionally, we noted TSA's draft FY 2005 RSSI, specifically investments in human capital and research and development, did not report outcomes and outputs as required by OMB Circular No. A-136.

Recommendation: We recommend that TSA develop and implement supervisory review policies and procedures over the reporting of RSSI. Further, TSA should develop and implement procedures to track relevant outcomes and outputs and report them as part of RSSI.

Office of the Assistant Secretary

U.S. Department of Homeland Security
601 South 12th Street
Arlington, VA 22202-4220

JUN 16 2006

Transportation
Security
Administration

ACTION

MEMORANDUM FOR: Richard L. Skinner
Inspector General

FROM: Kip Hawley KP
Assistant Secretary

SUBJECT: Draft Report: Letter on TSA's FY 2005 Financial Statements

Thank you for the opportunity to review and comment on the draft report titled "Letter on TSA's FY 2005 Financial Statements." The audit firm of KPMG LLP was engaged to perform a full-scope audit of TSA's consolidated balance sheet and related statements of net cost, changes in net position, budgetary resources, financing, and the accompanying notes. We have reviewed the report and its recommendations, and with certain exceptions noted below, we concur with the report.

During the final months of the FY 2005 financial statement audit, KPMG began to question the accounting policy used by TSA to report fees collected from airlines and airline passengers. After much analysis, it was determined that the policy followed in reporting these collections on the financial statements, despite having been acceptable to KPMG from TSA's inception in FY 2002 through FY 2004, was no longer acceptable. We recognize that as TSA and DHS evolve as organizations, policy changes and clarifications are to be expected. Accordingly, TSA and DHS management decided to end the FY 2005 financial statement audit, begin the process of resubmitting FY 2005 financial data in accordance with new fee reporting policies, and implementing required reporting changes for FY 2006 and beyond. It is important to note that the policy change is a matter of financial statement presentation – it has no bottom-line impact on the amount of budgetary resources used by TSA and it does not reflect on TSA's performance as a prudent steward of public funds.

During the course of the audit, KPMG noted certain operational and internal control weaknesses and offered recommendations to address them. The recommendations and the actions we are taking in response to them are outlined below:

1. **Accounting Treatment of Fees**. Concur. We have obtained a written opinion from the DHS Office of General Counsel to support its verbal interpretation that airline passenger and carrier fees should be retained and used by TSA. New procedures to implement the accounting policy change are being implemented and we are currently finalizing revisions to TSA's

September 30, 2005 financial statements. Our FY 2006 financial statements will reflect the new fee reporting policy interpretation.

2. **Financial Reporting**. Concur. We are working to implement all facets of this recommendation, including developing formal procedures for month and year-end closings, improving documentation of on-top adjustments to the financial statements and manual journal vouchers posted to the general ledger (especially those impacting the budgetary accounts), and scheduling of periodic "lessons learned" meetings to discuss the closing process.

3. **Financial Systems Security**. Concur. As noted in the draft report, the U.S. Coast Guard (USCG) Finance Center (FINCEN) began hosting TSA's financial applications and providing certain accounting services for TSA on a reimbursable basis in FY 2005. FINCEN is aware of the security weaknesses impacting TSA as they may also impact USCG's internal financial processing. FINCEN has provided TSA with copies of corrective action plans in response to security related audit findings and provides periodic updates as needed.

4. **Grants Monitoring and Year End Accounting**. Concur. We have coordinated with the DHS Office of Grant Policy and Oversight to strengthen and enforce grantee reporting requirements. With regard to the grants payable accrual, we are increasing staff focus on this key balance sheet liability and are developing procedures to periodically review the accrual methodology.

5. **Undelivered Orders, Contract File Maintenance and Letters of Intent Accrual**. Concur. In order to ensure that undelivered orders (obligations) recorded in the financial system are consistent with contract files, we have undertaken a validation and verification effort. This effort, which will become a recurring process, involves tracing balances reported in the system back to the source documentation and processing adjustments where required. With regard to the accounts payable accrual for Letters of Intent, we have implemented procedures to proactively confirm the FY 2006 3rd quarter actual balances and estimated year-end balances directly with the recipients.

6. **Human Resources**. Concur. We have developed and implemented policies and procedures to ensure documentation supporting salary levels is properly maintained in employee files. A contractor was hired to sample employee files and validate the corrective action. The contractor's sampling verified that the documentation problems had been resolved.

7. **Revenue and Accounts Receivable**. Concur. We accept the recommendations and are working to implement them by increasing management review of accounts receivable data and improving documentation of on-top adjustments to the financial statements and manual journal vouchers posted to the general ledger.

8. **Imputed Financing**. Concur with comment. TSA did not benefit from any intra-departmental imputed financing (another DHS bureau providing services to TSA without reimbursement) in FY 2005. We agree that policies should be developed to properly recognize the amount of imputed intra-departmental costs. However, this finding is more appropriately directed to DHS. In order to accurately report the cost of a service provided to another component (without reimbursement), the providing component must calculate the actual cost and notify the receiving bureau of that cost. TSA will work closely with DHS to develop procedures to properly recognize and report imputed intra-departmental costs in financial reports.

9. **Obligation Recoveries**. Concur. We have worked with our accounting service provider, the USCG FINCEN, to establish software capability to capture and report prior year obligation amounts deobligated at the transaction level in accordance with Federal financial management system requirements. This functionality is currently being tested. It is expected to be deployed in the 4th quarter of FY 2006 with full use beginning in FY 2007.

10. **Reporting Supplemental Information**. Concur. We are updating our procedures for reporting Required Supplementary Stewardship Information (RSSI) pertaining to grant programs, human capital, and research and development. As part of that effort, additional management oversight will be incorporated to ensure that the RSSI meets all requirements of the revised version of OMB Circular A-136, issued August 23, 2005.

The FY 2006 Financial Statement Audit began with the entrance conference on April 13, 2006. TSA will receive a stand-alone audit of its balance sheet. It is our goal to address the recommendations discussed above and improve our audit results.

I wish to take this opportunity to thank the Office of the Inspector General for taking the time to review, edit, and issue this report.

If you have additional questions, please contact Mr. Jeffrey Bobich, Acting Director, Office of Financial Management, at (571) 227-2118.

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