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COMMITTEE ON GOVERNMENT REFORM

U.S. HOUSE OF REPRESENTATIVES

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Good morning Mr. Chairman and Members of the Subcommittee: I am Richard L. Skinner, Acting Inspector General for the Department of Homeland Security (DHS). Thank you for the opportunity to be here today to discuss the work of the Office of Inspector General (OIG) regarding financial management at DHS.

State of DHS' Current Financial Reporting

DHS received a disclaimer of opinion on its FY 2004 financial statements¹; however, this overall disclaimer obscured some good news: for several DHS components with accounting operations, the auditors found relatively few problems that contributed to DHS' 10 material weaknesses. When one analyzes the reasons for the disclaimer and the material weaknesses, the "critical path" for improving financial reporting becomes clear: fix the processes at Immigration and Customs Enforcement (ICE), at Coast Guard, and in the DHS Office of the Chief Financial Officer.

I am pleased to report that the DHS CFO has taken significant steps in addressing the auditor's recommendations regarding the structure of his office. The CFO has hired a deputy CFO, added several accountants to his staff, and contracted with an accounting firm to evaluate the consolidated financial reporting process located in his office. His office has developed automated procedures that identify abnormalities in DHS and component financial reporting. Financial management staff in the bureaus research these abnormalities, and the CFO's staff monitor the bureaus' progress. The financial statement auditors will be reviewing these changes for effectiveness in the current audit cycle. The CFO is to be commended for taking these positive actions.

Coast Guard also has made some structural improvements. It created an additional civilian position to oversee and coordinate its financial reporting in order to lend continuity to the rotational environment of the military. This has allowed the hiring of an experienced, specialized financial manager at Coast Guard headquarters. Coast Guard also hired a contractor to evaluate its internal controls for certain significant financial processes, and this initiative has been rolled into a pilot program as part of DHS' overall effort to implement the DHS Financial Accountability Act.

ICE presents the most critical financial reporting challenge for DHS. Its financial management problems have reverberated throughout DHS, consuming large amounts of management time and affecting the accounts of other significant DHS components. Unless these problems are addressed in a significant way, DHS will have great difficulty completing its financial statements in time for the auditors to complete their work by the accelerated deadline of November 15. I will comment in more detail shortly about the challenges at ICE and the circumstances from which these acute problems arose.

¹ This disclaimer of opinion was due to financial management weaknesses at ICE, the inability to complete audit procedures over certain costs and budgetary transactions at the Coast Guard, the lack of reconciliations for intra-governmental balances, and the accelerated reporting deadline of November 15 that prevented an extension of audit procedures.

With regard to DHS' financial statements, the DHS CFO set a three-year vision for obtaining an unqualified audit opinion by FY 2007, starting with a qualified opinion on its balance sheet this year. The FY 2005 financial statement audit is well underway. In order to meet the accelerated reporting deadline, the auditors must perform the majority of their testing on June 30 balances. This phase of the audit has just begun. The department faces major challenges, particularly at ICE and Coast Guard, and is well aware that they have very limited time to address any problems during this phase.

Financial Management Challenges at ICE

When the department was established in 2003, three new bureaus were created out of two legacy agencies: the former Immigration and Naturalization Service (INS) and the U.S. Customs Service were divided into ICE, Customs and Border Protection (CBP), and U.S. Citizenship and Immigration Services (USCIS). To implement this new structure, DHS and bureau management said that they spent a significant amount of time dividing the administrative infrastructure of the two legacy agencies; at the same time, this infrastructure had to continue providing services to the new bureaus.

ICE had the greatest difficulty with this change. Because ICE retained much of the legacy INS infrastructure, it provided significant reimbursable services to other DHS bureaus. However, the parties involved did not agree to the level and cost of those services until late in FY 2004. This delay contributed to significant budget difficulties for ICE. In addition, in FY 2004, ICE began providing accounting services for several DHS components, such as the Science and Technology Directorate, whose previous service providers often were legacy departments or agencies outside of DHS. DHS and ICE had little time to develop a thorough, well-designed plan for this transition and either could not or did not get the skilled resources to develop and execute such a plan. Further, starting in the summer of 2003, ICE lost key, experienced financial staff, some who went to another DHS bureau. It is hard to overstate the toll these changes took on the state of ICE's financial management, the results of which flowed directly into DHS' consolidated financial reporting.

The financial statement auditors reported that in FY 2004 ICE fell seriously behind in basic accounting functions, such as account reconciliations, analysis of material abnormal balances, and proper budgetary accounting. They reported that weaknesses in controls might have allowed ICE to violate the Antideficiency Act or prevented management from knowing if they were in violation; however, the auditors were unable to complete their procedures because ICE had not adequately maintained its accounting records.

ICE has recently appointed a new acting CFO and financial management director. The financial statement auditors are currently reviewing the conditions at ICE. Our observations thus far are that ICE continues to struggle with its financial reporting.

Status of Material Weaknesses

KPMG identified 10 material weaknesses in internal control at DHS in FY 2004. ICE or Coast Guard were primary contributors to six material weaknesses: financial management at ICE; Fund Balance with Treasury; property, plant and equipment (PP&E); operating materials and supplies (OM&S); accounts payable and disbursements; and budgetary accounting. ICE or Coast Guard also were significant contributors, along with other components, to two other material weaknesses: financial reporting and intra-governmental and intra-departmental balances. The material weakness related to financial management structure was directed to the DHS Office of the CFO. The tenth material weakness related to information technology security, to which all bureaus were contributors.

As discussed earlier, the CFO has taken significant steps to address the weakness directed to his office. We anticipate that the two material weaknesses related to PP&E and OM&S will continue through FY 2005 based on longer-term corrective action plans at the Coast Guard. DHS has required bureaus to prepare and submit corrective plans for all material weaknesses to which they contribute; however, the department does not have easy fixes for most of these problems.

Implementing Internal Control Requirements of DHS Financial Accountability Act

The DHS Financial Accountability Act presents a tremendous challenge to DHS because of its requirement for an audit of internal controls over financial reporting in FY 2006. In FY 2005, DHS must provide an assertion about those internal controls.

The CFO is taking these requirements seriously, is committing department and bureau resources to the project, and has taken or is taking the following significant actions:

- Established an internal control committee with representatives from DHS, components, and lines of business;
- Developed a detailed draft implementation guide for use next year in supporting its internal control assertion that must be audited, and conducted training on the guide;
- Requiring the use of the Government Accountability Office's (GAO) *Internal Control and Management Evaluation Tool* by components and lines of business to support this year's assertion, as an interim step into next year's use of the implementation guide;
- Started pilot projects using the implementation guide at Coast Guard;
- Subjected the consolidated financial reporting process in his own office to an assessment using the draft implementation guide, performed by a contracted accounting firm.

To help provide some perspective on how enormous this challenge is for DHS, I would like to discuss some of the things DHS and its components will have to do to achieve a clean audit opinion on its internal controls over financial reporting. We base this on

discussions with our contract auditor and our expectation that the audit will have to be performed using the American Institute of Certified Public Accountants' (AICPA) revised standard, AT 501, *Reporting on an Entity's Internal Control of Financial Reporting*, which is currently in draft and incorporates changes that have occurred in the auditing environment since the establishment of the Public Company Accounting Oversight Board by the Sarbanes-Oxley Act. To "pass" such an audit, DHS and its bureaus will have to support an assertion that its controls are properly designed and operating effectively by doing the following:

- Identifying relevant controls for accounts and disclosures that are significant to the financial statements;
- Evaluating whether the controls are effectively designed;
- Testing whether the controls are operating effectively;
- Identifying deficiencies that are material weaknesses;
- Documenting all of the above; and
- Implementing effective corrective actions.

To a degree, auditors do this already when performing financial statement audits according to GAO guidance. However, under the new AICPA standard, the department will also have to perform these procedures to support its assertion. Under the Office of Management and Budget's revised Circular A-123, *Management's Responsibility for Internal Control*, all federal departments will be required to meet similar requirements starting in FY 2006 to support their assertions for the Federal Managers' Financial Integrity Act. However, in DHS' case, its assertion will be audited.

This approach is an excellent way to embed internal control into an organization, but it takes significant time and resources to achieve, and DHS faces particular challenges. DHS already has 10 material weaknesses and as of FY 2004 had a disclaimer of opinion on its financial statements. The CFO must focus on corrective actions at ICE and Coast Guard to achieve an unqualified financial statement audit opinion. The CFO Act agencies had several years to prepare financial statements before they had to meet an accelerated reporting deadline. In its third year of financial reporting, DHS will now lead the way among the executive departments in audits of internal control over financial reporting.

With resources and leadership, DHS, like other organizations, can be successful accomplishing these objectives. But short of that, it could be a long road.

Strengthening the Role of the CFO

I have previously reported my concern about the CFO's authority within the Department in the 2004 Management Challenges report. My concern was that under the Department's management directive, he does not have direct authority over financial management personnel at the DHS components. Component heads retain control over the financial management resources in their organization. This concept of operations tends to divide the responsibility for financial management from the authority to command the resources needed for good financial management.

Although in general I still have this concern, I am encouraged by the Secretary's and Deputy Secretary's commitment to financial management. In my meetings with them, they have made financial management in the department a priority. Further, the DHS Financial Accountability Act, if properly implemented, should bring strong internal control processes to the department and its bureaus. We will be auditing the department's progress in implementing this Act. The Secretary recently issued a memorandum to his executive management on the importance of meeting the Act's requirements. With strong leadership at the top, we look forward to steady progress by the department in transforming its financial management.

Mr. Chairman, that completes my prepared statement. I would be happy to answer any questions you or the members may have.