

OFFICE OF INSPECTOR GENERAL

**Independent Auditors'
Report on DHS' FY 2016
Financial Statements and
Internal Control over
Financial Reporting**



Homeland
Security

**November 14, 2016
OIG-17-12**



DHS OIG HIGHLIGHTS

Independent Auditors' Report on DHS' FY 2016 Financial Statements and Internal Control over Financial Reporting

November 14, 2016

Why We Did This Report

The *Chief Financial Officers Act of 1990* (Public Law 101-576) and the *Department Of Homeland Security Financial Accountability Act* (Public Law 108-330) require us to conduct an annual audit of the Department of Homeland Security's (DHS) consolidated financial statements and internal control over financial reporting.

What We Recommend

KPMG LLP made 51 recommendations to address three material weakness and three significant deficiencies, including issues related to information technology and financial system functionality; financial reporting; and property, plant and equipment.

For Further Information:

Contact our Office of Public Affairs at (202) 254-4100, or email us at DHS-OIG.OfficePublicAffairs@oig.dhs.gov

What We Found

The independent public accounting firm KPMG LLP (KPMG) has issued an unmodified (clean) opinion on DHS' consolidated financial statements. KPMG noted that the financial statements present fairly, in all material respects, DHS' financial position as of September 30, 2016.

KPMG issued an adverse opinion on DHS' internal control over financial reporting of its financial statements as of September 30, 2016. The report identifies six significant deficiencies in internal control; three of which are considered material weaknesses. The material weaknesses are in information technology controls and financial system functionality; financial reporting; and property, plant, and equipment. The report also identifies instances of noncompliance with four laws and regulations.

Management's Response

The Department concurred with the independent auditors' conclusions and indicated that management will continue to implement corrective actions to improve financial management and internal control.



OFFICE OF INSPECTOR GENERAL

Department of Homeland Security

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

November 14, 2016

MEMORANDUM FOR: The Honorable Jeh C. Johnson
Secretary

FROM: John Roth 
Inspector General

SUBJECT: *Independent Auditors' Report on DHS' FY 2016 Financial Statements and Internal Control over Financial Reporting*

The attached report presents the results of an integrated audit of the Department of Homeland Security's (DHS) fiscal year (FY) 2016 financial statements and internal control over financial reporting. This is a mandatory audit required by the *Chief Financial Officers Act of 1990*, as amended by the *Department of Homeland Security Financial Accountability Act of 2004*. This report is incorporated into the Department's FY 2016 *Agency Financial Report*. We contracted with the independent public accounting firm KPMG LLP (KPMG) to conduct the audit.

The Department continued to improve financial management in FY 2016 and achieved an unmodified (clean) opinion on all financial statements. However, KPMG issued an adverse opinion on DHS' internal control over financial reporting because of material weaknesses in internal control.

Summary

KPMG identified six significant deficiencies in internal control, of which three are considered material weaknesses. DHS also identified the same material weaknesses in the *Secretary's Assurance Statement*.

The following are the three significant deficiencies in internal control considered to be material weaknesses, the three other significant deficiencies in internal control, and the four laws and regulations with which KPMG identified instances of DHS' noncompliance:

Significant Deficiencies Considered To Be Material Weaknesses

- Information Technology Controls and Financial System Functionality
- Financial Reporting
- Property, Plant, and Equipment



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Department of Homeland Security

Other Significant Deficiencies

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

Laws and Regulations with Identified Instances of Noncompliance

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

Moving DHS' Financial Management Forward

The Department continued its commitment to identifying areas for improvement, developing and monitoring corrective actions, and establishing and maintaining effective internal controls over financial reporting this past fiscal year. Looking forward, the Department must continue remediation efforts, and stay focused, in order to sustain its clean opinion on its financial statements and obtain an unqualified (clean) opinion on its internal control over financial reporting.

KPMG is responsible for the attached Independent Auditors' Report dated November 14, 2016, and the conclusions expressed in the report. To ensure the quality of the audit work performed, we evaluated KPMG's qualifications and independence, reviewed the approach and planning of the audit, monitored the progress of the audit at key points, reviewed and accepted KPMG's audit report, and performed other procedures that we deemed necessary. Additionally, we provided oversight of the audit of financial statements and certain accounts and activities conducted at key components within the Department. Our review, as differentiated from an audit in accordance with generally accepted governments auditing standards, was not intended to enable us to express, and we do not express, an opinion on the financial statements or internal control or provide conclusions on compliance with laws and regulations. Our review disclosed no instances where KPMG did not comply, in all material respects, with generally accepted governments auditing standards.



OFFICE OF INSPECTOR GENERAL
Department of Homeland Security

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

We request that the Department provide us with a corrective action plan that demonstrates progress in addressing the report's recommendations.

Please call me with any questions, or your staff may contact Maureen Duddy, Deputy Assistant Inspector General for Audits, at (617) 565-8723.

Attachment



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Department of Homeland Security

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KPMG LLP
Suite 12000
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Washington, DC 20006

Independent Auditors' Report

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

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of the U.S. Department of Homeland Security (DHS or Department), which comprise the consolidated balance sheets as of September 30, 2016 and 2015, and the related consolidated statements of net cost, changes in net position, and custodial activity, and combined statements of budgetary resources for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 15-02, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 15-02 require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.



Opinion on the Financial Statements

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the U.S. Department of Homeland Security as of September 30, 2016 and 2015, and its net costs, changes in net position, budgetary resources, and custodial activity for the years then ended in accordance with U.S. generally accepted accounting principles.

Emphasis of Matter

As discussed in Notes 1T, 15, and 25 of the consolidated financial statements, the Department had intragovernmental debt of approximately \$23 billion used to finance the *National Flood Insurance Program* (NFIP) as of both September 30, 2016 and 2015, respectively. Due to the subsidized nature of the NFIP, the Department has determined that future insurance premiums, and other anticipated sources of revenue, may not be sufficient to repay this debt. Legislation will need to be enacted to provide funding to repay or forgive the debt. Our opinion is not modified with respect to this matter.

Other Matters

Interactive Data

Management has elected to reference to information on websites or other forms of interactive data outside the *Agency Financial Report* to provide additional information for the users of its financial statements. Such information is not a required part of the basic consolidated financial statements or supplementary information required by the Federal Accounting Standards Advisory Board. The information on these websites or the other interactive data has not been subjected to any of our auditing procedures, and accordingly we do not express an opinion or provide any assurance on it.

Required Supplementary Information

U.S. generally accepted accounting principles require that the information in the Management's Discussion and Analysis, Required Supplementary Information, and Required Supplementary Stewardship Information sections be presented to supplement the basic consolidated financial statements. Such information, although not a part of the basic consolidated financial statements, is required by the Federal Accounting Standards Advisory Board who considers it to be an essential part of financial reporting for placing the basic consolidated financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic consolidated financial statements, and other knowledge we obtained during our audits of the basic consolidated financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audits were conducted for the purpose of forming an opinion on the basic consolidated financial statements as a whole. The information in the Message from the Secretary, Message from the Chief Financial Officer, and Other Information section, as listed in the Table of Contents of the *DHS Agency Financial Report*, is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the basic consolidated financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Opinion on Internal Control Over Financial Reporting

We have audited DHS's internal control over financial reporting as of September 30, 2016, based on criteria established in the *Standards for Internal Control in the Federal Government* issued by the Comptroller General of the United States. DHS's management is responsible for maintaining effective internal control over financial reporting and for its evaluation of the effectiveness of internal control over financial reporting, included in the accompanying *Secretary's Assurance Statement* presented in the Management's Discussion and Analysis. Our responsibility is to express an opinion on the DHS's internal control over financial reporting based on our audit.



We conducted our audit in accordance with attestation standards established by the American Institute of Certified Public Accountants; the standards applicable to attestation engagements contained in *Government Auditing Standards* issued by the Comptroller General of the United States; and the internal control audit requirements included in OMB Bulletin No. 15-02. Those standards and OMB Bulletin No. 15-02 require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with U.S. generally accepted accounting principles. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

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 a combination of deficiencies, in internal control over financial reporting, 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. The following material weaknesses described in the accompanying Exhibit I have been identified and included in the *Secretary's Assurance Statement*.

- A. Information Technology Controls and Financial System Functionality
- B. Financial Reporting
- C. Property, Plant, and Equipment

In our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, DHS has not maintained effective internal control over financial reporting as of September 30, 2016, based on the criteria established in the *Standards for Internal Control in the Federal Government* issued by the Comptroller General of the United States. We do not express an opinion or any other form of assurance on management's evaluation and assurances made in the *Secretary's Assurance Statement*.

In accordance with *Government Auditing Standards*, we are required to report findings of significant deficiencies. 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. We consider the following deficiencies described in the accompanying Exhibit II to be significant deficiencies.

- D. Entity-Level Controls
- E. Grants Management
- F. Custodial Revenue and Refunds and Drawbacks

We considered the material weaknesses and significant deficiencies identified above in determining the nature, timing, and extent of audit tests applied in our audit of the fiscal year 2016 consolidated financial statements, and these findings do not affect our unmodified opinion on the consolidated financial statements.



This *Opinion on Internal Control Over Financial Reporting* is intended solely for the information and use of DHS management, the DHS Office of Inspector General, the OMB, the U.S. Government Accountability Office, and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Other Reporting Required by *Government Auditing Standards*

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the DHS's consolidated financial statements are free from material misstatement, we performed tests of its 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 financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed the following instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 15-02, and which are described in the accompanying Exhibit III.

- G. *Federal Managers' Financial Integrity Act of 1982*
- H. *Single Audit Act Amendments of 1996*
- I. *Antideficiency Act*

We also performed tests of its compliance with certain provisions referred to in Section 803(a) of the *Federal Financial Management Improvement Act of 1996* (FFMIA). Providing an opinion on compliance with FFMIA was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests of FFMIA disclosed instances, as described in finding J of Exhibit III, where DHS's financial management systems did not substantially comply with the (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level.

Purpose of the Other Reporting Required by *Government Auditing Standards*

The purpose of the communication described in the Other Reporting Required by *Government Auditing Standards* section is solely to describe the scope of our testing of compliance and the result of that testing, and not to provide an opinion on compliance. Accordingly, this communication is not suitable for any other purpose.

DHS's Response to Findings

DHS's response to the findings identified in our audit are attached in Appendix A. DHS's response was not subjected to the auditing procedures applied in the audit of the consolidated financial statements and, accordingly, we express no opinion on the response.

KPMG LLP

Washington, DC
November 14, 2016

Independent Auditors' Report
Introduction to Exhibits on Internal Control and Compliance and Other Matters

The internal control weaknesses in financial reporting, and findings related to compliance with certain laws, regulations, contracts, and grant agreements presented herein were identified during our audits of the U.S. Department of Homeland Security's (Department or DHS) financial statements as of September 30, 2016 and internal control over financial reporting. Our findings are presented in three Exhibits:

- Exhibit I** Findings that individually or in aggregate are considered material weaknesses in internal control over financial reporting affecting the DHS consolidated financial statements.
- Exhibit II** Findings that individually or in aggregate are considered significant deficiencies in internal control over financial reporting, which are less severe than a material weakness, yet important enough to merit attention of DHS management and others in positions of DHS oversight.
- Exhibit III** Instances of noncompliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters that are required to be reported under *Government Auditing Standards* or Office of Management and Budget (OMB) Bulletin No. 15-02, *Audit Requirements for Federal Financial Statements*.

Criteria *Index of Financial Reporting and Internal Control Criteria*

The determination of which findings rise to the level of a material weakness or significant deficiency is based on an evaluation of how deficiencies identified in all Components, considered in aggregate, may affect the DHS financial statements as of September 30, 2016.

We have reported the following three material weaknesses, three significant deficiencies, and four instances of noncompliance at the Department level in FY 2016:

Material Weaknesses (Exhibit I):

Comment	Financial Statement Area
A	IT Controls and Financial System Functionality
B	Financial Reporting
C	Property, Plant, and Equipment

Significant Deficiencies (Exhibit II):

Comment	Financial Statement Area
D	Entity-Level Controls
E	Grants Management
F	Custodial Revenue and Refunds and Drawbacks

Compliance and Other Matters (Exhibit III):

Comment	Compliance Area
G	<i>Federal Managers' Financial Integrity Act of 1982</i>
H	<i>Single Audit Act Amendments of 1996</i>
I	<i>Antideficiency Act</i>
J	<i>Federal Financial Management Improvement Act of 1996</i>

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

All Components of DHS, as defined in Note 1A – *Reporting Entity* to the financial statements, were considered in the scope of our integrated audit of the DHS financial statements and internal control over financial reporting of those financial statements.

Independent Auditors' Report
Exhibit I – Material Weaknesses

I-A Information Technology Controls and Financial System Functionality

Background: Information technology controls are a critical subset of an entity's internal control. They are typically categorized as either general IT controls (GITCs) or business process application controls (application controls). GITCs operate over all or a large portion of systems and represent the foundation of an IT control structure. They are applied at the entity-wide, system, and application level and include controls over security management, access, configuration management, segregation of duties, and contingency planning. Effective GITCs are necessary to create the foundation for the effective operation of application controls. Application controls are those controls that directly relate to specific IT applications and ensure the complete and accurate processing of data.

During our FY 2016 assessment of GITCs and application controls, we noted that although DHS made some progress in remediating IT findings we reported in FY 2015, new findings were noted in FY 2016. While management maintained appropriate focus on system modernization efforts, management did not take appropriate corrective action to address ongoing pervasive deficiencies that we identified in multiple information systems and reported to management as a material weakness for several years. The following internal control deficiencies were, collectively, deemed a material weakness in internal control over financial reporting.

Conditions Related to GITCs: We noted a greater number of control deficiencies in GITCs this year that represent an overall elevated risk to the Department. Deficiencies indicated in this Exhibit are a cross-section of GITC deficiencies identified across the Department. We noted the following:

Access Controls:

- Policies and procedures for managing and monitoring access to key financial applications and underlying system software components, including those owned and operated on behalf of the Department by third-party service organizations, were not consistently or completely developed and formally documented.
- Initial authorization and periodic recertification of application, database, and operating system user, service, and generic accounts (including emergency, temporary, developer, and migrator access) were inadequate, inconsistent, or in violation of the principles of least privilege and segregation of duties.
- Technical controls over logical access to key financial applications and underlying system software components were not consistently implemented in accordance with DHS requirements. Technical controls included password and inactivity requirements and account and data protection security configurations.
- Controls over the generation, review, analysis, and protection of application, database, and operating system audit logs were not fully implemented or were inconsistently performed.
- Access privileges for transferred and/or terminated employees and contractors were not always consistently or timely removed from financial systems and general support systems. Controls related to review and revocation of system access were not always implemented or finalized.

Configuration Management:

- Policies and procedures for the configuration management process were not consistently or completely developed and formally documented.
- Vulnerability management activities were not consistently performed. These activities include performing internal scans of financial applications and system software, monitoring vulnerabilities identified, and implementing vendor-recommended patches to address known vulnerabilities.
- Documentation of configuration management changes were not always maintained in accordance with DHS policy.

Independent Auditors' Report

Exhibit I – Material Weaknesses

Segregation of Duties:

- Implementation of segregation of duties for IT and financial management personnel with access to financial systems across several platforms and environments (including development and production environments) was inadequate or incomplete.

Conditions Related to Financial System Functionality: During our audit, we also evaluated and considered the impact of system functionality on financial reporting. In recent years, we noted that limitations in the Department's financial systems' functionality inhibit its ability to implement and maintain effective internal control, and to effectively and efficiently process and report financial data. Many key financial and feeder systems have not been substantially updated since being inherited from legacy agencies over a decade ago. Additionally, many key DHS financial systems were not compliant with Federal financial management system requirements as defined by FFMIA and OMB Circular No. A-123, Appendix D, *Compliance with Federal Financial Management Improvement Act of 1996*. Our observations related to pervasive functionality issues noted across DHS systems are described below.

We noted financial system functionality issues in the following general areas:

- System software supporting key financial applications, feeder systems, and general support systems either lacked the required functionality to implement effective controls or were outdated and no longer supported by the respective vendors. This resulted in unmitigated vulnerabilities that exposed underlying data to potential unauthorized and undetected access and exploitation.
- GITCs and financial process areas were implemented or supported by manual processes or outdated or decentralized systems or records management processes with limited automated capabilities. These limitations introduced a high risk of error and resulted in inconsistent, incomplete, or inaccurate control execution and supporting documentation.
- Multiple Components' financial system controls were not fully effective to provide readily auditable transaction populations without substantial manual intervention and additional supporting information, which increased the risk of error.

In addition to these general areas, system limitations contributed to deficiencies noted in multiple financial process areas across the Department. For example, system configurations and posting logic deficiencies limited the effectiveness of controls to accurately record certain activity at the transaction level, identify funding variances, or prevent or detect and correct excessive refund claims. In some cases, Components implemented manual processes to compensate for these limitations; however, these manual processes were more prone to error and increased the risk that financial data and transactions were improperly recorded in the respective systems.

Cause: The control deficiencies described in this Exhibit stem from a number of systemic root causes across the Department. In many cases, inadequately designed and implemented, or ineffectively operating controls were caused by the following: resource limitations; ineffective or inadequate management oversight, awareness and training; reduced efforts on remediating legacy system processes due to competing priorities related to the modernization of the financial information system; the complex, highly interrelated yet decentralized nature of systems and system components; a lack of communication between offices in the same organization regarding GITC ownership; a lack of continual self-review and risk assessments performed over GITCs; and/or error-prone manual processes. In some cases, cost-prohibitive options for vendor support limited system development activity to "break/fix" and sustainment activities.

Effect: Deficiencies related to access controls and segregation of duties increase the risk that current employees, separated employees, or contractors may obtain unauthorized or inappropriate access to financial and support systems or data. Such access could lead to unauthorized activities or inappropriate disclosures of sensitive data. Deficiencies related to configuration management increase the risk that unauthorized or inappropriate changes to systems will be applied and go undetected by management, resulting in lower assurance that information systems will operate as intended and that data is reliable, valid, and complete.

The conditions supporting our findings collectively limit DHS's ability to process, store, and report financial data in a manner that ensures accuracy, confidentiality, integrity, and availability. Some of the

Independent Auditors' Report

Exhibit I – Material Weaknesses

weaknesses could result in material errors in DHS's financial data that are not detected in a timely manner through the normal course of business. Because of the presence of IT control and financial system functionality weaknesses, there is added pressure on mitigating controls to operate effectively. Such mitigating controls often were not implemented (see Comment **I-B Financial Reporting**). However, when implemented, mitigating controls often were more manually focused, increasing the risk of human error that could materially affect the financial statements. Deficiencies identified related to design, implementation and operating effectiveness of manual mitigating controls contributed to the findings reported in Exhibits I, II, and III. Furthermore, due to these GITC deficiencies, we were unable to rely on application controls and information produced by the entity and used by management in the operation of certain key manual controls throughout the Department.

DHS management continued to recognize the need to modernize its financial systems and strengthen controls over legacy systems. Until legacy IT issues are addressed and updated IT solutions are implemented, DHS is reliant on compensating controls and other complex manual workarounds to support the Department's IT environment and financial reporting processes.

Criteria: We do not present relevant criteria for IT controls and financial system functionality due to the sensitive nature of DHS's systems. Relevant criteria is provided in individual limited distribution (For Official Use Only) Notices of Findings and Recommendations (NFRs) and separate IT management letters (ITMLs) to DHS and Component management.

Recommendations: We recommend that the DHS Office of the Chief Financial Officer (OCFO), in coordination with the Office of the Chief Information Officer (OCIO) and Component management, make the necessary improvements to the Department's financial management systems and supporting IT security controls as they continue their financial systems modernization initiative. Specific, more detailed recommendations were provided in individual limited distribution NFRs and separate ITMLs to DHS and Component management.

I-B Financial Reporting

Background: Financial reporting relates to the preparation of financial information to be included in the financial statements and related disclosures and includes the activities for initiation, authorization, recording, and processing transactions in the general ledger. It includes procedures used to enter transaction totals into the general ledger, procedures related to the selection and application of accounting policies, and management's oversight of the process. The Department continued to implement corrective action plans and made progress in certain areas, such as designing and implementing review and reconciliation controls at Immigration and Customs Enforcement (ICE) and the Components serviced by ICE for which deficiencies noted in the prior year contributed to the prior year material weakness in financial reporting. However, financial reporting continued to be a challenge for the Department as previously identified deficiencies persisted and new deficiencies were identified.

Conditions: We noted the following internal control deficiencies that, collectively, were deemed a material weakness in internal control over financial reporting.

DHS:

- Lacked sufficient manual controls in process areas to fully mitigate the risks caused by GITC deficiencies.
- Did not maintain effective internal control related to service organizations, including evaluating and documenting the roles of service and sub-service organizations, performing effective reviews of service organization control (SOC) reports, considering and/or implementing complimentary end user controls identified in SOC reports, and assessing and addressing service provider risk in the absence of SOC reports.
- Lacked fully effective controls to ensure the accuracy of reporting budgetary account balances. Specifically, controls were not fully effective to ensure:
 - Timely and accurate recording of obligations and liquidations;
 - Proper classification of unobligated balances as apportioned or unapportioned; and

Independent Auditors' Report
Exhibit I – Material Weaknesses

- Maintenance and availability of sufficient documentation to support budgetary activities, such as obligations, de-obligations, modifications, and recoveries of prior year obligations.

United States Coast Guard (USCG or Coast Guard):

- Lacked fully implemented processes and control procedures to perform timely, sufficient analyses to evaluate the interrelationship between certain account balances (e.g., operating expenses, construction in progress, and operating materials and supplies) of current year and residual clean-up activity to compensate for the inability to rely on transactional data due to system limitations.
- Lacked fully implemented controls related to sufficient review of activity, including adjusting entries, to prevent and/or timely detect and correct financial reporting errors related to property, plant, and equipment (PP&E) balances to ensure activity aligned with actual current year business events.
- Lacked effective controls to ensure accuracy of certain beginning balance and year-end close-out activities in its three general ledgers.
- Was not able to identify and reconcile intra-governmental activities and balances or ensure that transactions were coded to the correct trading partner. Additionally, internal controls associated with the periodic confirmation and reconciliation of intra-governmental activity were not properly designed or fully implemented to ensure identified differences were resolved timely.
- Did not perform a sufficient management review of reported valuations of actuarial pension and healthcare liabilities to support accuracy and continued appropriateness of underlying data and assumptions utilized by the actuary in estimating the liabilities.

Federal Emergency Management Agency (FEMA):

- Did not effectively monitor the National Flood Insurance Program's (NFIP) Write Your Own (WYO) insurance companies' processing of case loss reserves to ensure claim adjustments and closures were recorded timely and accurately.
- Did not effectively monitor the NFIP's WYO insurance companies' processing of claim payments to prevent improperly authorized payments and disbursements exceeding applicable coverage limitations.
- Lacked effective controls to ensure that results of reviews and bi-annual audits performed at NFIP's WYO insurance companies were considered in the calculation of its actuarial insurance liability.

Customs and Border Protection (CBP):

- Did not design and implement sufficient controls surrounding year-end reporting and the identification of subsequent events, such as changes to taxes, duties, and trade receivables and the proper classification of disbursements as capital expenditures instead of operating expenses.
- Did not have effective controls related to the preparation and review of manual journal entries, including underlying information.
- Did not have effective controls over the input and review of seized and forfeited information at the port level. In addition, controls over the presentation of disclosures related to seized and forfeited items were not designed at a level of precision to detect material misstatements.

Independent Auditors' Report

Exhibit I – Material Weaknesses

United States Secret Service (USSS):

- Did not fully assess risk, design and implement sufficient controls, and document processes over its actuarial pension liability.
- Did not design and implement sufficient policies and controls to appropriately track, monitor, and report the complete population of its not in evidence counterfeit note inventory.

Further, the deficiencies we identified at the National Protection and Programs Directorate (NPPD) related to PP&E are financial reporting in nature and also contributed to this financial reporting material weakness. See deficiencies cited at Comment **I-C**, *Property, Plant, and Equipment*.

Cause/Effect: The Department lacks robust continuous monitoring and testing of IT general controls necessary to identify weaknesses, assess the resulting risks created by IT deficiencies, and respond to those risks through compensating controls. The lack of compensating controls results in the Department's noncompliance with the requirements of FFMIA and OMB Circular No. A-123, Appendix D, *Compliance with Federal Financial Management Improvement Act of 1996* as reported in Comment **III-J**, *Federal Financial Management Improvement Act of 1996* (FFMIA). Personnel tasked with evaluating the roles of service organizations and the controls at service organizations as well as complimentary controls within the Components relying on those service organizations often do not possess the required understanding of internal control or the related business process to perform an effective assessment. DHS's decentralized structure enables obligations to be recorded across a multitude of locations by various authorized personnel and contributes to the challenge of enforcing existing policies, procedures, and internal controls surrounding budgetary accounting. Deficient controls in budgetary accounting increase the risk that the Department may misstate budgetary balances, and may lead to unintentional violations of the *Antideficiency Act*.

In FY 2016, the Coast Guard progressed in the development and implementation of routine evaluations of the transaction activity flowing through current year operating expenses based on residual property clean-up activity and other transaction activity that flows through this account as a result of system limitations. However, the Coast Guard did not fully design, implement, and consistently demonstrate the effectiveness of controls by year-end. Coast Guard's financial reporting organizational structure lacks a sufficient number of skilled resources with adequate overall entity and financial acumen to provide appropriate financial reporting oversight necessary to monitor the Coast Guard's multifaceted, complex, and decentralized financial operations. Coast Guard continued to have difficulties in providing complete and accurate data populations that sufficiently distinguished, at the transaction level, current year activity from residual clean-up activity as well as activity flowing through various general ledgers; thus, inhibiting management from performing adequate reviews of activity for reasonableness and alignment with current year business events. Additionally, related to actuarial liabilities, management improved documentation to evidence greater understanding of the Coast Guard actuarial pension and healthcare valuation processes, including assumptions and sources of data used in the valuations. However, management did not completely develop sufficient management review processes by year-end, inhibiting their ability to fully assess risk from a financial reporting perspective resulting in continued over reliance on actuarial specialists. Furthermore, the Coast Guard's three legacy general ledger systems, developed over a decade ago, have severe functional limitations, contributing to the Coast Guard's inability to address pervasive internal control weaknesses in financial reporting, strengthen the control environment, and comply with relevant Federal financial system requirements and guidelines, see Comment **III-J**, *Federal Financial Management Improvement Act of 1996* (FFMIA). Also refer to information technology (IT) system functionality issues described at Comment **I-A**, *Information Technology Controls and Financial System Functionality*. Coast Guard relies on significant manual interventions, which are more prone to error and are designed to detect rather than prevent errors, to attempt to compensate for these limitations. Despite these control deficiencies, Coast Guard was able to adequately support its FY 2016 account balances.

FEMA is not effectively monitoring the controls in place at the WYO insurance companies or the service provider responsible for preparing NFIP financial statements. The NFIP Standards Committee, responsible for monitoring and analyzing performance of WYO insurance companies and its service provider, did not meet in FY 2016. Additionally, FEMA has not established protocol for communicating findings identified through reviews and audits performed at the WYO insurance companies and service provider to the Chief

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Exhibit I – Material Weaknesses

Actuary. The results of these reviews are relevant for assessing completeness and accuracy of critical data elements relied upon in the calculation of FEMA's insurance liability.

In some cases, CBP did not properly identify the controls needed to mitigate the risks related to the financial reporting process; in other instances, CBP personnel did not follow the existing policies or procedures. CBP did not perform a sufficient risk assessment to determine the areas that may require adjustments at year-end due to CBP activities or existing policies. In addition, as a complex entity with a high volume and dollar amount of transactions, CBP lacks a sufficient number of skilled accounting personnel to oversee and monitor the financial reporting processes. Deficiencies in financial reporting resulted in significant adjustments to the current period financial statements and disclosures. Despite these control deficiencies, CBP was able to adequately support its FY 2016 account balances.

USSS management did not possess a sufficient understanding of the USSS actuarial pension valuation process to fully assess the appropriateness of the assumptions due to over reliance on an external actuary. USSS also did not properly assess the risks related to the processes or implement controls over not in evidence counterfeit inventory. Additionally, USSS lacks sufficient communication between the field offices, forensic services, and financial management divisions. These deficiencies resulted in the identification and correction of an understatement of not in evidence counterfeit inventory.

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

Recommendations: We recommend that:

DHS:

1. Develop continuous monitoring and testing of IT general controls to identify weaknesses, assess the resulting risks created by any identified IT deficiencies, and respond to those risks through implementing compensating controls.
2. Appropriately align knowledgeable resources to evaluate the roles of service organizations, assess controls at those service organizations, and identify and assess complimentary controls within the Components relying on those service organizations.
3. Reinforce existing policies and procedures related to processing obligation transactions; periodic review and validation of open obligations; timely recording of budgetary transactions; obtaining proper approvals; and retaining supporting documentation.

Coast Guard:

4. Establish new, or improve existing, policies, procedures, and related internal controls to ensure that:
 - a. Transactions flowing between various general ledger systems, whether the result of balance clean-up activities or system limitation manual workarounds, are sufficiently tracked and analyzed to ensure complete and accurate reporting of operational activity and related general ledger account balances.
 - b. All non-standard adjustments (i.e., journal entries and top side adjustments) impacting the general ledger are adequately researched, supported, and reviewed prior to their recording in the general ledger.
 - c. 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 supported.
 - d. All intra-governmental activities and balances are reconciled, accurately reflected in the financial statements, and differences are resolved in a timely manner.
 - e. Management possesses adequate understanding, maintains documentation, exercises oversight of chosen assumptions, and routinely evaluates the completeness and accuracy of underlying data and the continued appropriateness of assumptions used in significant estimates.

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Exhibit I – Material Weaknesses

5. Increase training and development of existing resources to better align them to financial reporting oversight roles.

FEMA:

6. Reinstitute regularly scheduled quarterly meetings with the NFIP Standards Committee to ensure there is sufficient oversight of operations at the WYO insurance companies and its service provider.
7. Develop and implement policies and procedures that ensure results of reviews and audits performed over WYO insurance companies are communicated to the actuary for consideration in the calculation of the insurance liability.

CBP:

8. Establish new, or improve existing policies, procedures, and internal controls to ensure subsequent events with potential financial reporting implications are identified (e.g. through development of a “look-back” analysis, evaluation of specific items, and/or comparison of available data sets).
9. Enforce existing policies, procedures, and related internal controls to ensure that the review of manual journal entries is sufficiently precise to identify errors, and that the underlying information utilized in the preparation of the entries is complete and accurate.
10. Enforce existing policies, procedures, and controls at the port level to ensure information recorded in the system of record for seized and forfeited items is complete and accurate. In addition, improve existing controls surrounding the review of financial disclosures related to seized and forfeited narcotics to ensure proper reporting.
11. Attract and deploy additional skilled resources and align them to financial reporting oversight roles.

USSS:

12. Establish new, or improve existing, policies, procedures, and related internal controls to ensure the adequate understanding and oversight of assumptions used in significant estimates is maintained by USSS management and continued appropriateness of those assumptions are routinely evaluated.
13. Employ additional resources and design and implement policies and controls to track, monitor, and report the complete population of its not in evidence counterfeit note inventory, including any note processing backlog.

I-C Property, Plant, and Equipment

Background: DHS PP&E is primarily concentrated in a few Components. The Coast Guard maintained approximately 50 percent of DHS’s general PP&E.

In FY 2016, the Coast Guard continued to design and implement robust control processes with a focus on sustainment activities and current year transactions while completing residual clean-up efforts of prior year property balance valuation identified through newly developed control processes. This represents a significant step forward in the maturation of the Coast Guard’s internal control environment. However, weaknesses continue to exist in the internal control over PP&E at the Coast Guard.

NPPD has several programs related to providing cyber security services to other Federal agencies. These programs, which have received significant appropriations in recent years, are expected to grow in future years and will require significant investment in hardware and software. Control deficiencies noted below relate to the identification and recording of PP&E for these programs, however, root causes are financial reporting in nature and thus, also contribute to the material weakness in financial reporting cited at Comment **I-B**, *Financial Reporting*.

USSS property primarily consists of equipment used to protect national leaders, visiting heads of state and government, designated sites, and national special security events. USSS property also consists of buildings and leasehold improvements related to field offices and its headquarters.

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Exhibit I – Material Weaknesses

Conditions: We noted the following internal control deficiencies that were, collectively, deemed a material weakness in internal control over financial reporting related to PP&E:

Coast Guard did not:

- Design and implement sufficient controls over monitoring of construction in progress (CIP) activity across its multiple general ledgers and allocation of CIP project costs, at an asset level, on an on-going basis.
- Implement controls effectively over the annual CIP accrual to ensure complete and accurate recording of general ledger balances related to in-service assets not yet interfaced.
- Review current year expenditures related to CIP projects timely in order to properly classify costs as capital or expense.
- Transfer completed assets from CIP to in-service assets in a timely manner.
- Implement controls effectively over the recording of adjustments timely to ensure the activity was properly reflected in the general ledger.
- Reconcile costs and underlying support effectively for asset activity to ensure asset additions, deletions, or other adjustments are recorded timely and accurately in all PP&E accounts.
- Document policies and control procedures to identify capitalized assets that were not currently in service and awaiting decision for removal action.
- Adhere to established inventory policies and procedures, such as those regarding asset identification, system mapping, and asset tagging processes, to clearly differentiate and track personal property assets in the fixed assets system. Additionally, control procedures over USCG's real property inventory process were not fully designed and implemented to ensure the completeness, existence, and accuracy of real property assets.

NPPD did not:

- Implement policies and procedures to identify contracts at the initial obligation level that are capitalizable in nature to ensure the appropriate accounting treatment is applied.
- Design and implement sufficient controls to appropriately track asset activity at a transaction level, and ensure the timely recording of asset additions, deletions, or other adjustments in all general PP&E accounts.
- Sufficiently control, monitor, and track adjustments, recorded in lieu of recording individual transactions, to ensure timely, complete and accurate recording of the PP&E balances.

USSS did not:

- Design and implement controls and processes to reconcile its PP&E detailed sub-ledger to the general ledger.
- Implement established inventory policies and control procedures to ensure the completeness, existence, and accuracy of real and personal property assets.
- Design and implement sufficient controls to appropriately track asset activity at a transaction level, and ensure the timely recording of asset additions, deletions, or other adjustments for PP&E.
- Design and implement controls and processes to identify instances of and criteria for asset impairment.

Cause/Effect: In FY 2016 USCG engaged in residual clean-up efforts related to PP&E balances, which were the result of Coast Guard's initial development and implementation of overall sustainment controls related to general PP&E balances. As Coast Guard continued to focus on implementation and operating effectiveness of existing control processes, controls over timely recording of asset activity, including timely posting of activity associated with adjustments, persisted as a weakness in the control environment. Further,

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Exhibit I – Material Weaknesses

specifically related to CIP, Coast Guard continued to have difficulties providing complete and accurate data populations that represent current year activity, based on business operations, and appropriately reconcile to reciprocal populations (e.g., operating expenses and other general PP&E accounts). Development of sufficient processes to monitor and record CIP activity was constrained by the design of Coast Guard's large construction contracts. Contracts related to the construction of USCG's various property fleets are not structured in such a way that costs can be sufficiently tracked to ensure proper application of capital expenditures to individual constructed assets. System limitations, including the highly interrelated yet decentralized nature of systems and system components, as well as insufficient system attributes at a transaction level, further complicate the PP&E CIP process and contribute to the noted deficiencies. Significant manual workarounds are necessary to compensate for system limitations, but are not fully documented or designed and implemented to effectively address risks resulting from the system limitations. Additionally, Coast Guard's overall property management division lacks a sufficient number of skilled resources to continue development and implementation of robust sustainment focused internal controls and provide appropriate financial reporting oversight necessary to monitor the Coast Guard's decentralized property operations.

NPPD management did not sufficiently assess the risk related to the identification of programs that may contain items that are capitalizable in nature. Specifically, contracts related to internal use software (IUS) are not structured in such a way that costs can be sufficiently tracked to ensure the proper classification of expenditures and that costs incurred can be traced at an asset level. Additionally, NPPD lacks a sufficient number of skilled resources to develop, document, and implement robust internal control procedures.

USSS did not properly assess the risks and implement controls related to the capital property processes, including proper integration between the sub-ledger and general ledger. USSS did not have the appropriate resources to monitor and oversee the reporting and recording of capital property. Additionally, the Administrative Operations Division and Financial Management Division did not communicate sufficiently to ensure proper accountability. As a result, USSS experienced significant difficulties in providing complete and accurate data populations to support operating controls and year-end PP&E balances.

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

Recommendations: We recommend that:

Coast Guard:

1. Design and implement controls to appropriately track asset activity at the transaction level and ensure the timely recording of asset additions, deletions, or other adjustments.
2. Develop processes and monitoring mechanisms to track CIP projects at an asset level, continue to implement controls over the transfer of completed CIP to in-use assets, and increase monitoring of CIP activity to ensure accurate recording in the general ledger.
3. Involve financial management personnel in the procurement of contracts for Coast Guard's major construction projects to ensure that they are structured to facilitate isolation of costs between development and maintenance (i.e., capitalizable vs. expensed), at an individual asset level, in order to enhance traceability of CIP costs.
4. Adhere to established inventory policies and procedures.
5. Establish new, or improve existing, policies, procedures, and related internal controls to sufficiently review personal and real property activity and balances in order to verify costs are appropriate and reflect USCG's business operations during the fiscal year.
6. Attract and deploy additional skilled resources to support the control environment and provide the necessary financial reporting oversight.

NPPD:

7. Involve financial management personnel in the procurement of contracts for NPPD's major IUS projects to ensure they are structured to facilitate isolation of costs between development,

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Exhibit I – Material Weaknesses

- maintenance, and research and development (i.e., capitalizable vs. expensed), at an individual asset level, in order to enhance traceability of capital costs.
8. Design and implement controls to appropriately track asset activity at the transaction level and ensure the timely recording of asset additions, deletions, or other adjustments.
 9. Attract and deploy additional skilled resources to support the control environment and provide the necessary financial reporting oversight.

USSS:

10. Design and implement controls and procedures to perform reconciliations between the PP&E sub-ledger to the general ledger and reconcile all significant differences.
11. Adhere to established inventory policies and procedures and design and implement controls to appropriately track asset activity at the transaction level and ensure the timely recording of asset additions, deletions, or other adjustments.
12. Establish new, or improve current communication channels within the Administrative Operations Division and Financial Management Division to ensure sufficient review of personal and real property activity and balances, including equipment, IUS, land, buildings and other structures, and to verify costs are appropriate and reflect USSS's business operations during the fiscal year.
13. Design and implement controls and processes to identify instances and criteria for asset impairment.
14. Attract and deploy additional skilled resources within the Administrative Operations Division and Financial Management Division to support the control environment and provide the necessary financial reporting oversight.

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Exhibit II – Significant Deficiencies

II-D Entity-Level Controls

Background: Entity-level controls are controls that have an overarching or pervasive effect on an entity. They include the entity's culture, values, and ethics as well as the attitudes, awareness, and actions of management and those charged with governance concerning the entity's internal control and its importance. Entity-level controls reside in all five components of internal control – control environment, risk assessment, control activities, monitoring, and information and communications – as defined by the *Standards for Internal Control in the Federal Government* issued by the Comptroller General of the United States. These controls must be effectively designed, implemented, and operating together in an integrated manner to create and sustain an organizational structure that is conducive to reliable financial reporting.

The conditions below should be read in conjunction with Comment **I-A**, *IT Controls and Financial System Functionality*; Comment **I-B**, *Financial Reporting*; Comment **I-C**, *Property, Plant, and Equipment*; Comment **II-E**, *Grants Management*; and Comment **II-F**, *Custodial Revenue and Refunds and Drawbacks*.

Conditions, Cause/Effect, and Recommendations: During our audit we noted certain control deficiencies for which underlying causes were similar and pervasive throughout the Department. The resulting recommendations, which we provided to correct the deficiencies, are based on improvements needed in management's risk assessment process, communication practices throughout the Department, and its monitoring activities. Accordingly, we deemed the entity-level control deficiencies described below to, collectively, merit the attention of those charged with governance.

Risk Assessments: The Department has not matured its risk assessment processes. As a result, events and transactions that have a greater likelihood of error are not always receiving an appropriate level of attention. Risk assessments should be improved at both the headquarters level by OCFO, and individual Components annually, and updated during the year as needed. Examples of areas that should be addressed annually and updated periodically in the risk assessment are:

- Needs for technical and resource support to remediate severe control deficiencies and continually evaluate for areas where material financial statement errors could occur and not be identified and corrected timely.
- Training needs assessments for personnel to match skills with roles and responsibilities and identify gaps that could lead to financial statement errors.
- Coordination between headquarters and smaller Components that do not have the resources to fully support a separate financial management infrastructure and the Department to identify financial accounting and reporting risks and remediate control deficiencies.
- Identification of financial accounts and transactions that are susceptible to error due to weaknesses in IT general controls and IT systems functionality (e.g., limitations in budgetary subsidiary IT systems). Refer to Comment **I-A**, *Information Technology Controls and Financial System Functionality*.

Information and Communications: Communications within Components, between headquarters and Components, and between financial and IT management, should be improved to ensure:

- Roles and responsibilities of program and field personnel that provide key financial information are defined and that those personnel understand and comply with policies.
- Management has a sufficient understanding of the implication of IT vulnerabilities and limitations, and manual compensating internal controls are designed and implemented to mitigate risk.
- Monitoring across larger Components with decentralized operations to ensure responsibilities have been properly assigned and clearly communicated, and that internal control over financial reporting and compliance with direct and material laws and regulations have been properly designed and implemented and are operating effectively across the organization.

Monitoring Controls: The Department should design continuous monitoring controls to ensure transactions with a higher risk of error are adequately examined. Components with ineffective, detective monitoring controls should look for opportunities to implement more reliable controls earlier in the process to prevent

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Exhibit II – Significant Deficiencies

errors at the transaction source. In addition, detective controls intended to compensate or mitigate weak preventive or process-level controls (e.g., management review controls of the financial statements) are not always designed at a level of precision to identify a significant error. Consequently, errors, or a combination of errors, in the financial statements could go undetected.

The Department continued progress in its identification and remediation of control deficiencies through executive level support for strong internal controls. Enhancement of internal testing of both financial and IT controls and progress in resolving weaknesses identified will be critical to sustaining auditable financial statements in the future. These conditions were further evidenced through control deficiencies cited at Comment **I-B**, *Financial Reporting*.

II-E Grants Management

Background: FEMA is the primary grantor within DHS, managing multiple Federal disaster and non-disaster grant programs.

Conditions: The majority of the following internal control deficiencies related to grants management were reported in the prior year and persisted in FY 2016. We deemed these deficiencies to, collectively, merit the attention of those charged with governance.

FEMA did not:

- Effectively communicate policies and procedures to the regional offices, where the majority of day-to-day management of its grantees occurs, such that internal controls have been properly designed and implemented, and are operating effectively surrounding the monitoring of grantees' compliance with laws and regulations.
- Compile a complete list of grantees requiring single audits in order to fully comply with the *Single Audit Act Amendments of 1996 (Single Audit Act)* as implemented by Title 2 of the Code of Federal Regulations (CFR), Part 200 - *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Super Circular). Refer to Comment **III-H**, *Single Audit Act Amendments of 1996*.
- Issue Management Decision Letters timely for single audit reports available in the Federal Audit Clearinghouse.
- Maintain accurate and timely documentation related to reviews performed of grantees' single audit reports.
- Reconcile grantee quarterly financial reports to FEMA's systems consistently and effectively.
- Implement a consistent, effective process to ensure timely closeout of FEMA's grants.

Cause/Effect: FEMA did not fully implement policies and procedures over its grant program in order to ensure compliance with the *Single Audit Act*, as implemented by the Super Circular. In addition, FEMA did not have a grants IT system in place to efficiently and comprehensively track grants to help ensure that all programmatic events were accurately and timely completed and properly recorded to the general ledger. Manual processes, which were not always effective, were used to reconcile open grants within grants systems to FEMA's general ledger system, and to track grants eligible for close-out. Refer to Comment **I-A**, *Information Technology Controls and Financial System Functionality*. FEMA did not implement effective monitoring procedures over its grant activities. Although responsibilities surrounding grants management have been assigned to discrete units within the organization, there is no overall central oversight to ensure the delegated responsibilities are being effectively carried out for all grants. Thus, FEMA cannot ensure there is effective management and administration of the grants process, as well as compliance with provisions of the *Single Audit Act*. Specifically, the lack of standardized internal controls within FEMA caused difficulty in assembling a comprehensive status of the cash on hand at grantees and the status of grants eligible for close-out, which creates risk of excessive cash on hand at grantees and untimely closure of grants.

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

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Exhibit II – Significant Deficiencies

Recommendations: We recommend that FEMA:

1. Assign the responsibility for central oversight of grants management to one program office within FEMA.
2. Complete the implementation of policies and procedures to ensure full compliance with the *Single Audit Act* related to receipt and review of grantees' single audit reports.
3. Implement monitoring procedures over obtaining, reviewing timely, and reconciling required quarterly grantee reports.
4. Develop and implement procedures to create and track comprehensive lists of FEMA grants that are eligible for close-out.
5. Develop and implement procedures to reconcile grant award information maintained in grant IT systems to the general ledger.
6. Implement a continuous quality assurance and grants monitoring process to include review of corrective actions resulting from implementation of the above recommendations.

II-F Custodial Revenue and Refunds and Drawbacks

Background: The Department collected \$40.3 billion in custodial revenue as presented in the statement of custodial activity. CBP is the primary collector of these revenues within the Department. The majority of CBP's collections are from merchandise entering the United States from foreign ports of origin which CBP assesses import duties, taxes, and fees against (identified below as the Entry Process). Receipts of import duties and related refunds are presented in the statement of custodial activity. To ensure the subsequent collection of these duties, taxes and fees CBP requires bonds from parties that import merchandise into the United States. The assessment of liquidated damages against a bond serves to promote compliance with laws and regulations.

Drawback claims are a remittance, in part or up to 99%, of duties, taxes, or fees previously paid by an importer. Drawback claims typically occur when 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. The *Trade Facilitation and Trade Enforcement Act of 2015* (TFTEA) contained provisions for drawback modernization that simplify the rules for determining if exports are eligible for refunds, expand the timeframe for drawback claims, and eliminate some of the documentation requirements.

In 2014, the President issued an executive order that requires full implementation of the International Trade Data System by December 2016. In order to meet this requirement, CBP has been transitioning various trade functions, including quota and cargo release, from Automated Commercial System (ACS), which is the current IT system for custodial collections to the Automated Commercial Environment (ACE) system. The remaining functions, including recording of collections and payment of drawback claims, are scheduled for migration to ACE in fiscal year 2017.

Many of the conditions cited below have existed for several years. Management has stated that the timeframe for remediation of these conditions is dependent on successful implementation of IT system upgrades and the TFTEA legislation changes.

Conditions: We identified the following internal control deficiencies related to custodial activities at CBP that we deemed to, collectively, merit the attention of those charged with governance:

Related to the Entry Process:

- Management did not fully implement and communicate policies and procedures that identified risk points and key controls for the entry functions that were transitioned to ACE and updates that were required due to changes in governing statutes during fiscal year 2016.
- Existing policies and procedures (1) were not consistently followed for review and verification of duties of entry edit and exception reports; (2) did not clearly establish consistent procedures for completing and documenting the review of the entry edit and exception and Budget Clearing

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Exhibit II – Significant Deficiencies

Account (BCA) reports; and (3) lacked a requirement for locations to implement controls to ensure the completeness and accuracy of alternative reports used when locations elected to modify the standard system-generated reports.

- In addition to deficiencies in the design and implementation of controls over the BCA report, we also identified specific instances of untimely removal from the BCA collections related to fines, penalties, and forfeitures and liabilities for deposit accounts.
- Controls over the review of Single Transaction Bonds (STBs) were not operating effectively. The system for processing STBs was operational for the entire fiscal year, however, it was not designed to replace the requirements for a manual review. Additionally, CBP was unable to provide documentation to support the manual review of bonds processed through the system.

Related to Refunds and Drawbacks:

- The current entry/collections system lacked automated controls necessary to prevent, or detect and correct, excessive drawback claims. The programming logic did not link drawback claims to imports at a sufficiently detailed level. In addition, the system did not have the capability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries and export documentation upon which the drawback claim was based. Further, the system had not been configured to restrict drawback claims to 99 percent of each entry summary in accordance with regulation.
- Manual drawback review policies did not require drawback specialists to sufficiently review prior drawback claims against a selected import entry to determine whether, in the aggregate, an excessive amount was claimed against import entries.
- Documentation retention periods were not appropriate to (1) ensure that support for drawback transactions was maintained for the full claim window, and (2) ensure support for importers qualifying for accelerated filer status was maintained.
- The automated control designed to prevent a claimant from exceeding the continuous bond amount on file did not operate effectively.
- Existing policies and procedures were not consistently followed for review and verification of the check proof listing report.

Cause/Effect: Policies and procedures over the review of entry edit, cancellation and exception and budget clearing account reports were not sufficiently specific to ensure controls were performed consistently at all locations during fiscal year 2016. In addition, existing policies and procedures do not require timely coordination with all applicable parties. Failure to consistently adhere to existing policies and procedures for review and verification of reports may result in a potential misstatement to the balance of taxes, duties, and trade receivables, net and total cash collections on the statement of custodial activities. Inadequate controls could result in the failure of CBP to identify amounts that are due to the Treasury General Fund.

CBP did not consistently adhere to policies and procedures for the review of STBs and CBP management did not develop and communicate policies and procedures to uniformly perform and document the manual review of STBs housed in the eBonds module of ACE. Failure to consistently adhere to existing policies and procedures for the review of STBs could lead to loss of revenue due to uncollected duties, taxes, and fees.

The mandated timeframe for the transition from ACS to ACE and resource constraints prevented full development of policies and procedures before the implementation of operational changes. Failure to fully establish and define control environments could lead to potential misstatements to the balance of taxes, duties, and trade receivables, net and total cash collections on the statement of custodial activities.

IT system functionality and outdated IT systems contribute to the weaknesses identified above. Refer to Comment **I-A**, *Information Technology Controls and Financial System Functionality*. ACS does not provide the necessary functionality to prevent the overpayment of drawback claims. CBP plans to replace ACS with ACE in fiscal year 2017. However, until such implementation occurs, CBP does not currently have sufficient resources to effectively perform compensating manual controls over drawback claims.

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Exhibit II – Significant Deficiencies

TFTEA simplifies the statutes that govern the drawback process further reducing the need for manual controls. However, it does not take effect until February 2018. The length of the drawback claim lifecycle often extends beyond the documentation retention period, which is set by statute. Until effective automated and manual controls are implemented over the drawback process, CBP may be subject to financial loss due to excessive drawback claims. In addition, drawback claims are governed by the laws and regulations in effect at the time of filing. As the length of the drawback lifecycle can last several years, it will take several years for claims existing prior to the implementation of TFTEA to be completed.

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

Recommendations: We recommend that CBP:

Related to the Entry Process:

1. Update and redistribute guidance to necessary personnel regarding the appropriate CBP directives to ensure consistent performance of controls across all locations.
2. Fully implement the automated controls over single transaction bond processing.
3. Develop policies and procedures that clearly identify risks, as well as controls to mitigate those risks for all trade functions transitioning to ACE.
4. Provide training to all personnel on new policies to ensure consistent implementation at decentralized locations.

Related to Refunds and Drawbacks:

5. Continue with the scheduled implementation of drawback in ACE.
6. Continue to enhance the manual controls to detect or prevent excessive drawback claims, including after the implementation of TFTEA, as current claims will take several years to be processed through the drawback lifecycle.
7. Implement relevant provisions of TFTEA, which will take effect on February 24, 2018.
8. Implement policies and procedures to ensure supporting documentation related to accelerated filer status is maintained.
9. Update and redistribute guidance to necessary personnel regarding the appropriate CBP directives to ensure consistent performance of controls across all locations.

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Exhibit III – Compliance and Other Matters

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

FMFIA requires agencies to establish effective internal control and financial systems and to continuously evaluate and assess the effectiveness of their internal control. DHS's implementation of OMB Circular No. A-123 facilitates compliance with the FMFIA. DHS has implemented a multi-year plan to achieve full assurance on internal control. However, the DHS *Secretary's Assurance Statement* dated November 14, 2016, as presented in *Management's Discussion and Analysis* of the Department's FY 2016 *Agency Financial Report* (AFR), acknowledged the existence of material weaknesses, and therefore provided qualified assurance that internal control over financial reporting was operating effectively as of September 30, 2016. Management's findings were similar to the control deficiencies we have described in Exhibits I and II. However, continuous monitoring and testing of both financial and IT controls was not performed over all significant areas.

While we noted the Department progressed toward full compliance with FMFIA and OMB Circular No. A-123, the Department did not fully establish effective systems, processes, policies, and testing procedures to ensure that internal controls are operating effectively throughout the Department.

Recommendations: We recommend that the Department continue its corrective actions to address internal control deficiencies in order to ensure full compliance with FMFIA and its OMB Circular No. A-123 approved plan in FY 2017. We also recommend that the Department conduct complete risk assessments to identify significant risk areas and continuously monitor and test the financial and IT controls within those areas.

III-H Single Audit Act Amendments of 1996 (Single Audit)

FEMA is the primary grantor in DHS, managing multiple Federal disaster and non-disaster grant programs. The *Single Audit Act Amendments of 1996*, as implemented by Title 2 of the Code of Federal Regulations (CFR), Part 200 - *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Super Circular), requires agencies awarding grants to monitor their grantees; ensure they receive grantee reports timely; and follow-up on single audit findings to ensure that grantees take appropriate and timely action. Although FEMA monitors grantees and their single audit findings, FEMA did not fully comply with provisions in the Super Circular in FY 2016. We noted that FEMA's monitoring efforts were inconsistent, and FEMA did not obtain and review all grantee single audit reports in a timely manner. Further, the decentralization of grants management prevents FEMA from being effectively able to monitor its grantees' compliance with applicable laws and regulations.

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

III-I Antideficiency Act (ADA)

Various management reviews and OIG investigations are ongoing within the Department, which have or may identify ADA violations, as follows:

- The independent investigation, at the Office of Intelligence and Analysis, related to the obligation of funds in excess of its continuing resolution apportionment in FY 2012 has been completed. The package to notify the President, Congress, and GAO of the violation is pending the Secretary's signature.
- In FY 2016, ICE finalized its investigation of payments exceeding statutory authority for continuing to provide medical care for detainees released from custody. The package to notify the President, Congress, and GAO of the violation is pending OMB review.
- In FY 2015, the Management Directorate completed the investigation of an overobligation of funds that occurred in FY 2013. The package to notify the President, Congress, and GAO of the violation has been signed and is in clearance at OMB for transmission.
- CBP is investigating two potential ADA violations. One potential violation is related to overtime in excess of the annual cap established in the FY 2014 and FY 2015 Appropriations Acts. The other potential violation is related to a contract awarded in base year 2015 with a one-year option in 2016 without the appropriate Congressional notification as required by statute.

Independent Auditors' Report
Exhibit III – Compliance and Other Matters

- DHS is investigating potential ADA violations related to contracts awarded from FY 2013 to FY 2016 without the appropriate Congressional notification.
- USSS is investigating a potential incident related to the acceptance of voluntary services in violation of the ADA in FY 2014.
- ICE is investigating a potential ADA violation related to FY 2016 expenditures made for improvements to the ICE Director's office in excess of \$5,000 without proper Congressional notification.
- The Transportation Security Administration is investigating a potential ADA violation related to potentially awarding Other Transaction Agreements from 2010 through 2015 without the appropriate Congressional notification.

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

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

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

We noted that the Department has progressed toward compliance with FFMIA and remediated some of the conditions identified in the prior year. However, multiple Components did not fully comply with at least one of the requirements of FFMIA based on criteria set forth in OMB Circular No. A-123, Appendix D, *Compliance with the Federal Financial Management Improvement Act of 1996*. The reasons for noncompliance are reported in Exhibits I and II. The DHS Secretary stated in the *Secretary's Assurance Statement*, dated November 14, 2016, that the Department's financial management systems do not substantially conform to government-wide requirements mandated by FFMIA. The Department's remedial actions and related timeframes are also presented in the FY 2016 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 Modernization Act of 2014* (FISMA). FISMA requires the head of each agency to be responsible for: (1) providing information security protections commensurate with the risk and magnitude of the harm resulting from unauthorized access, use, disclosure, disruption, modification, or destruction of (i) information collected or maintained and (ii) information systems used or operated; (2) complying with the requirements of the Act and related policies, procedures, standards, and guidelines, including (i) information security standards under the United States Code, Title 40, Section 11331, and (ii) information security standards and guidelines for national security systems; and (3) ensuring that information security management processes are integrated with agency strategic and operational planning processes.

We also noted weaknesses in financial systems security, reported by us in Comment **I-A**, *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 FFMIA, and implement the recommendations provided in Exhibits I and II.

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

Criteria	Reference	Report Exhibit
Budget Clearing Account and Suspense Item Report	Point 7	II-G
CBP 2013 Drawback Handbook, Issued (HB 3700-01B)	5.2 Accelerated Payment	II-G
CBP Business Rules and Process Documents (Internal) Version 3.3	7.2 Single Transaction Bonds	II-G
CBP Collection and Deposits Handbook (HB 5300-12B)	Section 1.4 Section 3.1	II-G
CBP Directive 3710-004B, <i>Refund of Miscellaneous Collections</i>	Section 2.2	II-G
CBP Directive 5610-004B, <i>Resolving Certain ACS Exception and Error Reports</i>	Section 5.4 Section 5.11	II-G
Code of Federal Regulations, Title 19	§111.23, §111.25, §113.13, §113.15, §113.26, §113.65, §163.4, §191.15, §191.38, §191.51, §191.92	II-G
Code of Federal Regulations, Title 31	§205.33	II-F
<i>Component Requirements Guide for Financial Reporting in FY 2015, Version 3.0, April 2015</i>	Section 3.1	I-B
	Section 7.5	
	Section 8.16	
	Section 9.9	I-C
	Section 9.10	
	Section 8.16	II-D
Department of Homeland Security Management Directive 125-02, <i>Interagency Agreements</i>	Section VI	II-D
Department of Homeland Security Management Directive 1104, <i>Fund Balance with Treasury</i>	Section VI	I-B
FASAB Technical Release 14: <i>Implementation Guidance on the Accounting for the Disposal of General Property, Plant, & Equipment</i>	Paragraph 10	I-B, I-C
Federal Acquisition Regulation (FAR)	§4.804	II-D

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Criteria	Reference	Report Exhibit
<i>Federal Financial Management Improvement Act of 1996</i>	Section 803	I-B, I-C
<i>Federal Managers' Financial Integrity Act of 1982</i>	Section 2	I-B, II-D, II-G
<i>Financial Resource Management Manual (FRMM COMDTINST M7100.3E), September 2013</i>	Section 7.12 Section 7.13 Section 10.2 Section 10.3	I-B, I-C
<i>GAO Standards for Internal Control in the Federal Government</i>	Principle 4 Principle 7 Principle 10 Principle 12	I-B, II-D, II-F
<i>GAO FINANCIAL MANAGEMENT FFMIA Implementation Critical for Federal Accountability (GAO-02-29)</i>	Page 1, Paragraph 2	I-B
<i>GAO Principles of Federal Appropriations Law, Second Edition, Volume II (GAO-OGC-92-13)</i>	A. Introduction	II-D
<i>Memorandum of Agreement Between the Department of Homeland Security, Federal Law Enforcement Training Centers and the Requesting Agency Regarding the Use of the Federal Law Enforcement Training Centers</i>	Section VII	II-D
<i>OMB Circular No. A-11, Preparation, Submission, and Execution of the Budget, July 2013</i>	Section 31.5 Appendix B	IB, I-C
<i>OMB Circular No. A-123, Management's Responsibility for Internal Control, Revised</i>	1. Purpose	II-D, II-G
	3. Policy	I-B, II-D, II-F, II-G
	I. Introduction	I-B, I-C, II-D, II-F, II-G
	II. Standards	II-B, II-G
	IV. Assessing Internal Control	I-B, II-G
	Appendix D	I-B, I-C
<i>OMB Circular No. A-127, Financial Management Systems, Revised</i>	Section 8	I-B

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OMB Circular No. A-133, <i>Revised to show changes published in the Federal Registers of June 27, 2003 and June 26, 2007 Audits of States, Local Governments, and Non-Profit Organizations</i>	Subpart B Subpart D	II-F
OMB Circular No. A-136, <i>Financial Reporting Requirements</i> , Revised	Section V	I-B
OMB Memorandum M-04-11, <i>Service Organization Audits</i>	Paragraph 1	I-B
<i>Single Audit Act Amendments of 1996</i>	Section 7502	II-F
Statement of Federal Financial Accounting Standards 1: <i>Accounting for Selected Assets and Liabilities</i>	Paragraphs 39, 41, 45, 77	I-B
Statement of Federal Financial Accounting Standards 3: <i>Accounting for Inventory and Related Property</i>	Summary, Paragraph 1, 36, 37, 39	I-B, I-C
Statement of Federal Financial Accounting Standards 5: <i>Accounting for Liabilities of The Federal Government</i>	Paragraph 19	I-B
Statement of Federal Financial Accounting Standards 6: <i>Accounting for Property, Plant, and Equipment</i>	Paragraph 17, 18, 19, 26, 31, 34, 39	I-B
	Paragraph 17, 18, 19, 26, 31, 34, 39, 40	I-C
Statement of Federal Financial Accounting Standards 7: <i>Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting</i>	Paragraph 79	II-D
Statement of Federal Financial Accounting Standards 10: <i>Accounting for Internal Use Software</i>	Paragraphs 16, 18, 20	I-B, I-C
Statement of Federal Financial Accounting Standards 29: <i>Heritage Assets and Stewardship Land</i>	Paragraph 25	I-C
Statement of Federal Financial Accounting Standards 33: <i>Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates</i>	Paragraph 33	I-B

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Statement of Federal Financial Accounting Standards 35: <i>Estimating the Historical Cost of General Property, Plant, and Equipment: Amending Statements of Federal Financial Accounting Standards 6 and 23</i>	SFFAS 6 - Paragraph 40 SFFAS 23 - Paragraph 16	I-B, I-C
Statement of Federal Financial Accounting Standards 39: <i>Subsequent Events: Codification of Accounting and Financial Reporting Standards Contained in the AICPA Statements on Auditing Standards</i>	Paragraph 11, 12	I-B
Transportation Security Administration, Internal Standard Operating Procedure, <i>Manual Processing of Non-CIMS Awards</i>	Section 5	II-D
Transportation Security Administration, Internal Standard Operating Procedure, <i>Processing Prior Year Adjustments (PYA) to Budgetary Resources</i>	Section 5	II-D
Transportation Security Administration, Internal Standard Operating Procedure, <i>UDO Verification and Validation</i>	Section 5	II-D
Treasury Financial Manual, Volume I	Part 2, Chapter 4700, Section 4706 Part 2, Chapter 4700, Appendix 10 Part 2, Chapter 5100, Appendix 2 Fund Balance With Treasury Reconciliation Procedures: A Supplement to TFM Volume I, Part 2, Chapter 5100, Section C	I-B
U.S. Department of Homeland Security Federal Emergency Management Agency Grant Programs Directorate Regional Coordination and Oversight Branch, <i>Cash Analysis Reporting SOP</i>	Section II, Part 3	II-F
United States Coast Guard Finance Center, Reports and Reconciliation Unit, <i>General IPAC Suspense Spreading Procedures</i>	Section 6.2	I-B
United States Coast Guard Finance Center, <i>Standard Operating Procedures Manual</i>	Chapter 12, Section A	I-B
United States Coast Guard <i>Environmental Liabilities Process Guide</i>	Section 2.3.3	I-B
United States Coast Guard, <i>Procedure for Physical Inventory and Year-End Certification of Personal Property</i>	Section 1.3 Section 5.5 Section 5.6 - 5.7	I-C

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Criteria	Reference	Report Exhibit
United States Coast Guard, <i>Procedure for Physical Inventory of Real Property</i>	Section 3.2	I-C
United States Coast Guard, National Pollution Fund Center Instruction 16451.2: <i>Technical Operating Procedures for Resource Documentation under The Oil Pollution Act of 1990</i>	Chapter 2, Section B	I-B
United States Coast Guard, National Pollution Fund Center, <i>Allowance for Doubtful Accounts Annual Rate Calculation</i>	Step 8	I-B
United States Coast Guard, <i>Procedures for the Accounts Payable Accrual Estimate and Validation</i>	Section 8	I-B
US Code Title 31, Chapter 13	§1341	II-D, II-F
US Code Title 31, Chapter 15	§1501, §1554	I-B, II-D



Homeland
Security

November 14, 2016

MEMORANDUM FOR: John Roth
Inspector General

FROM: Chip Fulghum 
Deputy Under Secretary for Management and
Chief Financial Officer

SUBJECT: Fiscal Year 2016 Financial and Internal Controls Audit

Thank you for your audit report on the Department's financial statements and internal controls over financial reporting for fiscal years (FY) 2015 and 2016. We agree with the Independent Public Accountant's conclusions. While sustaining the notable success of our fourth unmodified audit opinion on all financial statements, the report indicates that DHS still has improvement opportunities. The Department has made great strides to mature our organization from both an audit remediation and internal control perspective. Our highest priority is supporting the critical mission of DHS with reliable financial information, and we have implemented robust, centralized oversight to ensure the integration of controls and standard business processes across the Department.

Despite the complexities of disparate financial systems and associated business processes, many of our large components, such as the United States Coast Guard have made substantial progress in overcoming system limitations to implement controlled processes and improve accounting for property, plant and equipment. For information technology controls, we have prioritized and are addressing the most significant internal control improvements across the DHS financial systems portfolio. These efforts are multi-year and tightly monitored, yielding results now with a clear path to future internal control maturity.

We are confident, with the continued commitment and investment of our DHS financial management community, that our steadfast progress will be affirmed in FY 2017 on our path to achieve an unmodified audit opinion on our internal control over financial reporting.

I look forward to working collaboratively with the Office of Inspector General and the Independent Public Accountant to further strengthen DHS financial management and internal control.



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Appendix B
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