Performance and Accountability Report

Fiscal Year 2005

Financial Information

Part III

Homeland Security

Message from the Chief Financial Officer

NOVEMBER 14, 2005

Our fiscal year 2005 Performance and Accountability Report (PAR) summarizes the most important financial and program performance information for the Department of Homeland Security (DHS). The report is also our principal publication and report to the President, the Congress, and the American people on our accountability and control of funds entrusted to us and our efforts to improve program performance.

LEADERSHIP AND VISION

DHS leadership remains deeply committed to responsible financial management and places it as one of their top priorities. As the Chief Financial Officer (CFO) of DHS, I am especially aware of the importance of consistent, transparent, and effective Department-wide financial management practices.

The vision for successful financial management at DHS is one where there exists a framework of people, processes, and systems in which DHS stakeholders, such as our leaders and managers of all agencies, have accurate, timely and useful information to make effective decisions in support of the mission. This vision means that we can: support an unqualified opinion on our financial statements; make reasonable assurances over our internal controls on financial reporting; relate our spending to our performance; have integrated financial management systems; and have dedicated, highly talented financial managers who pull all of this together.

In August 2004, former Secretary Ridge initiated the Department's functional integration effort to bring all experts under one integrated method of operation. As a result, a series of Management Directives (MD) were approved in October 2004, including the Financial Management Line of Business Functional Integration Management Directive, which established the DHS authorities and responsibilities of my office and all CFO's within DHS. The directive is the principal document for leading, governing, integrating, and managing financial management functions throughout DHS.

Realizing financial management excellence requires every executive, manager, and employee in the Department to help create an environment that rewards collaboration, promotes best practices, and shares accountability for the performance of the management support systems that enable the Department to fulfill its mission. This concept of functional integration mandates that both component heads and key functional experts are responsible for our strategic goal of organizational excellence in financial management. As Chief Financial Officer, I am accountable for designing the system to optimize the financial management function, setting the standards for functional performance, creating department-wide policies and processes, providing the automated solutions to yield greater efficiencies, and nurturing the development and success of centers of excellence. Component heads will likewise be

accountable to support these progressive business functions as a key part of their commitment to mission accomplishment.

FINANCIAL REPORTING IMPROVEMENTS

This year, I initiated the Chief Financial Officer's Three Year Vision for DHS Financial Reporting. The theme for fiscal year 2005 is "*Full Visibility and Corrective Actions*." The goals for this year were: 1) timely fiscal year 2005 PAR submission, 2) prepare Secretary's Assertion on Internal Controls over Financial Reporting, 3) reduction of material weaknesses, and 4) qualified balance sheet opinion.

The Department was successful in meeting goals 1 and 2, and it is noteworthy that a successful outcome was achieved in a separate audit at the U.S. Customs and Border Protection. However, owing to material weaknesses in several components, the auditors were unable to complete testing necessary to support an overall opinion on the Department's fiscal year 2005 consolidated balance sheet. In addition, although the number of material weaknesses was not reduced in fiscal year 2005, many corrective actions were successfully carried out in the components and a formal monitoring program was implemented to oversee and measure component progress in addressing their corrective action plans.

In fiscal year 2005, we have made great improvements in the area of financial management, and I fully anticipate in fiscal year 2006 that the corrective actions to address weaknesses in internal control will be substantially implemented. Significant accomplishments to date include:

- We instituted strong quality control processes in the Office of the CFO (OCFO) and issued updated PAR guidance to DHS bureaus early on in the fiscal year;
- We hired and contracted additional accounting personnel that possess complementary technical skills including proficiency with the standard general ledger, financial reporting, system maintenance, internal controls, and financial management policy. In addition, our fiscal year 2006 budget request includes five additional positions;
- We initiated a comprehensive internal control assessment of the consolidated financial reporting process, using the criteria defined by the U.S. Government Accountability Office (GAO) and the recent revisions to OMB Circular A-123 and the DHS Financial Accountability Act (P.L. 108-330);
- We have open communication and regular reporting with the Secretary and Deputy Secretary, and other key stakeholders such as the Office of the Inspector General (OIG) and the independent public accountants;
- We are actively engaged with DHS components through regular Financial Management Working Groups and Internal Control Committee (ICC) meetings;
- We have started the process to have corrective action plans in place in all organizations with material weaknesses and spell out plans for how and when the weaknesses will be remediated;
- The Secretary has clearly communicated to the Department our goals for financial improvement; and

- We have hired a Deputy CFO to assist in driving internal controls and best practices into Department and component financial management operations. Our Deputy CFO led the Secretary's Second Stage Review agenda item for improving financial management.

We understand the challenges that we must address and are confident that the three-year strategy set forth for receiving an unqualified opinion on our consolidated financial statements and for eliminating all material weaknesses will be a success.

INTERNAL CONTROLS

One of the unique and most challenging financial management requirements we face at DHS is the audit of internal control over financial reporting. With respect to internal controls, Section 4 of the DHS Financial Accountability Act requires DHS to include in its Performance and Accountability Report for fiscal year 2005, an assertion of internal controls that apply to financial reporting. In addition, Section 4 requires that DHS include an audit opinion of its internal control over financial reporting in DHS' PAR beginning with fiscal year 2006.

The task of examining and documenting internal controls over financial reporting is time consuming and challenging, as many in the private sector would attest, but we agree that it is imperative that DHS move as swiftly as possible to improve financial management and correct identified material weaknesses. This will build a sustainable and reliable financial management framework that will withstand audit scrutiny and assure all that resources are used wisely. DHS will lead the Federal government in this regard.

DHS has initiated extraordinary steps to organize the Department to prepare for an audit of our internal controls over financial reporting. I am very pleased with our trailblazing implementation of an internal controls process. I believe DHS will be a model in the government as others go down this path. Significant accomplishments to date include:

- In December 2004, I directed the DHS Chief Financial Officer Council to nominate senior executives and senior staff to establish an ICC responsible for implementing the internal control provisions of P.L. 108-330.
- Initial ICC activities included developing a charter to set forth the applicable oversight, responsibilities, structure, and management of the group.
- In developing our strategy, we proactively reached out to the: Office of Management and Budget (OMB), CFO Council Financial Management Policies and Practices Subcommittee, DHS OIG, and an independent public accounting firm. In addition, numerous CFO Act agencies have contacted us to share experiences in developing our internal control program.
- In May 2005, with the assistance of a public accounting firm, we developed an implementation guide for complying with the internal control provisions of P.L. 108-330. Our guide provides the strategy and framework for implementing the DHS Financial Accountability Act.
- Over the summer, we executed a detailed and technical seven step plan to support the Secretary's fiscal year 2005 assertion statement and prepare for the fiscal year 2006 audit of internal control over financial reporting. These seven steps included:

1. Identifying the maturity level of internal control over financial reporting.
2. Assessing entity-level controls using the Government Accountability Office (GAO) Internal Control Management and Evaluation Tool. The GAO Tool was the assessment methodology to support the Secretary's assertion in fiscal year 2005.
3. Identifying financial reports to be included in the assessment.
4. Identifying significant line items and related accounts, disclosures, and processes/cycles.
5. Determining multiple-location coverage.
6. Summarizing the use of services organizations.
7. Other considerations including the year end financial reporting process, laws and regulations, system considerations, etc.

- As discussed earlier, we've initiated a comprehensive internal control assessment of the consolidated financial reporting process within the OCFO. In addition, the U.S. Coast Guard, one of our largest components, has initiated process level documentation pilots.
- Throughout the year, we have also made progress in developing a corrective action planning process. For example in fiscal year 2004, our independent auditors reported we did not prepare corrective actions for all material weaknesses and reportable conditions. This year, we have developed corrective action plans for all material weaknesses and reportable conditions and we are also developing a Management Directive and Process Guide to ensure these corrective action plans demonstrate results.
- With regard to provisions of the DHS Financial Accountability Act related to DHS-wide management controls, we have established an integrated framework to coordinate our overall internal control assessment with all other internal control-related activities. This framework includes various statutory requirements and overall management or functional areas that cut across many if not all of the DHS components and mission areas.

electronically Managing enterprise resources for government efficiency and effectiveness (*eMerge²*)

The eMerge² program is the Department's initiative to further streamline, consolidate, and improve financial management throughout DHS. eMerge² will provide a long-term solution to many of the Department's deficiencies and will be critical to improving financial management at DHS components. The eMerge² program's end-state vision is to improve systems and processes in DHS; reduce material weaknesses, systems and providers; and increase efficiency and effectiveness.

Since last year, DHS has completed an exhaustive, department-wide requirements definition and design phase, and is finishing our rollout strategy going forward. This spring, in conjunction with Secretary Chertoff's Second Stage Review, we began a reevaluation of our original planned approach to delivering improved financial systems to DHS organizations. The program review objectives are to see if there are additional opportunities to lower the cost and risks and to accelerate the implementation of a department-wide financial management system. Concurrently with the implementation of the long-term solution, the eMerge² Program Office is developing DHS-wide financial performance metrics which will be available to the DHS CFO community via an internal website. This dashboard will be vital to achieving DHS' vision of providing meaningful and useful information to managers. It will also be vital to tracking our financial performance as a Department.

We have made great progress under challenging circumstances. Now, with a strong, growing and motivated staff, and the continued support of the Department's leadership, OMB and Congress, we will realize even greater progress in the coming year.

Sincerely,

Andrew Maner
Chief Financial Officer

Office of Inspector General

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

November 15, 2005

MEMORANDUM FOR: The Honorable Michael Chertoff
Secretary

FROM: Richard L. Skinner
Inspector General

SUBJECT: Independent Auditors' Report on DHS' FY 2005 Financial Statements

The attached report presents the results of the Department of Homeland Security's (the Department) financial statement audits for fiscal year FY 2005 and FY 2004. These audits were required by the *Accountability of Tax Dollars Act of 2002*. This report is incorporated into the *Department's FY 2005 Performance and Accountability Report.* We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the audits.

Unfortunately, the Department made little or no progress to improve its overall financial reporting during FY 2005. KPMG was unable to provide an opinion on the Department's balance sheet, and the number of material weaknesses remains 10. The Transportation Security Administration (TSA), which received an unqualified opinion in 2004 from its stand-alone audit, was unable to complete its statements by the end of scheduled fieldwork this year, primarily due to a systems conversion. We have extended TSA's audit for an additional 30 days.

Summary

KPMG was unable to express an opinion on the Department's consolidated balance sheet as of September 30, 2005, and on the consolidated financial statements as of and for the year ended September 30, 2004. The disclaimer was due primarily to financial reporting problems at 5 bureaus. The FY 2005 auditors' report discusses 10 material weaknesses, 2 other reportable conditions in internal control, and instances of non-compliance with 7 laws and regulations, as follows:

Reportable Conditions That Are Considered To Be Material Weaknesses

A. Financial Management Oversight
B. Financial Reporting
C. Financial Systems Security
D. Fund Balance with Treasury
E. Property, Plant, and Equipment

F. Operating Materials and Supplies
G. Undelivered Orders, Accounts and Grants Payable, and Disbursements
H. Actuarial Liabilities
I. Budgetary Accounting
J. Intragovernmental and Intradepartmental Balances

Other Reportable Conditions

K. Environmental Liabilities
L. Custodial Revenue and Drawback

Non-compliance With Laws And Regulations

M. Federal Managers' Financial Integrity Act of 1982 (FMFIA)
N. Federal Financial Management Improvement Act of 1996 (FFMIA)
O. Federal Information Security Management Act (Electronic Government Act of 2002)
P. Single Audit Act Amendments of 1996, and Laws and Regulations Supporting OMB Circular No. A-50, Audit Follow-up, as revised
Q. Improper Payments Information Act of 2002
R. DHS Financial Accountability Act of 2004
S. Government Performance and Results Act of 1993

Moving DHS' Financial Management Forward

Financial management at the Department continued to falter during FY 2005, primarily due to problems at Immigration and Customs Enforcement (ICE) and the Coast Guard. However, TSA, State and Local Government Coordination and Preparedness (SLGCP), and Emergency, Preparedness and Response (EP&R) also experienced difficulties that they could not overcome by the reporting deadline, and they joined ICE and the Coast Guard in contributing to the Department's disclaimer of opinion. Those difficulties included: a systems conversion at TSA, problems involving SLGCP's accounting service provider, and Hurricane Katrina, which stretched EP&R's accounting resources late in the fiscal year despite its best efforts to support the financial statement audit. With focused management attention, we believe that TSA, SLGCP, and EP&R can get back on track for FY 2006.

ICE and the Coast Guard face much deeper problems, and the accounting problems at ICE further affect the bureaus it services. The auditors reported that financial management at ICE was ineffective and used unreliable processes and procedures for accounting and financial reporting. The auditors further reported that weaknesses in ICE's controls might have allowed ICE and the components it serviced to violate the Antideficiency Act. In particular, ICE had significant problems with respect to the completeness and accuracy of its recorded obligations and their timely recording.

The auditors reported that the Coast Guard did not have an organizational structure that fully supported the development and implementation of effective policies, procedures, and internal controls. Management acknowledged to the auditors that longstanding procedural, control, personnel, and cultural issues existed and had impeded their progress in addressing this structural weakness. The auditors reported that the Coast Guard's personnel rotation policy made it difficult

for the Coast Guard's Chief Financial Officer (CFO) to institutionalize internal controls related to financial management and reporting that were outside his direct organization. Within the Coast Guard's CFO organization, the auditors reported that financial reporting processes were complex and labor-intensive.

Although the Department inherited many of the reported conditions, the Department's CFO is ultimately responsible for ensuring that progress is made in financial management. The auditors reported that the Department's CFO office did not provide effective oversight of bureau corrective action plans to ensure their development, implementation, and successful completion.

DHS executive managers have the authority to set priorities and demand the corrective action for both Departmental and bureau personnel. Their active involvement is critical to moving financial management forward at DHS.

* * * * *

KPMG is responsible for the attached auditor's report dated November 14, 2005, and the conclusions expressed in the report. We do not express opinions on the financial statements or internal control or conclusions on compliance with laws and regulations.

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

We request that a corrective action plan that demonstrates DHS' progress in addressing the report's recommendations be provided to us within 90 days of the date of this letter.

We appreciate the cooperation extended to the auditors by DHS' financial offices. Should you have any questions, please call me, or your staff may contact J. Richard Berman, Assistant Inspector General for Audits, at 202-254-4100.

Attachment

KPMG LLP
2001 M Street, NW
Washington, DC 20036

INDEPENDENT AUDITORS' REPORT

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

We were engaged to audit the accompanying consolidated balance sheets of the U.S. Department of Homeland Security (DHS) as of September 30, 2005 and 2004, and the related consolidated statements of net cost, changes in net position, and financing, combined statement of budgetary resources, and statement of custodial activity for the year ended September 30, 2004 (referred to herein as "consolidated financial statements"). We were also engaged to consider DHS' internal control over financial reporting and to test DHS' compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements that could have a direct and material effect on these financial statements. We were not engaged to audit the accompanying consolidated statements of net cost, changes in net position, and financing, combined statement of budgetary resources, and statement of custodial activity for the year ended September 30, 2005.

Summary

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the DHS consolidated balance sheet as of September 30, 2005 and on the consolidated financial statements as of and for the year ended September 30, 2004.

Our fiscal year 2005 consideration of internal control over financial reporting resulted in the following conditions being identified as reportable conditions:

Reportable Conditions That Are Considered To Be Material Weaknesses

A. Financial Management Oversight
B. Financial Reporting
C. Financial Systems Security
D. Fund Balance with Treasury
E. Property, Plant, and Equipment
F. Operating Materials and Supplies
G. Undelivered Orders, Accounts and Grants Payable, and Disbursements
H. Actuarial Liabilities
I. Budgetary Accounting
J. Intragovernmental and Intradepartmental Balances

Other Reportable Conditions

K. Environmental Liabilities
L. Custodial Revenue and Drawback

KPMG LLP. KPMG LLP, a U.S. limited liability partnership, is
a member of KPMG International, a Swiss association.

The results of our tests of fiscal year 2005 compliance with certain provisions of the following laws, regulations, contracts, and grant agreements disclosed instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*:

M. *Federal Managers' Financial Integrity Act of 1982 (FMFIA)*
N. *Federal Financial Management Improvement Act of 1996 (FFMIA)*
O. *Federal Information Security Management Act (Electronic Government Act of 2002)*
P. *Single Audit Act Amendments of 1996,* and Laws and Regulations Supporting OMB Circular No. A-50*, Audit Follow-up*, as revised
Q. *Improper Payments Information Act of 2002*
R. *DHS Financial Accountability Act of 2004*
S. *Government Performance and Results Act of 1993*

DHS financial management systems did not substantially comply with the FFMIA Section 803(a) requirements related to compliance with Federal financial management system requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level.

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the consolidated balance sheet as of September 30, 2005, and we were not engaged to audit the accompanying consolidated statements of net cost, changes in net position, and financing, combined statement of budgetary resources, and statement of custodial activity for the year ended September 30, 2005. Accordingly, other internal control matters and other instances of non-compliance may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the September 30, 2005 consolidated balance sheet, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements.

The following sections discuss the reasons why we are unable to express an opinion on the accompanying DHS consolidated balance sheet as of September 30, 2005 and on the consolidated financial statements as of and for the year ended September 30, 2004; our consideration of DHS' internal control over financial reporting; our tests of DHS' compliance with certain provisions of applicable laws, regulations, contracts, and grant agreements; and management's and our responsibilities.

Report on the Financial Statements

We were engaged to audit the accompanying consolidated balance sheets of the U.S. Department of Homeland Security (DHS) as of September 30, 2005 and 2004, and the related consolidated statements of net cost, changes in net position, and financing, combined statement of budgetary resources, and statement of custodial activity for the year ended September 30, 2004. We were not engaged to audit the accompanying consolidated statements of net cost, changes in net position, and financing, combined statement of budgetary resources, and statement of custodial activity for the year ended September 30, 2005.

Immigration and Customs Enforcement (ICE), did not adequately maintain its accounting records during fiscal year 2005, or the accounting records of other DHS components – United States Citizenship and Immigration Service (USCIS), Science and Technology (S&T), Information Analysis and Infrastructure Protection (IAIP), DHS Management, and Border and Transportation Security (BTS) Headquarters (referred to herein as "DHS-ICE components"), for which ICE is the accounting service provider. ICE management was unable to provide sufficient evidential matter that supported the balance sheet accounts of ICE and DHS-ICE components as presented in the DHS consolidated balance sheet at September 30, 2005; or make knowledgeable representation of facts and circumstances regarding accounting and budgetary

transactions that occurred in fiscal year 2005. Throughout the year, and at September 30, 2005, ICE did not perform timely reconciliations of balance sheet accounts or complete its investigation of potential errors in the financial statements that may materially affect the fair presentation of the DHS consolidated financial statements, at September 30, 2005; and therefore, DHS management was unable to represent that the ICE and DHS-ICE component balance sheets are fairly stated as of September 30, 2005. The total assets of ICE and DHS-ICE components, as reported in the accompanying DHS consolidated balance sheet at September 30, 2005, are $5.8 billion or 5.1 percent of consolidated total assets.

The United States Coast Guard (Coast Guard), was unable to provide adequate supporting documentation during fiscal year 2005, particularly with respect to actuarially-derived liabilities, operating materials and supplies, undelivered orders, certain categories of property, plant and equipment, transactions related to the Coast Guard's fund balance with Treasury, and changes in net position and adjustments made as part of Coast Guard's financial reporting process, as presented in the accompanying DHS consolidated balance sheet at September 30, 2005. Adequate evidential matter in support of recorded transactions was not available in all cases and corrective action was not taken prior to the completion of DHS' *Fiscal Year 2005 Performance and Accountability Report*. Because of the significance of these balances, DHS management was unable to represent that the Coast Guard's balance sheet as of September 30, 2005, is fairly stated. The total assets of Coast Guard, as reported in the accompanying DHS consolidated balance sheet at September 30, 2005, are $11.4 billion or 9.9 percent of consolidated total assets.

State and Local Government Coordination and Preparedness (SLGCP) was unable to resolve discrepancies identified in the data underlying the calculation of its grants payable liability, and the related effect on net position, if any, at September 30, 2005, prior to the completion of DHS' *Fiscal Year 2005 Performance and Accountability Report*. SLGCP grants payable, as reported in the accompanying DHS consolidated balance sheet at September 30, 2005, is $171 million or 0.2 percent of consolidated total liabilities.

The Transportation Security Administration (TSA) was unable to fully reconcile and support the accuracy and completeness of its accounts payable with the public and net position prior to the completion of DHS' *Fiscal Year 2005 Performance and Accountability Report*. TSA accounts payable with the public and net position, as reported in the accompanying DHS consolidated balance sheet at September 30, 2005, are $851 million or 1.2 percent of consolidated total liabilities, and $2.4 billion or 5.4 percent of consolidated total net position, respectively.

Emergency Preparedness and Response (EPR) was unable to fully support the accuracy and completeness of certain components of its deferred revenue and accounts payable, and the related effect on net position, if any, prior to the completion of DHS' *Fiscal Year 2005 Performance and Accountability Report*. These liabilities, as reported in the accompanying DHS consolidated balance sheet at September 30, 2005, are $1.7 billion or 2.4 percent of consolidated total liabilities.

DHS was unable to reconcile intragovernmental transactions and balances, prior to the completion of DHS' *Fiscal Year 2005 Performance and Accountability Report*, totaling $1.6 billion, with other Federal trading partners, as of September 30, 2005. In addition, DHS omitted several financial statement note disclosures required by OMB Circular No. A-136, *Financial Reporting Requirements*, Part A, *Form and Content of the Performance and Accountability Report*.

As discussed above, we were unable to obtain appropriate representations from DHS management with respect to the accompanying DHS consolidated balance sheet as of September 30, 2005, and were unable to determine the effect of the lack of such representations on DHS' financial position as of September 30, 2005. Because of the matters discussed in the six preceding paragraphs, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying DHS consolidated balance sheet as of September 30, 2005.

We were not engaged to audit the accompanying consolidated statements of net cost, changes in net position, and financing, combined statement of budgetary resources, and statement of custodial activity for the year ended September 30, 2005, and accordingly, we do not express an opinion on those financial statements.

Regarding the fiscal year 2004 consolidated financial statements, ICE did not adequately maintain its accounting records during fiscal year 2004, particularly with respect to balances transferred in from legacy agencies, intradepartmental and intragovernmental agreements and transactions, suspense accounts, costs and budgetary transactions, thus requiring extensive reconciliation and adjustment of these and other accounts at year end, which ICE was unable to complete. Also, ICE management was unable to provide evidential matter or was not able to make knowledgeable representation of facts and circumstances, regarding certain transactions occurring in fiscal year 2004. DHS was unable to complete and review the accompanying fiscal year 2004 consolidated financial statements, or reconcile its intragovernmental balances, prior to the completion of our procedures. In addition, we were unable to complete audit procedures over certain costs and budgetary transactions of the Coast Guard for the year ended September 30, 2004. For fiscal year 2004, OMB required that federal agencies submit audited financial statements by November 15, 2004. It was impracticable to extend our audit procedures sufficiently to determine the extent to which the consolidated financial statements as of and for the year ended September 30, 2004, may have been affected by these conditions.

Because of the matters discussed in the previous paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying consolidated financial statements of DHS as of and for the year ended September 30, 2004.

As discussed in Note 30, DHS restated its fiscal year 2004 consolidated financial statements to correct an error in accounting for budgetary obligations related to the EPR National Flood Insurance Program as previously reported in DHS' fiscal year 2004 consolidated financial statements. We were not engaged to audit the restatement discussed in Note 30, and accordingly, we have not concluded on the appropriateness of this accounting treatment or the restatement of the fiscal year 2004 financial statements.

The information in the Management's Discussion and Analysis (MD&A), Required Supplementary Stewardship Information (RSSI), and Required Supplementary Information (RSI) sections is not a required part of the financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Circular No. A-136. We were unable to complete limited procedures over MD&A, RSSI, and RSI as prescribed by professional standards, because of the limitations on the scope of our audit described in the previous paragraphs of this section of our report. Certain information presented in the MD&A, RSSI, and RSI is based on fiscal years 2005 and 2004 consolidated financial statements on which we have not expressed an opinion. We did not audit the MD&A, RSSI, and RSI and, accordingly, we express no opinion on it. However, in fiscal years 2005 and 2004, we noted that DHS did not reconcile nonfiduciary accounts with its trading partners, as specified by OMB requirements, which could affect the intragovernmental information presented in RSI. In fiscal year 2004, we also noted that DHS did not present as RSI a schedule of budgetary resources by major budgetary account, as required.

The information in the Executive Summary, Performance Information, Other Accompanying Information, and Appendices sections of DHS' *Fiscal Year 2005 Performance and Accountability Report* are presented for purposes of additional analysis, and is not a required part of the consolidated financial statements. This information has not been subjected to auditing procedures, and accordingly, we express no opinion on it.

Internal Control over Financial Reporting

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by

the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect DHS' ability to record, process, summarize, and report financial data consistent with the assertions by management in the consolidated financial statements.

Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted certain matters, described in Appendices I and II involving internal control over financial reporting and its operation that we consider to be reportable conditions. We believe that reportable conditions A through J presented in Appendix I are material weaknesses. Appendix II represents other reportable conditions K and L. As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the consolidated balance sheet as of September 30, 2005, and accordingly, other internal control matters may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the September 30, 2005 consolidated balance sheet, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements.

* * * * *

A summary of the status of fiscal year 2004 reportable conditions is included as Appendix IV.

We also noted other matters involving internal control over financial reporting and its operation that we will report to the management of DHS in a separate letter dated November 15, 2005.

Internal Controls over Required Supplementary Stewardship Information and Performance Measures

We noted certain significant deficiencies in internal control over RSSI, discussed in Appendix I that, in our judgment, could adversely affect DHS' ability to collect, process, record, and summarize RSSI. With respect to the design of internal controls relating to existence and completeness assertions over performance measures determined by management to be key and reported in the MD&A section of DHS' *Fiscal Year 2005 Performance and Accountability Report*, we noted certain deficiencies in internal control over reported performance measures, discussed in Appendix I that, in our judgment, could adversely affect DHS' ability to collect, process, record, summarize and report performance measures in accordance with management's criteria.

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the consolidated balance sheet as of September 30, 2005, and accordingly, other internal control matters affecting RSSI and performance measures may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the September 30, 2005 consolidated balance sheet, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements.

Compliance and Other Matters

Our tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, as described in the Responsibilities section of this report, exclusive of those referred to in the FFMIA, disclosed six instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, and are described in Appendix III.

The results of our tests of compliance with certain provisions of other laws and regulations, exclusive of those referred to in FFMIA, disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02.

The results of our tests of FFMIA, disclosed instances where DHS' financial management systems did not substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and recording of financial transactions in accordance with the United States Government Standard General Ledger, that are presented in Appendices I and II.

As discussed in our report on the financial statements, the scope of our work was not sufficient to express an opinion on the consolidated balance sheet as of September 30, 2005, and accordingly, other instances of non-compliance with laws, regulations, contracts, and grant agreements may have been identified and reported, had we been able to perform all procedures necessary to express an opinion on the September 30, 2005 consolidated balance sheet, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements.

Additional Matter. ICE management represents that they intend to initiate a review over the completeness of obligations recorded in its accounting records that may identify instances of violations of the *Antideficiency Act,* or other violations of appropriation law that may have occurred during fiscal year 2005, and have not been reported as required by Federal government regulations.

Management's Response to Internal Control and Compliance Findings

DHS management has indicated, in a separate letter immediately following this report that it concurs with the findings presented in Appendices I, II and III of our report. Further, they have responded that they will take corrective action, as necessary, to ensure that the Chief Financial Officer, and the respective bureau management, within DHS address the matters presented herein.

Responsibilities

Management's Responsibilities. The *Government Management Reform Act of 1994* (GMRA), *Accountability of Tax Dollars Act of 2002,* and *Government Corporation Control Act* require agencies to report annually to Congress on their financial status and any other information needed to fairly present their financial position and results of operations. To meet these requirements, DHS prepares and submits financial statements in accordance with Part A of OMB Circular No. A-136.

DHS management is responsible for the financial statements, including:

- Preparing the financial statements in conformity with accounting principles generally accepted in the United States of America;
- Preparing the MD&A (including the performance measures), RSI, and RSSI;
- Establishing and maintaining internal controls over financial reporting; and
- Complying with laws, regulations, contracts, and grant agreements, including FFMIA.

In fulfilling this responsibility, management is required to make estimates and judgments to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements, due to error or fraud, may nevertheless occur and not be detected.

Auditors' Responsibilities. As discussed in our report on the financial statements, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the DHS consolidated balance sheet as of September 30, 2005, or the consolidated financial statements as of and for the year ended September 30, 2004.

In connection with our fiscal year 2005 engagement, we considered DHS' internal control over financial reporting by obtaining an understanding of DHS' internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our procedures. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*. The objective of our engagement was not to provide assurance on internal control over financial reporting. Consequently, we do not provide an opinion thereon. Further, other matters involving internal control over financial reporting may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS consolidated balance sheet as of September 30, 2005, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements.

As required by OMB Bulletin No. 01-02, in fiscal year 2005, we considered DHS' internal control over RSSI by obtaining an understanding of DHS' internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. Our procedures were not designed to provide assurance on internal control over RSSI and, accordingly, we do not provide an opinion thereon. Further, other matters involving internal control over RSSI may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS consolidated balance sheet as of September 30, 2005, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements.

OMB Bulletin No. 01-02 requires auditors, with respect to internal control related to performance measures determined by management to be key and reported in the MD&A and Performance sections, to obtain an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal controls over performance measures and, accordingly, we do not provide an opinion thereon. As discussed in our report on the financial statements, we were unable to complete procedures over the MD&A and performance measures presented in DHS' *Fiscal Year 2005 Performance and Accountability Report*.

In connection with our fiscal year 2005 engagement, we performed tests of DHS' compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of the consolidated balance sheet amounts as of September 30, 2005, and certain provisions of other laws and regulations specified in OMB Bulletin No. 01-02, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws, regulations, contracts, and grant agreements applicable to the DHS. Other matters involving compliance with laws, regulations, contracts, and grant agreements may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS consolidated balance sheet as of September 30, 2005, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements. Providing an opinion on compliance with laws, regulations, contracts, and grant agreements was not an objective of our engagement and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 01-02 and FFMIA, we are required to report whether DHS' financial management systems substantially comply with (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. Other instances of non-compliance may have been identified and reported had we been able to perform all procedures necessary to express an opinion on the DHS consolidated balance sheet as of September 30, 2005, and had we been engaged to audit the other fiscal year 2005 consolidated financial statements.

Distribution

This report is intended for the information and use of DHS management, DHS Office of Inspector General, OMB, Government Accountability Office, and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 14, 2005

Independent Auditors' Report
Appendix I – Material Weaknesses in Internal Control

A. Financial Management and Oversight

Background: In fiscal year 2004, we reported that financial management and oversight at Immigration and Customs Enforcement (ICE) was a material weakness, principally because its financial systems, processes, and control activities were inadequate to provide accounting services to itself and five other substantial Department of Homeland Security (DHS or the Department) components – U.S. Citizenship and Immigration Services (CIS), Science and Technology (S&T), Information Analysis and Infrastructure Protection (IAIP), Management, and Border and Transportation Security (BTS) Headquarters (referred to herein as "DHS-ICE components"). We also reported that weaknesses in financial management oversight hinder the United States Coast Guard's (Coast Guard) ability to prepare accurate, complete, and timely financial information.

In fiscal year 2004, we also reported that the DHS Chief Financial Officer (CFO) and his staff were challenged by a myriad of issues related to the inception of the Department, many of which were unique matters related to the set-up of the consolidated financial processes of DHS as a single operating entity. The DHS Office of the CFO (OCFO) has taken several positive steps in fiscal year 2005 toward correcting conditions we reported last year, e.g., hired a deputy CFO and additional personnel, prepared guidance and policies, implemented automated monitoring controls, and undertook a self review to improve its controls and processes. In addition, the OCFO implemented new policies and procedures to comply with the *DHS Financial Accountability Act of 2004*, which requires DHS management to provide an assertion on the effectiveness of internal control over financial reporting in fiscal year 2005.

However, the combination of conditions that exist in ICE and DHS-ICE components, the Coast Guard and the OCFO cause an organizational material weakness in financial management and oversight. The operations of ICE and DHS-ICE components for which ICE performs accounting services, combined with the Coast Guard, represent approximately 15.1 percent of total assets, and $15.4 billion or 14.4 percent of the total DHS fiscal year 2005 budget authority.

Conditions: The conditions described below are structural in nature, and rise to the level of a material weakness because they affect the overall integrity of DHS' consolidated financial statement reporting process and its ability to comply with laws and regulations.

1. ICE has not made sufficient, measurable progress in correcting its financial management oversight and weaknesses. All of the conditions we reported last year are repeated together with new findings. Financial management at ICE has been ineffective. We noted that ICE:

   - Did not have sufficient numbers of qualified financial managers and staff to perform its accounting responsibilities. Despite the hiring of a new acting CFO and a new financial director, ICE relied on OCFO assistance and outside contractors to diagnose problems, make management decisions, and provide routine accounting staff supervision. ICE continued to fall seriously behind in performing accounting functions, such as account reconciliations, analysis of material abnormal balances, and proper budgetary accounting, which prevented it from submitting timely and accurate periodic financial reports to the OCFO during fiscal year 2005. Specifically, during fiscal year 2005, ICE financial managers and staff were unable to:

     – Perform analysis of and record basic and routine accounting entries;
     – Correctly apply Federal accounting standards, in many instances, to ensure accurate and reliable financial reporting;

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- Develop and communicate accounting policies and procedures throughout ICE and the DHS-ICE components it serviced to ensure accuracy and consistency in financial reporting;
- Timely and accurately respond to data requests from the OCFO during the year; and
- Establish adequate internal controls that reasonably ensured the integrity of financial data, and that adhered to Government Accountability Office (GAO) *Standards for Internal Control in the Federal Government* (*Standards*).

- Lacked a comprehensive strategy to identify the root causes of its financial statement errors and to correct deficiencies in its accounting and financial reporting processes. As a result, pervasive, and potentially systemic, financial statement errors and abnormal balances existed, in both proprietary and budgetary accounts, throughout fiscal year 2005.
- In conjunction with the DHS-ICE components, ICE continued to operate unreliable processes and procedures that support accounting and financial reporting; resulting in material errors, irregularities, and abnormal balances in the DHS consolidated financial statements that existed for most of fiscal year 2004 and continued unresolved in fiscal year 2005.
- Continued to execute responsibilities for certain administrative / accounting functions for other DHS components without proper reimbursable agreements to cover these costs, well into the fiscal year.
- Was unable to quantify and record correcting adjustments to restate the fiscal year 2004 financial statements for known errors.

2. The Coast Guard:

- Has not fully implemented a financial management organizational structure that supports the development and implementation of effective policies, procedures, and internal controls to ensure data supporting financial statement assertions are complete and accurate.
- Has not established clear management oversight responsibilities and processes to review adjustments to account balances, identify the cause of abnormal balances, and account relationship discrepancies, e.g., budgetary to proprietary reconciliations, and investigate potential financial system concerns such as potential posting logic errors.
- Has not fully established management oversight functions to ensure that accounting principles are correctly applied, and to provide accounting operational guidance to other offices and facilities within the Coast Guard.

3. The OCFO has not:

- Completed its plan to expand the OCFO with sufficient resources, including personnel with the requisite experience and skills to effectively manage the financial reporting and internal control infrastructure of a large Executive Branch agency.
- Provided effective management and oversight to ensure that:
  - DHS component corrective action plans were developed, implemented, with progress tracked, and successfully completed, particularly at ICE and the Coast Guard, to support the elimination of material weaknesses and achieve consistent, timely, and reliable

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financial reporting from all DHS components, within the time-period requested by the Secretary;

- Financial management, and reporting problems in DHS components were promptly and effectively addressed;
- Workload among OCFO staff was separated to allow for proper supervisory reviews, and to provide appropriate back-up for key staff; and
- Processes were implemented to draft an accurate and complete DHS *Performance and Accountability Report* (PAR), within a reasonable time-frame after year-end, and to prepare accurate monthly financial statements throughout the year, that did not require restatements to previously published financial statements, as discussed further in Comment B – *Financial Reporting*.

The organizational weaknesses detailed above have led to specific conditions that affect the quality of financial reporting at DHS, and are further described in Comment B - *Financial Reporting.*

Cause/Effect: DHS has attempted the stand-up of a large, new, and complex Executive Branch agency, without the assistance of sufficient organizational and accounting expertise. Since its inception in 2003, the Department has not made sufficient investments in human capital and other critical infrastructure necessary for reliable financial processes. The Department CFO's ability to fully address these weaknesses has been significantly impaired by the financial management structure and the need to provide significant oversight at ICE and the Coast Guard. The severity of the conditions at ICE and the Coast Guard caused the CFO of both components to issue statements of "no assurance" on internal control over financial reporting. Due to the significance of the balance sheet accounts at ICE and the Coast Guard to DHS' consolidated balance sheet, the DHS Secretary and CFO were also unable to render assurances on the effectiveness of internal controls over financial reporting in fiscal year 2005.

The human resources, financial systems, processes, and control activities at ICE which also supported the DHS-ICE components were inadequate to process financial transactions for components of their size.

The Coast Guard has made progress in hiring qualified personnel and has developed a corrective action plan; however, management has acknowledged that longstanding procedural, control, personnel, and cultural issues have impeded progress toward installing an effective financial management structure. In addition, the Coast Guard's CFO must coordinate with heads of various divisions who have a role in the accounting and financial reporting processes, but who otherwise have limited exposure to financial statement audits. Further, these division heads change regularly as part of the Coast Guard military assignment and rotation polices, making it difficult for the CFO to institutionalize internal controls related to financial management and reporting that are outside the CFO's direct organization.

As a result, the conditions described above continue to prevent DHS from timely preparation of accurate financial information and reports, and have contributed to the conditions reported in Comment B – *Financial Reporting* of this Appendix. Lack of adequate processes, and sufficient experienced staff or contractors, has led management to place excessive reliance on the financial statement audit to identify errors in accounts and deficiencies in processes and controls. DHS will continue to have difficulty complying with Federal accounting standards and requirements, and implementing appropriate internal control as defined by the Comptroller General, until adequate processes and skilled management and staff resources are engaged at ICE, the Coast Guard and within the OCFO.

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Criteria: The Federal Managers' Financial Integrity Act of 1982 (FMFIA) requires that agencies establish internal controls according to standards prescribed by the Comptroller General and specified in the GAO *Standards*. The GAO defines internal control as an integral component of an organization's management that provides reasonable assurance that the following objectives are achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. Further, the GAO *Standards* identify five standards to be implemented: control environment, risk assessment, control activities, information and communication, and monitoring. These standards cover controls such as human capital practices, supervisory reviews, and segregation of duties, policies, procedures, and monitoring.

Recommendations: We recommend that

1. ICE:
   a) Perform a detailed capabilities assessment of financial personnel at ICE headquarters, the Dallas Finance Center, and the Debt Management Center, to identify critical skill-level gaps and develop and execute a hiring strategy to fill the gaps. In the short-run, solicit assistance from the Office of Management and Budget (OMB) or other Federal agencies by requesting temporary transfers of experienced management and accounting personnel. To be successful with this initiative, an experienced project manager must be identified, and the full support of the DHS Secretary, OCFO and ICE Assistant Secretary will be needed – including, if necessary, an emphasis in the ICE mission statement on reliable financial management and reporting objectives; and
   b) Critically assess the current accounting systems and processes, especially those with serious material weaknesses. Develop a financial reporting risk profile to assist management with ranking and prioritization of financial accounting, and reporting structural deficiencies. Develop a detailed financial accounting and reporting architecture of necessary systems, policies, processes, procedures, and internal controls; and finally implement corrective action plans to achieve the desired end-state of reliable and timely financial reporting.
2. Coast Guard:
   a) Evaluate the existing financial management organizational and internal control structure and conduct an assessment to determine the number of personnel and resources needed, along with the requisite skills and abilities necessary to provide effective guidance, and oversight to program offices that are significant to financial management and reporting, and make recommendations to senior management for appropriate changes. Consider the establishment of an Office of Financial Management that would have the authority, ability and appropriate resources to oversee all Coast Guard financial management policy, systems and reporting;
   b) Establish internal controls and related procedures for performing periodic reviews and oversight to assess the appropriateness, to include compliance with generally accepted accounting principles, of financial policies and procedures, and the design and operating effectiveness of internal controls. Consider prioritizing remediation of material weaknesses given the available resources;
   c) Establish clear management oversight responsibilities and processes to effectively review adjustments to account balances, identify the cause of abnormal balances and account for relationship discrepancies, e.g., budgetary to proprietary reconciliations, and investigate potential financial system concerns such as potential posting logic errors; and

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d) Consider establishing a process to benchmark Coast Guard financial management and oversight to other agencies that have been recognized for excellence in financial management, and have an established track record of unqualified opinions on their audited financial statements.

3. The OCFO:

a) In coordination with its independent auditor, consultants, and the Office of Inspector General, perform a gap analysis of the resource weaknesses, including personnel skill sets, and develop and implement a strategic plan to address those gaps and financial reporting and internal control weaknesses in the OCFO and throughout the Department;

b) Continue to supplement its accounting staff with personnel with skill-sets that compliment the current staff and result in a stronger Department-wide control environment;

c) Obtain and use authority from the Secretary's office to require DHS components to develop and implement sound, reasonable, appropriately funded, corrective action plans that will eliminate material weaknesses and result in timely, accurate financial reporting. This initiative will likely require assistance from the Secretary's office to emphasize the necessity of good financial management, hold components and departmental management accountable for progress, and in some cases will require substantial cultural shifts and a commitment of resources; and

d) Continue to implement processes and controls within the OCFO that will support the timely and accurate completion of the Department's interim financial reports and year-end PAR.

B. Financial Reporting

Background: Financial reporting at DHS is dependent upon the quality of financial reporting at its individual components, and the ability of the OCFO to consolidate information timely and consistently. Under the current financial reporting structure, the OCFO prepares consolidated financial statements, including footnote and supplementary data, from trial balances and other financial data submitted by the components to the OCFO, and submits data to the Treasury Information Executive Repository (TIER) system. The OCFO is also responsible for development and communication of appropriate accounting policies, ensuring that financial reporting controls exist, and performing certain quality control procedures to monitor financial information. The components are not required to prepare complete financial statements with footnotes and supplementary data that comply with generally accepted accounting principles. The vast majority of DHS' financial reporting resources have remained decentralized at the component level.

Conditions: We noted the following internal control weaknesses related to financial reporting in the OCFO and DHS components:

1. The OCFO:

- Was unable to prepare a balanced[1] consolidated financial statement during fiscal year 2005 until November 2005. In addition, the consolidated financial statement disclosures and notes

[1] Balanced in this context means: assets equal liabilities plus net position, on a consolidated basis, as presented on the balance sheet.

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contained critical errors and inconsistencies, when provided to us less than two weeks before the filing deadline of November 15, and required material adjustments to correct.

- Has not fully documented policies and procedures for many critical activities necessary to adequately manage financial reporting processes, such as policies and procedures related to a year-end or interim close schedule to prepare reliable consolidated financial statements, comprehensive requirements for resolving intradepartmental and intragovernmental elimination discrepancies, and making changes to the PAR guidance disseminated to the DHS components.
- Has not implemented sufficient procedures and monitoring controls to ensure monthly TIER submissions received from the components were prepared timely and accurately, including adequate supporting documentation for elimination entries and adjustments at the consolidated financial statement level necessary to prepare consolidated financial statements.
- Has implemented policies and procedures, but has not required the components to follow the policies and procedures and effectively use recently installed TIER analytical tools to improve the integrity and reliability of financial data at the components, and as a result, the component TIER submissions contained numerous abnormal balances and potential errors that were not explained in a timely manner. In addition, some OCFO personnel accepted explanations from components for financial statement abnormalities that were incomplete and inaccurate, and did not include sufficient detail to inform the reviewer of the nature of the error and when the condition would be corrected.
- Omitted two financial statement note disclosures required by OMB Circular No. A-136, *Financial Reporting Requirements*, Part A, *Form and Content of the Performance and Accountability Report*, which were:
  - A reconciliation of the Department's fiscal year 2004 budget amounts, as presented in the statement of budgetary resources to the President's budget; and
  - Intra-agency eliminations necessary to prepare the statement of net cost by sub-organization major programs.

2. At Coast Guard:

- The financial reporting process was complex and labor-intensive, and required a significant number of "on-top" adjustments (adjustments made outside the core accounting system for presentation of financial information given to DHS for consolidation). A significant amount of manual review was required to integrate data from three separate general ledger systems and overcome system and process deficiencies. One of the most significant deficiencies was that the Coast Guard produced its TIER submission from a database that did not have detail at the transactional level, and that did not agree to the transactional balances in the Coast Guard's general ledgers.
- Significant abnormal balances existed in its TIER submissions, but the Coast Guard only had limited procedures for identifying and resolving those abnormal balances, and potential errors at a transaction level. As a result, the Coast Guard made routine "top-side" adjustments to prepare its monthly TIER submission to the OCFO that, in some cases, might have masked potential errors that instead should have been researched.

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- The Coast Guard routinely used analytical comparisons to identify adjusting entries to the financial statements, without verifying that the ending balances were properly supported at the transaction level, e.g., budgetary accounts were adjusted to equal proprietary accounts, without verifying that the underlying transactional detail supported the ending balances.
- The processes that Finance Center personnel used for making year-end closing entries did not consistently include sufficient supporting documentation or internal controls at an appropriate level, such as effective management review, approval of individual adjusting entries, or procedures to determine that all necessary adjustments were identified.
- The processes used for some account reconciliations were not well designed. For example, procedures for reconciling cumulative results of operations, and resolving inconsistencies in the accounting treatment for inter-entity balances were weak and in many cases lacked documentation.
- Personnel did not effectively complete the GAO Disclosure Checklist for the September 30, 2005 DHS financial statements.

3. ICE has not:

- Established effective internal controls over the daily accounting and recording of transactions, supervisory review, reconciliation of accounts, and documentation of supporting information for auditor review. ICE routinely made "top-side" adjustments to financial information that was not adequately reviewed, supported by transactional data, or documented. For example, we noted that personnel often approved adjusting general ledger entries for which they did not have a thorough knowledge or understanding, and adequate supporting documentation for the adjusting journal entries was not maintained.
- Reconciled quarterly *Report on Budget Execution* (SF-133)s to approved *Apportionment and Reapportionment Schedule* (SF-132)s for all Treasury Appropriation Fund Symbol (TAFS) accounts. At September 30, 2005, we noted differences in the amounts reported in FFMS (the core accounting system) and some SF-133s and SF-132s, totaling more that $550 million across ICE and DHS-ICE components that could indicate a potential violation of the *Antideficiency Act*.
- Adequately designed the processes to be used for some account reconciliations. For example, procedures for reconciling cumulative results of operations, and resolving inconsistencies in the accounting treatment for inter-entity balances were weak and in many cases lacked documentation.
- Provided guidance to DHS-ICE components regarding how to process financial transactions timely and accurately, and did not have documented policies and procedures that will ensure that financial information submitted monthly to the OCFO is in compliance with generally accepted accounting principles.
- Adhered to the schedule set by the OCFO, to submit accurate monthly TIER reports and other accompanying information, complete the GAO checklist, and provide other information needed by the OCFO to prepare the fiscal year 2005 PAR. For example, we noted that ICE was unable to file an accurate TIER submission without DHS CFO waivers of significant error conditions for every month we reviewed (seven in total), and was unable to perform an effective hard-close at June 30, 2005, as requested by the DHS CFO.

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- Successfully integrated the Federal Protective Service (FPS) accounting processes from the General Service Administration (GSA) to ICE, creating numerous issues with the integrity of FPS transaction data.

4. The Transportation Security Administration (TSA) experienced difficulties in the monthly closing of its general ledger due, in part, to its change in accounting services providers. Specifically, we noted accrual amounts were not included in the initial financial data submission for year-end, numerous other on-top adjustments were made thereafter, account reconciliations were not performed timely throughout the year, material abnormal balances and analytical account variances were not resolved timely throughout the year, and detailed schedules to support financial statement amounts were not always provided timely.
5. The Coast Guard and ICE did not have effective financial information systems, or sufficiently documented processes, to accumulate cost data by DHS strategic goal, as required by Statement of Financial Accounting Standard (SFFAS) No. 4, *Managerial Cost Accounting Concepts and Standards*. In addition, TSA and Emergency Preparedness and Response (EPR) did not have documentation to support their presentation of the full cost for each strategic goal, as included in the notes to the consolidated financial statements.
6. Office of State and Local Government Coordination and Preparedness (SLGCP) has not obtained a thorough understanding of control activities over the financial reporting processes performed by its accounting service provider on its behalf, to ensure services received are consistent with the intent of the parties. The financial statement impact of this condition is further explained in Comment G – *Undelivered Orders, Accounts and Grants Payable, and Disbursements*, in this appendix.
7. EPR's contractor for the National Flood Insurance Program (NFIP) did not provide final NFIP financial statements until November 8, 2005, after the time that final EPR fiscal year 2005 financial statement balances had been submitted to the OCFO. The NFIP financial statements reported an accounts payable balance that was approximately $3 billion lower than the estimate provided to the OCFO, and consequently DHS was required to record a late adjustment in the consolidated financial statements to true-up the final balances. Without timely receipt of the NFIP financial statements, EPR is unable to make an accurate estimate of accounts payable related to the NFIP. In addition, the required timing of the contractor's Statement of Auditing Standards No. (SAS 70) *Service Organizations*, review report has not been modified based on accelerated financial statement reporting deadlines for the Federal government

Cause/Effect: Many of the issues mentioned above stem from the conditions described in Comment A - *Financial Management and Oversight*. The OCFO is still working to develop effective and consistent financial policies and procedures that will ensure a smooth and reliable month-end close for all components. Financial data received from the components during fiscal year 2005 often contained large abnormal or unusual balances that were not timely reviewed and cleared. The lack of quality financial data received from the components placed a heavy burden on the OCFO to identify the issues, reconcile accounts, engage the components in researching the issues, and eventually work with the components to record correcting entries – before accurate consolidated financial statements could be prepared. The OCFO is not staffed to perform these functions on a regular basis. As described above, some components have not developed adequate policies and procedures to perform a reliable monthly close, and accurately export data from their general ledgers for periodic TIER submissions.

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At the Coast Guard, the accuracy of financial information is highly dependent on the knowledge and experience of a limited number of key financial personnel rather than on clearly documented procedures manuals, and process flow documentation. In addition, the Coast Guard suffers from system deficiencies that make the financial reporting process more complex and difficult. ICE has been unable to successfully complete of the integration of the accounting processes of the five DHS components for which it became responsible in fiscal year 2004. A financial accounting system conversion at TSA, during fiscal year 2005, contributed to its reporting problems, and caused errors and delays in DHS financial reporting.

SLGCP places a significant amount of reliance on its accounting services provider, an entity outside DHS, to process and report its transactions because it lacks resources to perform effective oversight of the financial reporting process, and related control activities performed on its behalf. As a result, SLGCP lacks assurance that the processing of its financial activities coincides with its business operations, and are accurately reported and properly controlled.

Companies participating in the NFIP are required to submit their NFIP-related financial statements to EPR's contractor each month within 21 days of the month end. The contractor combines these financial statements with the financial information for the NFIP's administrative activities, and then submits final NFIP financial statements to EPR for recording in EPR's general ledger. However, the process of compiling the information into the final NFIP financial statements can be an extended process, because it takes time for the information to be received from the NFIP participants and then for that information to be properly processed and reported.

Criteria: FMFIA requires that agencies establish internal controls according to standards prescribed by the Comptroller General and specified in the GAO *Standards*. These standards define internal control as an integral component of an organization's management that provides reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. The GAO *Standards* require that internal controls be documented in management directives, administrative policies, or operating manuals; transactions and other significant events be clearly documented; and information be recorded and communicated timely with those who need it within a timeframe that enables them to carry out their internal control procedures and other responsibilities. According to these standards, the five essential control elements are: control environment, risk assessment, control activities, information and communication, and monitoring.

Recommendations: We recommend that:

1. The OCFO:

    a) Implement a standardized financial reporting process, including formal policies and procedures that require components to prepare financial reporting closing packages with footnotes and supplementary data that comply with generally accepted accounting principles to assist the components and the OCFO to execute a monthly close that results in complete and reliable financial reporting on an interim basis, and at year end. The interim hard close and year-end process should include procedures to prepare financial statement notes, Management's Discussion and Analysis (MD&A), Required Supplementary Stewardship Information (RSSI), Required Supplementary Information (RSI), and performance data that are in full compliance with generally accepted accounting principles, and OMB Circular No. A-136. The OCFO should perform several "test runs" during fiscal year 2006, e.g., each quarter, to critically evaluate and improve the process as necessary;

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b) Assist the components with an assessment to determine the reasons for TIER reporting delays and provide management oversight to correct weaknesses;

c) Maintain supporting documentation for all elimination and other adjusting entries made at the consolidated financial statement level; and

d) Establish procedures that will improve the effectiveness of monitoring controls over financial data to ensure that abnormal balances and potential errors submitted by the components are resolved monthly.

2. Coast Guard:

a) Conduct an assessment of its current financial reporting process, including a review of its three general ledger systems, with the goal of reducing complexity, implementing appropriate internal controls, improving financial systems integration and automating manual processes. Processes should be designed to ensure that all financial statement line items are fully supported by transactional detail contained in the general and subsidiary ledgers, and causative research performed for imbalances and abnormalities. The timely reconciliation of all account balances to transactional detail should be documented and retained for auditor review throughout the year;

b) Improve documentation for year-end closing entries, including effective management review and approval, and clear identification of all on-top adjustments with all associated general ledger account entries;

c) Analyze and, as appropriate, redesign its processes for account reconciliations; and

d) Implement policies and procedures to fully identify and resolve significant abnormal balances at a transaction level before the monthly TIER is submitted to the OCFO.

3. ICE:

a) Establish effective internal controls over the daily accounting, recording, reconciliation and documentation of transactions. Supervisory reviews should be performed by persons with sufficient knowledge to be an effective control, i.e., to discover an error through review. Specific procedures and controls should be implemented over "top-side" adjustments made to financial information because these transactions are more prone to error;

b) Reconcile its SF-133s to approved SF-132s on a quarterly basis, and research and resolve the discrepancies that existed at September 30, 2005, and report any violations of the *Antideficiency Act*;

c) Analyze and, as appropriate, redesign its processes for account reconciliation;

d) In conjunction with the DHS CFO, implement policies, procedures, and guidance that fully describe how operating offices and DHS-ICE component entities are required to process accounting transactions. When complete, the redesigned processes should result in timely and accurate financial information submitted monthly to the OCFO that is in compliance with generally accepted accounting principles;

e) Establish and maintain routine communication channels with the DHS OCFO to assist in meeting deliverable deadlines; and

f) Continue efforts to resolve all issues arising from the integration of FPS accounting processes from GSA to ICE.

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4. TSA:
   a) Conduct an assessment of the monthly closing process to identify and correct weaknesses that impede timely and efficient reporting processes; reduce the number of on-top adjustments; and perform regular quality control reviews of financial reports; and
   b) Document key standard operating procedures (SOPs) for significant financial reporting processes, including the TIER submissions.
5. The Coast Guard and ICE should develop financial information systems and document processes to accumulate and present cost data by DHS strategic goal, as required by SFFAS No. 4. Additionally, TSA and EPR should develop a process to validate, document and report the full cost of each strategic goal, as presented in the notes to the DHS consolidated financial statements, so that the computations and presentation in the financial statements are consistent with generally accepted accounting principles.
6. SLGCP:
   a) Designate an official to perform a financial oversight role, and take responsibility for monitoring the financial processing and reporting activities performed by its accounting services provider. This official should obtain appropriate assurances from the accounting services provider (e.g., through a SAS 70 review report) to be able to assess that controls relevant to SLGCP's financial activities are properly designed and operating effectively; and
   b) Work with DHS management to migrate SLGCP's general ledger and grants management system to a system maintained by a component within DHS.
7. EPR should coordinate with its NFIP contractor, and modify its existing contract with the company, if necessary, to ensure that (a) the contractor can provide final year-end NFIP financial statements to EPR for inclusion in EPR's final TIER submission, and (b) the contractor's annual SAS 70 report covers at least nine months of DHS' fiscal year and is available in final form no later than September 1, each year.

C. Financial Systems Security

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

During fiscal year 2005, DHS took several actions to improve its IT general control environment, and to address many prior year general IT control issues. For example, DHS issued an update to DHS Policy 4300A, *Sensitive System Handbook*. The purpose of this Handbook update was to provide specific techniques and procedures for implementing the requirements of DHS' *IT Security Program for Sensitive Systems*. These actions resulted in the correction of some conditions we reported in 2004. Despite these improvements, several significant general IT and application control weaknesses remain that collectively limit DHS' ability to ensure that critical financial and operational data is maintained in a manner to ensure confidentiality, integrity, and availability.

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Conditions: In fiscal year 2005, the following IT and financial system control weaknesses were identified at DHS and its components. Most of the technical issues identified during our fiscal year 2005 audit were also identified during fiscal year 2004:

1. Entity-wide security program planning and management – we noted:
   - Despite improvements in the process of performing Certification and Accreditation (C&A) of IT systems, five DHS component financial and associated feeder systems were not properly certified and accredited.
   - Instances of fragmented, incomplete, or missing security policies and procedures relating to the hiring and termination of employees, reviewing of access to key financial systems, computer incident response capabilities, and interconnectivity agreements exist.
2. Access controls – we noted:
   - Instances of missing and weak user passwords on key servers and databases.
   - User account lists were not periodically reviewed for appropriateness, and inappropriate authorizations and excessive access privileges for group user accounts were allowed.
   - Instances where workstations, servers, or network devices were configured without necessary security patches, or were not configured in the most secure manner.
   - Application and operating system settings were not configured for automatic log-off or account lockout.
3. Application software development and change control – we noted:
   - Instances where policies and procedures regarding configuration management controls were not in place to prevent users from having concurrent access to the development, test, and production environments of the system.
   - Changes made to the configuration of the system were not always documented through System Change Requests (SCRs), test plans, test results, or software modifications. Additionally, documented approval did not exist, or was not always retained, for emergency enhancements, "bug" fixes, and data fixes, and in some cases, audit logs for tracking changes to the data or systems were not activated.
4. System software – we noted:
   - Instances where policies and procedures for restricting and monitoring access to operating system software were not implemented or were inadequate. In some cases, the ability to monitor security logs did not exist.
   - Changes to sensitive operating system settings and other sensitive utility software and hardware were not always documented.
5. Segregation of duties – we noted:
   - Instances where individuals were able to perform incompatible functions, such as the changing, testing, and implementing of software, without sufficient compensating controls in place.
   - Instances where key security positions were not defined or assigned, and descriptions of positions were not documented or updated.

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6. Service continuity – we noted:
   - Five DHS components had incomplete or outdated business continuity plans and systems with incomplete or outdated disaster recovery plans. Some plans did not contain current system information, emergency processing priorities, procedures for backup and storage, or other critical information.
   - Five DHS component's service continuity plans were not consistently and/or adequately tested, and individuals did not receive training on how to respond to emergency situations.
7. Application controls – we noted:
   - Several instances of weak access and segregation of duty controls associated with key DHS financial applications, such as a DHS component's core financial application, as well as procurement and payable applications. These weaknesses include weak or expired user passwords, user accounts that were not kept current, and certain users with access privileges to certain key processes of an application. Many of these weaknesses were identified during our general control testing of access controls and segregation of duties; however, since these same issues also impact controls over specific key financial applications, they are reported here as well.

Cause/Effect: Many of these weaknesses were inherited from the legacy agencies that came into DHS, and will take several years to fully address. Management has undertaken a complicated task of merging numerous and varying financial management systems and control environments into a DHS environment. At many of the larger components, IT and financial system support operations are decentralized, contributing to challenges in integrating DHS IT and financial operations. In addition, financial system functionality weaknesses, as discussed throughout our report on internal controls, in various processes, can be attributed to non-integrated legacy financial systems that do not have the embedded functionality called for by OMB Circular No. A-127, *Financial Management Systems*. Further, there is no consistent testing and monitoring of IT controls by individual DHS components and by the DHS-CIO to identify and mitigate weaknesses.

Criteria: The *Federal Information Security Management Act* (FISMA), passed as part of the *Electronic Government Act of 2002,* mandates that Federal entities maintain IT security programs in accordance with OMB and National Institute of Standards and Technology (NIST) guidance. OMB Circular No. A-130, *Management of Federal Information Resources,* and various NIST guidelines describe specific essential criteria for maintaining effective general IT controls. In addition, OMB Circular No. A-127 prescribes policies and standards for executive departments and agencies to follow in developing, operating, evaluating, and reporting on financial management systems.

Recommendations: We recommend that the DHS Office of Chief Information Officer in coordination with the OCFO:

1. For entity-wide security program planning and management:
   a) Enforce a DHS C&A program across all DHS components, which should include an emphasis on a consistent and thorough approach to the testing of key technical controls during the certification process; and
   b) Enforce the consistent implementation of security programs, policies, and procedures.

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2. For access control:
   a) Enforce password controls that meet DHS password requirements on all key financial systems;
   b) Implement an account management certification process within all the components, to ensure the periodic review of user accounts for appropriate access;
   c) Implement a DHS-wide patch and security configuration process, and enforce the requirement that systems are periodically tested by individual DHS components and the DHS-CIO; and
   d) Conduct periodic vulnerability assessments, whereby systems are periodically reviewed for access controls not in compliance with DHS and Federal guidance.
3. For application software development and change control:
   a) Develop policies and procedures regarding configuration management controls, and implement to ensure segregation of change control duties; and
   b) Enforce policies that require changes to the configuration of the system are approved and documented, and audit logs are activated and reviewed on a periodic basis.
4. For system software, actively monitor the use, and changes related to operating systems, and other sensitive utility software and hardware.
5. For segregation of duties:
   a) Document the user responsibilities so that incompatible duties are consistently separated. If this is not feasible given the smaller size of certain functions, then sufficient compensating controls, such as periodic peer reviews, should be implemented; and
   b) Assign key security positions, and ensure that position descriptions are kept current.
6. For service continuity:
   a) Develop and implement complete current business continuity plans, and system disaster recovery plans; and
   b) Perform component-specific and DHS-wide testing of key service continuity capabilities, and assess the need to provide appropriate and timely emergency training.
7. For application controls:
   a) Implement policies to ensure that password controls meet DHS password requirements on all key financial applications and feeder systems;
   b) Implement an account management certification process within all the components, to ensure the periodic review of user accounts for appropriate access; and
   c) Document the user responsibilities so that incompatible duties are consistently separated. If this is not feasible given the smaller size of certain functions, then sufficient compensating controls, such as periodic peer reviews, should be implemented.

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D. Fund Balance with Treasury

Background: Fund Balance with Treasury (FBWT) represents accounts held at Treasury from which an agency can make disbursements to pay for its operations. Regular reconciliation of an agency's FBWT records with Treasury is essential to monitoring and safeguarding these funds, improving the integrity of various U.S. Government financial reports, and providing a more accurate measurement of budget resources and status. FBWT at ICE, and the other DHS-ICE components it services, and at the Coast Guard totaled approximately $9.2 billion or 9.5 percent of total DHS assets at September 30, 2005. The majority of these funds represented appropriated amounts that were obligated but not yet disbursed at September 30, 2005.

Conditions: We noted the following internal control weaknesses related to FBWT, many of which are repeated from fiscal 2004:

1. ICE:

- Did not complete accurate and timely reconciliations of all of its FBWT accounts during the year, as required by the Treasury Financial Manual (TFM). ICE assumes Treasury balances are correct and often makes adjustments to force its balances to equal Treasury. Specifically, ICE did not perform procedures to reconcile FBWT to Treasury forms FMS 6652, *Statement of Differences*; FMS 6653/54 *Undisbursed Appropriation Account Ledger/Trial Balance*; SF 224 *Statement of Transactions*; and/or FMS 6655 *Receipt Account Ledger/Trial Balance* in accordance with TFM 5145. In addition, ICE did not maintain documentation supporting the reconciliation processes as required by TFM 2-5100.
- Did not timely clear items carried in suspense clearing accounts during the year. A significant number of transactions were carried in suspense, some of which were more than six months old and related to fiscal year 2004 transactions, totaling over $100 million dollars in unreconciled balances. In addition, the subsidiary ledger that contained detail listings of suspense transactions was not reconciled to the general ledger.
- Did not accurately clear suspense transactions to the proper obligation or other Standard General Ledger (SGL) account, particularly for Intra-Governmental Payment and Collection (IPAC) transactions from other Federal agencies, and for disbursements made by legacy agencies on behalf of itself and DHS-ICE components.
- Lacked written policies that clearly explain the correct reconciliation processes and internal controls that must be performed to ensure that monthly collection and disbursement activity is reported accurately and timely to the Treasury, and reflected in ICE and DHS-ICE components' general ledgers.
- Was unable to obtain document level information for financial transactions (both procurement and disbursement) of the DHS-ICE components that were processed by legacy agencies, which resulted in large, unreconciled FBWT items.

2. Coast Guard:

- Did not effectively manage its suspense accounts to include accurately aging and clearing items carried in suspense clearing accounts in a timely manner during the year. From a sample of 45 suspense transactions, we identified 5 transactions that were posted to an inappropriate obligating document, and 3 sample items that had activity dates in fiscal years 2001 and 2002.

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- Did not maintain adequate supporting documentation that validated the accuracy of the FBWT reconciliations and the clearing of suspense items.

Cause/Effect: The procedures followed by ICE placed inappropriate reliance on the Treasury's records for the status of funds, resulting in incomplete monthly reconciliations. These conditions have existed at ICE for several years, in part because of inadequate management oversight and direction, as discussed in Comment A, above. ICE and Coast Guard did not maintain sufficiently detailed records to clear suspense accounts in a timely manner, and did not use tools available to them to improve the process, such as the *Government-wide Accounting System* (GWA). Failure to implement timely and effective reconciliation processes could increase the risks of fraud, abuse, undetected violations of appropriation laws, including instances of undiscovered *Antideficiency Act* violations, and mismanagement of funds, which leads to inaccurate financial reporting, and affects DHS' ability to effectively monitor its budget status.

Criteria: The TFM[2] states, "Federal agencies must reconcile their SGL account No.1010, and any related sub-accounts, with the FMS 6652, 6653, 6654 and 6655 on a monthly basis (at minimum). They must review those accounts each month to maintain the accuracy and reliability of their fund balance records for both prior year and current year appropriations. Agencies must reconcile no-year, revolving, deposit, and trust fund accounts. They also must reconcile clearing and receipt accounts. This detailed reconciliation assures that agency data accumulated in the fund balance account is accurate. It also allows the agency to resolve differences in a timely manner. Federal agencies must research and resolve differences reported on the monthly FMS 6652. They also must resolve all differences between the balances reported on their general ledger FBWT accounts, and balances reported on the FMS 6653, 6654 and 6655. When resolving differences, agencies should maintain detailed reconciliation worksheets that, if needed, can be reviewed by the Agency's auditors or Treasury." TFM Section 5145, *Reconciling Budget Clearing Account Differences*, states, "Agencies must reconcile all Budget Clearing Account Balances, including F3875 accounts. They must reclassify these balances to appropriate Treasury account symbols." TFM Section 5125 – *Background*, specifies the procedures to be performed when reconciling FBWT.

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

Recommendations: We recommend that:

1. ICE:
   a) Perform all procedures required by the TFM, including sections 5125, 5145 and Supplement I of TFM 2-5100 and maintain supporting documentation;
   b) Develop accurate and complete procedures to reconcile and clear FMS 6652 items for its Agency Location Codes (ALCs) on a monthly basis, and provide proper training to employees;
   c) Develop and implement written policies that require timely and accurate reconciliation, and clearing of suspense balances to the proper SGL account, and retention of adequate supporting documentation that facilitate supervisory review, and other monitoring controls. Typically, significant balances should not be held in suspense more than 30 days; and

[2] TFM, Supplement I TFM 2-5100 (November 1999)

d) In conjunction with the DHS OCFO, develop policies and procedures for obtaining relevant legacy agency processed transactions in order to timely record all transactions affecting FBWT.

2. Coast Guard implement written policies, including detailed procedures that result in timely reconciliation of FBWT in accordance with the TFM, timely and accurate clearing of suspense balances, and the retention of adequate supporting documentation that will facilitate supervisory review and other monitoring controls. The policies should be based on Treasury guidance and tailored to the Coast Guard's operations and financial accounting system(s).

E. Property, Plant, and Equipment

Background: Property, plant, and equipment (PP&E) represents approximately 9.1 percent of total DHS assets and more than 62.6 percent of non-monetary assets. DHS uses a wide variety of capital assets to accomplish its mission, some of which are not typically maintained by non-defense agencies, such as aircraft, boats, and vessels. These assets often have long useful lives and undergo extensive routine servicing that may increase their value or extend their useful lives and require comprehensive policies and procedures to ensure accurate and timely accounting. While the Coast Guard has made progress in providing auditable documentation for certain categories of PP&E, most of the conditions cited below for the Coast Guard are repeated from our fiscal year 2004 report, because the Coast Guard has not fully completed its corrective action plans. In addition, as noted in our 2004 report, DHS has several internal use software development projects underway that will result in capitalized software balances in future years. Consequently, application of proper accounting standards to account for PP&E is important to the accuracy of DHS' consolidated financial statements.

Conditions: We noted the following internal control weaknesses related to PP&E at DHS components, which are mostly repeated from fiscal year 2004:

1. Coast Guard has not:

- Implemented appropriate controls and related processes to accurately, consistently, and timely record PP&E, to include additions, transfers from other agencies, and disposals in its fixed asset system.
- Consistently applied policies and procedures to ensure appropriate documentation supporting PP&E acquisitions is maintained, and readily available for audit. The acquisition values of approximately twenty five percent of items selected for testwork did not have proper supporting documentation.
- Developed and documented methodologies and assumptions to support the value of PP&E that is not supported by original acquisition or other documentation.
- Implemented asset identification, system mapping, and tagging processes that include sufficient detail, e.g., serial number, to clearly differentiate and accurately track assets in the fixed asset system.
- Developed an effective physical inventory process and appropriate support for the valuation method and classification of repairable PP&E.
- Properly accounted for some improvements and impairments to buildings and structures, and selected useful lives for depreciation purposes, consistent with generally accepted accounting principles.

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2. ICE (who provides accounting services for BTS), specifically the US-VISIT program, did not consistently apply procedures to identify and capitalize software development costs or to reclassify software placed into production from software in development. At September 30, 2005, software costs were not considered material to the consolidated financial statements; however, software development costs are expected to increase in future years.

Cause/Effect: Coast Guard has implemented policies and procedures affecting PP&E; however, they are not comprehensive and; therefore, do not provide reasonable assurance that all transactions affecting PP&E will be accounted for consistent with generally accepted accounting principles. In addition, the fixed asset module of the Coast Guard's core accounting system is not updated for effective tracking of all PP&E, and its capabilities are not fully utilized to clearly differentiate and accurately track assets. The Coast Guard also lacks sufficient policies and procedures for PP&E that ensure complete supporting documentation is maintained and available for audit. As such, we were unable to complete audit procedures over approximately $1.7 billion of net PP&E as of September 30, 2005.

BTS lacks sufficient accounting policies for software development costs. Over the next few years, significant resources for the development of new software, such as the US-VISIT system, will likely be spent. Therefore, the lack of sufficient policies at BTS increases the risk of financial statement errors due to misapplication of accounting standards for software.

Criteria: SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, requires that:

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

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

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

Recommendations: We recommend that:

1. Coast Guard:

   a) Improve controls and related processes and procedures to ensure that PP&E, to include additions, transfers, and disposals are recorded accurately, consistently, and timely in the fixed asset system; that an identifying number is entered in the fixed asset system at the time of asset purchase to facilitate identification and tracking; and that the status of assets is accurately maintained in the system;

b) Develop and implement internal controls to ensure the quality, sufficiency, and retention of documentation for future PP&E acquisitions and disposals;

c) Develop and document methodologies and assumptions to support the value of PP&E that is not evidenced by original acquisition or other sufficient documentation;

d) Revise procedures for performing physical inventories of repairable items, to include procedures for resolving differences, and reporting results, to ensure that repairable PP&E is accurately and completely classified and recorded. Support the pricing methodology used to value repairable PP&E to ensure that balances, as presented in the financial statements, approximate amortized historical cost; and

e) Review policies and procedures to account for improvements and impairments to buildings and structures, and identify proper useful lives for depreciation purposes.

2. ICE:

a) Perform a review of its existing software capitalization policy to determine adequacy for financial reporting purposes. The policy should be sufficiently detailed to allow developers and accounting personnel to identify the various phases of the software development life cycle, and the associated accounting treatment, as described in SFFAS No. 10; and

b) Develop and implement procedures for developers to track and notify accounting personnel when software has been placed into production so that accounting personnel can properly classify and amortize the software costs.

F. Operating Materials and Supplies

Background: Operating Materials and Supplies (OM&S) are maintained by the Coast Guard in significant quantities, and consist of tangible personal property to be consumed in normal operations to service marine equipment, aircraft, and other operating equipment. The majority of the Coast Guard's OM&S is physically located at either two Inventory Control Points (ICPs) or in the field. The ICPs use the Naval Electronics Supply Support System (NESSS) and the Aircraft Logistics Management Information System (ALMIS) to track inventory, and field held OM&S is recorded in the Configuration Management Plus system. These three systems provide the subsidiary records that support the general ledger's OM&S balance. The Coast Guard's policy requires regularly scheduled physical counts of OM&S, which are important to the proper valuation of OM&S and its safekeeping. The conditions cited below for Coast Guard are based on findings reported in fiscal 2004, updated as necessary to reflect the conditions noted in fiscal year 2005.

Conditions: We noted the following internal control weaknesses related to OM&S at the Coast Guard:

- Internal controls over physical counts at field locations were not designed and implemented to remediate conditions identified during fiscal year 2003 and 2004. In fiscal year 2004, we reported that items were not always properly bar-coded or tagged, on-hand quantities frequently did not agree to the perpetual inventory records, and procedures did not sufficiently address whether all inventory on hand was properly recorded in the perpetual records or require discrepancies to be resolved timely. Coast Guard has acknowledged that the weaknesses continued to exist in fiscal year 2005, and represented their intent to implement corrective action over field held OM&S, to include implementation of internal controls, in fiscal year 2006.

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- Policies, procedures and controls designed to remediate conditions related to conducting physical inventories of OM&S at the ICPs were not completely implemented in fiscal year 2005. ICP physical inventory procedures lacked key elements of an effective physical inventory, e.g., reconciliation of sample population to perpetual records, statistically valid methods of sampling, and proper evaluation and reporting of results. Comprehensive step-by-step physical inventory instructions that clearly addressed each objective of a physical inventory were not communicated in a timely manner in fiscal year 2004, and the Coast Guard has acknowledged that the weaknesses continued to exist in fiscal year 2005. Coast Guard management has represented their intent to implement corrective action over ICP physical inventory procedures, to include implementation of internal controls, in fiscal year 2006.
- Processes and controls were not in place to fully support the calculated value of field-held and ICP OM&S to approximate historical cost. Coast Guard management has represented their intent to implement corrective actions over valuation of OM&S in fiscal year 2006.

Cause/Effect: Coast Guard management deferred correction of most OM&S weaknesses reported in fiscal year 2004 until fiscal year 2006, and acknowledged that the conditions we reported in prior years remained throughout fiscal year 2005. Lack of comprehensive and effective policies and controls over the performance of physical counts, and appropriate support for valuation may result in errors in the physical inventory process, or inventory discrepancies that could result in financial statement misstatements.

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

Recommendations: We recommend that the Coast Guard:

a) Update OM&S physical count policies, procedures, and controls, and provide training to personnel responsible for conducting physical inventories;

b) Implement effective oversight and monitoring procedures to ensure that physical inventory counts are performed, and evaluated in accordance with policies and procedures;

c) Perform a review of the inventory information contained in NESSS to identify and correct discrepancies between the perpetual records, and actual physical item counts and warehouse locations;

d) Consider developing risk-based cycle counting procedures for OM&S; and

e) Provide adequate support for the value of OM&S to approximate historical cost.

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G. Undelivered Orders, Accounts and Grants Payable, and Disbursements

Background: Most of the DHS components estimate accounts payable at year end, for accelerated financial reporting purposes, as a percentage of undelivered orders (UDOs) based on historical trends. UDOs are obligations, or budgetary funds reserved, for good and services ordered but not yet delivered to DHS. Historically, at year-end, DHS has reported approximately $20 billion in UDOs. Reliable accounting processes surrounding obligations, UDOs, and disbursements are key to the accurate reporting of accounts payable in DHS' financial statements.

ICE had serious difficulties with maintaining accurate financial records related to obligations, UDOs, and disbursements during fiscal year 2005, including the records of DHS-ICE components.

The majority of conditions cited below for Coast Guard are repeated from our fiscal year 2004 report. The Coast Guard has initiated a review of its obligation and procurement processes, including those related to the Integrated Deepwater System, which is targeted for completion in fiscal year 2006.

SLGCP uses its accounting services provider's grants management system to support SLGCP's grant making activities. The grants management system allows grantees to submit their financial status reports electronically via web-based connections.

In late 2004, responsibility for the issuance and related accounting for numerous TSA grant programs was transferred to SLGCP, while TSA retained responsibility for previously issued grants until closeout and certain other grant programs.

Conditions: We noted the following internal control weaknesses related to UDOs, accounts and grants payable, and disbursements, many of which are repeated from fiscal year 2004:

1. ICE has not:
   - Established reliable internal controls to ensure that all invoices are paid timely, that all IPACs are cleared from suspense timely, that invoice payments and supporting documentation are matched with an originating obligation prior to disbursement, and that documentation supporting receipt of goods and services required from other Federal agencies for IPAC transactions are verified timely.
   - Recorded disbursements made by legacy agencies for prior year obligations of S&T and IAIP at the transaction level timely, because such information was not provided by the legacy agencies timely. Often, disbursements made by legacy agencies were not identified until ICE prepared its FBWT reconciliations and noticed unrecorded disbursements made against S&T and IAIP funds. Unrecorded legacy agency disbursements ranged from a high of almost $200 million during the second quarter of fiscal year 2005, to approximately $10 million at September 30, 2005.
   - Established sufficient controls to prevent duplicate payments to vendors related to prior year obligations or to prevent negative balances in certain Treasury accounts used by both ICE and the legacy agencies to make disbursements.
   - Implemented sufficient controls to ensure that open obligations were properly liquidated when corresponding accounts payable were recorded, and that liquidation was occurring at the proper detailed fund code level.
   - Adopted policies related to verification and validation of obligations performed by field personnel that clearly define their responsibilities, including the proper classification of requisitions that require the completion of receiving tickets upon orders being delivered,

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ensuring receipt of services and goods, prior to payment of invoices and communicate the consequences for not adhering to policy.

- Verified the completeness, existence, and accuracy of its recorded obligations created in PRISM, and other ICE systems. ICE did not have effective controls to monitor the completeness of all procurement, and other obligations, created in the field and program offices. For example, UDO subsidiary ledgers are not routinely reconciled to the general ledger.

2. At the Coast Guard:

- The periodic review and validation of UDOs was not properly designed, and was not effective to ensure that recorded obligations were valid, obligations incurred were recorded timely, and that proper approvals and supporting documentation existed. In addition, programming logic and transaction codes used to record advances for which an obligation was not previously recorded are not operating effectively to ensure the obligation and UDO are properly recorded.
- A reconciliation of paid delivered orders to FBWT disbursement activity was not performed. Delivered orders - unpaid were not properly and timely reclassified to delivered orders-paid status when disbursements were made. Instead, Coast Guard made on-top adjustments to delivered orders accounts without supporting detail for financial reporting purposes.
- Policies were not fully implemented to ensure that contract awards were recorded in the general ledger in a timely manner, and as a result, obligations might have been temporarily understated. In addition we noted a lack of segregation of duties associated with the creation and approval of purchase requisitions, certification of funds availability, and the recording of the obligation.
- Policies and procedures related to Coast Guard's automated requisition and procurement process have not been consistently followed in all regions. Specifically, the Financial and Procurement Desktop (FPD) system can be overridden to allow non-conforming numbering for purchase requisitions. This created a risk that commitments were not properly tracked or matched with obligations in the accounting records. FPD were also not properly reconciled to the Core Accounting System (CAS), affecting the completeness, existence and accuracy of the year-end "pipeline" adjustment that was made to record obligations executed before year-end, but which were not made into the system prior to year-end close.
- The procurement Management Effectiveness Assessment (MEA), which is an on-site assessment of procurement activity for compliance with Federal statutes and regulations, was not fully performed as planned in fiscal year 2005. The MEA is an important risk assessment, and monitoring control function that, when properly performed, assists in assessing compliance with applicable laws and regulations.
- The process used to estimate accounts payable was not fully documented as to the criteria used to develop the estimate for financial reporting.

3. SLGCP's accounting services provider was unable to resolve discrepancies identified in the data underlying the calculation of SLGCP's grants payable liability at September 30, 2005, prior to the completion of the DHS *Fiscal Year 2005 Performance and Accountability Report*.

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4. TSA:
   - Was unable to fully reconcile and support the accuracy and completeness of its accounts payable and UDOs prior to the completion of the DHS *Fiscal Year 2005 Performance and Accountability Report*.
   - Did not have policies and procedures in place to validate TSA's fiscal year 2004 grant accrual to ensure the methodology used provided a reasonable estimate of the actual amount owed September 30, 2004. TSA used the same methodology to estimate the grant accrual at September 30, 2005.
5. EPR, SLGCP, and TSA did not have sufficient policies and procedures in place to fully comply with the OMB Circular No. A-133, *Audits of States, Local Governments, and Non-profit Organizations*, and laws and regulations supporting OMB Circular No. A-50, *Audit Follow-up*, as revised.

Cause/Effect: Some of the conditions at ICE resulted from unique circumstances and difficulties with the transfer of S&T, IAIP, and DHS management accounting operations from legacy agencies to ICE in fiscal year 2004. ICE and the DHS OCFO did not establish clear operating procedures or coordinate the sharing of information with legacy agencies. These issues continued in fiscal year 2005, partly because ICE and DHS OCFO management were unable to develop policies and procedures with the legacy agencies requiring the timely transfer of such information. This condition has existed since the inception of the Department in 2003. Further, ICE's system of internal control is weak, allowing financial errors to occur, and be undetected for long time periods. These conditions can also be attributed directly to weaknesses described in Comment A - *Financial Management and Oversight.* In addition procedures for verification and validation of obligations were not clearly written and understood by field personnel. These procedural weaknesses resulted in the misclassification of open obligations and misstatements of undelivered and delivered orders.

The Coast Guard elected to defer correction of most fiscal year 2004 findings we reported in this area until late in fiscal year 2005 and 2006.

Because SLGCP management did not perform sufficient monitoring of its financial reporting processes, SLGCP could not take timely action to ensure that discrepancies noted in the data underlying the grant accrual calculation would not materially impact its financial statement balances. These weaknesses could result in a misstatement of grant payables, expenses, and UDOs.

At EPR, SLGCP, and TSA, if grants are not appropriately monitored, it is possible that funding will not be used for its intended purpose.

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

Recommendations: We recommend that:

1. ICE:
   a) Establish reliable internal controls to ensure that all invoices are paid timely, all IPACs are cleared from suspense timely, invoice payments are matched with an originating obligation

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prior to disbursement, open obligations are properly liquidated when corresponding accounts payable are recorded, and IPACs are matched with an originating obligation as soon as practicable after the transaction is recorded. Incorporate unique IPAC processing considerations in subsequent disbursement testing procedures;

b) Establish policies and procedures over disbursements made by ICE operating offices to ensure that disbursements are made only after proper approval of the invoice, and evidence of the receipt of goods and services has been received. The policies should be updated to require the completion of a receiving report for all goods and services before invoices are approved for payment. If necessary, additional training should occur to enhance understanding of the procedures;

c) Establish written procedures that require legacy agencies to timely submit all information affecting ICE's accounting for component disbursements, and work with legacy agencies to implement them. If possible, consider transferring all accounting services for prior year obligations from legacy agencies into ICE, and improve procedures to prevent duplicate payments from accounts used by both ICE and its service provider;

d) Expand the policies and procedures documentation related to obligation verification and validation to more clearly communicate the process to field personnel, and to ensure that supporting documentation exists to substantiate accounts payable balances;

e) Issue polices and procedures that require monthly reconciliations of all obligations created in PRISM, and other manual or automated procurement tracking systems to the general ledger; and

f) Adhere to existing policies and procedures requiring UDO subsidiary records be routinely reconciled to the general ledger.

2. Coast Guard:

a) Improve controls related to processing obligation transactions, to include periodic review and validation of UDOs. Emphasize to all fund managers the need to perform effective reviews of open obligations, obtain proper approvals, and retain supporting documentation. Develop effective monitoring controls for reviewing and approving obligation transactions prior to processing;

b) Reconcile paid delivered orders activity to FBWT disbursement activity, to ensure that delivered orders are moved from unpaid status properly and timely, and to eliminate the current practice of making unsupported on-top adjustments to delivered orders for financial reporting purposes;

c) Improve segregation of duties for transactions related to the creation and approval of purchase requisitions, certification of funds availability, and the recording of the obligations, and record contracts timely;

d) Evaluate programming logic and transactions codes used to record advances for which an obligation was not previously recorded to ensure the obligation and UDO is properly recorded;

e) Update the program logic of FPD to improve controls over document numbering for purchase requisitions. The system design of FPD and the core accounting system should be evaluated to ensure that obligation transactions are correctly processed;

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f) Reconcile FPD to CAS to ensure the completeness, existence, and accuracy of the year-end "pipeline" adjustment that is made to record obligations executed before year-end but not recorded in the system prior to year-end close;

g) Revise Commandant Instruction 4200.30B, *Program Management Review Program*, in order to implement effective oversight and monitoring procedures of the contract acquisition process, including the frequency of MEAs at major procurement regions; and

h) Improve documentation of policies, procedures, and controls over the accounts payable estimation process.

3. SLGCP should require its accounting services provider to (a) perform a review to correct discrepancies in the underlying grant data, (b) complete a full validation of the SLGCP grants payable, as presented in the DHS consolidated balance sheet at September 30, 2005, to determine if it is materially misstated, and (c) record a correcting adjustment if necessary to completely and accurately state the balance.

4. TSA:

   a) Perform a review to assess whether TSA accounts payable and UDOs, as presented in the DHS consolidated balance sheet at September 30, 2005, are materially misstated and record a correcting adjustment, if necessary, to completely and accurately state the balances; and
   b) Implement policies and procedures to annually validate that the methodology used to estimate its grant accrual provides a reasonable estimate of the actual amount owed.

5. EPR, SLGCP, and TSA implement policies and procedures to ensure full compliance with OMB Circular Nos. A-133 and A-50.

H. Actuarial Liabilities

Background: The Coast Guard maintains pension, medical, and post-employment travel benefit programs that require actuarial computations to determine the proper liability for financial reporting purposes. The Military Retirement System (MRS) is a defined benefit plan that covers both retirement pay and health care benefits for all active duty and reserve military members of the Coast Guard. The post-employment travel benefit program is a benefit program that pays the cost of transportation for uniformed service members upon separation from the Coast Guard. The unfunded accrued liability for both plans is reported in the DHS consolidated balance sheet at September 30, 2005 and 2004. Annually, participant data is extracted by Coast Guard from its records, and provided to an actuarial firm as input for the liability calculations. The accuracy of the actuarial liability as reported in the consolidated financial statements is dependent on the accuracy and completeness of the underlying participant data provided to the actuary.

Conditions: The Coast Guard:

- Was unable to fully support its assertions relating to accuracy and completeness of the underlying participant data, medical cost data, and trend and experience data provided to, and used by, the actuary for the calculation of the MRS, and post employment travel benefits liabilities. In addition, the salary increase assumptions used by the actuary in the MRS liability were outdated, and the Coast Guard did not have an established process to inform the

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actuary of Congressional legislation that changed allotments, entitlements, calculation methods, and amounts of military pay, which could materially affect the calculation of actuarial liabilities.

- Did not follow established policies and procedures to accumulate data for the actuary to compute post-employment travel benefits. The actuary determined that the data was unreliable and; therefore, could not complete their work. In addition, the Coast Guard's post-employment travel liability at September 30, 2005, did not reflect the most current participant data.
- Did not perform periodic reconciliations between the medical expenditures subsidiary ledger and the general ledger, which would have identified errors in underlying data. In addition, the Coast Guard did not perform a reconciliation of the payroll system data to military personnel records to ensure the accuracy of headcount information prior to the submission of data to the actuary.
- Did not have effective policies, procedures, and controls to monitor the expenditures for medical services to ensure they were billed at proper rates, and for valid participants only, e.g., service members and their families, and retiree/survivors.

Cause/Effect: The Coast Guard does not have well-established procedures in place, including adequate internal controls, such as supervisory reviews, to ensure that data and other information provided to the actuary is complete and accurate. Much of the data required by the actuary comes from personnel and payroll systems that are outside of Coast Guard's accounting organization, and are instead managed by Coast Guard's Personnel Service Center (PSC). Strong lines of communication are needed between PSC and accounting personnel. In addition, it appears that the definition of data requirements provided to the PSC is not always clear, resulting in incomplete or inaccurate data being submitted to the actuary, that was not discovered until after the actuary identifies data anomalies, or the underlying participant data is subjected to our audit procedures. As a result of weak controls, errors were discovered too late in the year for corrective action to occur, and the Coast Guard's actuary to recompute the pension and other post-retirement liabilities to accurately state those balances in the DHS consolidated balance sheet as of September 30, 2005.

The Coast Guard could be billed for services provided to non-Coast Guard participants/sponsors. Inaccurate medical costs submitted to the Coast Guard actuary could result in a misstatement of the actuarial medical liability and related expenses.

Criteria: GAO *Standards* state that management is responsible for developing policies, procedures, techniques, and mechanisms that enforce management's directives. Control activities include approvals, authorizations, verifications, reconciliations, performance review, and the creation and maintenance of related records that provide evidence of execution of these activities, as well as appropriate documentation.

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

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Recommendations: We recommend that the Coast Guard:

a) Establish and document specific procedures and internal controls to provide review and oversight of its actuarial firm, to ensure that appropriate assumptions and accurate data, e.g., participant, medical cost, trend and experience, are used by the actuary to develop the estimate for post-employment actuarial liabilities, to include MRS and post employment travel benefits;

b) Perform a periodic reconciliation between the medical expenditures recorded in the subsidiary ledger and those recorded in the CAS, and clearly identify reasons for variances in expenditures and UDOs. This reconciliation should be performed for all significant sources of medical actuarial data, including TriCare, and DoD Military Treatment Facilities (MTFs). In addition, this reconciliation should be reviewed by someone other than the preparer to ensure accuracy. The reviews / reconciliations should:

   - Determine whether personnel data and retroactive payroll transactions are negatively impacting other business processes such as payroll and/or budgeting, and take corrective action as appropriate; Institute an annual review of data from the active/reserve population submitted to the actuary to determine if member attributes are complete and accurate, and follow up on any errors in order to correct them;
   - Assess the impact of year-end retroactive payroll transactions on data populations provided to Coast Guard actuary;
   - Review of the spreadsheet used to record and monitor medical expenses, to identify and correct any technical errors;
   - Include an update to the current experience studies to provide more accurate trend information for Coast Guard, as recommended by Coast Guard's actuary;
   - Review the annual headcounts provided by the PSC to the actuary, specifically by reconciling and resolving any discrepancies between payroll data to personnel data to ensure completeness and accuracy

c) Perform an analysis of its policies, procedures, and systems to determine why certain IT system interfaces or query programs did not reliably process attribute data provided to the actuary and to identify key controls that were absent or ineffective; and

d) Monitor medical care costs, including incurred but not reported costs. These procedures could include analysis of monthly medical cost payment trends, and related evaluations of trends to assess the accuracy and consistency of billings (between the military services), and for various treatment types (e.g., in-patient, out-patient). Such a trend analysis could assist the Coast Guard in budgeting medical payment costs for future periods. Verify that MTFs only bill for services provided to eligible Coast Guard participants and sponsors.

I. Budgetary Accounting

Background: Budgetary accounts are a category of general ledger accounts where transactions related to the receipt, obligation, and disbursement of appropriations and other authorities to obligate and spend agency resources are recorded. Combined ICE and DHS-ICE components have over 90 separate TAFS, each with separate budgetary accounts that must be maintained in accordance with

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OMB and Treasury guidance. The Coast Guard also has a complex budget that includes budget authority from a variety of sources: annual, multi-year, and no-year appropriations; and several revolving, special, and trust funds. In total, the Coast Guard has over 80 separate Treasury fund symbols where budgetary authority is accounted for separately.

In fiscal year 2005, TSA migrated to the Coast Guard's financial systems, and Coast Guard became TSA's accounting services provider.

Conditions: We noted the following internal control weaknesses related to budgetary accounting, many of which were repeated from fiscal year 2004:

1. At ICE and DHS-ICE components:

   - Weaknesses existed in controls that might have allowed ICE and DHS-ICE components to violate the *Antideficiency Act*, or prevented management from knowing if they were in violation. Circumstances existed during the year that indicated a strong possibility that ICE funds were insufficient to cover obligations. ICE management and the DHS OCFO commenced an internal review to determine the extent of unrecorded obligations at ICE because of ICE's ongoing budgetary accounting difficulties; however, the internal review was suspended prior to its completion. Identification of potential unrecorded obligations is contemplated as part of ICE's *Financial Action Plan* to be executed in fiscal year 2006. As stated in our *Independent Auditors' Report*, we were unable to complete our audit of the financial statements as of, and for the year ended September 30, 2005, and accordingly, we were unable to complete our procedures related to testing for ICE's compliance with the *Antideficiency Act*.
   - Obligations for ICE and the DHS-ICE components were not always recorded in a timely manner. We noted many instances during the year when goods and services were procured before available funding was confirmed, and without an obligating document recorded in the system. We noted instances where invoices were held for payment due to for lack of funds. Because of the deterioration of the timeliness of recording obligations at ICE that were identified during the first half of fiscal year 2005, the Assistant Secretary for ICE intervened by issuing an instruction to all ICE program offices in April 2005 to record all known obligations. This was reiterated by an instruction in June 2005 from the Acting CFO, in preparation for the June 30, 2005, hard close.
   - The listing of open obligations in ICE's core accounting system (FFMS) was not complete and accurate for ICE and all DHS-ICE components. Obligations were recorded or modified in FFMS without verifying that the obligation data keyed into FFMS agreed with supporting documentation. We noted instances where obligations were partially recorded and instances where the obligation was not recorded related to services that were provided over a period that crossed fiscal years. We also noted an instance where an obligation was not properly authorized before it was entered into FFMS.
   - The transfer of accounting records and responsibilities from legacy agencies was not coordinated properly. Ending balances for budgetary accounts maintained by legacy agencies often did not equal the beginning balances shown in the DHS-ICE component's financial records, dating back to the inception of the Department in 2003. During fiscal year 2005, legacy agencies continued to approve and pay for prior year obligations, without providing timely information that ICE needed to update the relevant accounting records.

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- Certain Customs and Border Patrol (CBP) obligations, and the related disbursements, were retained in the accounting records of ICE upon the transfer of certain operations from ICE to CBP. However, the fiscal year 2005 transactions and remaining obligations were not reported to CBP timely, causing misstatements in the financial statements of both components.
- Contracting officer approvals were not clearly documented on obligating documents, and in one instance a contracting officer approved a purchase for an amount in excess of the officer's warrant authority. Further, ICE and the DHS-ICE components were unable to provide a complete and accurate listing of contracting officers with their approval thresholds.
- Weaknesses existed in controls over the preparation, submission and reconciliation to the general ledger of the SF-132, and the SF-133. Information reported on the SF-133 did not agree with the accounting records and was not reconciled timely resulting in inaccuracies in the June 2005 financial statements for ICE and the DHS-ICE components.

2. At Coast Guard:
   - Obligations related to post-employment permanent changes of station (PCS) were not recorded at the time orders were approved and issued.
   - The electronic validation and edit checks within the FPD, a feeder system to the CAS, were not fully utilized. Use of such a control is one method that would allow the Coast Guard to automatically flag and prevent the recording of commitments (a reservation of funds for future obligation) and obligations in excess of appropriations, apportionments, or allotments.
   - Obligations were recorded in FPD, but were not properly interfaced with the CAS, and were not supported by adequate documentation.
   - Weaknesses existed in system capabilities and controls over the recording of budgetary authority. The Coast Guard's financial systems were unable to record budget authority until it had been apportioned, which resulted in temporary understatements of budget authority for certain types of funding sources, e.g., transferred authority, that is not typically apportioned before receipt of the funds.
   - No automated system controls existed to preclude the processing of procurement transactions if the contracting officer's warrant authority had expired, and a manual check compensating control was not effective since listings of warranted contracting officers were outdated.
   - Commitments were not routinely monitored for aging, or released timely, so that funds could be committed and obligated elsewhere. As of September 30, 2005, Coast Guard had recorded unobligated commitments prior to fiscal year 2005 totaling $57 million.
3. The CAS used by TSA's accounting service provider, did not have the functionality to record amounts deobligated from prior year obligations at the transaction level, in accordance with the SGL requirements.

Cause/Effect: Many of the budgetary accounting issues at ICE appeared to be systemic in nature, rooted in inadequate financial management processes, together with a lack of discipline in the operating offices to follow prescribed policies. In addition, the internal control system is weak, allowing financial errors to occur, such as unrecorded obligations, and go undetected by employees in the normal course of business. These conditions can also be attributed directly to weaknesses described in Comment A - *Financial Management and Oversight.* Several of the conditions at ICE

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remain from difficulties with the transfer of the accounting operations of DHS-ICE components from legacy agencies to ICE in fiscal year 2004. ICE and legacy agency management did not coordinate the transition process to ensure that all transactions were properly recorded in the general ledgers of DHS-ICE components during the transfer of accounts to ICE.

Several of the Coast Guard's budgetary control weaknesses can be corrected by modifications or improvements to the financial accounting system, process improvements, and strengthened policies. The Coast Guard has deferred correction of these conditions until fiscal year 2006.

Weak controls in budgetary accounting, and associated contracting practices increase the risk that DHS and its components could violate the *Antideficiency Act,* and overspend their budget authority. The financial statements are also at greater risk of misstatement. The untimely release of commitments may prevent funds from being used timely for other purposes.

Criteria: The *Antideficiency Act* prohibits agencies from obligating or disbursing more than their appropriations and apportionments, has strict requirements for reporting violations, and includes penalties for violations. GAO *Standards* hold that transactions should be properly authorized, documented, and recorded accurately and timely. OMB Circular No. A-11, *Preparation, Submission, and Execution of the Budget,* requires Federal agencies to submit their apportionment requests on an SF-132 for each appropriation, unless permission is granted otherwise, and provides guidance on when it is proper to record obligations for financial reporting purposes. According to JFMIP's *Core Financial System Requirements* publication, an agency's core financial management system must ensure that an agency does not obligate or disburse funds in excess of those appropriated and/or authorized, and specific system edits and user notifications related to funds control must be in place. The *Federal Acquisition Regulation* (FAR) Section 1.16 addresses the authorities and responsibilities granted contracting officers. Treasury's SGL guidance specifies the accounting entries related to budgetary transactions.

Recommendations: We recommend that:

1. ICE and DHS-ICE components:

    a) Perform a root cause analysis of the financial management process, including relevant IT systems, to identify the reasons why obligations were not recorded accurately and timely during fiscal year 2005. If the review identifies violations of the *Antideficiency Act* that occurred during fiscal year 2005 or 2004, each instance of non-compliance should be reported in accordance with U.S.C. Title 31;

    b) Redesign the procurement process, as necessary, and establish appropriate internal controls to ensure that all obligations are accurately entered into FFMS in a timely manner, in accordance with applicable accounting standards, e.g., OMB Circular No. A-11, including transactions conducted by legacy agencies for DHS-ICE component entities, and transactions made on behalf of other DHS components, e.g., CBP for transferred operations;

    c) Verify and validate the completeness and accuracy of obligations currently recorded in FFMS, and that all obligations have been properly approved by a contracting officer with the appropriate authority to approve the transaction;

    d) Improve polices and procedures to ensure that adequate documentation, including contracting officer approvals, is maintained to support all obligations; and

    e) Improve policies and procedures related to preparation and reconciliationof the SF-132 and SF-133 with differences investigated and properly corrected.

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2. Coast Guard:
   a) Implement procedures to ensure that obligations related to PCS are recorded at the time orders are approved and issued, and supporting documentation is maintained;
   b) While no violations were noted, consider activating the electronic edit checks in FPD to the general ledger system to prevent incurring commitments and obligations in excess of appropriations and apportionments, and establish automated controls to prevent the processing of procurement transactions by contracting officers who do not have active warrant authority;
   c) Revise controls and related policies and procedures to periodically review commitments, e.g., monitor aging, and determine the feasibility of modifying FPD to transmit all commitments, regardless of dollar amount, to the general ledger system, and to properly interface FPD with CAS;
   d) Implement a system change to the general ledger accounting system posting logic, to properly record budget authority;
   e) Develop and implement policies and procedures to ensure that the certification process is effective, and year-end obligations not recorded in CAS are validated, accurate, and supported by proper documentation; and
   f) Develop and provide specific training related to any internal controls and related policy and procedure changes.
3. TSA, in coordination with its accounting services provider, should establish the necessary program logic in CAS to capture and report amounts deobligated from prior year obligations at the transaction level, in accordance with the SGL requirements.

J. Intragovernmental and Intradepartmental Balances

Background: DHS conducts business with other Federal agencies resulting in intragovernmental receivables, payables, and the reporting of revenues and expenses from intragovernmental transactions. Federal accounting and reporting regulations require Federal agencies to routinely identify and reconcile intragovernmental balances and transactions with trading partners. These procedures help ensure that intragovernmental balances properly eliminate in the government-wide consolidated financial statements. DHS components also conduct business with each other, resulting in the same type of transactions and balances that must be eliminated against each other to produce accurate consolidated financial statements for DHS.

Conditions: During fiscal year 2005, including the fourth quarter, DHS did not timely or completely reconcile intragovernmental balances with other Federal entities, particularly the Department of Defense. Consequently, the DHS' *Material Difference/Status of Disposition Certification Report*, submitted to Treasury for September 30, 2005, showed material differences attributable to accounting/reporting errors in excess of $1.6 billion. These conditions also impacted DHS' ability to accurately report transactions with Federal government trading partners in the consolidated financial statements, and in the RSI section of the financial statements, as required. The DHS OCFO did not perform reconciliations throughout the year of all intragovernmental balances. We noted that ICE, DHS-ICE components, and Coast Guard have not developed and adopted effective SOPs, or established systems to completely track, confirm, and reconcile intra-governmental balances and/or transactions with trading partners, in a timely manner, which contributed to the material differences.

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We did note a decrease in out-of-balance conditions from the prior year and during fiscal year 2005. However, DHS was still unable to produce accurate consolidated financial statements due, in part, to unreconciled eliminations between DHS components in a timely manner. Intra-DHS transactions between ICE, CBP, CIS and other DHS components did not eliminate correctly at the consolidated level during the year. Further, DHS was unable to completely reconcile out-of-balance intradepartmental transactions at year-end, resulting in the need for "on-top" adjustments, based primarily on estimates and analytical comparisons, to close the general ledger and prepare balanced consolidated financial statements.

Cause/Effect: Business process limitations at ICE, DHS-ICE components, and the Coast Guard prevented these components from tracking activity with government trading partners and thus, manual processes were established. Accounting data for DHS-ICE components did not include detailed supporting schedules of trading partner activity that would have facilitated the reconciliation process. The Coast Guard has not fully utilized its accounting system functionality to identify and track intragovernmental balances. A lack of resources in the OCFO prevented the accountant responsible for intragovermental reconciliations from researching and reconciling intragovernmental differences in a timely manner during the year and at year-end. Reconciling trading partner activity and balances at least quarterly is necessary to identify material out-of-balance conditions between Federal entities and to support an accurate consolidation of DHS and the Government-wide financial statements.

Criteria: The *Treasury Financial Management Service Memorandum M-03-01*, dated October 4, 2002, provides guidance to Federal agencies for standardizing the processing and recording of intragovernmental activities. The *Treasury Federal Intragovernmental Transactions Accounting Policies Guide*, dated October 23, 2002, requires quarterly reconciliation of intragovernmental asset, liability, and revenue amounts with trading partners. Further, the TFM, Section 4060, *Intragovernmental Activity/Balances*, requires reporting agencies to reconcile and confirm intragovernmental activity and balances quarterly for specific reciprocal groupings. OMB Circular No. A-136 requires the presentation of transactions with trading partners to be presented in RSI. It also requires agency financial statements to be presented on a consolidated basis, including the elimination of significant intradepartmental transactions and balances for reporting purposes.

Recommendation: We recommend that all DHS components and programs, in conjunction with the DHS OCFO, develop and implement procedures to positively confirm and reconcile, at least on a quarterly basis, all intragovernmental activity and balances with their intragovernmental trading partners, including other DHS component entities, as prescribed by Treasury guidance. In addition, transactions with trading partners should be completely and accurately presented in the RSI section of the Department's PAR. These procedures also should ensure that all intradepartmental activity and balances are identified and properly eliminated for DHS' consolidated financial statements.

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Appendix II – Other Reportable Conditions

K. Environmental Liabilities

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

The Plum Island Animal Disease Center (PIADC) was transferred to DHS from the Department of Agriculture and is dedicated to the study of animal diseases to better protect the food supply. Previously the PIADC was a U.S. Army installation. The type of research conducted at PIADC and its past use as a military facility are indicators that the land and buildings may require substantial environmental clean-up to eliminate environmental contaminants. PIADC is now part of DHS' S&T Directorate.

CBP's environmental liabilities are created primarily from underground fuel storage tanks and firing ranges.

Conditions: We noted the following internal control weaknesses related to DHS' environmental liabilities:

1. At Coast Guard:
   - Consistent policies or procedures have not been developed for the identification, evaluation, and estimation of potential environmental remediation of Coast Guard sites, thereby resulting in different approaches by shore facility commands and ultimately varying liability estimates.
   - Environmental liability estimates associated with lighthouses and light stations did not include future Phase II (soil testing) assessment or remediation costs and will not be completed until fiscal year 2006.
   - The total estimate for shore facilities was misstated due to ineffective procedures. We noted that the Coast Guard did not properly index the liability costs to current year dollars, nor did it properly include contingency factors for unknown conditions, resulting in a potential understatement of the shore facility liability in the financial statements.
   - Consistent policies and procedures have not been developed to estimate the cost of remediation of specific projects, such as lighthouses and small arms firing ranges and will not be completed until fiscal year 2006.
   - Segregation of duties in calculating and reviewing the vessels liability estimates did not exist.
   - Policies and procedures had not been developed to review shore facility project estimates that would provide reasonable coverage of the entire shore facility population.
2. At S&T, policies and procedures have not been developed to determine if an environmental liability exists at the PIADC, and if so, to accurately estimate and record an environmental liability for the cost of cleanup.
3. CBP had not determined the environmental liabilities to be recorded in the September 30, 2005, financial statements, until a review was performed in response to our audit inquiry. CBP's analysis resulted in an environmental liability of approximately $43 million. We further noted that no single program existed to manage CBP's environmental liabilities, resulting in the necessity for an ad hoc process to be implemented at year-end. In addition, we noted a lack of communication throughout the organization, related to the requirements associated with

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environmental liabilities and weaknesses in documentation of data supporting the computation of liability for financial statement purposes.

Cause/Effect: Coast Guard has not developed consistent written agency-wide policies, to define the technical approach, cost estimation methodology, and overall management of its environmental remediation projects, resulting in inconsistency in its estimates and possible misstatement of the liability in its financial statements. S&T and CBP did not have policies and procedures in place that required an annual review to identify a comprehensive list of sites that required environmental remediation and clean-up.

Criteria: SFFAS No. 6, paragraph 85, defines environmental cleanup costs as those costs for removing, containing, and/or disposing of (1) hazardous waste from property, or (2) material and/or property that consists of hazardous waste at permanent or temporary closure or shutdown of associated PP&E. Paragraph 88 states that these cleanup costs meet the definition of liability provided in SFFAS No. 5. In addition, SFFAS No. 6, paragraph 96, states that remediation estimates shall be revised periodically to account for material changes due to inflation or deflation and changes in regulations, plans and/or technology. New remediation cost estimates should be provided if there is evidence that material changes have occurred; otherwise estimates may be revised through indexing.

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

The GAO *Standards* state that management is responsible for developing and documenting detailed policies, procedures, and practices that fit their agency's operations. As part of their monitoring of internal control, management must continue to maintain these policies and procedures and assess the quality of performance over time.

Recommendations: We recommend that:

1. Coast Guard:
   a) Implement policies and procedures to ensure the proper calculation and review of cost estimates for consistency and accuracy in financial reporting including determining proper segregation of duties;
   b) Develop controls to ensure identification of and recording of all environmental liabilities, such as, soil testing and remediation, lighthouses, small arms ranges, and vessels; and continue efforts to implement corrective action plans regarding small arms firing ranges (SAFR) and lighthouse/light station remediation projects; and
   c) Develop and implement policies and procedures to apply indexing and contingencies to environmental estimates on a consistent basis, and to require the retention of supporting documentation for environmental estimates.
2. S&T evaluate the PIADC facility, using a qualified environmental specialist, to determine if an environmental liability exists, and if so to accurately estimate and record an environmental

liability for the cost of cleanup. S&T should also develop policies and procedures to routinely assess environmental liabilities.

3. CBP:
   a) Designate one central person or department to be responsible for management and reporting of environmental liabilities, e.g., identification, valuation, tracking, and financial statement reporting;
   b) Improve the communication throughout CBP to ensure that a clear understanding of the financial reporting requirements for environmental liabilities exists;
   c) Implement a process to ensure that all sites with potential environmental liabilities are identified and liabilities are properly estimated and recorded in the financial statements, in accordance with generally accepted accounting principles;
   d) Ensure that the liability is updated on a quarterly basis; and
   e) Improve the traceability of its Environmental Liabilities Summary Sheet estimate to its supporting documentation.

L. Custodial Revenue and Drawback

Background: CBP, as a component of DHS, has continued to perform an important revenue collection function for the U.S. Treasury. CBP collects approximately $24 billion in annual import duties, taxes, and fees on merchandise arriving in the United States from foreign countries. Receipts of import duties and related refunds are presented in the statement of custodial activity in the DHS consolidated financial statements. CBP is the only DHS component with significant custodial responsibilities.

Drawback is a remittance, in whole or in part, of duties, taxes, or fees previously paid by an importer. Drawback typically occurs when the imported goods on which duties, taxes, or fees have been previously paid, are subsequently exported from the United States or destroyed prior to entering the commerce of the United States. Depending on the type of claim, the claimant may have up to eight years from the date of importation to file for drawback.

CBP employs a risk-based system of internal control over the collection of taxes, duties, and fees. By design, imports are subjected to various controls depending on a risk assessment associated with the importer, country of origin, merchandise being imported to the United States, and other factors. Low risk imports are subjected to fewer trade compliance controls, while high risk imports are subjected to increased control, e.g. inspection, review of import documentation, etc. To measure the effectiveness of this risk-based control approach, CBP uses a technique known as Compliance Measurement Program (CMP), which is essentially a control self-assessment. The CMP is also used to compute the "revenue gap", as described by SFFAS No. 7, *Accounting for Revenue and Other Financing Sources*, and disclosed in the CBP's PAR in compliance with OMB Circular No. A-136.

Bonded Warehouses (BW) are facilities under the joint supervision of CBP and the Bonded Warehouse Proprietor used to store merchandise that has not made entry into the United States commerce. Foreign Trade Zones (FTZ) are secured areas under CBP supervision that are considered outside of the CBP territory, upon activation. Authority for establishing FTZs is granted by the U.S. Department of Commerce's Foreign Trade Zones Board, under the *Foreign Trade*

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Zones Act of 1934, as amended (19 U.S.C. 81a-81u). Foreign and domestic merchandise may be admitted into zones for operations not otherwise prohibited by law, including storage, exhibition, assembly, manufacturing, and processing.

Conditions: We noted the following internal control weaknesses at CBP:

Related to drawback:

- The revenue accounting system, Automated Commercial System (ACS), lacked controls to detect and prevent excessive drawback claims and payments, necessitating inefficient manual processes to compensate. ACS did not have the capability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries or export documentation upon which the drawback claim was based. For example, ACS did not contain electronic edit checks that would flag duplicate claims for export of the same merchandise.
- Drawback review policies did not require drawback specialists to review all related drawback claims against the underlying consumption entries to determine whether, in the aggregate, an excessive amount was claimed.

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

- Policies and procedures that describe how to perform a CMP exam, the role of the CM coordinator, and documentation of findings, etc. were outdated and not well documented or communicated. We noted that performance of the CMP has been inconsistent in various ports throughout the United States. For example we noted that the extent of physical inspection of merchandise varied depending upon the port and inspector performing the inspection.
- CBP management identified other weaknesses in the documentation and accumulation of CMP sample data that could mitigate the effectiveness of the program as a quality control measurement tool, and the accuracy of the revenue gap disclosed in the CBP PAR. For example, we noted that CMP sample data was not reviewed for errors before it was used by a statistician to compute the revenue gap, and CBP identified a high error rate in the quality of other, non-financial CMP generated data.
- The CMP sample size used during fiscal year 2005 was lower than in previous years, and consequently caused a high standard deviation of potential error in the statistical computation of the revenue gap.

Related to BW and FTZ:

- CBP lacked official guidance and proper training to address the monitoring of BWs and FTZs. For example, we identified incomplete risk assessments and spot checks of BWs and FTZs.
- CBP has not implemented a CMP to measure the revenue gap and effectiveness of controls over trade compliance at FTZs and BWs, similar to the entry process described above.

(continued)

Independent Auditors' Report
Appendix II – Other Reportable Conditions

Cause/Effect: CBP has been challenged to balance its commitment of limited resources to two important mission objectives – trade compliance, including the collection of taxes, duties and fees owed to the Federal government, and securing the U.S. borders from potential terrorist entry. While these mission objectives do overlap somewhat, there are differences in how resources are deployed. During fiscal year 2005, CBP reduced its sample size for its CMP by a factor of 50 percent, to devote more resources to border security. Further, CMP policies and procedures have not gone through a significant review and update in several years. Turnover and reassignment of personnel have caused the CMP knowledge base to go stale in some ports. For drawback, much of the process is manual until planned IT system functionality improvements are made, placing an added burden on limited resources. Policies and procedures have not been developed or implemented to reliably and accurately review and track the BWs and FTZs. Without an effective process to review the compliance of CBW and FTZ, CBP cannot determine the loss of revenue associated with these facilities, and it is possible that some of the facilities were not accounted for and that others were counted twice.

Criteria: Under FMFIA, management must implement cost-effective controls to safeguard assets and ensure reliable financial reporting. OMB's *Revised Implementation Guidance for FFMIA,* states that financial systems should "routinely provide reliable financial information consistently, accurately, and reported uniformly" to support management of current operations. JFMIP publications and OMB Circular No. A-127 outlines the requirements for Federal systems. JFMIP's *Core Financial System Requirements* states that the core financial system must maintain detailed information by account sufficient to provide audit trails and to support billing and research activities. Circular No. A-127 requires that the design of financial systems should eliminate unnecessary duplication of a transaction entry. Wherever appropriate, data needed by the systems to support financial functions should be entered only once and other parts of the system should be updated through electronic means consistent with the timing requirements of normal business/transaction cycles.

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

Recommendations: We recommend that CBP:

Related to drawback:

a) Implement effective internal controls over drawback claims as part of any new systems initiatives, including the ability to compare, verify, and track essential information on drawback claims to the related underlying consumption entries and export documentation for which the drawback claim is based, and identify duplicate or excessive drawback claims; and

b) Revise current policies and procedures to require drawback specialists to review all prior related drawback claims against a designated consumption entry to determine whether, in the aggregate, an excessive amount was claimed against the consumption entries.

Related to entry and CMP:

c) Update policies and procedures to fully describe how to perform a CMP exam, define the roles and responsibilities of the CM coordinator, and to describe how to document test results to improve the quality of CMP data;

(continued)

Independent Auditors' Report
Appendix II – Other Reportable Conditions

d) Provide training to CM coordinators, CBP officers and import specialists on how to fully achieve the objective of the CMP; and

e) Develop and implement additional procedures that will improve the precision of the revenue gap calculation, including the statistical results.

Related to FTZ and BW:

f) Finalize and issue CBP policies and provide appropriate training regarding compliance reviews of FTZs and BWs. This policy should include a standard national checklist to help CBP officers perform thorough reviews and measure compliance rates and to document the reviews consistently. In addition, this policy should include specific corrective action plans, based on the inspection results; and

g) Consider the cost/effectiveness of implementing a CMP over FTZs and BWs to assess the risk of revenue loss and violations of trade regulations by importers.

(continued)

Independent Auditors' Report
Appendix III – Compliance and Other Matters

(Findings A – J and K – L are presented in Appendices I and II, respectively)

M. *Federal Managers' Financial Integrity Act of 1982*

OMB Circular No. A-123 requires agencies and Federal managers to (1) develop and implement management controls; (2) assess the adequacy of management controls; (3) identify needed improvements; (4) take corresponding corrective action; and (5) report annually on management controls (commonly known as management's FMFIA report). During fiscal year 2005, DHS OCFO significantly enhanced its FMFIA assessment policies and procedures to be conducted by the components, in part to prepare for an audit of internal control over financial reporting in fiscal year 2006, pursuant to the *DHS Financial Accountability Act of 2004*. The OCFO required the components to implement certain processes and undergo a self evaluation of some entity level controls.

While also we noted a considerable improvement in DHS' FMFIA processes, some components still have not established effective systems, processes, policies and procedures to evaluate and report on internal accounting and administrative controls, and conformance of accounting systems to properly and accurately report on compliance with Sections FMFIA Sections 2 and 4.

Recommendations: We recommend that DHS components fully implement the FMFIA process, as prescribed by the OCFO, to ensure compliance with the FMFIA in fiscal year 2006. We also recommend that the OCFO consider additional training for the components, to ensure a thorough understanding of requirements.

N. *Federal Financial Management Improvement Act of 1996*

Passage of the *DHS Financial Accountability Act of 2004* made DHS subject to the FFMIA, in fiscal year 2005. In previous fiscal years – 2003 and 2004 – DHS was not subject to FFMIA. Section 803(a) of FFMIA, requires that agency Federal financial management systems comply with (1) Federal accounting standards, (2) Federal system requirements, and (3) the United States Standard General Ledger 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 DHS and each significant component – CBP, ICE and DHS-ICE components, EPR, SLGCP, TSA and Coast Guard did not fully comply with at least one of the requirements of FFMIA. The reasons for non-compliance are reported in Appendices I and II.

Recommendations: We recommend that DHS improve its processes to ensure compliance with the FFMIA in fiscal year 2006.

O. *Federal Information Security Management Act (Electronic Government Act of 2002)*

DHS is required to comply with the FISMA, which was enacted as part of the *Electronic Government Act of 2002*. FISMA requires agencies and departments to: (1) provide information security for the systems that support the operations under their control; (2) develop, document and implement an organization-wide information security program; (3) develop and maintain information security policies, procedures and control techniques; (4) provide security training and oversee personnel with significant responsibilities for information security; (5) assist senior officials concerning their security responsibilities; and (6) ensure the organization has sufficient trained personnel to comply with FISMA requirements. We noted instances of non-compliance with FISMA that have been reported by us in Appendix I within Comment C– *Financial Systems Security*.

(continued)

Independent Auditors' Report
Appendix III – Compliance and Other Matters

Recommendations: We recommend that DHS follow the recommendations provided in Appendix I, Comment C and fully implement the requirements of FISMA in fiscal year 2006.

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

As grant-making agencies, EPR, SLGCP, and TSA are required to comply with certain provisions of OMB Circular No. A-133 and OMB Circular No. A-50, as revised. These circulars require agencies awarding grants to ensure they receive grantee reports timely and to follow-up on grantee single audit findings.

Additional, OMB Circular No. A-50, as revised, provides policies and procedures for use by executive agencies when considering reports issued by Inspectors General, and other executive branch audit organizations, the GAO, and non-Federal auditors, where follow up is necessary. Corrective action taken by management on findings and recommendations is essential to improve the effectiveness and efficiency of government operations.

Although certain procedures have been implemented to monitor grantees and their audit findings, we noted that EPR, SLGCP, and TSA did not have procedures in place to fully comply with provisions in OMB Circular Nos. A-133 and A-50, that require them to timely obtain and review grantee single audit reports and follow up on questioned costs and other matters identified in these reports. Since single audits typically are performed by other entities outside of DHS, procedures related to these reports are not always entirely within the control of EPR, SLGCP, and TSA.

DHS and its components did not fully develop corrective action plans to address all material weaknesses and reportable conditions identified by previous financial statement audits, and in two cases, management did not provide a response to fiscal year 2004 audit findings, as required by OMB Circular No. A-50, as revised. We also noted that some corrective action plans lack sufficient detail, such as clearly defined roles and responsibilities, actions to be taken, time-table for completion of actions, and documented supervisory review and approval of completed actions.

Recommendations: We recommend that:

1. DHS management develop and implement department-wide polices and procedures to ensure compliance with OMB Circular Nos. A-133 and A-50, including the identification of which components must comply. Until policy guidance is received from DHS management, EPR, SLGCP, and TSA should perform the following in fiscal year 2006:
   a) Develop and implement a tracking system to identify each grantee for which an OMB Circular No. A-133 single audit is required, and the date the audit report is due;
   b) Use the tracking system to ensure audit and performance reports are received timely, or to follow-up when reports are overdue; and
   c) Perform reviews of grantee audit reports, issue related management decisions, and ensure that the grantees take appropriate corrective action, on a timely basis.
2. DHS develop policies and procedures, including the development of a process to ensure that corrective action plans addressing all DHS audit findings are developed and implemented, together with appropriate supervisory review.

(continued)

Independent Auditors' Report
Appendix III – Compliance and Other Matters

Q. *Improper Payments Information Act of 2002*

DHS is required to comply with the *Improper Payments Information Act of 2002* (the Act). The Act requires agencies to review all programs and activities they administer annually and identify those that may be susceptible to significant erroneous payments. For all programs and activities where the risk of erroneous payments is significant, agencies must estimate the annual amounts of erroneous payments, and report the estimates to the President and Congress with a progress report on actions to reduce them. The agency must report a statistically valid error projection for susceptible programs in its annual PAR. To facilitate the implementation of the Act, OMB issued guidance in Memorandum M-03-13, *Implementation Guide for the Improper Payments Information Act of 2002*, which among other matters provided a recommended process to meet the disclosure requirements. We noted that DHS did not comply with the Act, as follows:

DHS did not:

- Institute a systematic method of reviewing all programs and identifying those it believed were susceptible to significant erroneous payments; and
- Perform testwork to evaluate improper payments for all material programs. Testing was only performed over the TAFS with the largest disbursements for each component or the largest TAFS maintained by an internal DHS accounting service provider.

Recommendation: We recommend that DHS follow the guidance provided in OMB M-03-13 in fiscal year 2006, including completing the necessary susceptibility assessments, performing testwork over all material programs, and instituting sampling techniques to allow for statistical projection of the results.

R. *DHS Financial Accountability Act of 2004*

Section 3 of Public Law 108-330, *DHS Financial Accountability Act of 2004,* states that the President of the United States shall appoint a Chief Financial Officer of DHS not later than 180 days after the date of the enactment of this Act signed in October 2004, to be confirmed by the U.S. Senate. To date, a CFO for DHS has not been nominated or Senate confirmed. Currently DHS is operating with an Acting CFO, while no waiver or amendment to this law has been obtained by DHS management. The *DHS Financial Accountability Act of 2004* also made DHS subject to the *Chief Financial Officers Act of 1990*, as amended, which requires DHS to submit to the Congress and OMB audited financial statements annually. DHS engaged an independent auditor to audit the September 30, 2005, consolidated balance sheet only.

Recommendation: We recommend that DHS complete the interviewing process and formally nominate an applicant to fill the CFO position in a timely manner. We also recommend that DHS and its components continue to implement corrective action plans in order to remediate the fiscal year 2005 material weaknesses and reportable conditions in order to obtain an opinion covering all of its consolidated financial statements in the future.

S. *Government Performance and Results Act of 1993*

The *Government Performance and Results Act* requires each agency to prepare performance plans that include a description of the operational processes, skills and technology, and the resources required to meet the goals, and a description of the means used to verify and validate the measured results. In addition, the PAR should include performance indicators established in the annual

(continued)

Independent Auditors' Report
Appendix III – Compliance and Other Matters

performance plan, the actual performance achieved compared with the prior year goals, and an evaluation of the current year performance plan with respect to success in achieving the performance goals. The fiscal year 2006 DHS *Annual Performance Plan* did not include details related to requisite resources to meet DHS goals or a description of the means used to verify and validate performance results. Also, DHS did not consistently present performance measures in the PAR as written in the annual performance plans, did not provide explanations of performance results, and did not have supporting documentation substantiating the changes in performance measure goals between the annual performance plan and the PAR.

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

(continued)

Independent Auditors' Report
Appendix IV – Status of Prior Year Findings

Summary of Conditions As Reported in 2004 DHS Performance and Accountability Report	Fiscal Year 2005 Status/ Disposition
Material Weaknesses:	
A. Financial Management Structure Office of the Chief Financial Officer (OCFO) has not fully established processes that bridge the gap between where DHS' consolidated reporting responsibilities lie (at the OCFO) and where most accounting resources and detailed knowledge resides; hired or contracted sufficient qualified personnel to properly perform the financial reporting function; provided the DHS bureaus sufficient management oversight and timely policy guidance; and established sufficient internal controls over financial reporting.	**Partially Repeated as Material Weakness** (Comment A)
B. Financial Management and Oversight at Immigration and Customs Enforcement ICE did not have a well-designed plan for the transition of accounting operations of major DHS directorates and components to its accounting systems, resulting in material errors, irregularities, and abnormal balances in the DHS consolidated financial statements; a process to establish and maintain more than 30 important shared services agreements with trading partners; a process for identifying and fixing deficiencies in its accounting and financial reporting process, including internal control weaknesses, human capital needs, and information technology needs. Its financial systems, processes, and control activities were inadequate for providing accounting services for itself and five other major DHS operating units; sufficient leadership and guidance, from both the OCFO and within its own management ranks. ICE fell seriously behind in performance of basic accounting functions, such as account reconciliations, analysis of material abnormal balances, and proper budgetary accounting, which prevented it from submitting timely and accurate periodic financial reports to DHS during fiscal year2004, correctly applying Federal accounting standards, and implementing internal controls that comply with GAO *Standards*.	**Repeated as Material Weakness** (Comment A)
C. Financial Reporting in the Office of the Chief Financial Officer and DHS Components 1. The OCFO did not adhere to the schedule to meet the accelerating reporting deadlines; prepare a balanced consolidated financial statement until November 2004; prepare accurate periodic consolidated financial statements; implement sufficient processes and monitoring controls to ensure consolidated financial information was received timely and was accurate from DHS components; provide adequate guidance to DHS components; and implement procedures and controls over the FMFIA reporting process.	**Partially Repeated as Material Weakness** (Comments A & B)

Independent Auditors' Report
Appendix IV – Status of Prior Year Findings

Summary of Conditions As Reported in 2004 DHS Performance and Accountability Report	Fiscal Year 2005 Status/ Disposition
2. Coast Guard has a reporting process that is complex and requires a significant number of on-top entries, and lacks documentation of internal controls; year-end closing entries did not consistently include sufficient supporting documentation or internal controls, such as management review; the accuracy of financial information was dependent on a few knowledgble personnel instead of well documented policies and procedures; and had weaknesses in financial management oversight. 3. ICE, EPR, and SLGCP do not have documented policies and procedures for exporting data from the general ledger for the TIER submission routinely; quality control procedures over financial reports are not regularly performed; TIER input is not reconciled to outputs provided by the OCFO; and the accuracy of financial information is highly dependent on the knowledge of a few individuals. 4. Coast Guard, SLGCP, and ICE did not have effective financial information systems or sufficiently documented processes to accumulate and present cost data by strategic goal as required by SFFAS No. 4. 5. EPR monthly TIER transmissions did not accurately and completely reflect the financial transactions of the Strategic National Stockpile. 6. SLGCP was not actively involved in the financial reporting process of its accounting services provider, and did not provide adequate oversight.	
D. Financial Systems Functionality and Technology OCFO and DHS bureaus have IT and financial system control and functionality weaknesses in entity-wide security program planning and management, access controls, application software development and change controls, system software, segregation of duties, and service continuity.	**Repeated as Material Weakness** (Comment C)
E. Fund Balance with Treasury 1. ICE did not perform timely reconciliation procedures for FBWT, and lack SOPs on FBWT reconciliation procedures. 2. Guard did not perform timely reconciliation procedures for FBWT, and lack SOPs on FBWT reconciliation procedures.	**Repeated as Material Weakness** (Comment D)

Independent Auditors' Report
Appendix IV – Status of Prior Year Findings

Summary of Conditions As Reported in 2004 DHS Performance and Accountability Report	Fiscal Year 2005 Status/ Disposition
F. Property, Plant, and Equipment	
1. Coast Guard has not implemented appropriate controls and related processes to properly, accurately and timely record PP&E additions, transfers from other agencies, and disposals in its fixed assets system; maintained cost documentation for some PP&E; implemented an adequate asset identification and tagging system; developed a physical inventory processes; accounted properly for depreciation of improvements made for some PP&E; established policies related to the useful lives of certain vessels; properly classified repairable items as PP&E and established procedures to identify and evaluate lease agreements.	**Repeated as Material Weakness** (Comment E)
2. ICE has not consistently applied procedures to identify and capitalize software development costs or to reclassify software placed into production from software in development.	
G. Operating Materials and Supplies, and Seized Property	
1. Coast Guard procedures and internal controls over physical counts were not operating effectively; OM&S was not always properly tagged; on-hand quantities frequently did not agree to the perpetual inventory records; he policies were not updated to ensure correct financial reporting; and the weighted average pricing methodology used to value OM&S was not appropriately supported.	**Partially Repeated as Material Weakness** (Comment F)
2. Secret Service counterfeit currency records did not accurately reflect the activity for the year.	
H. Undelivered Orders, Accounts and Grants Payable, and Disbursements	
1. ICE did not establish sufficient controls to properly account for disbursements made by legacy agencies for DHS-ICE components; prevent duplicate payments for vendors related to prior year obligations or to prevent anti-deficient situations in certain Treasury accounts; did not have sufficient controls to ensure that open obligations were properly liquidated when corresponding accounts payable were recorded; and did not have policies related to verification and validation of obligations. The methods used by ICE to estimate accounts payable itself and other DHS-ICE components was not based on historical disbursements or other information unique to those programs.	**Repeated as Material Weakness** (Comment G)

Independent Auditors' Report
Appendix IV – Status of Prior Year Findings

Summary of Conditions As Reported in 2004 DHS Performance and Accountability Report	Fiscal Year 2005 Status/ Disposition
2. Coast Guard did not have adequate controls and systems to periodically review and validate UDOs, and record obligations and advances timely and accurately; did not record contract awards timely; did not consistently follow policies and procedures related to procurement and requisitions; did not address possible programming logic in IT systems timely; and the verification process of accounts payable included erroneous data. 3. SLGCP did not perform sufficient monitoring over the legacy agency's activities performed on its behalf related to grant accruals. 4. TSA lacked policies and procedures to monitor compliance with OMB Circular A-133 and did not maintain adequate supporting documentation for disbursed grants.	
I. Budgetary Accounting 1. ICE has weakness in internal controls that may have allowed it to violate the Antideficiency Act; the transfer of accounting records and responsibilities from prior accounting services providers was not coordinated properly; obligations were not recorded properly; disbursements and resulting adjustments to obligation balances related to CBP were not recorded timely; contracting officer approvals were clearly documented on obligating documents; controls were weak over the preparation and submission of the SF-132 and SF-133 process. 2. Coast Guard, electronic edit checks over budget authority and commitments were not fully employed; weaknesses existed in controls over recording of budgetary authority, commitments, obligations, and related disbursements and recissions; weakness existed in controls over the preparation, submission and document retention of the SF-132 and SF-133; contracting officers with expired authority continued to approve obligations; commitments were not routinely monitored 3. EPR's method of accounting for investments resulted in an audit adjustment to correct the misstatement in the statement of budgetary resources.	**Partially Repeated as Material Weakness** (Comment I)
J. Intragovermental and Intradepartmental Balances Coast Guard, EPR, CBP, and CIS/ICE do not have effective SOPs to track, confirm, or reconcile intragovernmental balances and transactions with trading partners; and DHS OCFO does not have an adequate process for reconciling differences with other Federal government trading partners.	**Repeated as Material Weakness** (Comment J)

Independent Auditors' Report
Appendix IV – Status of Prior Year Findings

Summary of Conditions As Reported in 2004 DHS Performance and Accountability Report	Fiscal Year 2005 Status/ Disposition
Other Reportable Conditions:	
K. Deferred Revenue on Immigration and Naturalization Applications CIS lacks SOPs for identifying the accuracy and reliability of application status data and fees correction with immigration applications were not always deposited in accordance with Treasury guidelines.	**Closed**
L. Environmental Liabilities 1. Coast Guard have not developed consistent written policies and procedures for the identification, evaluation, and estimation of potential environmental remediation of sites; liability estimates for lighthouses did not include soil testing; did not properly index costs; lacked management review of liability estimates. 2. S&T had not developed policies and procedures to determine if an environmental liability exists at PIADC, and if so to accurately estimate the liability for financial statement reporting purposes	**Repeated as Reportable Condition** (Comment K)
M. Custodial Activity Performed by Customs and Border Protection CBP did not have a reliable process of monitoring the movement of in-bond shipments, adequate written SOPs, and consistent performance of a compliance measurement program to assess the risk and compute an estimate of underpayment of duties, taxes, and fees.	**Repeated as Reportable Condition** (Comment L)
Compliance and Other Matters:	
N. *Federal Managers' Financial Integrity Act of 1982* DHS management's FMFIA report did not contain corrective action plans for all material weaknesses identified in the PAR. In addition, DHS and its components have not established effective systems, processes, policies and procedures to evaluate and report on FMFIA compliance.	**Repeated as Reportable Condition** (Comment M)

Independent Auditors' Report
Appendix IV – Status of Prior Year Findings

Summary of Conditions As Reported in 2004 DHS Performance and Accountability Report	Fiscal Year 2005 Status/ Disposition
O. ***Federal Information Security Management Act (Electronic Government Act of 2002)*** Instances on non-compliance with the FISMA were noted.	**Repeated as Reportable Condition** (Comment O)
P. ***Single Audit Act Amendments of 1996,* and Laws and Regulations Supporting OMB Circular No. A-50, *Audit Follow-up,* as revised** EPR, SLGCP, and TSA did not have procedures to monitor grantees and their audit findings.	**Partially Repeated as Reportable Condition** (Comment P)
Q. ***Improper Payments Information Act of 2002*** DHS did not properly define programs and activities, institute a systematic method of reviewing all programs and identifying those at risk of significant erroneous payments, and properly sample or compute the estimated dollar amount of improper payments.	**Repeated as Reportable Condition** (Comment Q)

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

November 15, 2005

MEMORANDUM FOR: Richard L. Skinner,
Inspector General

FROM: Andrew B. Maner
Chief Financial Officer

SUBJECT: Management's Response to the Independent Auditor's Report

Thank you for the opportunity to respond to the Independent Auditor's Report. Overall, the Report was well balanced and the Department concurs with the Independent Auditor's recommendations. Detailed corrective action plans for material weaknesses, reportable conditions, and non-compliance with laws and regulations are provided in the Management Discussion and Analysis section of the PAR, however, we would like to take this opportunity to highlight significant actions currently underway to address the material weaknesses reported. Over the next year we will:

- Execute the Secretary's Second Stage Review agenda item for improving DHS financial management.
- Build upon our progress in implementing the *Department of Homeland Security Financial Accountability Act.* Management's assessment for the Act's annual assertion requirement on internal control over financial reporting will be the framework to ensure that all financial management processes across the Department are designed and implemented with strong internal controls.
- Implement a standardized financial reporting process, including formal policies and procedures that require Components to prepare a comprehensive financial reporting package that will result in complete and reliable financial reporting.
- Issue a formal Corrective Action Planning Management Directive and Process Guide to improve our corrective action plans and ensure they demonstrate results.
- Continue to invest in and expand accounting staffs with the right skill sets to improve internal controls over financial reporting.
- Carry on with our efforts to implement a Department-wide IT security program in accordance with OMB and NIST guidance.

Since our inception in March 2003, the Department has demonstrated resolve in subjecting our financial statements to an independent audit. In fiscal year 2006 we will continue to demonstrate our commitment to success in our long-term transformational efforts. Finally, we wanted to reaffirm our appreciation of the efforts of your office and the independent auditors. We are proud of the professional and cooperative working relationships amongst our staffs. Ultimately, we share the common goal of *Organizational Excellence* and we look forward to continuing our joint efforts in developing a culture of integrity, accountability, and excellence in all we do. Once again, thank you for a well balanced report.

Introduction

The principal consolidated financial statements included in this report are prepared pursuant to the requirements of the Accountability of Tax Dollars Act of 2002 and the Department of Homeland Security (DHS) Financial Accountability Act of 2004, to meet the requirements of the Chief Financial Officers Act of 1990. Other requirements include the Government Management Reform Act of 1994, and the Office of Management and Budget's (OMB) Circular No. A-136. The responsibility for the integrity of the financial information included in these statements rests with the management of DHS. An independent certified public accounting firm, selected by the Department's Inspector General, was engaged to perform the audit of the consolidated balance sheet. The independent auditors' report accompanies the principal consolidated statements. These financial statements include the following:

- The **Consolidated Balance Sheet** presents as of September 30, 2005 and 2004, those resources owned or managed by DHS which are available for future economic benefits (assets); amounts owed by DHS that will require payments from those resources or future resources (liabilities) and residual amounts retained by DHS, comprising the difference (net position).
- The **Consolidated Statement of Net Cost** presents the net cost of DHS operations for the years ended September 30, 2005 and 2004. DHS net cost of operations includes the gross costs incurred by DHS less any exchange revenue earned from DHS activities.
- The **Consolidated Statement of Changes in Net Position** presents the change in DHS' net position resulting from the net cost of DHS operations, budgetary financing sources and other financing sources for the years ended September 30, 2005 and 2004.
- The **Combined Statement of Budgetary Resources** presents the budgetary resources available to DHS during fiscal years 2005 and 2004, the status of these resources at September 30, 2005 and 2004, and the outlay of budgetary resources for the years ended September 30, 2005 and 2004.
- The **Consolidated Statement of Financing** presents the reconciliation of the net cost of operations with the budgetary resources for the years ended September 30, 2005 and 2004.
- The **Statement of Custodial Activity** presents the disposition of custodial revenue collected and disbursed by DHS on behalf of other recipient entities for the years ended September 30, 2005 and 2004.

LIMITATIONS OF FINANCIAL STATEMENTS

The principal financial statements have been prepared to report the financial position and results of operations of the entity, pursuant to the requirements of Title 31, United States Code, Section 3515 (b) relating to financial statements of agencies. While the statements have been prepared from the books and records of the agency in accordance with U.S. generally accepted accounting principles (GAAP) for Federal entities and the formats prescribed by OMB, the statements are in addition to the

financial reports used to monitor and control budgetary resources which are prepared from the same books and records. The statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity.

Department of Homeland Security
Consolidated Balance Sheet
As of September 30, 2005 and 2004
(In Millions)

	2005 (Unaudited)	2004 (Unaudited)
ASSETS (Notes 2 and 22)		
Intragovernmental		
Fund Balance with Treasury (Notes 2 and 3)	$97,004	$33,436
Investments, Net (Note 4)	738	1,625
Advances and Prepayments (Note 6)	2,937	2,886
Other (Note 12)	361	481
Total Intragovernmental	**101,040**	**38,428**
Accounts Receivable, Net (Note 5)	532	463
Tax, Duties, and Trade Receivables, Net (Notes 2 and 7)	1,400	1,273
Operating Materials, Supplies, and Inventory, Net (Note 9)	506	496
General Property, Plant, and Equipment, Net (Note 11)	10,470	9,746
Other (Note 12)	558	400
Total Assets	**$114,506**	**$50,806**
LIABILITIES (Note 13)		
Intragovernmental		
Due to the Treasury General Fund (Note 14)	$1,434	$1,257
Accounts Payable	870	911
Other (Note 19)	854	563
Total Intragovernmental	**3,158**	**2,731**
Accounts Payable	3,329	2,791
Claims and Claims Settlement Liabilities (Note 15)	23,433	1,417
Deferred Revenue and Advances from others (Note 16)	2,014	2,020
Accrued Payroll and Benefits (Note 17)	2,845	2,692
Military Service and Other Retirement Benefits (Note 18)	29,021	26,502
Other (Note 19)	5,945	4,166
Total Liabilities	**69,745**	**42,319**
Commitments and contingencies (Notes 20 and 21)		
Net Position		
Unexpended Appropriations	87,166	25,504
Cumulative Results of Operations	(42,405)	(17,017)
Total Net Position	**$44,761**	**$8,487**
Total Liabilities and Net Position (Note 22)	**$114,506**	**$50,806**

The accompanying notes are an integral part of these statements.

Department of Homeland Security
Consolidated Statement of Net Cost
For the Years Ended September 30, 2005 and 2004
(In Millions)

Directorates and Other Components (Note 23)	2005 (Unaudited)	2004 (Unaudited)
Border and Transportation Security		
Gross Cost	$17,914	$16,646
Less Earned Revenue	(3,547)	(2,905)
Net Cost	**14,367**	**13,741**
Emergency Preparedness and Response		
Gross Cost	39,805	7,819
Less Earned Revenue	(2,178)	(2,020)
Net Cost of Continuing Operations	37,627	5,799
Cost of Transferred Operations (Note 29)	-	98
Net Cost	**37,627**	**5,897**
Information Analysis and Infrastructure Protection		
Gross Cost	652	497
Less Earned Revenue	-	-
Net Cost	**652**	**497**
Science and Technology		
Gross Cost	743	755
Less Earned Revenue	(12)	-
Net Cost	**731**	**755**
United States Coast Guard		
Gross Cost	9,589	8,317
Less Earned Revenue	(220)	(157)
Net Cost	**9,369**	**8,160**
United States Secret Service		
Gross Cost	1,505	1,386
Less Earned Revenue	(22)	(18)
Net Cost	**1,483**	**1,368**
United States Citizenship and Immigration Services		
Gross Cost	1,291	1,758
Less Earned Revenue	(1,622)	(1,310)
Net Cost	**(331)**	**448**
Departmental Operations and Other		
Gross Cost	2,519	2,270
Less Earned Revenue	(12)	(8)
Net Cost	**2,507**	**2,262**
Net Cost of Operations (Note 23)	**$66,405**	**$33,128**

The accompanying notes are an integral part of these statements.

Department of Homeland Security
Consolidated Statement of Changes in Net Position
For the Years Ended September 30, 2005 and 2004
(In Millions)

	2005		2004	
	Cumulative Results of Operations (Unaudited)	Unexpended Appropriations (Unaudited)	Cumulative Results of Operations (Unaudited)	Unexpended Appropriations (Unaudited)
BEGINNING BALANCES	**$(17,017)**	**$25,504**	**$(15,680)**	**$23,560**
Budgetary Financing Sources:				
Prior Period Adjustments:				
Correction of Errors (Note 30)	(127)	163	-	-
Beginning Balance, as Adjusted	**(17,144)**	**25,667**	**(15,680)**	**23,560**
Budgetary Financing Sources:				
Appropriations Received (Note 24)	-	101,251	-	33,410
Appropriations Transferred in/out	-	158	-	(398)
Rescissions and Other Adjustments (Notes 3 and 24)	-	(1,876)	-	(2,398)
Appropriations Used	38,034	(38,034)	28,670	(28,670)
Non-exchange Revenue	2,315	-	2,308	-
Donations and Forfeitures of Cash/Equivalents	3	-	3	-
Transfers in/out without Reimbursement	265	-	672	-
Other	(143)	-	73	-
Other Financing Sources:				
Donations and Forfeitures of Property	8	-	8	-
Transfers in/out Without Reimbursement	11	-	(685)	-
Imputed Financing from Costs Absorbed by Others	651	-	742	-
Total Financing Sources	**41,144**	**61,499**	**31,791**	**1,944**
Net Cost of Operations	(66,405)	-	(33,128)	-
Net Change	(25,261)	61,499	(1,337)	1,944
ENDING BALANCES	**$(42,405)**	**$87,166**	**$(17,017)**	**$25,504**

The accompanying notes are an integral part of these statements.

Department of Homeland Security
Combined Statement of Budgetary Resources (page 1 of 2)
For the Years Ended September 30, 2005 and 2004
(In Millions)

BUDGETARY RESOURCES	2005 (Unaudited)	2004 (Unaudited) (Restated)
Budget Authority:		
Appropriations Received	$106,691	$38,303
Borrowing Authority	2,026	26
Net Transfers	326	757
Unobligated Balance:		
Beginning of Period (Notes 24 and 30)	8,392	8,659
Net Transfers	11	41
Spending Authority from Offsetting Collections:		
Earned:		
Collected	7,716	6,282
Receivable from Federal Sources	(142)	9
Change in Unfilled Customer Orders:		
Advance Received	571	87
Without Advance From Federal Sources	569	258
Transfers from Trust Funds	50	55
Subtotal	8,764	6,691
Recoveries of Prior Year Obligations	1,431	1,982
Temporarily Not Available Pursuant to Public Law	-	(17)
Permanently Not Available (Note 24)	(1,961)	(2,563)
TOTAL BUDGETARY RESOURCES	**$125,680**	**$53,879**
STATUS OF BUDGETARY RESOURCES		
Obligations Incurred:		
Direct (Note 24)	$64,227	$42,607
Reimbursable (Note 24)	4,394	2,880
Subtotal	68,621	45,487
Unobligated Balance:		
Apportioned		
Balance, Currently Available	51,837	6,712
Exempt from Apportionment	45	42
Unobligated Balance Not Available	5,177	1,638
TOTAL STATUS OF BUDGETARY RESOURCES	**$125,680**	**$53,879**

The accompanying notes are an integral part of these statements.

Department of Homeland Security
Combined Statement of Budgetary Resources (page 2 of 2)
For the Years Ended September 30, 2005 and 2004
(In Millions)

RELATIONSHIP OF OBLIGATIONS TO OUTLAYS	2005 (Unaudited)	2004 (Unaudited) (Restated)
Obligated Balance, Net, Beginning of Period (Notes 24 and 30)	24,781	19,689
Obligated Balance Transferred, Net	89	(559)
Obligated Balance, Net, End of Period:		
Accounts Receivable	(295)	(437)
Unfilled Customer Orders from Federal Sources	(1,550)	(981)
Undelivered Orders	34,614	21,354
Accounts Payable	5,674	4,845
Outlays:		
Disbursements	53,175	37,601
Collections	(8,336)	(6,424)
Subtotal	44,839	31,177
Less: Offsetting Receipts	(4,152)	(3,779)
NET OUTLAYS	**$40,687**	**$27,398**

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The accompanying notes are an integral part of these statements.

Department of Homeland Security
Consolidated Statement of Financing (page 1 of 2)
For the Years Ended September 30, 2005 and 2004
(In Millions)

	2005 (Unaudited)	2004 (Unaudited) (Restated)
Resources Used to Finance Activities:		
Budgetary Resources Obligated		
Obligations Incurred	$68,621	$45,487
Less: Spending Authority from Offsetting Collections and Recoveries	(10,195)	(8,673)
Obligations Net of Offsetting Collections and Recoveries	58,426	36,814
Less: Offsetting Receipts	(4,152)	(3,779)
Net Obligations	54,274	33,035
Other Resources		
Donations and Forfeiture of Property	8	8
Transfers in(out) Without Reimbursement	11	(685)
Imputed Financing from Costs Absorbed by Others	651	742
Net Other Resources Used to Finance Activities	670	65
Total Resources Used to Finance Activities	**54,944**	**33,100**
Resources Used to Finance Items Not Part of the Net Cost of Operations		
Change in Budgetary Resources Obligated for Goods, Services and Benefits Ordered but not yet Provided	12,866	5,029
Resources that Fund Expenses Recognized in Prior Periods	26	578
Budgetary Offsetting Collections and Receipts that do not Affect Net Cost of Operations:		
Credit program Collections that increase Liabilities for Loan Guarantees or Allowances for Subsidy	(8)	(1,182)
Other	(344)	(816)
Resources that Finance the Acquisition of Assets or Liquidation of Liabilities	1,860	1,575
Other Resources or Adjustments to Net Obligated Resources that do not Affect Net Cost of Operations	(499)	(471)
Total Resources Used to Finance Items Not Part of the Net Cost of Operations	14,898	4,713
Total Resources Used to Finance the Net Cost of Operations	**40,046**	**28,387**

The accompanying notes are an integral part of these statements.

Department of Homeland Security
Consolidated Statement of Financing (page 2 of 2)
For the Years Ended September 30, 2005 and 2004
(In Millions)

	2005 (Unaudited)	2004 (Unaudited) (Restated)
Components of the Net Cost of Operations that will not Require or Generate Resources in the Current Period:		
Components Requiring or Generating Resources in Future Periods:		
Increase in Annual Leave Liability	67	202
Increase in Unfunded Environmental and Disposal Liability	13	62
Increase in Unfunded Claims and Claims Settlement Liabilities	21,651	1,021
Increase in Exchange Revenue Receivable from the Public	(95)	(32)
Increase in Actuarial Pension Liability	1,691	-
Increase in CG Military Post Employment Benefits	17	1,217
Increase in Actuarial Health Insurance Liability	811	133
Other	311	786
Total Components of Net Cost of Operations that will Require or Generate Resources in Future Periods	24,465	3,389
Components not Requiring or Generating Resources:		
Depreciation and Amortization	1,108	1,011
Revaluation of Assets or Liabilities	543	39
Other	243	302
Total Components of Net Cost of Operations that will not Require or Generate Resources	1,894	1,352
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	**26,359**	**4,741**
Net Cost of Operations	**$66,405**	**$33,128**

The accompanying notes are an integral part of these statements.

Department of Homeland Security
Consolidated Statement of Financing (page 2 of 2)
For the Years Ended September 30, 2005 and 2004
(In Millions)

	2005 (Unaudited)	2004 (Unaudited)
Revenue Activity:		
Sources of Cash Collections:		
Duties	$23,198	$20,966
User Fees	1,305	924
Excise Taxes	2,335	2,271
Fines and Penalties	63	57
Interest	9	11
Miscellaneous	417	225
Total Cash Collections	27,327	24,454
Accrual Adjustment	253	(5)
Total Custodial Revenue	27,580	24,449
Disposition of Collections:		
Transferred to Non-Federal Entities	522	182
Transferred to Federal Entities	25,649	23,287
Refunds and Drawbacks (Notes 19 and 25)	1,159	970
Retained by the Department	250	10
Total Disposition of Custodial Revenue	27,580	24,449
Net Custodial Activity	$0	$0

The accompanying notes are an integral part of these statements.

Notes to the Financial Statements

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1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

The Department of Homeland Security (DHS or Department) was established by the *Homeland Security Act of 2002 (HSA)*, Public Law (P.L.) 107-296, dated March 25, 2002, as an executive department of the United States government. The Department is subject to the requirements of the *Department of Homeland Security Financial Accountability Act* (DHS Accountability Act). The strategic goals directly linked to the Department's mission are:

- **Awareness:** Identify and understand threats, assess vulnerabilities, determine potential impacts and disseminate timely information to our homeland security partners and the American public;
- **Prevention:** Detect, deter and mitigate threats to our homeland;
- **Protection:** Safeguard our people and their freedoms, critical infrastructure, property and the economy from acts of terrorism, natural disasters or other emergencies;
- **Response:** Lead, manage and coordinate the national response to acts of terrorism, natural disasters, or other emergencies;
- **Recovery:** Lead Federal, state, local and private sector efforts to restore services and rebuild communities after acts of terrorism, natural disasters, or other emergencies;
- **Service:** Serve the public effectively by facilitating lawful trade, travel and immigration; and
- **Organizational Excellence:** Value our most important resource, our people. Create a culture that promotes a common identity, innovation, mutual respect, accountability and teamwork to achieve efficiencies, effectiveness and operational synergies.

The Department is composed of the following organizational elements, hereafter referred to as components:

Directorates:
Border and Transportation Security Directorate (BTS):

- U.S. Customs and Border Protection (CBP)
- U.S. Immigration and Customs Enforcement (ICE), including Federal Protective Service (FPS) and Federal Air Marshal Service (FAM)
- Transportation Security Administration (TSA)
- Federal Law Enforcement Training Center (FLETC)

Emergency Preparedness and Response Directorate (EP&R): the core of EP&R includes the Federal Emergency Management Agency (FEMA)

Information Analysis and Infrastructure Protection Directorate (IAIP)
Science and Technology Directorate (S&T)

Management Directorate (presented in the Net Cost Statement and related notes as part of Departmental Operations and Other, which includes the Office of State and Local Government Coordination and Preparedness and Office of the Inspector General)

Other Components:

U.S. Coast Guard (USCG)

U.S. Secret Service (USSS)

U.S. Citizenship and Immigration Services (USCIS)

Office of State and Local Government Coordination and Preparedness (SLGCP)

Office of the Inspector General (OIG)

On July 21, 2004, the President signed the *Project Bioshield Act of 2004*, P.L. 108-276. This Act authorized the transfer of the Strategic National Stockpile (SNS) functions, personnel, assets, unexpended balances and liabilities to the Department of Health and Human Services (HHS). Pursuant to P*roject Bioshield Act of 2004*, on August 13, 2004, the Department transferred the SNS from EP&R to HHS. Although the program was transferred, operations related to the SNS activities are reflected in the Department's Consolidated Statement of Net Cost through the date of transfer.

During fiscal year 2004, the Department merged the Office of Domestic Preparedness (ODP) with the Office of State and Local Government Coordination (SLGC) to form SLGCP. The SLGCP reports directly to the Secretary and is responsible for information flow between the Department and state and local governments, for state and local grant award functions, and for building and sustaining the terrorism preparedness of the first responder community. Beginning in fiscal year 2005, select grant award functions previously administered by EP&R and TSA were transferred to SLGCP. Consequently, the Department is presenting the SLGCP as part of Departmental Operations and Other in the consolidated financial statements and related notes, previously SLGCP was presented as part of the BTS in the consolidated financial statements and related notes. Beginning in fiscal year 2005, FPS was transferred within the Border and Transportation Security Directorate to ICE. Fiscal year 2004 SLGCP and FPS financial results have been reclassified for comparative purposes to conform with the fiscal year 2005 presentation.

The fiscal year 2005 Department of Homeland Security Appropriations Act directed the transfer of missions and assets of the Air Marine Operations (AMO) from ICE to CBP (both components of BTS). The transfer was completed in two phases. Phase One was completed on October 31, 2004, moving AMO intact from ICE to CBP. This phase included the transfer of responsibility for all AMO operations, personnel, missions, commitments, facilities, and assets to CBP. Phase Two, which commenced in late November 2004 and completed in August 2005, integrated all CBP air and marine operations, personnel, missions, and assets into the CBP Office of Border Patrol. Fiscal year 2004 AMO financial results have been reclassified in the accompanying financial statements for comparative purposes to conform with the fiscal year 2005 presentation.

Beginning fiscal year 2005, ICE assumed the financial management functions previously provided to FPS by the General Services Administration, and USCG assumed the financial management functions of TSA and FAM.

On July, 13, 2005, the DHS Secretary announced details of a realignment of the Department to increase its ability to prepare, prevent, and respond to terrorist attacks and other emergencies. The statutory authority of the HSA provides certain flexibility for the Secretary of DHS to establish, consolidate, alter or discontinue organizational units within the Department. The mechanism for implementing these changes is a notification to Congress, required under Section 872 of the HSA, allowing for the changes to take effect after 60 days. Other proposed changes require legislative action. Proposed changes impacting several Directorates including BTS, IAIP and ERP are not scheduled to take place until fiscal year 2006, pending congressional approval.

B. Basis of Accounting and Presentation

The financial statements have been prepared from the accounting records of the Department and its components in conformity with accounting principles generally accepted in the United States, and the Office of Management and Budget (OMB) Circular A-136, *Financial Reporting Requirements* (Circular A-136). Accounting principles generally accepted for Federal entities are the standards prescribed by the Federal Accounting Standards Advisory Board (FASAB), the official accounting standards-setting body of the Federal government.

These financial statements are prepared pursuant to the *DHS Accountability Act* and *Accountability of Tax Dollars Act* (applies to fiscal year 2004) and *Chief Financial Officers Act*. These financial statements consist of the Consolidated Balance Sheet, the Consolidated Statement of Net Cost, the Consolidated Statement of Changes in Net Position, the Combined Statement of Budgetary Resources, the Consolidated Statement of Financing and the Statement of Custodial Activity as of and for the years ended September 30, 2005 and 2004.

The Department's financial statements reflect the reporting of component activities including appropriations received to conduct operations and revenue generated from operations. The financial statements also reflect the reporting of certain non-entity (custodial) functions performed on behalf of the Federal government and others (CBP has the authority to assess and collect duties, taxes and fees for the governments of Puerto Rico and the U.S. Virgin Islands).

Transactions are recorded on an accrual and a budgetary basis of accounting. Under the accrual basis, revenues are recorded when earned and expenses are recognized when a liability is incurred, regardless of when cash is exchanged. The Combined Statement of Budgetary Resources facilitates compliance with legal constraints and the use of Federal funds. Obligations are recognized when new orders are placed, contracts are awarded and services are received, which will require payments during the same or future periods. The Consolidated Statement of Financing reconciles the net cost of operations with the budgetary resources. Non-entity revenue and refunds are reported on the Statement of Custodial Activity using a modified cash basis. With this method, revenues from cash collections are reported separately from receivable accruals, and cash disbursements are reported separately from payable accruals.

Intragovernmental assets and liabilities result from activity with other Federal agencies. All other assets and liabilities result from activity with parties outside the Federal government, such as domestic and foreign persons, organizations, or governments. Intragovernmental earned revenues are collections or accruals of revenue from other Federal agencies. Intragovernmental costs are payments or

accruals to other Federal agencies. Transactions and balances among the Department's components have been eliminated from the Consolidated Balance Sheet, the Consolidated Statement of Net Cost, and the Consolidated Statement of Changes in Net Position. As provided by OMB Circular A-136, the Statement of Budgetary Resources is presented on a combined basis; therefore, intradepartmental transactions and balances have not been eliminated from this statement. In accordance with OMB Circular A-136, intradepartmental transactions and balances have been eliminated from all amounts on the Consolidated Statement of Financing, except for obligations incurred and spending authority from offsetting collections and adjustments, which are presented on a combined basis.

The Consolidated Statement of Net Cost no longer separates intragovernmental and public costs and revenues on the face of the statement. These separate costs and revenues are displayed in Note 23. Within this disclosure, intragovernmental costs (exchange transactions made between two reporting entities within the Federal government) are presented separately from costs with the public (exchange transactions made between the reporting entity and a non-Federal entity). Intragovernmental exchange revenue (exchange transactions made between two reporting entities within the Federal government) are disclosed separately from exchange revenue with the public (exchange transactions made between the reporting entity and a non-Federal entity). The criteria used for this classification requires that the intragovernmental expenses relate to the source of goods and services purchased by the reporting entity and not to the classification of related revenue. For example, with "exchange revenue with the public," the buyer of the goods or services is a non-Federal entity. With "intragovernmental costs," the buyer and seller are both Federal entities. If a Federal entity purchases goods or services from another Federal entity and sells them to the public, the exchange revenue would be classified as "with the public," but the related costs would be classified as "intragovernmental." The purpose of this classification is to enable the Federal government to provide consolidated financial statements, and not to match public and intragovernmental revenue with costs that are incurred to produce public and intragovernmental revenue.

While these financial statements have been prepared from the books and records of the Department in accordance with the formats prescribed by OMB, these financial statements are in addition to the financial reports used to monitor and control budgetary resources, which are prepared from the same books and records.

These financial statements should be read with the realization that they are for a component of a sovereign entity, that liabilities not covered by budgetary resources cannot be liquidated without the enactment of an appropriation, and that the payment of all liabilities other than for contracts can be abrogated by the sovereign entity.

C. Entity Revenue and Financing Sources

The Department receives the majority of funding needed to support its programs through Congressional appropriations. The Department receives annual, multi-year, and no-year appropriations that may be used, within statutory limits, for operating and capital expenditures. Additional funding is obtained through exchange revenues, non-exchange revenues and transfers-in.
Appropriations are recognized as financing sources when related expenses are incurred or assets are purchased. Revenue from reimbursable agreements is recognized when the goods or services are provided by the Department. Prices for goods and services sold to the public are based on recovery of full cost or are set at a market price. Reimbursable work between Federal appropriations is subject to

the *Economy Act (31 United States Code (U.S.C.) 1535)* or other statutes authorizing reimbursement. Prices for goods and services sold to other Federal government agencies are generally limited to the recovery of direct cost.

Exchange revenues are recognized when earned; i.e., goods have been delivered or services have been rendered. Non-exchange revenues are recognized when a specifically identifiable, legally enforceable claim to resources arises, and to the extent that collection is probable and the amount is reasonably estimable. Non-exchange revenues consist primarily of user fees collected by CBP to off-set certain costs of operations. Other financing sources, such as donations and transfers of assets without reimbursements, are recognized on the Consolidated Statement of Changes in Net Position during the period in which the donations and transfers occurred.

Fees for flood mitigation products and services, such as insurance provided through FEMA's National Flood Insurance Program (NFIP), are established at rates necessary to sustain a self-supporting program. NFIP premium revenues are recognized ratably over the life of the policies. Deferred revenue relates to unearned premiums reserved to provide for the remaining period of insurance coverage.

Exchange revenue for TSA consists of security fees assessed on the public and air carriers pursuant to PL 107-71, the Aviation and Transportation Security Act.

USCIS requires advance payments of the fees for adjudication of applications or petitions for immigration, nationality and citizenship benefits. Revenue associated with the application fees received is deferred and not considered earned until the application is adjudicated.

Imputed Financing Sources

In certain instances, operating costs of DHS are paid out of funds appropriated to other Federal agencies. For example, the Office of Personnel Management (OPM), by law, pays certain costs of retirement programs, and certain legal judgments against DHS are paid from a Judgment Fund maintained by the Department of the Treasury. When costs that are identifiable to DHS and directly attributable to DHS operations are paid by other agencies, DHS recognizes these amounts as operating expenses. DHS also recognizes an imputed financing source on the Consolidated Statement of Changes in Net Position to indicate the funding of DHS operations by other Federal agencies.

Imputed intradepartmental costs are the un-reimbursed portion of the full costs of goods and services received by the Department or a component from a providing component that is part of DHS. DHS identifies intra-entity costs that meet the criteria for recognition (materiality, significance to the entity, directness of the relationship to entity operations and identifiability) that are not fully reimbursed by the receiving component and recognizes them at full cost. To accomplish this recognition, the receiving component recognizes an imputed financing source for the difference between the actual payment, if any, and the full cost. In preparation of the financial statements, these costs and imputed financing sources have been eliminated in the process of consolidation.

D. Non-Entity Assets, Revenue and Disbursements

Non-entity assets are held by the Department but are not available for use by the Department. Non-

entity Fund Balance with Treasury represents funds available to pay refunds and drawback claims of duties, taxes and fees; and other non-entity amounts to be distributed to the Treasury General Fund and other Federal agencies in the future.

Non-entity revenue reported on the Department's Statement of Custodial Activity include duties, excise taxes, and various non-exchange fees collected by CBP and USCIS that are subsequently remitted to Treasury's General Fund or to other Federal agencies. CBP assesses duties, taxes, and fees on goods and merchandise brought into the United States from foreign countries. At the time an importer's merchandise is brought into the United States, the importer is required to file entry documents. Generally, within ten working days after release of the merchandise into the United States commerce, the importer is to submit an entry document with payment of estimated duties, taxes, and fees. Non-entity tax and trade accounts receivables, custodial revenue, and disposition of revenue is recognized when CBP is entitled to collect duties, user fees, fines and penalties, refunds and drawback overpayments, and interest associated with import/export activity on behalf of the Federal Government that have been established as a specifically identifiable, legally enforceable claim and remain uncollected as of year-end. These revenue collections primarily result from current fiscal year activities. Generally, CBP records an equal and offsetting liability due to the Treasury General Fund for amounts recognized as non-entity tax and trade receivable and custodial revenue. CBP accrues an estimate of duties, taxes and fees related to commerce released prior to year-end where receipt of payment is anticipated subsequent to year-end. Application fees collected by USCIS for nonimmigrant petitions are recorded as deferred revenue at the time of collection, and the revenue is recognized as the petitions are adjudicated.

The significant types of non-entity accounts receivable (custodial revenues as presented in the Statement of Custodial Activity) are described below.

- **Duties:** amounts collected on imported goods and other miscellaneous taxes collected on behalf of the Federal government.
- **Excise taxes:** amounts collected on imported distilled spirits, wines and tobacco products.
- **User fees:** amounts designed to maintain United States harbors and to defray the cost of other miscellaneous service programs. User fees include application fees collected from employers sponsoring nonimmigrant petitions.
- **Fines and penalties:** amounts collected for violations of laws and regulations.
- **Refunds:** amounts of duties, taxes and fees previously paid by an importer/exporter. Refunds include drawback remittance paid when imported merchandise, for which duty was previously paid, is exported from the United States.

Duties, user fees, fines and penalties are assessed pursuant to the provisions of Title 19 United States Code (U.S.C.); Immigration fees under Title 8 U.S.C., and; Excise taxes under Title 26 U.S.C. CBP also enforces over 400 laws and regulations some of which require the collection of fees or the imposition of fines and penalties pursuant to other Titles within the U.S.C. or Code of Federal Regulations (C.F.R.).
Non-entity receivables are presented net of amounts deemed uncollectible. CBP tracks and enforces payment of estimated duties, taxes and fees receivable by establishing a liquidated damage case that generally results in fines and penalties receivable. A fine or penalty, including interest on past due

balances, is established when a violation of import/export law is discovered. An allowance for doubtful collections is established for substantially all accrued fines and penalties and related interest. The amount is based on past experience in resolving disputed assessments, the debtor's payment record and willingness to pay, the probable recovery of amounts from secondary sources, such as sureties and an analysis of aged receivable activity. CBP regulations allow importers to dispute the assessment of duties, taxes and fees. Receivables related to disputed assessments are not recorded until the protest period expires or a protest decision is rendered in CBP's favor.

Refunds and drawback of duties, taxes and fees are recognized when payment is made. A permanent, indefinite appropriation is used to fund the disbursement of refunds and drawbacks. Disbursements are recorded as a decrease in the amount Transferred to Federal Entities as reported on the Statement of Custodial Activity. An accrual adjustment is recorded on the Statement of Custodial Activity to adjust cash collections and refund disbursements with the net increase or decrease of accrued non-entity accounts receivables, net of uncollectible amounts and refunds payable at year-end.

E. Fund Balance with Treasury, Cash and Other Monetary Assets

Entity Fund Balance with Treasury amounts are primarily appropriated, revolving, trust, deposit, receipt and special fund amounts remaining as of the fiscal year-end from which the Department is authorized to make expenditures and pay liabilities resulting from operational activity, except as restricted by law. Except for small amounts within EP&R, the Department does not maintain cash in commercial bank accounts. Certain receipts are processed by commercial banks for deposit into individual accounts maintained at the U.S. Treasury. The Department's cash and other monetary assets primarily consist of undeposited collections, imprest funds, cash used in undercover operations, cash held as evidence and seized cash and monetary instruments. Cash and other monetary assets are presented as a component of other assets in the accompanying Consolidated Balance Sheet.

F. Investments, Net

Investments consist of United States government non-marketable Treasury securities and are reported at cost or amortized cost net of premiums or discounts. The Bureau of Public Debt (BPD) manages certain trust funds for the Department, including the USCG Oil Spill Liability Trust Fund. Premiums or discounts are amortized into interest income over the terms of the investment using the effective interest method. No provision is made for unrealized gains or losses on these securities because it is the Department's intent to hold these investments to maturity.

G. Advances and Prepayments

Intragovernmental advances consist primarily of EP&R's disaster recovery and assistance grants to other Federal agencies tasked with mission assignments. Advances are expensed as they are used by grant recipients. At year-end, the amount of grant funding unexpended is estimated based on cash transactions reported by the grant administrator used by EP&R. In accordance with OMB Circular A-110, the Department provides advance funds to grant recipients to incur expenses related to the approved grant. Advances are made within the amount of the total grant obligation.
Advances and Prepayments to the public, presented as a component of other assets in the accompanying Consolidated Balance Sheet, consist primarily of EP&R and SLGCP disaster recovery and assistance grants to states and other grants. The largest category is Emergency Management Performance

Grants, a consolidation of grant programs that supports state and local emergency management staffs and insurance policy acquisition costs. Insurance policy acquisition costs include commissions incurred at policy issuance. Commissions are amortized over the period in which the related premiums are earned, generally one to three years.

H. Accounts Receivable, Net

Accounts receivable represent amounts owed to the Department by other Federal agencies and the public. Intragovernmental accounts receivable reported as a component of other intragovernmental assets on the Consolidated Balance Sheet generally arise from the provision of goods and services to other Federal agencies and are expected to be fully collected.

Public accounts receivable consist of amounts due to CBP from commercial air and sea vessel carriers for immigration user fees, 1931 Act overtime services, and breached bonds; reimbursable services and user fees collected and interest assessed by CBP; premiums and restitution due to EP&R from Write Your Own (WYO) insurance companies participating in EP&R's Federal Insurance and Mitigation Administration flood insurance program and amounts due from insurance policy holders; amounts due to the USCG's Oil Spill Liability Trust Fund to recover costs incurred to respond to oil pollution incidents and to collect civil fines and penalties from parties responsible for oil spills recognized when the claim arises; and security fees assessed by TSA on the public and air carriers. Public accounts receivable are presented net of an allowance for doubtful accounts, which is based on analyses of debtors' ability to pay, specific identification of probable losses, aging analysis of past due receivables and historical collection experience. Interest due on past due receivables is fully reserved until collected.

I. Credit Program Receivables, Net

EP&R operates the Community Disaster Loan program to support any local government which has suffered a substantial loss of tax and other revenues as a result of a major disaster and which demonstrates a need for Federal financial assistance in order to perform its governmental functions. Under the program, EP&R transacts direct loans to local governments who meet statutorily set eligibility criteria. Credit program receivables consist of such loans and are recorded as other assets in the accompanying Consolidated Balance Sheet. Loans are accounted for as receivables as funds are disbursed.

Post 1991 obligated direct loans and the resulting receivables are governed by the *Federal Credit Reform Act of 1990 (FCRA)*. Under FCRA, for direct loans disbursed during a fiscal year, the corresponding receivable is adjusted for subsidy costs. Subsidy costs are an estimated long-term cost to the United States Government for its loan programs. The subsidy cost is equal to the present value of the estimated cash outflows over the life of the loans minus the present value of the estimated cash inflows, discounted at the applicable Treasury interest rate. Administrative costs such as salaries and contractual fees are not included. Subsidy costs can arise from interest rate differentials, interest subsidies, delinquencies and defaults, and other cash flows. EP&R calculates the subsidy costs based on a subsidy calculator model created by OMB.
Loans receivable are recorded at the present value of the estimated cash inflows less cash outflows. The difference between the outstanding principal of the loans and the present value of their net cash inflows is recorded in the allowance for subsidy, which is estimated and adjusted annually, as of year-end.

J. Operating Materials, Supplies, and Inventory, Net

Operating materials and supplies (OM&S) are primarily consumed during normal operations to service USCG, and, to a lesser extent, CBP vessels and aircraft. OM&S are valued based on a weighted moving average method or on actual prices paid. OM&S are expensed when consumed or issued for use. Excess, obsolete, and unserviceable OM&S are stated at net realizable value net of an allowance, which is based on the condition of various asset categories, as well as USCG's and CBP's historical experience with using and disposing of such assets.

Inventories consist primarily of USCG Supply Fund's uniform clothing, subsistence provisions, retail stores, general stores, technical material and fuel, and USCG Yard Fund's ship repair and general inventory. Inventories on hand at year-end are stated at cost using standard price/specific identification, last acquisition price, or weighted average cost methods, which approximates historical cost. Revenue on inventory sales and associated cost of goods sold are recorded when merchandise is sold to the end user. USCG's inventory is restricted to sales within the USCG, and is not available for sale to the public or other government agencies.

K. Seized and Forfeited Property

Prohibited seized property results primarily from CBP criminal investigations and passenger/cargo processing. Seized property is not considered an asset of the Department and is not reported as such in the Department's financial statements. However, the Department has a stewardship responsibility until the disposition of the seized items are determined; i.e., judicially or administratively forfeited or returned to the entity from which it was seized. Non-prohibited seized property, including non-cash monetary instruments, real property and tangible personal property of others in the actual or constructive possession of the Department will be transferred to the Treasury Forfeiture Fund and is not presented in the accompanying consolidated financial statements of the Department.

Forfeited property is seized property for which the title has passed to the United States government. However, prohibited forfeited items such as counterfeit goods, narcotics, or firearms are held by CBP until disposed of or destroyed. In accordance with Statement of Federal Financial Accounting Standard (SFFAS) No. 3, *Accounting for Inventory and Related Property*, analyses of changes in seized and forfeited property of prohibited items are disclosed in note 10.

CBP will take into custody, without risk or expense, merchandise termed "general order property," which for various reasons cannot legally enter into the commerce of the United States. CBP's sole responsibility with general order property is to ensure the property does not enter the nation's commerce. If general order property remains in CBP custody for a prescribed period of time, without payment of all estimated duties, storage and other charges, the property is considered unclaimed and abandoned and can be sold by CBP at public auction or donated to charity (if not prohibited by law). Auction sales revenue in excess of charges associated with the sale or storage of the item is remitted to the Treasury General Fund. In some cases, CBP incurs charges prior to the sale and funds these costs from entity appropriations. Regulations permit CBP to offset these costs of sale before returning excess amounts to Treasury.

USSS seizes property for violation of laws it is authorized to enforce. Seized and forfeited property result principally from investigations of credit card fraud, bank fraud, wire fraud, computer fraud and counterfeiting. The items seized by USSS include genuine and counterfeit currency, monetary instruments (cashier's checks, money orders), real property and tangible personal property of others. Although the property is not legally owned by USSS until judicially or administratively forfeited, USSS does have a fiduciary responsibility for such property.

L. Property, Plant, and Equipment, Net

The Department's property, plant, and equipment (PP&E) consists of aircraft, vessels, vehicles, land, structures, facilities, leasehold improvements, software, information technology and other equipment. PP&E is recorded at cost. The Department capitalizes acquisitions of PP&E when the cost equals or exceeds an established threshold and has a useful life of two years or more. Costs for construction projects are recorded as construction-in-progress until completed, and are valued at actual (direct) costs, plus applied overhead and other indirect costs. In cases where historical cost information was not maintained, PP&E is capitalized using an estimated cost based on the cost of similar assets at the time of acquisition or the current cost of similar assets discounted for inflation since the time of acquisition. The Department owns some of the buildings in which components operate. Other buildings are provided by the General Services Administration (GSA), which charges rent equivalent to the commercial rental rates for similar properties.

Internal use software includes purchased commercial off-the-shelf software (COTS), contractor developed software, and internally developed software. For COTS software, the capitalized costs include the amount paid to the vendor for the software. For contractor developed software the capitalized costs include the amount paid to a contractor to design, program, install and implement the software. Capitalized costs for internally developed software include the full cost (direct and indirect) incurred during the software development phase.

Multi-use heritage assets consist primarily of buildings and structures owned by CBP and USCG, and are included in general PP&E on the Consolidated Balance Sheet. The physical quantity information for the multi-use heritage assets is included in the Required Supplementary Stewardship Information for heritage assets.

The schedule of capitalization thresholds shown below is a summary of the range of capitalization rules in place for the 22 legacy agencies that comprise the Department at inception. The DHS policy, Management Directive No. 1120, allows these agencies to continue using their legacy rules until a more comprehensive approach is developed that takes into account the vast differences across components in size and asset usage.

CAPITALIZATION THRESHOLD

The ranges of capitalization thresholds used by components, by primary asset category, are as follows:

Asset Description	Capitalization Threshold
Land	Regardless of cost to $100,000
Buildings and improvement	$25,000 to $200,000
Equipment and capital leases	$5,000 to $50,000
Software	$200,000 to $750,000

The Department begins to recognize depreciation expense once the asset has been placed in service. Depreciation is calculated on a straight-line method for all asset classes over their estimated useful lives. Land is not depreciated. Depreciation on buildings and equipment leased by GSA is not recognized by the Department. Leasehold improvements are depreciated over the shorter of the term of the remaining portion of the lease or the useful life of the improvement. Buildings and equipment acquired under capital leases are amortized over the lease term. The estimated useful life is 3 to 10 years for calculating amortization of software using the straight-line method. Amortization of capitalized software begins on the date of acquisition if purchased, or when the module or component has been placed in use (i.e., successfully installed and tested) if contractor or internally developed. There are no restrictions on the use or convertibility of general PP&E.

M. Liabilities

Liabilities represent the probable and measurable future outflow or other sacrifice of resources as a result of past transactions or events. Since the Department is a component of the United States Government, a sovereign entity, the Department's liabilities cannot be liquidated without legislation that provides resources or an appropriation. Liabilities covered by budgetary resources are those liabilities for which Congress has appropriated funds or funding is otherwise available to pay amounts due. Liabilities not covered by budgetary or other resources represent amounts owed in excess of available, Congressionally appropriated funds or other amounts, and there is no certainty that the appropriations will be enacted. The United States Government, acting in its sovereign capacity, can abrogate liabilities of the Department arising from other than contracts.

N. Contingent Legal Liabilities and Environmental Cleanup Costs

Contingent Legal Liabilities

Certain conditions exist as of the date the financial statements are issued, which may result in a loss contingency to the government, but which will only be resolved when one or more future events occur or fail to occur. DHS management and general legal counsel assess such contingent liabilities, and such assessment inherently involves an exercise of judgment. In assessing contingencies related to legal proceedings that are pending against DHS, or unasserted claims that may result in such pro-

ceedings, general legal counsel evaluates the perceived merits of any legal proceedings or unasserted claims as well as the perceived merits of the amounts of relief sought or expected to be brought therein.

If the assessment of the loss contingency indicates that it is probable that a material liability has been incurred and the amount of the liability can be estimated, then the estimated liability is accrued in the financial statements. If the assessment indicates that a potentially material contingent liability is not probable but is reasonably possible, or is probable but cannot be estimated, then the nature of the contingent liability, together with an estimate of the range of possible loss if determinable and material is disclosed.

Contingent liabilities considered remote are generally not disclosed unless they involve guarantees, in which case the nature of the guarantee would be disclosed.

Environmental Cleanup Costs

Accruals for environmental cleanup costs are the costs of removing, containing, and/or disposing of hazardous wastes or materials that, because of quantity, concentration, or physical or chemical characteristics may pose a substantial present or potential hazard to human health or the environment. Cleanup costs for general PP&E placed into service in fiscal year 1998 and thereafter may be allocated to operating periods based on the physical capacity of the PP&E or accrued over the useful life if physical capacity is not applicable or estimable. Expense recognition shall begin on the date that the PP&E is placed into service. Regardless of the method the result should be the accumulation of total cleanup costs liability at the time when the PP&E ceases operation.

For all PP&E in service as of October 1, 1997, DHS recognizes the estimated total (ultimate) cleanup costs associated with the PP&E at the time the cleanup requirement is identified. DHS will not prorate a cleanup cost over the life of these PP&E. However, the estimate may be subsequently adjusted for material changes due to inflation/deflation or changes in regulations, plans, or technology. The applicable costs of decommissioning DHS' existing and future vessels will be considered cleanup costs.

O. Grants Liability

EP&R, SLGCP, and TSA award grants and cooperative agreements to Federal, state and local governments, universities, non-profit organizations, and private sector companies for the purpose of building capacity to respond to disasters and emergencies, conduct research into preparedness, enhance and ensure the security of passenger and cargo transportation by air, land, or sea, and other Department-related activities. EP&R estimates a year-end grant accrual representing the amounts payable to grantees, using historical disbursement patterns over a period of 20 quarters to predict unreported grantee expenditures. The SLGCP and TSA grant liability accrual is estimated using known reported expenditures reported by grantees and the estimated daily expenditure rate for the period subsequent to the latest grantee submission in relation to the cumulative grant amount. Grants issued by TSA through September 30, 2004 are maintained jointly by TSA and SLGCP. Grants liabilities are combined with accounts payable to the public in the accompanying Consolidated Balance Sheet.

P. Claims and Claims Settlement Liabilities

EP&R administers the National Flood Insurance Program (NFIP) through sale or continuation-in-force of insurance in communities that enact and enforce appropriate flood plain management measures. Claims and claims settlement liability represents an estimate of NFIP losses that are unpaid at the balance sheet date and is based on the loss and loss adjustment expense factors inherent in the NFIP insurance underwriting operations experience and expectations. Estimation factors used by the insurance underwriting operations reflect current case basis estimates and give effect to estimates of trends in claim severity and frequency. These estimates are continually reviewed, and adjustments, reflected in current operations, are made as deemed necessary. Although the insurance underwriting operations believes the liability for unpaid losses and loss adjustment expenses is reasonable and adequate in the circumstances, the insurance underwriting operations' actual incurred losses and loss adjustment expenses may not conform to the assumptions inherent in the estimation of the liability. Accordingly, the ultimate settlement of losses and the related loss adjustment expenses may vary from the amount included in the financial statements.

Q. Debt and Borrowing Authority

Debt is reported within other intragovernmental liabilities and results from Treasury loans and related interest payable to fund NFIP and Disaster Assistance Direct Loan Program (DADLP) operations. NFIP loan and interest payments are financed by flood premiums and map collection fees. Additional funding for NFIP may be obtained through Treasury borrowing authority of $1.5 billion. DADLP annually requests borrowing authority to cover the principal amount of direct loans not to exceed $25 million less the subsidy due from the program account. DADLP borrowing authority is for EP&R "State Share Loans". Borrowing authority for Community Disaster Loans is requested on an "as needed basis".

R. Annual, Sick and Other Accrued Leave

Earned annual and other vested compensatory leave is an accrued liability. The liability is reduced as leave is taken. At year-end, the balances in the accrued leave accounts are adjusted to reflect the liability at current pay rates and leave balances, and are reported within accrued payroll and benefits in the Consolidated Balance Sheet. Sick leave and other types of non-vested leave are not earned benefits. Accordingly, non-vested leave is expensed when used.

S. Workers' Compensation

A liability is recorded for accrued and estimated future payments to be made for workers' compensation pursuant to the *Federal Employees' Compensation Act* (FECA). The accrued liability is presented as a component of intragovernmental other liabilities as it is payable to the U. S. Department of Labor (DOL), and the actuarial liability is presented within accrued payroll and benefits in the accompanying Consolidated Balance Sheet. The FECA program is administered by the DOL, which initially pays valid claims and subsequently seeks reimbursement from Federal agencies employing the claimants. Reimbursement to DOL on payments made occurs approximately two years subsequent to the actual disbursement. Budgetary resources for this intragovernmental liability are made available to the Department as part of its annual appropriation from Congress in the year in which the reimbursement takes place.

Additionally, a liability due to the public is recorded that includes the expected liability for death, disability, medical and miscellaneous costs for approved compensation cases. The liability is determined using an actuarial method that utilizes historical benefit payment patterns related to a specific incurred period to predict the ultimate payments related to that period. The Department allocates the actuarial liability to its components based on payment history provided by DOL. The accrued liability is not covered by budgetary resources and will require future funding.

T. Military Service and Other Retirement Benefits

DHS and Component Civilian Workforce Pension and Other Benefits

The Department recognizes the full annual cost of its civilian employees' pension benefits; however, the assets of the plan and liability associated with pension costs are recognized by OPM rather than the Department.

Most employees of the Department hired prior to January 1, 1984, participate in the Civil Service Retirement System (CSRS), to which the Department contributes 7 percent of base pay for regular CSRS employees, and 7.5 percent of base pay for law enforcement agents. The majority of employees hired after December 31, 1983 are covered by the Federal Employees Retirement System (FERS) and Social Security. For the FERS basic annuity benefit the Department contributes 11.2 percent of base pay for regular FERS employees and 23.8 percent for law enforcement agents. A primary feature of FERS is that it also offers a defined contribution plan to which the Department automatically contributes 1 percent of base pay and matches employee contributions up to an additional 4 percent of base pay. The Department also contributes the employer's Social Security matching share for FERS participants.

Similar to CSRS and FERS, OPM rather than the Department reports the liability for future payments to retired employees who participate in the Federal Employees Health Benefits Program and Federal Employees Group Life Insurance Program. The Department is required to report the full annual cost of providing these other retirement benefits (ORB) for its retired employees as well as reporting contributions made for active employees. In addition, the Department recognizes an expense and liability for other post employment benefits (OPEB), which includes all types of benefits provided to former or inactive (but not retired) employees, their beneficiaries and covered dependents.

The difference between the full annual cost of CSRS or FERS retirement, ORB and OPEB benefits and the amount paid by the Department is recorded as an imputed cost and off-setting imputed financing source in the accompanying Consolidated Statement of Net Cost, Consolidated Statement of Changes in Net Position, and Consolidated Statement of Financing.

USCG – Military Retirement System Liability

The USCG Military Retirement System (MRS) is a defined benefit plan that covers both retirement pay and health care benefits for all active duty and reserve military members of the USCG. The plan is funded through annual appropriations and, as such, is a pay-as-you-go system. The unfunded accrued liability reported on the accompanying Consolidated Balance Sheet is actuarially determined by subtracting the present value of future employer/employee contributions, as well as any plan assets, from the present value of the future cost of benefits. Current period expense is computed using the aggre-

gate entry age normal actuarial cost method.
A portion of the accrued MRS liability is for the health care of non-Medicare eligible retirees/survivors. Effective October 1, 2002, USCG transferred its liability for the health care of Medicare eligible retirees/survivors to the Department of Defense (DoD) Medicare-Eligible Retiree Health Care Fund (the Fund), which was established in order to finance the health care benefits for the Medicare-eligible beneficiaries of all DoD and non-DoD uniformed services. DoD is the administrative entity and in accordance with SFFAS No. 5, is required to recognize the liability on the Fund's financial statements. The USCG makes monthly payments to the Fund for current active duty members. Benefits for USCG members who retired prior to the establishment of the Fund are provided by payments from the Treasury to the Fund. The future cost and liability of the Fund is determined using claim factors and claims cost data developed by the DoD, adjusted for USCG retiree and actual claims experience. The USCG uses the current year actual costs to project costs for all future years.

USCG – Post-employment Military Travel Benefit

USCG uniformed service members are entitled to travel and transportation allowances for travel performed or to be performed under orders, without regard to the comparative costs of the various modes of transportation. These allowances, upon separation from the service, include the temporary disability retired list placement, release from active duty, retirement and entitlement for travel from the member's last duty station to home or the place from which the member was called or ordered to active duty, whether or not the member is or will be an active member of a uniformed service at the time the travel is or will be performed.

USCG recognizes an expense and a liability for this OPEB when a future outflow or other sacrifice of resources is probable and measurable on the basis of events occurring on or before the reporting date. The OPEB liability is measured at the present value of future payments, which requires the USCG to estimate the amount and timing of future payments, and to discount the future outflow using the Treasury borrowing rate for securities of similar maturity to the period over which the payments are made.

USSS – Uniformed Division and Special Agent Pension Liability

The District of Columbia Police and Fireman's Retirement System (the DC Pension Plan) is a defined benefit plan that covers USSS Uniformed Division and Special Agents. The DC Pension Plan makes benefit payments to retirees and/or their beneficiaries. The USSS receives permanent, indefinite appropriations each year to pay the excess of benefit payments over salary deductions. The DC Pension Plan is funded through annual appropriations and, as such, is a pay-as-you-go system. The unfunded accrued liability reported on the accompanying Consolidated Balance Sheet is actuarially determined by subtracting the present value of future employer/employee contributions, as well as any plan assets, from the present value of future cost of benefits. Current period expense is computed using the aggregate cost method.

U. Use of Estimates

Management has made certain estimates and assumptions in the reporting of assets, liabilities, revenues, expenses, obligations incurred, spending authority from offsetting collections and note disclosures in the consolidated financial statements. Actual results could differ from these estimates. Significant estimates include: the allocation of trust fund receipts, year-end accruals of accounts and grants

payable, contingent legal and environmental liabilities, accrued workers' compensation, allowance for doubtful accounts receivable, allowances for obsolete inventory and OM&S balances, allocations of indirect common costs to construction-in-progress, depreciation, subsidy re-estimates, deferred revenues, NFIP claims and settlements, actuarial workers compensation assumptions, MRS and other pension, retirement and post-retirement benefit assumptions, allowances for doubtful duties, fines, and penalties, and certain non-entity receivables and payables related to custodial activities. Certain accounts payable balances are estimated based on current payments that relate to prior periods or a current assessment of services/products received but not yet paid.

V. Taxes

The Department, as a Federal agency, is not subject to Federal, state or local income taxes and accordingly, no provision for income taxes has been recorded in the accompanying consolidated financial statements.

W. Reclassifications

Certain fiscal year 2004 balances have been reclassified for consistent disclosures with 2005 balances, including transfer of the FPS from BTS to ICE, the transfer of the Air and Marine Interdiction program from ICE to CBP, and realignment of SLGCP from BTS Directorate to Management Directorate. Some Grants were realigned between EP&R and TSA and the Management Directorate (which includes SLGCP). In addition, taxes, duties, and receivables were combined by entity and non-entity.

2. NON-ENTITY ASSETS

Non-entity assets at September 30, consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
Intragovernmental:		
Fund Balance with Treasury	$5,067	$3,342
Receivables Due From Treasury (note 12)	144	170
Total Intragovernmental	5,211	3,512
Public:		
Tax, Duties, and Trade Receivables, Net (note 7)	1,349	1,195
Other	63	36
Total Public	1,412	1,231
Total Non-Entity Assets	6,623	4,743
Total Entity Assets	107,883	46,063
Total Assets	**$114,506**	**$50,806**

Non-entity fund balance with Treasury consists of special and deposit funds, permanent and indefinite appropriations and miscellaneous receipts that are available to pay non-entity liabilities presented on the Consolidated Balance Sheet. Non-entity fund balance with Treasury at September 30, 2005 and 2004, includes (in deposit fund) approximately $4.7 billion and $2.9 billion of duties collected by CBP on imports of Canadian softwood lumber and $316 million and $375 million (in special fund) for Injured Domestic Industries (IDI) at September 30, 2005 and 2004, respectively. These assets off-set accrued liabilities at September 30, 2005 and 2004 (see note 19).

Non-entity receivables due from Treasury represent an estimate of duty, tax and/or fee refunds and drawbacks that will be reimbursed by a permanent and indefinite appropriation account and will be used to pay estimated duty refunds and drawbacks payable of $118 million and $132 million at September 30, 2005 and 2004, respectively (see note 19). Duties and taxes receivable from public represents amounts due from importers for goods and merchandise imported to the United States, and upon collection, will be available to pay the accrued intragovernmental liability due to the Treasury General Fund, which equaled $1.4 billion and $1.3 billion at September 30, 2005 and 2004, respectively (see notes 7 and 14).

3. FUND BALANCE WITH TREASURY

A. Fund Balance with Treasury

Fund Balance with Treasury at September 30, consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
Appropriated Funds	$89,494	$27,587
Trust Funds	39	48
Revolving, Liquidating, and Working Capital Funds	100	435
Special Funds	2,455	2,131
Deposit Funds	4,916	3,235
Total Fund Balance with Treasury	**$97,004**	**$33,436**

Appropriated funds consist of amounts appropriated annually by Congress to fund the operations of the Department and its components. Appropriated funds included clearing funds totaling $106 million and a $457 million at September 30, 2005 and 2004, which represent reconciling differences with Treasury balances. The significant increase in appropriated funds is due to the Disaster Relief Fund receiving two emergency supplemental appropriations in September 2005 for Hurricane Katrina. For further details, see Other Accompanying Information, Effects of Hurricanes Katrina and Rita.

Trust funds include both receipt accounts and expenditure accounts that are designated by law as a trust fund. Trust fund receipts are used for specific purposes, generally to offset the cost of expanding border and port enforcement activities, oil spill related claims and activities, or to hold CIS bond receipts.

Revolving funds are used for continuing cycles of business-like activity, in which the fund charges for the sale of products or services and uses the proceeds to finance its spending, usually without requirement for annual appropriations. The Working Capital Fund is a fee-for-service fund established to support operations of Department component bureaus. Also included are the liquidating and financing funds for credit reform and the national flood insurance fund of $25 million and $321 million at September 30, 2005 and 2004, respectively.

Special funds are receipts and/or off-setting receipt funds earmarked for specific purposes including the disbursement of non-entity monies received in connection with antidumping and countervailing duty orders due to qualifying IDI of $316 million and $375 million at September 30, 2005 and 2004, respectively. The Department also has special funds for immigration user fees of $179 million and $154 million at September 30, 2005 and 2004, respectively; CBP user fees of $741 million and $730 million at September 30, 2005 and 2004, respectively; immigration examination fees of $777 million and $715 million at September 30, 2005 and 2004 respectively; as well as inspection fees, flood map modernization subsidy, off-set and refund transfers.

Deposit funds represent amounts received as an advance that are not accompanied by an order and include non-entity collections that do not belong to the Federal Government and for which final disposition has not been determined at year-end, including $4.7 billion and $2.9 billion of duties collected on imports of Canadian softwood lumber at September 30, 2005 and 2004, respectively (see Notes 2 and 19).

B. Status of Fund Balance with Treasury

The status of Fund Balance with Treasury at September 30, consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
Unobligated Balances:		
Available	$51,882	$5,718
Unavailable	5,177	1,638
Obligated Balance Not Yet Disbursed	38,443	25,802
Subtotal	95,502	33,158
Adjustments for:		
Receipt, Clearing, and Deposit Funds	5,026	3,466
Borrowing Authority	(3,301)	(1,500)
Investments	(729)	(1,612)
Receivable Transfers and Imprest Fund	(79)	(76)
Receipt unavailable for obligation	585	-
Total Status of Fund Balance with Treasury	**$97,004**	**$33,436**

Adjustments are made to reconcile the budgetary status to Fund Balance with Treasury for the following reasons:

- Receipt, clearing and deposit funds represent amounts on deposit with Treasury that have no budget status at September 30, 2005 and 2004. Included in adjustments for deposit funds are restricted balances of $4.7 billion and $2.9 billion for Canadian softwood lumber at September 30, 2005 and 2004, respectively, of non-entity funds, and receipts that are not available for obligation.
- Borrowing authority is in budgetary status for use by EP&R for disaster relief purposes and Community disaster loans.
- Budgetary resources have investments included; however, the money has been moved from the Fund Balance with Treasury asset account to investments.
- Receivable transfers of currently invested balances increases the budget authority at the time the transfer is realized and obligations may be incurred before the actual transfer of funds.
- Imprest funds represent monies moved from fund balance with Treasury to imprest funds with no change in the budgetary status.
- Reciepts immediately upon collection are unavailable for obligation. The receipts are not available for obligation until a specified time in the future.

Portions of the unobligated balances available, unavailable and obligations balance not yet disbursed contains CBP's user fees of $741 million and $730 million (at September 30, 2005 and 2004), which is restricted by law in its use to offset costs incurred by CBP until authority is granted through appropriations acts.

Portions of the unobligated balance unavailable includes amounts appropriated in prior fiscal years that are not available to fund new obligations. However, it can be used for upward and downward adjustments for existing obligations in future years.

During September 2005, the Disaster Relief Fund received two supplemental appropriations totaling $60 billion for Hurricane Katrina. As of September 30, 2005, this fund has an unobligated balance available of $46.4 billion. For further details, see Other Accompanying Information, Effects of Hurricanes Katrina and Rita.

The obligated not yet disbursed balance represents amounts designated for payment of goods and services ordered but not received or goods and services received but for which payment has not yet been made. Part of this balance contains obligations from the disaster relief fund of $16.8 billion and $6.4 billion at September 30, 2005 and 2004, respectively.

4. INVESTMENTS, NET

Investments at September 30, consisted of the following (in millions):

Type of Investment:	2005 (unaudited)	2004 (unaudited)
U.S. Treasury Securities:		
USCG – Non-Marketable, Par Value	$736	$839
EP&R – Non-Marketable, Market-Based	2	786
Total Intragovernmental Investments, Net	**$738**	**$1,625**

Unexpended funds in the USCG Oil Spill Liability Trust Fund (OSLTF) and the gift fund are invested by the U.S. Treasury – Bureau of Public Debt in U.S. government securities and are purchased and redeemed at par. Interest and principal on invested balances in the USCG's oil spill fund are considered investment authority and are available for use by the USCG to offset the cost of oil spill cleanup, payment of environmental claims against the fund and for specific funding of cleanup related operations.

EP&R maintains investments for the NFIP and the gifts and bequests fund. EP&R investments are restricted to Treasury bonds, bills, notes and overnight securities. EP&R's non-marketable, market-based investments balance at September 30, 2005 represents investments remaining in the gifts and bequests fund. Investments in NFIP were withdrawn in fiscal year 2005 to pay flood insurance claims for damages caused by four major hurricanes which occurred late in fiscal year 2004. The current EP&R investments portfolio consists principally of overnight securities, which have neither market value variances nor unamortized premium or discount.

Market value of all investments approximates cost and balances include applicable accrued interest.

5. ACCOUNTS RECEIVABLE, NET

Accounts Receivable with public at September 30, consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
Accounts Receivable	$929	$781
Allowance for Doubtful Accounts	(397)	(318)
Net Accounts Receivable w/ Public	**$532**	**$463**

Intragovernmental accounts receivable are presented as a component of other assets, and results from reimbursable work performed by USCG, ICE, EP&R, and CBP (see note 12). Accounts receivable with the public consists of amounts due to CBP, TSA, EP&R, USCG and ICE for overpayment of refunds, reimbursable services and user fees.

6. ADVANCES AND PREPAYMENTS

Intragovernmental advances and prepayments at September 30, consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
Disaster Relief Fund	$2,726	$2,718
Other	211	168
Total Intragovernmental Advances and Prepayments	**$2,937**	**$2,886**

Disaster relief fund (DRF) advances consists of EP&R's disaster assistance grants to other Federal agencies (principally the Department of Transportation) tasked with mission assignments that support state and local emergency management staffs and operations.

Advances and prepayments made to the public are presented as a component of other assets on the accompanying Consolidated Balance Sheets (see note 12).

7. TAX, DUTIES, AND TRADE RECEIVABLES, NET

Tax, duties and trade receivables at September 30, consisted of the following (in millions):

As of September 30, 2005 (unaudited):

Receivables Category	Gross Receivables	Allowance	Total Net Receivables
Duties	$1,207	($97)	$1,110
Excise Taxes	88	(6)	82
User Fees	84	(1)	83
Fines/Penalties	1,116	(1,032)	84
Anti-Dumping/Countervailing Duties	217	(176)	41
Total Tax, Duties, and Trade Receivables, Net	**$2,712**	**($1,312)**	**$1,400**

As of September 30, 2004 (unaudited):

Receivables Category	Gross Receivables	Allowance	Total Net Receivables
Duties	$1,127	($95)	$1,032
Excise Taxes	73	(2)	71
User Fees	80	(1)	79
Fines/Penalties	798	(745)	53
Anti-Dumping/Countervailing Duties	180	(142)	38
Total Tax, Duties, and Trade Receivables, Net	**$2,258**	**($985)**	**$1,273**

When a violation of import/export law is discovered, a fine or penalty is established, typically for the full value of the merchandise. After receiving the notice of assessment, the importer or surety has a period of time to either file a petition requesting a review of the assessment or pay the assessed amount. Once a petition is received, CBP investigates the circumstances as required by its mitigation guidelines and directives. Until this process has been completed, CBP records an allowance on fines and penalties of approximately 93 percent (94 percent at September 30, 2004) of the total assessment based on historical experience of fines and penalties mitigation and collection.

8. CREDIT PROGRAM RECEIVABLES, NET

All credit program activities and the related receivables of the Department relate to EP&R.

A. Summary of Direct Loans to Non-Federal Borrowers at September 30 (in millions):

	2005 (unaudited) Loans Receivable, Net	2004 (unaudited) Loans Receivable, Net
Community Disaster Loans	**$.5**	**$6.8**

An analysis of loans receivable and the nature and amounts of the subsidy and administrative costs associated with the direct loans is provided in the following sections.

B. Direct Loans Obligated Prior to Fiscal Year 1992 (Present Value Method, in millions):

Direct loans obligated prior to fiscal year 1992 have been fully collected during fiscal year 2004, and therefore no balances remained as of September 30, 2004 (unaudited).

C. Direct Loans Obligated After FY 1991 (in millions):

At September 30, 2005 (unaudited):	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Value of Assets Related to Direct Loans
Community Disaster Loans	**$2.3**	**$1.4**	**($3.2)**	**$.5**

At September 30, 2004 (unaudited):	Loans Receivable, Gross	Interest Receivable	Allowance for Subsidy Cost (Present Value)	Value of Assets Related to Direct Loans
Community Disaster Loans	**$129.4**	**$62.5**	**($185.1)**	**$6.8**

The value of assets related to direct loans, net of allowance for subsidy cost, is included in other assets on the consolidated balance sheet.

D. Total Amount of Direct Loans Disbursed, Post-1991: None.

E. Subsidy Expense for Direct Loans (in millions):

	2005 (unaudited)	2004 (unaudited)
Subsidy Expense for New Direct Loans Disbursed	None	None
Modifications and Re-estimates (Prior reporting year)	$4.5	None
Total Direct Loan Subsidy Expense	$4.5	None

F. Direct Loan Subsidy Rates

The direct loan subsidy rates, by program, are as follows:

	2005 (unaudited)		2004 (unaudited)	
	Community Disaster Loans	State Share Loans	Community Disaster Loans	State Share Loans
Interest Subsidy Cost	3.72 %	(2.98) %	2.48 %	(2.40) %
Default Costs	- %	- %	- %	- %
Other	89.72 %	0.38 %	90.78 %	0.38 %

G. Schedule for Reconciling Subsidy Cost Allowance Balances (in millions):

	2005 (unaudited)	2004 (unaudited)
Beginning Balance of the Subsidy cost allowance	$185.1	$171
Adjustments:		
(a) Loans written off	(188.4)	(1.7)
(b) Subsidy allowance amortization	6.5	11.3
Ending balance of the subsidy cost allowance before reestimates	3.2	180.6
Add subsidy reestimate by component		
(a) Technical/default reestimate	-	4.5
Ending balance of the subsidy cost allowance	**$3.2**	**$185.1**

The amount of loans written off during fiscal year 2005 includes the cancellation of $127 million (principal only) in loan to the government of the Virgin Islands.

H. Administrative Expenses (in millions):

	2005 (unaudited)	2004 (unaudited)
Community Disaster and State Share Loans	**$.4**	**$.5**

9. OPERATING MATERIALS, SUPPLIES, AND INVENTORY, NET

Operating materials and supplies (OM&S) and inventory, net at September 30, consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
OM&S		
Items Held for Use	$362	$360
Items Held for Future Use	86	84
Excess, Obsolete and Unserviceable Items	7	7
Less: Allowance for Losses	(7)	(7)
Total OM&S, Net	**448**	**444**
Inventory		
Inventory Purchased for Resale	59	53
Less: Allowance for Losses	(1)	(1)
Total Inventory, Net	**58**	**52**
Total OM&S and Inventory, Net	**$506**	**$496**

10. PROHIBITED SEIZED PROPERTY

Prohibited seized property item counts, as of September 30, and activity for the fiscal years ended September 30, 2005 and 2004, are as follows:

2005

Seizure Activity

Seized Property:	Fiscal Year Ended September 30, 2005 (unaudited)					Seized Property:
Category	Balance October 1, 2004	New Seizures	Remissions	New Forfeitures	Adjustments	September 30 Weight/ Items
Illegal Drugs (in kilograms):						
Cannabis (marijuana)	2,176	444,751	-	(446,861)	436	502
Cocaine	144	31,818	-	(31,345)	(455)	162
Heroin	18	1,230	-	(1,225)	3	26
Firearms and Explosives (in number of items)	7,788	1,454	(5,798)	(1,364)	(59)	2,021
Counterfeit Currency (US/ Foreign, in number of items)	2,877,743	804,946	-	-	(328,629)	3,364,060
Pornography (in number of items)	133	213	(5)	(182)	(18)	141

Forfeiture Activity

Forfeited Property:	Fiscal Year Ended September 30, 2005 (unaudited)					Forfeited Property:
Category	Balance October 1, 2004	New Forfeitures	Transfers	Destroyed	Adjustments	September 30 Weight/ Items
Illegal Drugs (in kilograms):						
Cannabis (marijuana)	98,657	446,861	(641)	(419,668)	(32,375)	92,834
Cocaine	17,348	31,345	(58)	(26,576)	(546)	21,513
Heroin	2,545	1,225	(1)	(1,664)	(1)	2,104
Firearms and Explosives (in number of items)	297	1,364	(1,307)	(14)	(64)	276
Pornography (in number of items)	37	182	-	(189)	9	39

2004

Seizure Activity

Seized Property:	Fiscal Year Ended September 30, 2004 (unaudited)					Seized Property:
Category	Balance October 1, 2003	New Seizures	Remissions	New Forfeitures	Adjustments	September 30 Weight/ Items
Illegal Drugs (in kilograms):						
Cannabis (marijuana)	331	560,809	-	(561,551)	2,587	2,176
Cocaine	153	36,632	-	(36,630)	(11)	144
Heroin	22	1,591	-	(1,597)	2	18
Firearms and Explosives (in number of items)	7,757	3,830	(1,112,180)	-	(199,964)	2,887,743
Counterfeit Currency (US/Foreign, in number of items)	2,853,395	1,346,492	(1,112,180)	-	(199,964)	2,887,743
Pornography (in number of items)	178	353	(5)	(367)		133

Forfeiture Activity

Forfeited Property:	Fiscal Year Ended September 30, 2004 (unaudited)					Forfeited Property:
Category	Balance October 1, 2003	New Forfeitures	Transfers	Destroyed	Adjustments	September 30 Weight/ Items
Illegal Drugs (in kilograms):						
Cannabis (marijuana)	113,531	561,551	(6,114)	(521,349)	(48,962)	98,657
Cocaine	16,970	36,630	(298)	(34,971)	(983)	17,348
Heroin	2,977	1,597	(8)	(13,980)	11,959	2,545
Firearms and Explosives (in number of items)	1,340	634	(1,699)	(39)	61	297
Pornography (in number of items)	80	367	-	(414)	4	37

This schedule is presented for material prohibited (non-valued) seized and forfeited property only. These items are retained and ultimately destroyed by CBP and USSS and are not transferred to the Departments of Treasury or Justice Asset Forfeiture Funds or other Federal agencies. The ending balance for firearms includes only those seized items that can actually be used as firearms. Illegal drugs are presented in kilograms and a significant portion of the weight includes packaging, which often cannot be reasonably separated from the weight of the drugs since the packaging must be maintained for evidentiary purposes. Firearms, explosives and pornography are presented in number of items; and counterfeit currency is presented in number of bills.

USCG also seizes and takes temporary possession of small boats, equipment, contraband and other illegal drugs. USCG usually disposes of these properties within three days by transfer to CBP (who transfers non-prohibited seized property to the Treasury Forfeiture Fund), the Drug Enforcement Administration, or foreign governments, or by destroying it. Seized property in USCG possession at year-end is considered insignificant and therefore is not itemized and is not reported in the consolidated financial statements of the Department.

11. PROPERTY, PLANT, AND EQUIPMENT, NET

Property, plant, and equipment (PP&E), at September 30, consisted of the following (in millions):

As of September 30, 2005 (unaudited):	Service Life	Gross Cost	Accumulated Depreciation/ Amortization	Total Net Book Value
Land and Land Rights	N/A	$63	$ -	$63
Improvements to Land	3-50 yrs	50	22	28
Construction in Progress	N/A	2,403	-	2,403
Buildings, Other Structures and Facilities	2-50 yrs	3,702	1,803	1,899
Equipment:				
ADP Equipment	3-5 yrs	212	98	114
Aircraft	10-35 yrs	2,318	1,288	1,030
Vessels	5-45 yrs	4,131	2,009	2,122
Vehicles	3-6 yrs	503	344	159
Other Equipment	2-30 yrs	3,459	1,701	1,758
Assets Under Capital Lease	2-20 yrs	81	26	55
Leasehold Improvements	3-50 yrs	280	76	204
Internal Use Software	3-10 yrs	481	250	231
Internal Use Software- in Development	N/A	404	-	404
Total Property, Plant, and Equipment		**$18,087**	**$7,617**	**$10,470**

As of September 30, 2004 (unaudited):	Service Life	Gross Cost	Accumulated Depreciation/ Amortization	Total Net Book Value
Land and Land Rights	N/A	$54	$ -	$54
Improvements to Land	3-50 yrs	23	10	13
Construction in Progress	N/A	1,570	-	1,570
Buildings, Other Structures and Facilities	2-50 yrs	3,556	1,697	1,859
Equipment:				
ADP Equipment	3-5 yrs	280	115	165
Aircraft	10-35 yrs	2,885	1,919	966
Vessels	5-45 yrs	4,045	1,843	2,202
Vehicles	3-6 yrs	484	311	173
Other Equipment	2-30 yrs	3,418	1,500	1,918
Assets Under Capital Lease	2-20 yrs	81	21	60
Leasehold Improvements	3-50 yrs	264	62	202
Internal Use Software	3-10 yrs	694	162	532
Internal Use Software- in Development	N/A	32	-	32
Total Property, Plant, and Equipment		**$17,386**	**$7,640**	**$9,746**

12. OTHER ASSETS

Other assets at September 30, consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
Intragovernmental:		
Accounts Receivable (note 5)	$217	$311
Receivables Due From Treasury (note 2)	144	170
Total Intragovernmental	361	481
Public:		
Advances and Prepayments	480	356
Cash and Other Monetary Assets	78	87
Credit Program Receivables, Net (note 8)	-	7
Other	-	(50)
Total Public	558	400
Total Other Assets	**$919**	**$881**

Advances and prepayments with the public consist primarily of NFIP payments made by EP&R.

The negative $50 million represents an allowance for subsidy which exceeds the amount due. This excess allowance was written off during the current fiscal year.

13. LIABILITIES NOT COVERED BY BUDGETARY RESOURCES

Liabilities not covered by budgetary resources at September 30, consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited) Restated
Intragovernmental:		
Accrued FECA Liability (Note 17)	$358	$240
Borrowings from U.S. Treasury (BPD)	226	8
Other	-	2
Total Intragovernmental	584	250
Public:		
Military Service and Other Retirement Benefits (Note 18)	29,021	26,502
Accrued Payroll and Benefits:		
Accrued Leave (Note 17)	729	663
Other Employment Related Liability (Note 17)	105	105
Actuarial FECA Liability (Note 17)	1,473	1,398
Claims and Claims Settlement Liabilities (Notes 15 and 30)	22,679	1,030
Other:		
Environmental Cleanup Costs (Note 21)	158	144
Contingent Liabilities (Note 21)	221	54
Capital Lease Liability (Note 20)	75	148
Total Public	54,461	30,044
Total Liabilities Not Covered by Budgetary Resources	$55,045	$30,294
Liabilities Covered by Budgetary Resources or Non-Entity Assets	14,700	12,025
Total Liabilities	**$69,745**	**$42,319**

The Department anticipates that the liabilities listed above will be funded from future budgetary resources when required. Budgetary resources are generally provided for unfunded leave when it is used.

14. DUE TO THE TREASURY GENERAL FUND

Amounts due to the Treasury General Fund of $1.4 billion and $1.3 billion, as of September 30, 2005 and 2004, respectively, represent duty, tax, and fee revenues collected by CBP to be remitted to various General Fund accounts maintained by Treasury. Treasury further distributes these revenues to other Federal agencies in accordance with various laws and regulations.

15. CLAIMS AND CLAIMS SETTLEMENT LIABILITIES

Claims and Claims Settlement Liabilities at September 30, consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
National Flood Insurance Program	$23,406	$1,357
Cerro Grande Fire Assistance Act	27	60
Total Claims and Claims Settlement Liabilities	**$23,433**	**$1,417**

A. National Flood Insurance Program (NFIP)

The NFIP liability for unpaid losses and related loss adjustment expenses and amounts paid for the year ended September 30, 2005 and 2004, consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
Beginning Balance	$1,357	672
Incurred losses and increase estimated losses	25,407	1,505
Less: Amounts paid during current period	(3,358)	(820)
Total NFIP Liability at September 30	**$23,406**	**$1,357**

The increase in 'Incurred losses and increase estimated losses' was primarily due to hurricane Katrina which impacted the Gulf Coast in August 2005. The funded NFIP liability at September 30, 2005 and 2004 is $727 million and $327 million, respectively.

B. *Cerro Grande Fire Assistance Act*

The U.S. Department of Interior, National Park Service initiated a prescribed burn that resulted in the loss of Federal, state, local, Indian tribal and private property. In July 2000, Congress passed the *Cerro Grande Fire Assistance Act* (CGFAA) to compensate as fully as possible those parties who suffered damages from the Cerro Grande Fire.

At September 30, 2005 and 2004, the liability for unpaid claims and claim adjustment expenses represents an estimate of the known probable and estimable losses that are unpaid as of September 30, 2005 and 2004, based on the Final Rules dated March 21, 2001, entitled, the Disaster Assistance: Cerro Grande Fire Assistance, Final Rule, published in the *Federal Register Part II* at 44 Code of Federal Regulations Chapter I, Part 295. This estimated claims liability for September 30, 2005 and 2004, includes $7 million and $9 million, respectively, which is unfunded.

16. DEFERRED REVENUE AND ADVANCES FROM OTHERS

Deferred revenue at September 30, and CIS application fee activity for the years ended September 30, 2005 and 2004, consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
CIS Application Fees:		
Beginning Balance	$889	$949
Collection deposited	1,604	1,354
Less: earned revenue (completed applications)	(1,733)	(1,429)
Adjustments for undeposited collections and other	13	15
Total CIS Application Fees	773	889
EP&R Unexpired NFIP premium	1,226	1,095
Advances from Others	14	14
Deferred Credits	1	22
Total Deferred Revenue	**$2,014**	**$2,020**

CIS requires advance payments of the fees for applications or petitions for immigration, nationality and citizenship benefits. EP&R's deferred revenue relates to unearned NFIP premiums that are reserved to provide for the unexpired period of insurance coverage.

17. ACCRUED PAYROLL AND BENEFITS

Accrued Payroll and Benefits at September 30, consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
Accrued Funded Payroll and Benefits	$523	$495
Accrued Unfunded Leave	729	663
Unfunded Employment Related Liabilities	105	105
Actuarial FECA Liability	1,473	1,398
Other	15	31
Total Accrued Payroll and Benefits	**$2,845**	**$2,692**

Workers' Compensation

Claims incurred for the benefit of Department employees under FECA are administered by DOL and are ultimately paid by the Department. The accrued FECA liability representing money owed for current claims at September 30, 2005 and 2004 was $358 million and $240 million, respectively, and is included in other liabilities (see note 19). Future workers' compensation estimates, generated from an application of actuarial procedures developed by the DOL, for the future cost of approved compensation cases at September 30, 2005 and 2004, were approximately $1.5 billion and $1.4 billion, respectively. Workers' compensation expense was $141 million and $130 million, respectively, for the fiscal years ended September 30, 2005 and 2004.

18. MILITARY SERVICE AND OTHER RETIREMENT BENEFITS

Accrued liability for military service and other retirement benefits at September 30, consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
USCG Military Retirement and Healthcare Benefits	$25,468	$23,037
USCG Post-Employment Military Travel Benefits	100	83
USSS DC Pension Plan Benefits	3,453	3,382
Total Military Service and Other Retirement Benefits Liability	**$29,021**	**$26,502**

A. Military Retirement System Expense

The components of the Military Retirement System (MRS) expense for the years ended September 30, 2005 and 2004, consisted of the following (in millions):

Defined Benefit Plan:	2005 (unaudited)	2004 (unaudited)
Normal cost	$481	$419
Interest on the liability	1,259	1,162
Actuarial losses/(gains)	617	(101)
Actuarial Assumption Change	103	39
Plan Amendments	-	432
Total Defined Benefit Plan Expense	2,460	1,951
Post-retirement Healthcare:		
Normal cost	174	143
Interest on the liability	266	219
Losses/(gains) due to change in medical inflation rate assumptions	471	(128)
Adjustments	24	-
Total Post-retirement Healthcare Expense	935	234
Total MRS Expense	**$3,395**	**$2,185**

The USCG's MRS includes the USCG Military Health Services System. The USCG's military service members (both active duty and reservists) participate in the MRS. USCG receives an annual "Retired Pay" appropriation to fund MRS benefits, thus the MRS is treated as a pay-as-you-go plan. The retirement system allows voluntary retirement for active members upon credit of at least 20 years of active service at any age. Reserve members may retire after 20 years of creditable service with benefits beginning at age 60. The health services plan is a post-retirement medical benefit plan, which covers all active duty and reserve members of the USCG. The retirement plan's only assets are accounts receivable representing unintentional overpayments of retiree benefits. The plan may subsequently recover such amounts through future benefit payment adjustments or may elect to waive its right to recover such amounts. The health services plan has no assets.

The unfunded accrued liability, presented as a component of the liability for military service and other retirement in the accompanying Consolidated Balance Sheet, represents both retired pay and health care benefits for non-Medicare eligible retirees/survivors. On October 1, 2002, USCG transferred the actuarial liability for payments for the health care benefits of Medicare eligible retirees and survivors to the Department of Defense Medicare-Eligible Retiree Health Care Fund (the Fund). USCG makes monthly payments to the Fund for current service members. Valuation of the plan's liability is based on the actuarial present value of accumulated plan benefits derived from the future payments that are attributable, under the retirement plan's provisions, to a participant's credited service as of the valuation date. Credited service is the years of service from active duty base date (or constructive date in the case of active duty reservists) to date of retirement measured in years and completed months. The present value of future benefits is then converted to an unfunded accrued liability by subtracting the

present value of future employer/employee normal contributions. USCG plan participants may retire after 20 years of active service at any age with annual benefits equal to 2.5 percent of retired base pay for each year of credited service up to 75 percent of basic pay. Personnel who became members after August 1, 1986 may elect to receive a $30,000 lump sum bonus after 15 years of service and reduced benefits prior to age 62. Annual disability is equal to the retired pay base multiplied by the larger of (1) 2.5 percent times years of service, or (2) percent disability. The benefit cannot be more than 75 percent of retired pay base. If a USCG member is disabled, the member is entitled to disability benefits, assuming the disability is at least 30 percent (under a standard schedule of rating disabilities by Veterans Affairs) and either: (1) the member has 8 years of service, (2) the disability results from active duty, or (3) the disability occurred in the line of duty during a time of war or national emergency or certain other time periods.

The significant actuarial assumptions used to compute the MRS accrued liability are:

(1) life expectancy is based upon the DoD death mortality table;
(2) cost of living increases are 3.0 percent annually; and
(3) annual rate of investment return is 6.25 percent.

These assumptions are based on a 1997 Experience Study and USCG plans to update the study in fiscal year 2006. Fiscal year 2005 actuarial assumption changes included a salary scale increase from 3.5% to 3.75% and updated Veterans Administration (VA) waiver and combat related pay assumptions.

B. District of Columbia Police and Fireman's Retirement System for U.S. Secret Service Employees

Special agents and personnel in certain job series hired by USSS before January 1, 1984, are eligible to transfer to the District of Columbia Police and Fireman's Retirement System (DC Pension Plan) after completion of ten years of protection related experience. All uniformed USSS officers who were hired before January 1, 1984, are automatically covered under this retirement system. Participants in the DC Pension Plan make contributions of 7 percent of base pay with no matching contribution made by USSS. Annuitants of this plan receive benefit payments directly from the DC Pension Plan. The USSS reimburses the District of Columbia for the difference between benefits provided to the annuitants, and payroll contributions received from current employees. This liability is presented as a component of the liability for military service and other retirement benefits in the accompanying consolidated balance sheet. SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, requires the administrative entity (administrator) to report the actuarial liability. However, the USSS adopted the provisions of SFFAS No. 5 because the administrator, the DC Pension Plan, is not a Federal entity and as such the liability for future funding would not otherwise be recorded in the United States government wide consolidated financial statements.

The liability and expense are computed using the aggregate cost method. The primary actuarial assumptions used to determine the liability at September 30, 2005 are:

(1) life expectancy is based upon the 1994 Uninsured Pension (UP94) tables;
(2) cost of living increases are 3.5 percent annually;
(3) rates of salary increases are 3.5 percent annually; and
(4) annual rate of investment return is 7.25 percent.

Total expenses related to the DC Pension Plan for the fiscal years ended September 30, 2005 and 2004, were $188 million and $173 million, respectively, of which $17 million and $16 million were funded but not paid at September 30, 2005 and 2004, respectively.

19. OTHER LIABILITIES

Other liabilities at September 30, consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
Intragovernmental:		
Accrued FECA Liability	$358	$240
Advances from Others	109	139
Employer Benefits Contributions and Payroll Taxes	96	69
Borrowings from Treasury	226	-
Other Intragovernmental Liabilities	65	115
Total Intragovernmental Other Liabilities	854	563
Public:		
Duties for Imports of Canadian Softwood Lumber (Notes 2 and 3)	4,706	2,940
Injured Domestic Industries (Notes 2 and 3)	237	332
Contingent Legal Liabilities (Note 21)	247	80
Capital Lease Liability (Note 20)	129	148
Environmental and Disposal Liabilities (Note 21)	172	159
Refunds and Drawbacks (Note 2 and 25)	118	132
Other Public Liabilities	336	375
Total Public Other Liabilities	5,945	4,166
Total Other Liabilities	**$6,799**	**$4,729**

Intragovernmental accrued FECA liability primarily represents the unfunded workers' compensation for current claims. Borrowings from Treasury represents money borrowed against the NFIP borrowing authority of $1.5 billion to pay flood insurance claims, mainly for damages caused by four major hurricanes which occurred late in fiscal year 2004. Other public liabilities consist primarily of liability for deposit funds and suspense at ICE and CBP. Intragovernmental other liabilities consist principally of current liabilities, while the majority of public other liabilities are considered non-current.

The *Continued Dumping and Subsidy Offset Act of 2000* calls for CBP to collect and disburse monies received in connection with antidumping and countervailing duty orders and findings to qualifying Injured Domestic Industries (IDI). Antidumping duties are collected when it is determined that a class or kind of foreign merchandise is being released into the U.S. economy at less than its fair value to the detriment of a U.S. industry. Countervailing duties are collected when it is determined that a foreign government is providing a subsidy to its local industries to manufacture, produce, or export a class or kind of merchandise for import into the U.S. commerce to the detriment of a U.S. industry. Antidumping and countervailing duties collected and due to IDIs at September 30, 2005 and 2004, totaled $237 million and $332 million, respectively. CBP has collected Canadian softwood lumber duties of $4.7 billion and $2.9 billion respectively, as of September 30, 2005 and 2004. The duties will eventually be distributed, pursuant to rulings by the Department of Commerce (DOC). Duties for imports of Canadian

softwood lumber are included in non-entity fund balance with Treasury, and represent a non-entity liability for which there is an antidumping dispute currently being litigated.

Refunds and Other Payments

Disbursements from the refunds and drawback account for the fiscal years ended September 30, 2005 and 2004 consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
Refunds	$729	$566
Drawback	430	404
Total	**$1,159**	**$970**

The disbursements include interest payments of $33 million and $45 million, for the fiscal years ended September 30, 2005 and 2004 respectively. Refunds and other payments funded from collections rather than the refunds and drawback account totaled $354 million and $251 million for the fiscal years ended September 30, 2005 and 2004, respectively.

Amounts refunded during the fiscal years ended September 30, 2005 and 2004, identified by entry year, consisted of the following (in millions):

Entry Year	2005 (unaudited)	2004 (unaudited)
2005	$684	$ -
2004	139	531
2003	42	128
2002	21	64
Prior Years	273	247
Total	**$1,159**	**$970**

The disbursement totals for refunds include antidumping and countervailing duties collected that are refunded pursuant to rulings by the DOC. These duties are refunded when the DOC issues a decision in favor of the foreign industry.

The total amounts of antidumping and countervailing duties vary from year to year depending on decisions from DOC. Antidumping and countervailing duty refunds (included in total refunds presented above) and associated interest refunded for the fiscal year ended September 30, 2005 and 2004 consisted of the following (in millions):

	2005 (unaudited)	2004 (unaudited)
Antidumping and countervailing duty refunds	$124	$75
Interest	14	19
Total Antidumping and countervailing duty refunds	**$138**	**$94**

20. LEASES

A. Operating Leases (unaudited)

The Department leases various facilities and equipment under leases accounted for as operating leases. Leased items consist of offices, warehouses, vehicles and other equipment. The majority of office space occupied by the Department is either owned by the Federal government or is leased by GSA from commercial sources. The Department is not committed to continue to pay rent to GSA beyond the period occupied providing proper advance notice to GSA is made and unless the space occupied is designated as unique to Department operations. However, it is expected the Department will continue to occupy and lease office space from GSA in future years and lease charges will be adjusted annually to reflect operating costs incurred by GSA.

As of September 30, 2005, estimated future minimum lease commitments under operating leases for equipment and GSA controlled leases were as follows (in millions):

	GSA	Non-GSA	Total
FY 2006	$813	$134	$947
FY 2007	844	150	994
FY 2008	851	155	1,006
FY 2009	870	161	1,031
FY 2010/ Beyond FY 2009	893	165	1,058
Beyond FY 2010	4,309	655	4,964
Total future minimum lease payments	$8,580	$1,420	**$10,000**

The estimated future lease payments for GSA controlled leases are based on payments made during the year ended September 30, 2005.

B. Capital Leases

The Department maintains capital leases for equipment, buildings and commercial software license agreements. The liabilities associated with capital leases and software license agreements are presented as other liabilities in the accompanying consolidated financial statements based upon the present value of the future minimum lease payments.

Certain license agreements are cancelable depending on future funding. Substantially all of the net present value of capital lease obligations and software license agreements may be funded from future sources.

21. CONTINGENT LIABILITIES AND OTHER COMMITMENTS

A. Legal Contingent Liabilities

The estimated contingent liability recorded in the accompanying financial statements included with other liabilities for all probable and estimable litigation related claims at September 30, 2005, was $247 million, of which $26 million is funded. (At September 30, 2004, the estimated contingent liability was $80 million, of which $26 million was funded). Asserted and pending legal claims for which loss is reasonably possible was estimated to range from $319 million to $2.5 billion, at September 30, 2005. The Department is subject to various other legal proceedings and claims. In management's opinion, the ultimate resolution of other actions will not materially affect the Department's financial position or net costs.

B. Environmental Cleanup Liabilities

The Department is responsible to remediate its sites with environmental contamination, and is party to various administrative proceedings, legal actions and tort claims which may result in settlements or decisions adverse to the Federal government.

The source of remediation requirements to determine the environmental liability is based on compliance with Federal and state or local environmental laws and regulations. The major Federal laws covering environmental response, cleanup and monitoring are the *Comprehensive Environmental Response, Compensation and Liability Act* and the *Resource Conservation and Recovery Act*. Environmental liability of $172 million ($14 million funded), as of September 30, 2005 and $159 million ($15 million funded), as of September 30, 2004 is presented with other liabilities in the accompanying Consolidated Balance Sheet. The liabilities consist primarily of fuel storage tank program, fuels, solvents, industrial, chemicals and other environmental cleanup associated with normal operations of CBP and the USCG. For Plum Island Animal Disease Center, under S&T, potential environmental liabilities that are not presently estimable could exist due to the facility's age, old building materials used and other materials associated with the facility's past use as a United States Army installation for coastline defense. Cost estimates for environmental and disposal liabilities are subject to revision as a result of changes in technology, environmental laws and regulations, and plans for disposal.

C. Duty and Trade Refunds

There are various trade related matters that fall under the jurisdiction of other Federal agencies, such as the Department of Commerce, which may result in refunds of duties, taxes and fees collected by CBP. Until a decision is reached by the other Federal agencies, CBP does not have sufficient information to estimate a contingent liability amount, if any, for trade related refunds under jurisdiction of other Federal agencies in addition to the amount accrued on the accompanying financial statements. All known refunds as of September 30, 2005, and 2004, have been recorded.

D. Loaned Aircraft and Equipment

The Department is generally liable to the DoD for damage or loss to aircraft on loan to CBP, AMO. As of September 30, 2005, CBP had 16 aircraft loaned from DoD with an acquisition value of $94 million

(unaudited). (These aircraft were reported as on loan to ICE, as of September 30, 2004. During fiscal year 2005, ICE transferred these loaned aircraft to CBP. No damage or aircraft losses were accrued as of September 30, 2005.

E. Other Contractual Arrangements

In addition to future lease commitments discussed in Note 20, the Department is committed under contractual agreements for goods and services that have been ordered but not yet received (undelivered orders) at fiscal year-end. Aggregate undelivered orders for all Department activities amounted to $35 billion and $21 billion as of September 30, 2005 and 2004, respectively.

During fiscal year 2004, TSA entered into a number of *Letters of Intent for Modifications to Airport Facilities* with eight major airports in which TSA may reimburse the airports for 75% (estimated total of $957 million) of the cost to modify the facilities for security purposes. These Letters of Intent would not obligate TSA until funds have been appropriated and obligated. In addition, each airport shall have title to any improvements to its facilities. During fiscal year 2005, $269 million was appropriated and is available for payment to the airports upon submission to TSA of an invoice for the modification costs incurred. As of September 30, 2005, TSA has received invoices or documentation for costs incurred and paid in a total of $204 million related to these agreements. The amounts requested under these Letters of Intent may differ significantly from the original estimates and, therefore, TSA could ultimately pay substantially more than originally estimated.

F. NFIP Premiums

NFIP premium rates are generally established for actuarially rated policies with the intent of generating sufficient premiums to cover losses and loss adjustment expenses of a historical average loss year and to provide a surplus to compensate the Insurance Underwriting Operations for the loss potential of an unusually severe loss year due to catastrophic flooding.

Notwithstanding the foregoing, subsidized rates have historically been charged on a countrywide basis for certain classifications of insured. These subsidized rates produce a premium less than the loss and loss adjustment expenses expected to be incurred in a historical average loss year. The subsidized rates do not include a provision for losses from catastrophic flooding. Subsidized rates are used to provide affordable insurance on construction or substantial improvements started on or before December 31, 1974, or before the effective date of the initial Flood Insurance Rate Map (i.e., an official map of a community on which NFIP has delineated both the special hazard areas and the non-subsidized premium zones applicable to the community).

FEMA's practice of recording a year-end obligation against budgetary obligations for estimated losses was changed in fiscal year 2005. Consistent with the guidance contained in Section 20.5 of OMB Circular A-11, FEMA now enters obligations against its budgetary allocation when final approval is provided on a claim. The resulting correction of this error is disclosed in Note 30 to these financial statements.

22. BALANCE SHEET CROSSWALK TO OMB CIRCULAR A-136 CLASSIFICATIONS

The Department's consolidated balance sheet is presented in a format which varies from the format prescribed by OMB Circular A-136. The following tables show reclassification adjustments needed to present the Balance Sheet in the OMB Circular A-136 format (in millions):

As of September 30, 2005: (Unaudited)	As Presented	Reclassification debit	Reclassification credit	OMB A-136
Assets				
Intragovernmental:				
Fund Balance with Treasury	$97,004	$ -	$ -	$97,004
Investments	738	-	-	738
Advances and Prepayments	2,937	-	2,937	-
Accounts Receivable	-	217	-	217
Loans Receivable	-	-	-	-
Other	361	2,720	-	3,081
Total Intragovernmental	101,040	2,937	2,937	101,040
Cash and Other Monetary Assets	-	78	-	78
Investments	-	-	-	-
Accounts Receivable	532	-	-	532
Taxes Receivable, Net	1,400	-	-	1,400
Loans Receivable, Net	-	-	-	-
Operating Materials, Supplies, & Inventory, Net	506	-	506	-
Inventory and Related Property, Net	-	506	-	506
General Property, Plant and Equipment, Net	10,470	-	-	10,470
Other	558	-	78	480
Total Assets	**$114,506**	**$3,521**	**$3,521**	**$114,506**
Liabilities				
Intragovernmental:				
Due to the Treasury General Fund	$1,434	$1,434	$ -	$ -
Accounts Payable	870	-	-	870
Debt	-	-	226	226
Other	854	-	1,208	2,062
Total Intragovernmental	3,158	1,434	1,434	3,158
Accounts Payable	3,329	-	-	3,329
Loan Guarantee Liability	-	-	-	-
Debt held by the Public	-	-	-	-
Claims and Claims Settlement Liabilities	23,433	23,433	-	-
Deferred Revenue and Advances from Others	2,014	2,014	-	-
Accrued Payroll and Benefits	2,845	2,845	-	-
Military Service and Other Retirement Benefits	29,021	29,021	-	-
Federal Employee and Veteran Benefits	-	-	30,501	30,501
Environmental and Disposal Liability	-	-	172	172
Benefits Due and Payable	-	-	-	-
Other	5,945	-	26,640	32,585
Total Liabilities	**69,745**	**58,747**	**58,747**	**69,745**
Net Position				
Unexpended Appropriations	87,166	-	-	87,166
Cumulative Results of Operations	(42,405)	-	-	(42,405)
Total Net Position	**$44,761**	**$ -**	**$ -**	**$44,761**
Total Liabilities and Net Position	**$114,506**	**$58,747**	**$58,747**	**$114,506**

As of September 30, 2004: (Unaudited)	As Presented	Reclassification debit	Reclassification credit	OMB A-136
Assets				
Intragovernmental:				
Fund Balance with Treasury	$33,436	$ -	$ -	$33,436
Investments	1,625	-	-	1,625
Advances and Prepayments	2,886	-	2,886	-
Accounts Receivable	-	311	-	311
Loans Receivable	-	-	-	-
Other	481	2,575	-	3,056
Total Intragovernmental	38,428	2,886	2,886	38,428
Cash and Other Monetary Assets	-	87	-	87
Investments	-	-	-	-
Accounts Receivable	463	-	-	463
Taxes Receivable, Net	1,273	13	-	1,286
Loans Receivable, Net	-	-	-	-
Operating Materials, Supplies, & Inventory, Net	496	-	496	-
Inventory and Related Property, Net	-	496	-	496
General Property, Plant and Equipment, Net	9,746	-	-	9,746
Other	400	-	100	300
Total Assets	**$50,806**	**$3,482**	**$3,482**	**$50,806**
Liabilities				
Intragovernmental:				
Due to the Treasury General Fund	$1,257	$1,257	$ -	$ -
Accounts Payable	911	-	-	911
Debt	-	-	8	8
Other	563	-	1,249	1,812
Total Intragovernmental	2,731	1,257	1,257	2,731
Accounts Payable	2,791	-	-	2,791
Loan Guarantee Liability	-	-	-	-
Debt held by the Public	-	-	-	-
Claims and Claims Settlement Liabilities	1,417	1,417	-	-
Deferred Revenue and Advances from Others	2,020	2,020	-	-
Accrued Payroll and Benefits	2,692	2,692	-	-
Military Service and Other Retirement Benefits	26,502	26,502	-	-
Federal Employee and Veteran Benefits	-	-	27,828	27,828
Environmental and Disposal Liability	-	-	159	159
Benefits Due and Payable	-	-	-	-
Other	4,166	-	4,644	8,810
Total Liabilities	**42,319**	**33,888**	**33,888**	**42,319**
Net Position				
Unexpended Appropriations	25,504	-	-	25,504
Cumulative Results of Operations	(17,017)	-	-	(17,017)
Total Net Position	**$8,487**	**$ -**	**$ -**	**$8,487**
Total Liabilities and Net Position	**$50,806**	**$33,888**	**$33,888**	**$50,806**

23. CONSOLIDATED STATEMENT OF NET COST AND NET COSTS OF DHS COMPONENTS

Operating costs are summarized in the Consolidated Statement of Net Cost by responsibility segment, as applicable to the reporting period. The net cost of operations is the gross (i.e., total) cost incurred by the Department, less any exchange (i.e., earned) revenue. A responsibility segment is the component that carries out a mission or major line of activity, and whose managers report directly to Departmental Management. For fiscal year 2004, the Department's responsibility segments were responsible for accomplishing the three objectives of the President's *National Strategy for Homeland Security*.

During fiscal year 2004, the Department interpreted the National Strategy and developed its first Strategic Plan, which included seven goals presented in Note 1.A., Reporting Entity.

Beginning with the fiscal year 2005 budget, the Department integrated budget and performance information as required by the *President's Management Agenda* and the *Government Performance and Results Act*. To integrate performance and financial information, a supplemental schedule of net cost is included in this note, in which costs by program are allocated to Departmental strategic goals. Also, the required disclosure on intragovernmental costs and exchange revenue is presented by DHS sub-organizations. In addition, due to the complexity of the Border and Transportation Security Directorate organizational structure, a supplemental schedule is presented to show the net cost of the BTS Directorate's sub organizations.

Net Costs of Department Sub-organizations by Strategic Goal (in millions)

For the year ended September 30, 2005 (Unaudited)

	Awareness	Prevention	Protection	Response	Recovery	Service	Organizational Excellence	TOTAL
BTS Directorate:								
BTS HQ	$ -	$100	$ -	$ -	$ -	$82	$ -	**$182**
CBP	-	5,939	-	-	-	501	-	**6,440**
ICE	-	3,378	500	-	-	-	-	**3,878**
TSA	7	3,572	62	-			-	**3,641**
FLE	-	226	-	-	-	-	-	**226**
Subtotal – BTS Directorate	7	13,215	562	-	-	583	-	**14,367**
EP&R Directorate	-	-	25,933	2,272	9,422	-	-	**37,627**
IAIP Directorate	263	-	389	-	-	-	-	**652**
S&T Directorate	114	417	174	26	-	-	-	**731**
USCG	937	3,723	2,032	1,155	29	1,493	-	**9,369**
USSS	-	-	1,483	-	-	-	-	**1,483**
CIS	-	(93)	-	-	-	(238)	-	**(331)**
Departmental Operations/Other	-	-	1,886	-	-	-	621	**2,507**
TOTAL Department	**$1,321**	**$17,262**	**$32,459**	**$3,453**	**$9,451**	**$1,838**	**$621**	**$66,405**

Net Costs of Department Sub-organizations by Strategic Goal (in millions)

For the year ended September 30, 2004 (Unaudited)

	Awareness	Prevention	Protection	Response	Recovery	Service	Organizational Excellence	TOTAL
BTS Directorate:								
BTS HQ	$ -	$9	$1	$1	$ -	$ -	$ -	**$11**
CBP	-	5,511	-	-	-	413	-	**5,924**
ICE	58	3,023	737	-	-	-	-	**3,818**
TSA	151	2,473	1,018	37			113	**3,792**
FLE	22	88	85	-	-	-	1	**196**
Subtotal – BTS Directorate	231	11,104	1,841	38	-	413	114	**13,741**
EP&R Directorate	-	-	1,501	1,125	3,271	-	-	**5,897**
IAIP Directorate	140	-	357	-	-	-	-	**497**
S&T Directorate	66	439	126	100	24	-	-	**755**
USCG	560	4,840	1,564	975	113	108	-	**8,160**
USSS	-	-	1,368	-	-	-	-	**1,368**
CIS	-	99	-	-	-	349	-	**448**
Departmental Operations/Other	-	-	1,937	-	-	-	325	**2,262**
TOTAL Department	**$997**	**$16,482**	**$8,694**	**$2,238**	**$3,408**	**$870**	**$439**	**$33,128**

Statement of Net Cost sub-schedule:
Intragovernmental Costs and Exchange Revenue (in millions)
For the year ended September 30, 2005
(Unaudited)

	Intragovernmental	With the Public	Total
BTS Directorate			
Gross Cost	$3,702	$14,212	$17,914
Less Earned Revenue	(640)	(2,907)	(3,547)
Net Cost	3,062	11,305	14,367
EP&R Directorate			
Gross Cost	1,785	38,020	39,805
Less Earned Revenue	(107)	(2,071)	(2,178)
Net Cost	1,678	35,949	37,627
IAIP Directorate			
Gross Cost	475	177	652
Less Earned Revenue	-	-	-
Net Cost	475	177	652
S&T Directorate			
Gross Cost	484	259	743
Less Earned Revenue	(12)	-	(12)
Net Cost	472	259	731
USCG			
Gross Cost	980	8,609	9,589
Less Earned Revenue	(133)	(87)	(220)
Net Cost	847	8,522	9,369
USSS			
Gross Cost	361	1,144	1,505
Less Earned Revenue	(22)	-	(22)
Net Cost	339	1,144	1,483
USCIS			
Gross Cost	525	766	1,291
Less Earned Revenue	(14)	(1,608)	(1,622)
Net Cost	511	(842)	(331)
Departmental Operations and Other			
Gross Cost	460	2,059	2,519
Less Earned Revenue	(12)	-	(12)
Net Cost	448	2,059	2,507
DHS Total			
Gross Cost	8,772	65,246	74,018
Less Earned Revenue	(940)	(6,673)	(7,613)
NET COST	**$7,832**	**$58,573**	**$66,405**

Statement of Net Cost sub-schedule:
Intragovernmental Costs and Exchange Revenue (in millions)
For the year ended September 30, 2004
(Unaudited)

	Intragovernmental	With the Public	Total
BTS Directorate			
Gross Cost	$2,891	$13,755	$16,646
Less Earned Revenue	(547)	(2,358)	(2,905)
Net Cost	2,344	11,397	13,741
EP&R Directorate			
Gross Cost	599	7,220	7,819
Less Earned Revenue	(119)	(1,901)	(2,020)
Net Cost of Continuing Operations	480	5,319	5,799
Cost of Transferred Operations	98		98
Net Cost	578	5,319	5,897
IAIP Directorate			
Gross Cost	349	148	497
Less Earned Revenue	-	-	-
Net Cost	349	148	497
S&T Directorate			
Gross Cost	359	396	755
Less Earned Revenue	-	-	-
Net Cost	359	396	755
USCG			
Gross Cost	1,186	7,131	8,317
Less Earned Revenue	(90)	(67)	(157)
Net Cost	1,096	7,064	8,160
USSS			
Gross Cost	389	997	1,386
Less Earned Revenue	(18)	-	(18)
Net Cost	371	997	1,368
USCIS			
Gross Cost	553	1,205	1,758
Less Earned Revenue	15	(1,325)	(1,310)
Net Cost	568	(120)	448
Departmental Operations and Other			
Gross Cost	380	1890	2,270
Less Earned Revenue	(7)	(1)	(8)
Net Cost	373	1,889	2,262
DHS Total			
Gross Cost	6,804	32,742	39,546
Less Earned Revenue	(766)	(5,652)	(6,418)
NET COST	**$6,038**	**$27,090**	**$33,128**

Statement of Net Cost sub-schedule:
Components of Border and Transportation Security (BTS) Directorate (in millions)
For the year ended September 30, 2005
(Unaudited)

	Intragovernmental	With the Public	Total
BTS HQ (Office of Undersecretary)			
Gross Cost	$28	$154	$182
Less Earned Revenue	-	-	-
Net Cost	28	154	182
CBP			
Gross Cost	1,188	5,871	7,059
Less Earned Revenue	(33)	(586)	(619)
Net Cost	1,155	5,285	6,440
ICE (with FAM)			
Gross Cost	1,309	3,213	4,522
Less Earned Revenue	(557)	(87)	(644)
Net Cost	752	3,126	3,878
TSA			
Gross Cost	1,150	4,744	5,894
Less Earned Revenue	(20)	(2,233)	(2,253)
Net Cost	1,130	2,511	3,641
FLETC			
Gross Cost	27	230	257
Less Earned Revenue	(30)	(1)	(31)
Net Cost	(3)	229	226
BTS Directorate Total			
Gross Cost	3,702	14,212	17,914
Less Earned Revenue	(640)	(2,907)	(3,547)
NET COST - BTS	**$3,062**	**$11,305**	**$14,367**

Statement of Net Cost sub-schedule:
Components of Border and Transportation Security (BTS) Directorate (in millions)
For the year ended September 30, 2004
(Unaudited)

	Intragovernmental	With the Public	Total
BTS HQ (Office of Undersecretary)			
Gross Cost	$6	$5	$11
Less Earned Revenue	-	-	-
Net Cost	6	5	11
CBP			
Gross Cost	1,677	4,582	6,259
Less Earned Revenue	(62)	(273)	(335)
Net Cost	1,615	4,309	5,924
ICE (with FAM)			
Gross Cost	610	3,586	4,196
Less Earned Revenue	(366)	(12)	(378)
Net Cost	244	3,574	3,818
TSA			
Gross Cost	571	5,387	5,958
Less Earned Revenue	(95)	(2,071)	(2,166)
Net Cost	476	3,316	3,792
FLETC			
Gross Cost	27	195	222
Less Earned Revenue	(24)	(2)	(26)
Net Cost	3	193	196
BTS Directorate Total			
Gross Cost	2,891	13,755	16,646
Less Earned Revenue	(547)	(2,358)	(2,905)
NET COST - BTS	**$2,344**	**$11,397**	**$13,741**

24. COMBINED STATEMENT OF BUDGETARY RESOURCES (SBR)

The Combined Statement of Budgetary Resources (SBR) provides information about how budgetary resources were made available as well as their status at the end of the period. It is the only financial statement exclusively derived from the entity's budgetary general ledger in accordance with budgetary accounting rules that are incorporated into generally accepted accounting principles for the Federal government. The total Budgetary Resources of $124,661 million and $53,879 million for fiscal years 2005 and 2004, respectively, include new budget authority, unobligated balances at the beginning of the year and transferred in/out, spending authority from offsetting collections, recoveries of prior year obligations and adjustments.

A. Appropriations Received (in millions)

Appropriations received on the SBR of $106,691 million will not equal the amounts reported on the Consolidated Statement of Changes in Net Position (SCNP) of $101,251 million due to: 1) $4,544 million of trust and special fund receipts that are not reflected in the unexpended appropriation section of the SCNP; 2) $33 million of change in amounts appropriated from specific Treasury-managed trust funds; 3) $845 million of refunds and drawbacks; and 4) $18 million of receipts unavailable for obligations upon collections.

B. Permanently Not Available/Adjustments (in millions)

	2005 (unaudited)	2004 (unaudited)
Budgetary resources permanently not available per SBR	$1,961	$2,563
Appropriations Returned per SCNP	1,876	2,398
Difference (explained below)	$85	$165

Budgetary resources permanently not available on the SBR do not agree with the unavailable appropriations returned to Treasury on the SCNP due to: (1) trust, special and revolving funds which go through the cumulative results of operations and not unexpended appropriations; (2) repayments of debt that were processed through payables and not unexpended appropriations; and (3) reductions of borrowing authority that have no effect on the proprietary accounts.

C. Apportionment Categories of Obligations Incurred

Apportionment categories are determined in accordance with the guidance provided in OMB Circular A-11, *Preparation, Submission* and *Execution of the Budget*. Category A represents resources apportioned for calendar quarters. Category B represents resources apportioned for other time periods; for activities, projects, or objectives; or for any combination thereof (in millions).

FY Ended September 30, 2005:	Apportionment Category A	Apportionment Category B	Exempt from Apportionment	Total
Obligations Incurred - Direct	$27,064	$36,310	$853	**$64,227**
Obligations Incurred - Reimbursable	3,740	655	(1)	**4,394**
Total Obligations Incurred	**$30,804**	**$36,965**	**$852**	**$68,621**

FY Ended September 30, 2004:	Apportionment Category A	Apportionment Category B	Exempt from Apportionment	Total
Obligations Incurred - Direct	$23,239	$18,634	$734	**$42,607**
Obligations Incurred - Reimbursable	2,015	854	11	**2,880**
Total Obligations Incurred	**$25,254**	**$19,488**	**$745**	**$45,487**

D. Borrowing Authority for EP&R

The NFIP has borrowing authority of $3.5 billion and $1.5 billion, as of September 30, 2005 and 2004 respectively, available for disaster relief purposes. NFIP loans are for a three-year term. Interest rates are obtained from the Bureau of Public Debt. Simple interest is calculated monthly, and is offset by any interest rebate, if applicable. Interest is paid semi-annually on October 1 and April 1. Partial loan repayments are permitted. Principal repayments are required only at maturity, but are permitted at any time during the term of the loan. At the end of the fiscal year, borrowing authority is reduced by the amount of any unused portion. EP&R's liability for borrowed amounts was $226 million and $8 million respectively, at September 30, 2005 and 2004.

Under Credit Reform, the unsubsidized portion of direct loans is borrowed from the Treasury. The repayment terms of EP&R's borrowing from Treasury are based on the life of each cohort of direct loans. Proceeds from collections of principal and interest from the borrowers are used to repay the Treasury. In addition, an annual reestimate is performed to determine any change from the original subsidy rate. If an upward reestimate is determined to be necessary, these funds are available through permanent indefinite authority. Once these funds are appropriated, the original borrowings are repaid to the Treasury.

EP&R maintains three funds under the *Credit Reform Act*:

- 70-4234: Disaster Assistance Direct Loan Financing
- 70-0703: Disaster Assistance Direct Loan Program (no-year)
- 70-0703: Disaster Assistance Direct Loan Program (annual)

E. Non-Budgetary, Credit Program and Financing Account

Included in the SBR are amounts for the Department's one financing account in EP&R for Disaster Assistance Direct Loans. This non-budgetary financing account is not presented separately on the SBR because the amounts and impact are immaterial. Financing account information for the fiscal years ended September 30, 2005 and 2004 is presented below (in millions):

Budgetary Resources

	2005 (unaudited)	2004 (unaudited)
Budget Authority:		
Borrowing Authority	$26	$26
Spending Authority from Offsetting Collections:		
Receivable from Federal Sources	8	(3)
Recoveries of Prior Year Obligations	-	3
Permanently Not Available:		
Other Authority Withdrawn	(8)	(26)
Total Budgetary Resources	**$26**	**$0**
Total Status of Budgetary Resources	**$26**	**$0**
Total Outlays	**$8**	**$0**

F. Explanation of Differences between the Combined Statement of Budgetary Resources and the Budget of the United States Government

The SBR has been prepared in a format consistent with the amounts shown in the President's Budget (Budget of the United States Government). The actual amounts for fiscal year 2005 in the President's Budget have not been published at the time these financial statements were prepared. The President's Budget with the actual fiscal year 2004 amounts was released in February 2005, and the actual fiscal year 2005 amounts are estimated to be released in February 2006.

The Department's fiscal year 2004 budget amounts does not match the fiscal year 2004 President's Budget. The Obligated Balance, Beginning of Period, and the Unobligated Balance, Beginning of Period, does not equal the balance reported in the prior fiscal year as a result of a correction of an error associated with the recording of obligations for FEMA's National Flood Insurance Program (see Note 30).

25. PERMANENT INDEFINITE APPROPRIATIONS

Permanent indefinite appropriations refer to the appropriations that result from permanent public laws, which authorize the Department to retain certain receipts. The amount appropriated depends upon the amount of the receipts rather than on a specific amount. The Department has two permanent indefinite appropriations as follows:

- CBP has a permanent and indefinite appropriation, which is used to disburse tax and duty refunds, and duty drawbacks. Although funded through appropriations, refund and drawback activity is, in most instances, reported as a custodial activity of the Department. Refunds are custodial revenue-related activity in that refunds are a direct result of taxpayer overpayments of their tax liabilities. Federal tax revenue received from taxpayers is not available for use in the operation of the Department and is not reported on the Consolidated Statement of Net Cost. Likewise, the refunds of overpayments are not available for use by the Department in its operations. Refunds and drawback disbursements totaled $1,159 million and $970 million for the fiscal years ended September 30, 2005 and 2004 respectively, and are presented as a use of custodial revenue on the Statement of Custodial Activity.
- USSS has a permanent and indefinite appropriation, which is used to reimburse the District of Columbia Police and Fireman's Retirement System (DC Pension Plan) for the difference between benefits to participants in the DC Pension Plan (see note 18), and payroll contributions received from current employees.

These appropriations are not subject to budgetary ceilings established by Congress. CBP's refunds payable at year-end are not subject to funding restrictions. Refund payment funding is recognized as appropriations are used.

26. LEGAL ARRANGEMENTS AFFECTING THE USE OF UNOBLIGATED BALANCES OF BUDGET AUTHORITY

Unobligated balances, whose period of availability has expired, are not available to fund new obligations. Expired unobligated balances are available to pay for current period adjustments to obligations incurred prior to expiration. For a fixed appropriation account, the balance can be carried forward for five fiscal years after the period of availability ends. At the end of the fifth fiscal year, the account is closed and any remaining balance is canceled. For a no-year account, the unobligated balance is carried forward indefinitely until (1) specifically rescinded by law; or (2) the head of the agency concerned or the President determines that the purposes for which the appropriation was made have been carried out and disbursements have not been made against the appropriation for two consecutive years.

Included in the cumulative results of operations for special funds is $760 million and $1,015 million at September 30, 2005 and 2004 respectively, that represents the Department's authority to assess and collect user fees relating to merchandise and passenger processing, to assess and collect fees associated with services performed at certain small airports or other facilities, retain amounts needed to offset costs associated with collecting duties, and taxes and fees for the government of Puerto Rico. These special fund balances are restricted by law in their use to offset specific costs incurred by the Department. Part of the passenger fees in the User Fees Account, totaling approximately $741 million and $730 million at September 30, 2005 and 2004 respectively, is restricted by law in its use to offset specific costs incurred by the Department and are available to the extent provided in Department Appropriation Acts.

The entity trust fund balances result from the Department's authority to use the proceeds from general order items sold at auction to offset specific costs incurred by the Department relating to their sale, to

use available funds in the Salaries and Expense Trust Fund to offset specific costs for expanding border and port enforcement activities, and to use available funds from the Harbor Maintenance Fee Trust Fund to offset administrative expenses related to the collection of the Harbor Maintenance Fee.

27. EXPLANATION OF THE RELATIONSHIP BETWEEN LIABILITIES NOT COVERED BY BUDGETARY RESOURCES AND THE CHANGES IN COMPONENTS REQUIRING OR GENERATING RESOURCES IN FUTURE PERIODS

The relationship between the amounts reported as liabilities not covered by budgetary resources on the balance sheet and amounts reported as components requiring or generating resources in future periods on the Consolidated Statement of Financing were analyzed. The differences are primarily due to the increase in EP&R claims and claims settlement of $21.6 billion and USCG actuarial pension liability of $1.7 billion and other USCG military post employment liability of $1 billion in fiscal year 2005, which do not generate net cost of operations or require the use of budgetary resources. In fiscal year 2004, the differences were primarily due to the increase in EP&R claims and claims settlement liability of $1.0 billion and the increase in the USCG actuarial pension liability of $1.3 billion.

28. DEDICATED COLLECTIONS

The Department administers various Trust Funds that receive dedicated collections. In the U.S. Government budget, Trust Funds are accounted for separately and used only for specified purposes. A brief description of the major Trust Funds and their purpose follows.

A. Oil Spill Liability Trust Fund

The Oil Spill Liability Trust Fund (OSLTF) was established by the *Oil Pollution Act (OPA) of 1990*, P.L. 101-380, to help facilitate cleanup activities and compensate for damages from oil spills. The OSLTF account includes the parent OSLTF fund that is managed by BPD, the USCG Oil Spill Recovery transfer account, the USCG Trust Fund Share of Expenses transfer account and the USCG OPA Claims transfer account. These three transfer accounts fund outlays through SF-1151 non-expenditure transfers from the BPD OSLTF parent fund.

B. Boat Safety Account

The USCG's Boat Safety Account was established by *Federal Boat Safety Act (FBSA) of 1971*, P.L. 92-75, to "encourage greater State participation and uniformity in boating safety efforts, and particularly to permit the States to assume the greater share of boating safety education, assistance and enforcement activities." The Boat Safety Account receives funding from the Department of Interior's Sport Fish Restoration Account, which is funded in part from the Aquatic Resource Trust Fund (ARTF) managed by Bureau of Public Debt (BPD). Funds are available until expended (no-year). Outlays in this account are funded through SF-1151 non-expenditure transfers from the Sport Fish account.

Condensed financial information as of and for the fiscal years ended September 30, 2005 and 2004 is presented below (in millions):

	2005 (unaudited)		2004 (unaudited)	
	Oil Spill Liability Trust Fund	Boat Safety Account	Oil Spill Liability Trust Fund	Boat Safety Account
Assets:				
Investments	$735	$ -	$838	$ -
Other Assets	48	71	26	68
Total Assets	$783	$71	$864	$68
Liabilities:				
Accounts Payable	$ -	$16	$1	$19
Other Liabilities	-	-	-	-
Total Liabilities	-	16	1	19
Net Position:				
Beginning Balance	863	49	1,010	35
Non-Exchange Revenue	44	64	(32)	64
Less: Program Expenses	(124)	(58)	(115)	(50)
Net Position	783	55	863	49
Total Liabilities and Net Position	$783	$71	$864	$68

29. TRANSFER OF THE STRATEGIC NATIONAL STOCKPILE

The transfer of the Strategic National Stockpile (SNS) pursuant to *Project Bioshield Act of 2004* had an effect on all of the Department's fiscal year 2004 financial statements, except for the Statement of Custodial Activity.

The following lines on the Department's Consolidated Balance Sheet, Consolidated Statement of Net Cost, Consolidated Statement of Changes in Net Position, Consolidated Statement of Financing and Combined Statement of Budgetary Resources include the transfer out of assets, liabilities, net position and budgetary resources of the SNS as of August 13, 2004, the date of transfer.

Consolidated Balance Sheet (in millions)

Fund Balance with Treasury	$626
Operating Materials and Supplies, Inventory and Stockpile	924
Property, Plant and Equipment, Net	5
Total Assets	$1,555
Accounts Payable	$88
Unexpended Appropriations	538
Cumulative Results of Operations	929
Total Liabilities and Net Position	$1,555

Consolidated Statement of Net Cost (in millions)

Costs – Intragovernmental	$98
Less Earned Revenue – Intragovernmental	-
Net Cost – Intragovernmental	$98
Costs – With the Public	$ -
Less Earned Revenue – With the Public	-
Net Cost – With the Public	$ -
Net Cost of Operation	$98

Consolidated Statement of Changes in Net Position (SCNP) and Consolidated Statement of Financing (SOF) (in millions)

Appropriations Transferred In/Out (Unexpended Appropriations) – SCNP only	$538
Other Financing Sources (Non-Exchange): Transfers In/Out without Reimbursement (Cumulative Results) – Both SCNP and SOF	$929

Combined Statements of Budgetary Resources (in millions)

Budgetary Resources – Budget Authority – Net Transfers, Current Year	$11
Budgetary Resources – Budget Authority – Net Transfers, Balance	$53
Budgetary Resources – Unobligated Balance – Net Transfers	$64
Budgetary Resources – Relationship of Obligations to Outlays – Obligated Balance Transferred, Net	$561

30. RESTATEMENTS

A. Budgetary Obligations Related to EPR National Flood Insurance Program

DHS restated amounts in the FY 2004 combined statement of budgetary resources to correct an error associated with the recording of budgetary obligations for the National Flood Insurance Program (NFIP). EPR previously recorded a year-end obligation against budgetary allocations for estimated losses related to the NFIP. Following hurricane Katrina in August 2005, OMB informed EPR that their accounting policy of recording budgetary obligations for estimated losses, prior to the receipt of a claim and approval of payment by the government, was inconsistent with the guidance provided in OMB Circular A-11. Consistent with the guidance contained in Section 20.5 of OMB Circular A-11, EPR should enter obligations against their budgetary allocation when final approval is provided on the claim. After consultation with DHS budget management and legal council, DHS agreed to correct its accounting policy and restate its fiscal year 2004 Combined Statement of Budgetary Resources and Consolidated Statement of Financing. There was no effect on the Consolidated Balance Sheet, Consolidated Statement of Net Cost, Consolidated Statement of Changes in Net Position, or Statement of Custodial Activity due to this change in realigning flood insurance obligations. The Combined Statement of Budgetary Resources and Consolidated Statement of Financing are presented below reflecting the balances as presented in fiscal year 2004 and as restated in fiscal year 2005 financial statements.

Combined Statement of Budgetary Resources (in millions)

Status of Budgetary Resources	As Presented	As Restated	Change
Obligations incurred:			
Direct	$43,628	$42,607	$(1,021)
Reimbursable	2,880	2,880	-
Total obligations incurred	$46,508	$45,487	$(1,021)
Unobligated Balance			
Apportioned	$5,691	$6,712	$1,021
Exempt from Apportionment	42	42	-
Unobligated Balance Not Available	1,638	1,638	-
Total Status of Budgetary Resources	$53,879	$53,879	$ -
Relationship of Obligations to Outlays			
Accounts Payable	$5,866	$4,845	$(1,021)

Consolidated Statement of Financing (in millions)

Resources Used to Finance Activities	Original	Restated	Change
Budgetary Resources Obligated			
Obligations Incurred	$46,508	$45,487	$(1,021)
Obligations Net of Offsetting Collections and Recoveries	37,835	36,814	(1,021)
Net Obligations	34,056	33,035	(1,021)
Total Resources Used to Finance Activities	34,121	33,100	(1,021)
Total Resources Used to Finance the Net Cost of Operations	29,408	28,387	(1,021)
Components Requiring or Generating Resources in Future Periods:			
Increase in Claims and Claims Settlement Liabilities	-	1,021	1,021
Total Components of Net Cost of Operations that will Require or Generate Resources in Future Periods	2,368	3,389	1,021
Total Components of Net Cost of Operations That Will Not Require or Generate Resources in the Current Period	3,720	4,741	1,021

Liabilities Not Covered by Budgetary Resources (Note 13) (in millions)

	Original	Restated	Change
Claims and Claims Settlement Liabilities	$9	$1,030	$1,021
Total Public	29,023	30,044	1,021
Total Liabilities Not Covered by Budgetary Resources	29,273	30,294	1,021
Liabilities Covered by Budgetary Resources or Non-Entity Assets	13,046	12,025	(1,021)

B. Correction of Error in the Accounts at ICE:

Financial statement errors, affecting the prior year, were discovered while performing reconciliations of accounts receivable, and clearing balances carried in suspense over a long period of time. Since the errors related to transactions that occurred in prior years, correcting adjustments were made to restate the beginning fiscal year 2005 statement of net position by decreasing cumulative results of operations by $127 million, and increasing unexpended appropriations by $163 million.

Required Supplementary Information (unaudited)

DEFERRED MAINTENANCE

The Department components use condition assessment as the method for determining the deferred maintenance for each class of asset. The procedure includes reviewing equipment, building and other structure logistic reports. Component logistic personnel identify maintenance not performed as scheduled and establish future performance dates. Logistic personnel use a condition assessment survey to determine the status of referenced assets according to the range of conditions shown below:

Good. Facility/equipment condition meets established maintenance standards, operates efficiently and has a normal life expectancy. Scheduled maintenance should be sufficient to maintain the current condition. There is no deferred maintenance on buildings or equipment in good condition.

Fair. Facility/equipment condition meets minimum standards but requires additional maintenance or repair to prevent further deterioration, increase operating efficiency and to achieve normal life expectancy.

Poor. Facility/equipment does not meet most maintenance standards and requires frequent repairs to prevent accelerated deterioration and provide a minimal level of operating function. In some cases, this includes condemned or failed facilities. Based on periodic condition assessments, an indicator of condition is the percent of facilities and item of equipment in each of the good, fair, or poor categories.

Deferred maintenance as of September 30, 2005 was estimated to range from $734 million to $890 million on general property, plant and equipment and heritage assets. In fiscal year 2004, the Department reported estimated deferred maintenance of $591 million (without range). These amounts represent maintenance on vehicles, vessels and buildings and structures owned by the Department that was not performed when it should have been or was scheduled to be and which is delayed for a future period.

A summary of deferred maintenance at September 30, 2005 is presented below (in millions):

	Low estimate	High estimate	Asset Condition
Building & Structures	$497	$619	Poor to Fair
Equipment (vehicles and vessels)	113	127	Poor to Fair
Heritage assets	124	144	Poor to Fair
Total	**$734**	**$890**	

See accompanying Independent Auditors' Report.
Required Supplementary Information

INTRAGOVERNMENTAL TRANSACTION DISCLOSURES

Intragovernmental transaction amounts represent transactions between Federal entities included in the Financial Report of the United States Government (formerly the Consolidated Financial Statements of the United States Government) published by the U.S. Department of the Treasury. All amounts presented are net of intra-departmental eliminations.

The amount of intragovernmental assets and liabilities classified by trading partner at September 30, 2005 and 2004, are summarized below.

Intragovernmental Assets as of September 30, 2005 (in millions)

Partner Agency	Fund Balance with Treasury	Investments and Related Interest	Advances and Prepayments	Other
Treasury General Fund	$97,004	$ -	$ -	$144
Department of Commerce	-	-	52	-
Department of Interior	-	-	31	72
Department of Justice	-	-	84	3
Department of Labor	-	-	31	-
Department of the Navy	-	-	2	17
Department of State	-	-	(2)	6
Department of Treasury	-	738	12	49
Environmental Protection Agency	-	-	-	9
Department of the Air Force	-	-	-	8
Department of the Army	-	-	-	12
Department of Transportation	-	-	2,639	2
Department of Housing and Urban Development	-	-	79	-
Office of the Secretary of Defense Agencies	-	-	8	21
The Judiciary	-	-	-	12
Other	-	-	1	6
Totals	**$97,004**	**$738**	**$2,937**	**$361**

See accompanying Independent Auditors' Report.
Required Supplementary Information

Intragovernmental Assets as of September 30, 2004 (in millions)

Partner Agency	Fund Balance with Treasury	Investments and Related Interest	Advances and Prepayments	Other
Treasury General Fund	$33,436	$-	$ -	$170
Department of Commerce	-	-	3	-
Department of Interior	-	-	-	69
Department of Justice	-	-	83	61
Department of Labor	-	-	63	-
Department of the Navy	-	-	12	17
Department of State	-	-	-	13
Department of Treasury	-	1,625	15	40
Social Security Administration	-	-	-	5
Department of the Army	-	-	-	12
National Science Foundation	-	-	-	6
Department of Transportation	-	-	2,673	6
Office of the Secretary of Defense Agencies	-	-	37	80
Other	-	-	-	2
Totals	**$33,436**	**$1,625**	**$2,886**	**$481**

Intragovernmental Liabilities as of September 30, 2005 (in millions)

Partner Agency	Due to Treasury	Accounts Payable	Other
Treasury General Fund	$1,434	$ -	$14
Department of Agriculture	-	24	-
Department of Commerce	-	2	-
Department of Interior	-	7	-
Department of Justice	-	167	9
Department of Labor	-	3	358
Department of the Navy	-	66	2
Department of State	-	6	8
Department of Treasury	-	4	236
Department of Veterans Affairs	-	10	-
Department of the Army	-	30	77
Department of the Air force	-	23	-
Office of Personnel Management	-	6	66
Social Security Administration	-	-	10
General Services Administration	-	(40)	42
Environmental Protection Agency	-	13	2
Department of Transportation	-	2	12
Agency for International Development	-	4	-
Department of Health & Human Services	-	21	3
Department of Energy	-	144	2
National Science Foundation	-	3	-
U.S. Army Corps of Engineers	-	91	-
Office of the Secretary of Defense Agencies	-	283	12
Other	-	1	1
Totals	**$1,434**	**$870**	**$854**

See accompanying Independent Auditors' Report.
Required Supplementary Information

Intragovernmental Liabilities as of September 30, 2004 (in millions)

Partner Agency	Due to Treasury	Accounts Payable	Other
Treasury General Fund	$1,257	$ -	$8
Department of Agriculture	-	16	2
Department of Commerce	-	-	-
Department of Interior	-	12	-
Department of Justice	-	123	30
Department of Labor	-	-	242
Department of the Navy	-	38	7
Department of State	-	7	13
Department of Treasury	-	(4)	26
Department of Veterans Affairs	-	10	4
Department of the Army	-	24	41
Office of Personnel Management	-	4	52
Social Security Administration	-	-	9
General Services Administration	-	18	63
Environmental Protection Agency	-	10	1
Department of the Air Force	-	18	2
Department of Transportation	-	12	34
Department of Health & Human Services	-	40	6
Department of Energy	-	127	3
U.S. Army Corps of Engineers	-	136	-
Office of the Secretary of Defense Agencies	-	316	12
Other	-	4	8
Totals	**$1,257**	**$911**	**$563**

See accompanying Independent Auditors' Report.
Required Supplementary Information

FY 2005 Intragovernmental Exchange Revenue from Trade Transactions (in millions)

Partner Agency	Exchange Revenue
Library of Congress	$3
The Judiciary	63
Department of Agriculture	19
Department of Commerce	13
Department of Interior	20
Department of Justice	115
Department of Labor	8
Department of the Navy	29
United States Postal Service	6
Department of State	36
Department of Treasury	138
Department of the Army	109
Social Security Administration	94
Department of Veterans Affairs	12
General Services Administration	21
National Science Foundation	20
Department of the Air Force	8
Environmental Protection Agency	27
Department of Transportation	52
Agency for International Development	9
Department of Health & Human Services	25
Department of Housing & Urban Development	6
Department of Energy	6
Department of Education	6
U.S. Equal Employment Opportunity Commission	3
U.S. Army Corps of Engineers	12
Office of the Sec'y of Defense Agencies	59
Other	21
Totals	**$940**

See accompanying Independent Auditors' Report.
Required Supplementary Information

FY 2004 Intragovernmental Exchange Revenue from Trade Transactions (in millions)

Partner Agency	Exchange Revenue
Executive Office of the President	$8
Department of Agriculture	7
Department of Commerce	7
Department of Interior	7
Department of Justice	152
Department of the Navy	24
Department of State	52
Department of Treasury	70
Department of the Army	102
Social Security Administration	101
General Services Administration	16
National Science Foundation	13
Environmental Protection Agency	25
Department of Transportation	135
Department of Health & Human Services	19
Department of Education	7
National Transportation Safety Board	16
Other	5
Totals	**$766**

FY 2005 Cost to Generate Intragovernmental Exchange Revenue, by Budget Subfunction (in millions)

Budget Subfunction	Cost
National Defense	$6
Transportation	185
Community and Regional Development	107
Administration of Justice	72
General Government	618
Total	**$988**

FY 2004 Cost to Generate Intragovernmental Exchange Revenue, by Budget Subfunction (in millions)

Budget Subfunction	Cost
Transportation	$123
Community and Regional Development	87
Administration of Justice	147
General Government	840
Total	**$1,197**

See accompanying Independent Auditors' Report.
Required Supplementary Information

FY 2005 Intragovernmental Non-Exchange Revenue (in millions)

Partner Agency	Transfers-In	Transfers-Out
Treasury General Fund	$38	$ -
Department of Agriculture	208	-
Department of Commerce	-	5
Department of Interior	64	7
Department of Treasury	17	7
Environmental Protection Agency	-	16
Department of Transportation	-	15
U.S. Army of Corps of Engineers	3	-
Office of the Sec'y of Defense Agencies	14	15
Other	2	6
Totals	**$346**	**$71**

FY 2004 Intragovernmental Non-Exchange Revenue (in millions)

Partner Agency	Transfers-In	Transfers-Out
Department of Interior	$ -	$7
Department of Treasury	240	161
General Services Administration	101	-
Environmental Protection Agency	-	16
Department of Transportation	-	13
Other	2	5
Totals	**$343**	**$202**

See accompanying Independent Auditors' Report.
Required Supplementary Information

COMBINED SCHEDULE OF FY 2005 BUDGETARY RESOURCES BY RESPONSIBILITY SEGMENTS (IN MILLIONS) (PAGE 1 OF 3)

	Border and Transport-ation Security	Emergency Preparedness & Response	Information Analysis & Infrastructure Protection	Science & Technology	U.S. Coast Guard	U.S. Secret Service	U.S. Citizenship & Immigration Services	Depart-mental Offices & Other	**Total**
BUDGETARY RESOURCES									
Budget Authority:									
Appropriations Received	$17,332	$72,014	$894	$1,115	$7,649	$1,386	$1,702	$4,599	**$106,691**
Borrowing Authority	-	2,026	-	-	-	-	-	-	**2,026**
Net Transfers	232	(14)	(7)	(5)	98	-	-	22	**326**
Unobligated Balance:									
Beginning of Period	2,881	3,150	106	381	1,077	55	317	425	**8,392**
Net Transfers	(89)	-	-	-	100	-	-	-	**11**
Spending Authority from Offsetting Collections:									
Earned:									
Collected	4,264	2,710	1	24	421	23	54	219	**7,716**
Receivable from Federal Sources	(20)	(7)	-	-	(65)	5	(67)	12	**(142)**
Change in Unfilled Customer Orders:									
Advances Received	(17)	534	-	(4)	(7)	(12)	(7)	84	**571**
Without Advances From Federal Sources	251	188	5	(1)	30	(5)	7	94	**569**
Transfers from Trust Funds – Collected	3	-	-	-	47	-	-	-	**50**
Total Spending Authority from Offsetting Collections	4,481	3,425	6	19	426	11	(13)	409	**8,764**

(continued)

COMBINED SCHEDULE OF FY 2005 BUDGETARY RESOURCES BY RESPONSIBILITY SEGMENTS (IN MILLIONS) (PAGE 2 OF 3)

Combined Schedule of FY 2005 Budgetary Resources by Responsibility Segments (in millions), (page 2 of 3)

	Border and Transport-ation Security	Emergency Preparedness & Response	Information Analysis & Infrastructure Protection	Science & Technology	U.S. Coast Guard	U.S. Secret Service	U.S. Citizenship & Immigration Services	Depart-mental Offices & Other	**Total**
Recoveries of Prior Year Obligations	472	614	127	64	77	-	56	21	**1,431**
Temporarily Not Available Pursuant to Public Law	-	-	-	-	-	-	-	-	**-**
Permanently Not Available	(1,828)	(38)	(5)	-	(52)	(13)	(1)	(24)	**(1,961)**
TOTAL BUDGETARY RESOURCES	**$23,481**	**$81,177**	**$1,121**	**$1,574**	**$9,375**	**$1,439**	**$2,061**	**$5,452**	**$125,680**
STATUS OF BUDGETARY RESOURCES									
Obligations Incurred:									
Direct	$17,757	$28,537	$922	$1,283	$7,747	$1,318	$1,815	$4,848	**$64,227**
Reimbursable	2,548	1,069	5	15	374	43	(65)	405	**4,394**
Total Obligations Incurred	20,305	29,606	927	1,298	8,121	1,361	1,750	5,253	**68,621**
Unobligated Balances Available:									
Apportioned:									
Apportioned Balance Currently Available	1,030	49,290	186	277	831	1	67	155	**51,837**
Exempt from Apportionment	-	13	-	-	32	-	-	-	**45**
Unobligated Balances Not Available	2,146	2,268	8	(1)	391	77	244	44	**5,177**
TOTAL STATUS OF BUDGETARY RESOURCES	**$23,481**	**$81,177**	**$1,121**	**$1,574**	**$9,375**	**$1,439**	**$2,061**	**$5,452**	**$125,680**

(continued)

COMBINED SCHEDULE OF FY 2005 BUDGETARY RESOURCES BY RESPONSIBILITY SEGMENTS (IN MILLIONS) (PAGE 3 OF 3)

	Border and Transport-ation Security	Emergency Preparedness & Response	Information Analysis & Infrastructure Protection	Science & Technology	U.S. Coast Guard	U.S. Secret Service	U.S. Citizenship & Immigration Services	Depart-mental Offices & Other	**Total**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS									
Obligated Balance, Net, Beginning of Period	$4,954	$9,125	$550	$571	$2,578	$291	$532	$6,167	**$24,781**
Obligated Balance Transferred, Net	87	-	-	-	-	-	2	-	**89**
Obligated Balance, Net, End of Period:									
Accounts Receivable	(177)	(15)	-	-	(80)	(5)	(2)	(16)	**(295)**
Unfilled Customer Orders from Federal Sources	(739)	(524)	(6)	-	(102)	(4)	(9)	(166)	**(1,550)**
Undelivered Orders	4,324	19,185	404	720	2,385	163	475	6,958	**34,614**
Accounts Payable	1,939	2,115	175	232	676	80	154	304	**5,674**
Total Obligated Balance, Net, End of Period	$5,346	$20,761	$573	$952	$2,879	$234	$618	$7,080	$38,443
Outlays:									
Disbursements	$19,296	$17,175	$771	$855	$7,778	$1,417	$1,670	$4,213	**$53,175**
Collections	(4,249)	(3,244)	(1)	(20)	(461)	(11)	(47)	(303)	**(8,336)**
Total Outlays	15,047	13,931	770	835	7,317	1,406	1,623	3,910	**44,839**
Less: Offsetting Receipts	(2,312)	(5)	-	-	(24)	-	(1,811)	-	**(4,152)**
NET OUTLAYS	**$12,735**	**$13,926**	**$770**	**$835**	**$7,293**	**$1,406**	**($188)**	**$3,910**	**$40,687**

COMBINED SCHEDULE OF FY 2004 BUDGETARY RESOURCES BY RESPONSIBILITY SEGMENTS - RESTATED (IN MILLIONS) (PAGE 1 OF 3)

	Border and Transport-ation Security	Emergency Preparedness & Response	Information Analysis & Infrastructure Protection	Science & Technology	U.S. Coast Guard	U.S. Secret Service	U.S. Citizenship & Immigration Services	Depart-mental Offices & Other	**Total**
BUDGETARY RESOURCES									
Budget Authority:									
Appropriations Received	$19,467	$6,793	$839	$918	$6,928	$1,341	$1,551	$466	**$38,303**
Borrowing Authority	-	26	-	-	-	-	-	-	**26**
Net Transfers	619	(63)	-	-	204	-	(25)	22	**757**
Unobligated Balance:									
Beginning of Period	3,464	3,306	25	352	1,023	101	190	198	**8,659**
Net Transfers	76	(45)	11	-	-	(1)	-	-	**41**
Spending Authority from Offsetting Collections:									
Earned:									
Collected	3,843	2,046	1	-	311	27	11	43	**6,282**
Receivable from Federal Sources	(30)	(3)	-	-	42	-	(4)	4	**9**
Change in Unfilled Customer Orders:									
Advances Received	37	25	-	22	(25)	22	10	(4)	**87**
Without Advances From Federal Sources	(21)	215	-	2	(5)	(2)	7	62	**258**
Transfers from Trust Funds	3	-	-	-	52	-	-	-	**55**
Total Spending Authority from Offsetting Collections	3,832	2,283	1	24	375	47	24	105	**6,691**

(continued)

COMBINED SCHEDULE OF FY 2004 BUDGETARY RESOURCES BY RESPONSIBILITY SEGMENTS - RESTATED (IN MILLIONS) (PAGE 2 OF 3)

	Border and Transport-ation Security	Emergency Preparedness & Response	Information Analysis & Infrastructure Protection	Science & Technology	U.S. Coast Guard	U.S. Secret Service	U.S. Citizenship & Immigration Services	Depart-mental Offices & Other	**Total**
Recoveries of Prior Year Obligations	1,220	483	6	-	63	16	187	7	**1,982**
Temporarily Not Available Pursuant to Public Law	-	(17)	-	-	-	-	-	-	**(17)**
Permanently Not Available	(2,056)	(288)	(15)	(5)	(145)	(46)	(4)	(4)	**(2,563)**
TOTAL BUDGETARY RESOURCES	**$26,622**	**$12,478**	**$867**	**$1,289**	**$8,448**	**$1,458**	**$1,923**	**$794**	**$53,879**
STATUS OF BUDGETARY RESOURCES									
Obligations Incurred:									
Direct	$21,543	$8,937	$760	$891	$7,021	$1,362	$1,557	$536	**$42,607**
Reimbursable	1,934	389	1	17	350	42	49	98	**2,880**
Total Obligations Incurred	23,477	9,326	761	908	7,371	1,404	1,606	634	**45,487**
Unobligated Balances Available:									
Apportioned	2,091	3,047	80	381	858	11	110	134	**6,712**
Exempt from Apportionment	-	10	-	-	32	-	-	-	**42**
Unobligated Balances Not Available	1,054	95	26	-	187	43	207	26	**1,638**
TOTAL STATUS OF BUDGETARY RESOURCES	**$26,622**	**$12,478**	**$867**	**$1,289**	**$8,448**	**$1,458**	**$1,923**	**$794**	**$53,879**

(continued)

COMBINED SCHEDULE OF FY 2004 BUDGETARY RESOURCES BY RESPONSIBILITY SEGMENTS - RESTATED (IN MILLIONS) (PAGE 3 OF 3)

	Border and Transport-ation Security	Emergency Preparedness & Response	Information Analysis & Infrastructure Protection	Science & Technology	U.S. Coast Guard	U.S. Secret Service	U.S. Citizenship & Immigration Services	Depart-mental Offices & Other	**Total**
RELATIONSHIP OF OBLIGATIONS TO OUTLAYS									
Obligated Balance, Net, Beginning of Period	$7,605	$8,038	$192	$119	$2,489	$268	$679	$299	**$19,689**
Obligated Balance Transferred, Net	-	(561)	2	-	-	-	-	-	**(559)**
Obligated Balance, Net, End of Period:									
Accounts Receivable	(198)	(21)	-	-	(145)	-	(69)	(4)	**(437)**
Unfilled Customer Orders from Federal Sources	(488)	(336)	(1)	(2)	(72)	(9)	(2)	(71)	**(981)**
Undelivered Orders	9,035	8,463	412	356	2,044	246	427	371	**21,354**
Accounts Payable	2,378	1,017	140	217	751	54	176	112	**4,845**
Total Obligated Balance, Net, End of Period	$10,727	$9,123	$551	$571	$2,578	$291	$532	$408	$24,781
Outlays:									
Disbursements	$19,200	$6,983	$400	$455	$7,182	$1,368	$1,563	$450	**$37,601**
Collections	(3,883)	(2,070)	(1)	(23)	(339)	(49)	(21)	(38)	**(6,424)**
Total Outlays	15,317	4,913	399	432	6,843	1,319	1,542	412	**31,177**
Less: Offsetting Receipts	(2,292)	(2)	-	-	(20)	(1)	(1,464)	-	**(3,779)**
NET OUTLAYS	**$13,025**	**$4,911**	**$399**	**$432**	**$6,823**	**$1,318**	**$78**	**$412**	**$27,398**

See accompanying Independent Auditors' Report.
Required Supplementary Information

CUSTODIAL ACTIVITY

Substantially all duty, tax and fee revenues collected by CBP are remitted to various General Fund accounts maintained by Treasury. Treasury further distributes these revenues to other Federal agencies in accordance with various laws and regulations. CBP transfers the remaining revenue (generally less than two percent of revenues collected) directly to other Federal agencies, the Governments of Puerto Rico and the U.S. Virgin Islands, or retains funds as authorized by law or regulations. Refunds of revenues collected from import/export activities are recorded in separate accounts established for this purpose and are funded through permanent indefinite appropriations. These activities reflect the non-entity, or custodial, responsibilities that CBP, as an agency of the Federal government, has been authorized by law to enforce.

CBP reviews selected documents to ensure all duties, taxes and fees owed to the Federal government are paid and to ensure regulations are followed. If CBP believes duties, taxes, fees, fines, or penalties are due in addition to estimated amounts previously paid by the importer/violator, the importer/violator is notified of the additional amount due. CBP regulations allow the importer/violator to file a protest on the additional amount due for review by the Port Director. A protest allows the importer/violator the opportunity to submit additional documentation supporting their claim of a lower amount due or to cancel the additional amount due in its entirety. Work in progress will continue until all protest options have expired or an agreement is reached. During this protest period, CBP does not have a legal right to the importer/violator's assets, and consequently CBP recognizes accounts receivable only when the protest period has expired or an agreement is reached. For fiscal years 2005 and 2004, CBP had legal right to collect $1.4 billion and $1.3 billion of receivables respectively. In addition, there was an additional $1.86 billion and $1.58 billion representing records still in the protest phase for fiscal years 2005 and 2004 respectively. CBP recognized as write-offs $134 million and $136 million respectively, of assessments that the Department has statutory authority to collect at September 30, 2005 and 2004, but has no future collection potential. Most of this amount represents fines, penalties and interest..

USCG collects various fines, penalties and miscellaneous user fees from the public that are deposited to the General Fund miscellaneous receipts of the U.S. Treasury. USCG does not collect taxes or duties. As of September 30, 2005 and 2004, USCG had outstanding general fund receipt receivables due to the Treasury General Fund of $15 million and $14 million, respectively.

See accompanying Independent Auditors' Report.
Required Supplementary Information

SEGMENT INFORMATION (IN MILLIONS):

	September 30, 2005			September 30, 2004		
	Working Capital Fund	Revolving Fund: Supply	Revolving Fund: Yard	Working Capital Fund	Revolving Fund: Supply	Revolving Fund: Yard
Fund Balance with Treasury	$18	$28	$28	$51	$32	$30
Accounts Receivable	10	6	7	4	6	6
Property, Plant and equipment	2	-	41	-	-	55
Other Assets	9	41	15	-	36	14
Total Assets	$39	$75	$91	$55	$74	$105
Accounts Payable	$22	$23	$4	$3	$23	$3
Other Liabilities	-	-	42	-	-	47
Total Liabilities	22	23	46	3	23	50
Net Position, Beginning	52	51	55	121	54	56
Revenue	167	96	73	8	96	78
Less: Cost	(202)	(95)	(83)	(77)	(99)	(79)
Net Position, Ending	17	52	45	52	51	55
Total Liabilities and Net Position	$39	$75	$91	$55	$74	$105

The Department's Working Capital Fund (WCF) is a fee-for-service fund that is fully reimbursable. The WCF provides a variety of support services primarily to the Department's components, and to other Federal entities. The WCF operates on a revolving fund basis, whereby current-operating expenses charged to the customer finance the cost of goods and services. The overall financial goal of the fund is to fully cover the operating expenses while building a minimal capital improvement reserve.

The USCG Yard revolving fund (Yard Fund) finances the industrial operations at the USCG Yard in Curtis Bay, Maryland and other USCG industrial sites. The USCG Supply revolving fund (Supply Fund) finances the procurement of uniform clothing, commissary provisions at USCG dining facilities, general stores, technical material and fuel for vessels over 180 feet in length.

See accompanying Independent Auditors' Report.
Required Supplementary Information

RISK ASSUMED INFORMATION

The Department has performed an analysis of the contingencies associated with the unearned premium reserve for the National Flood Insurance Program (NFIP). That analysis shows unearned premium reserve is greater than the combined values of (i) the estimated present value of unpaid expected losses and (ii) other operating expenses associated with existing policy contracts. Therefore, the Department can state the unearned premium reserve will be adequate to pay future losses and other operating expenses associated with existing policy contracts. However, there is a remote chance that the volume of flood losses in the next year could exceed the unearned premium reserve.

Our estimate of the present value of unpaid expected losses is based on a loss ratio (losses to premium), which is then multiplied by the current unearned premium reserve. This loss ratio is derived from the NFIP actual historical premium, historical losses and historical mix of business, each adjusted to today's level. More specifically, historical premiums have been adjusted to reflect the premium levels of the present by making adjustments for historical rate changes and historical changes in coverage amounts. Historical losses have been adjusted for inflation, using inflation indexes such as the Consumer Price Index as well as chain price indexes, to reflect the values that historical losses would settle as if they were settled today. In addition, the historical mix of business is adjusted to reflect today's mix of business. Examples of how the historical mix of business includes proportionately fewer pre-firm policies versus post-firm policies are in force today. Also, there are proportionately more preferred risk policies in force than in past years.

See accompanying Independent Auditors' Report.
Required Supplementary Information

Required Supplementary Stewardship Information (unaudited)

HERITAGE ASSETS

USCG and CBP maintain heritage assets, located in the United States, including the commonwealth of Puerto Rico. Heritage assets are property, plant and equipment that have historical or national significance; cultural, educational, or artistic importance; or significant architectural characteristics. Heritage assets are generally expected to be preserved indefinitely. Multi-use heritage assets have more than one purpose such as an operational purpose and historical purpose.

The following table summarizes activity related to Heritage Assets for the fiscal years ended September 30, 2005 and 2004 (in number of units).

	2005 (unaudited)			2004 (unaudited)		
	USCG	CBP	Total	USCG	CBP	Total
Beginning Balance	19,930	4	19,934	19,619	4	19,623
Additions	599	-	599	516	-	516
Withdrawals	(275)	-	(275)	(205)	-	(205)
Ending Balance	20,254	4	20,258	19,930	4	19,934

USCG possesses artifacts that can be divided into four general areas: ship's equipment, lighthouse and other aids-to-navigation items, military uniforms and display models. The addition of artifacts is the result of gifts to USCG.

- Ship's equipment is generally acquired when the ship is decommissioned and includes small items such as sextants, ship's clocks, wall plaques, steering wheels, bells, binnacles, engine order telegraphs and ship's name boards. Conditions will vary based upon use and age.
- Aids-to-navigation items include fog and buoy bells, lanterns, lamp changing apparatus and lighthouse lenses. Buoy equipment is usually acquired when new technology renders the equipment obsolete. Classical lighthouse lenses can vary in condition. The condition is normally dependent on how long the item has been out of service. The lenses go to local museums or USCG bases as display items.
- Military uniforms are generally donated by retired USCG members and include clothing as well as insignia and accessories. Most clothing is in fair to good condition, particularly full dress items.

See accompanying Independent Auditors' Report.
Required Supplementary Information

- Display models are mostly of USCG vessels and aircraft. These are often builders' models. Display models are generally in very good condition. Builders' models are acquired by USCG as part of the contracts with the ship or aircraft builders. The withdrawal of display models normally results from excessive wear.

The USCG also has non-collection type heritage assets, such as sunken vessels and aircraft under the property clause of the *U.S. Constitution*, Articles 95 and 96 of the *International Law of the Sea Convention* and the sovereign immunity provisions of *Admiralty* law. Despite the passage of time or the physical condition of these assets, they remain Government-owned until the Congress of the United States formally declares them abandoned. The USCG desires to retain custody of these assets to safeguard the remains of crew members who were lost at sea, to prevent the unauthorized handling of explosives or ordnance which may be aboard and to preserve culturally valuable relics of the USCG's long and rich tradition of service to our Nation in harm's way.

Buildings and Structures - USCG does not acquire or retain heritage buildings and structures without an operational use. Most real property, even if designated as historical, is acquired for operational use and is transferred to other government agencies or public entities when no longer required for operations. Of the USCG buildings and structures designated as heritage, including memorials, recreational areas and other historical areas, over two-thirds are multi-use heritage. The remaining are historical lighthouses, which are no longer in use and awaiting disposal; their related assets; and a gravesite. CBP also has four multi-use heritage assets located in Puerto Rico. All multi-use heritage assets are reflected on the Consolidated Balance Sheet. Financial information for multi-use heritage assets is presented in the principal statements and notes. Deferred maintenance information for heritage assets and general PP&E is presented in the required supplementary information.

STEWARDSHIP INVESTMENTS

Due to the transformational nature of DHS Programs, stewardship investments information is presented only for fiscal year 2005. Stewardship investments are substantial investments made by the Federal government for the benefit of the nation. When incurred, they are treated as expenses in calculating net cost, but they are separately reported as Required Supplementary Stewardship Information (RSSI) to highlight the extent of investments that are made for long-term benefit. Fiscal year 2005, investment amounts reported below are an allocation of gross cost based on program outlays.

Summary of Stewardship Investments (in millions)

Programs	Non-Federal Property	Human Capital	Research and Development
SLGCP – First Responders Programs	$ -	$29	$320
S&T – Research and Development Programs	-	-	543
Total	**$ -**	**$29**	**$863**

See accompanying Independent Auditors' Report.
Required Supplementary Information

INVESTMENTS IN HUMAN CAPITAL

These investments include expenses incurred for programs for education and training of the public that are intended to increase or maintain national productive capacity and that produce outputs and outcomes that provide evidence of maintaining or increasing national productive capacity. Based on a review of the Department's programs, SLGCP has made significant investments in Human Capital.

SLGCP

First Responders Training Programs: In fiscal year 2005, SLGCP provided various training initiatives to improve the knowledge, skills, and abilities of first responders for prevention, response, and recovery. Highlights of performance information include:

SLGCP

First Responders Training Programs

Program	Performance Measure	FY 2005 Target	FY 2005 Results
State and Local Training	Average percentage increase in Weapons of Mass Destruction (WMD) and other knowledge, skills, and abilities of state and local homeland security preparedness professionals receiving training from pre and post assessments.	37%	38.5%
State and Local Training	Percent of jurisdictions demonstrating acceptable performance on applicable critical tasks in exercises using SLGCP approved scenarios.	23%	40%
State and Local Training	The number of state and local homeland security preparedness professionals trained each year.	350,000	487,414

See accompanying Independent Auditors' Report.
Required Supplementary Information

INVESTMENTS IN RESEARCH AND DEVELOPMENT

These investments represent expenses incurred to support the search for new or refined knowledge and ideas and for the application or use of such knowledge and ideas for the development of new or improved products and processes with the expectation of maintaining or increasing national productive capacity or yielding other future benefits. Based on a review of the Department's programs, SLGCP and S&T have made significant investments in Research and Development.

SLGCP

First Responder Research and Development Programs: In fiscal year 2005, SLGCP supported initiatives that improved processes or capabilities of the nation's first responders for prevention, response, and recovery. Highlights of performance information include:

SLGCP

First Responders Research and Development Programs

Program	Performance Measure	FY 2005 Target	FY 2005 Results
National Exercise Program	Percent of jurisdictions demonstrating acceptable performance on applicable critical tasks in exercises using SLGCP approved scenarios.	23%	40%
National Exercise Program	Percentage of action items identified in After-Action Reports (AAR) that were implemented.	41%	7%
State Preparedness Grants Program	Percent of jurisdictions demonstrating acceptable performance on applicable critical tasks in exercises using State SLGCP approved scenarios.	23%	40%
State Preparedness Grants Program	Percent of state and local homeland security agency grant recipients reporting measurable progress towards identified goals and objectives to prevent and respond to terrorist attacks.	50%	35%
Urban Areas Security Initiative	Percent of jurisdictions demonstrating acceptable performance on applicable critical tasks in exercises using SLGCP approved scenarios.	Baseline	40%
Urban Areas Security Initiative	Percent of participating urban area grant recipients reporting measurable progress made towards identified goals and objectives to prevent and respond to terrorist attacks.	50%	8%
Technical Assistance	Percent of weaknesses addressed by Technical Assistance in fulfillment of strategic goals to prepare, prevent, and respond to terrorism incidents in the State Strategies each year.	85%	87%

See accompanying Independent Auditors' Report.
Required Supplementary Information

S&T

Research and Development Programs: In fiscal year 2005, S&T sponsored several research and development programs to advance the science and intellectual capacity needed to support the Department's mission. Highlights of performance information include:

S&T

First Responders Research and Development Programs

Program	Performance Measure	FY 2005 Target	FY 2005 Results
Radiological & Nuclear Countermeasures	Progression on planned capability development for Nuclear Incident Management and Recovery.	Demonstrate two advanced detection technologies.	Demonstrated two advanced detection technologies.
Threat and Vulnerability, Testing Assessments	Improvement in the national capability to assess threats and vulnerabilities to terrorist attacks: 10 categories to be assessed.	7	7
Cyber Security	Development of research infrastructure to provide broad-based support to government/university/private sector research communities, through development and support of a cyber security test bed and cyber security data sets collection and dissemination program.	Prepare demonstration of operational use of cyber security test bed	Multiple demonstrations
Explosives Countermeasures	Number of pilot tests of standoff detection technologies.	One rail environment to detect suicide bombs	One rail environment
Rapid Prototyping	Percent of technologies prototyped or commercialized.	3%	11%
Standards	Establish technical standards and test/evaluation protocols for weapons of mass destruction decontamination technologies and analysis tools. 2) Establish and accredit a network of private/public labs to perform testing, evaluation, and certification of weapons of mass destruction emergency response technologies to allow effective procurement and deployment of technologies that will substantially reduce risk and enhance resiliency of the federal, state, and local response capability.	Develop technical standards and test/evaluation protocols for WMD decontamination technologies. Develop a network of private/public labs to perform testing, evaluation and certification of WMD emergency response technologies.	Technical standards and test/evaluation protocols were developed. A network of private/public labs to perform testing, evaluation and certification of WMD emergency response technologies was developed.

See accompanying Independent Auditors' Report.
Required Supplementary Information

S&T

First Responders Research and Development Programs

Program	Performance Measure	FY 2005 Target	FY 2005 Results
Biological Counter-measures	Improved capabilities to detect threats in urban areas (Urban Monitoring Program)	Increase coverage in top 10 threat cities.	Coverage was increased in top 10 threat cities.
Counter Man-Portable Air Defense System (MANPADS)	Number of effective technology/technologies for commercial aircraft to defeat man-portable anti-aircraft missiles identified. Technologies identified, and prototypes developed and tested.	2 (estimate)	2
University Programs	Number of scholars and fellows supported and number of University Centers of Excellence.	200/4	300/4
Chemical Counter-measures	Development of protocols for the highest priority toxic industrial chemicals (TICs) and toxic industrial materials (TIMs).	Protocols Developed	Development of a prototype mobile laboratory capable of on-site, high through-put analysis of TICs and CWAs was completed and the candidates characterized in field test. An initial evaluation of the risks, vulnerabilities, and consequences due to attacks using the TIC cyanide was initiated.
Interoperability & Compatibility	Improve emergency response interoperability and compatibility to strengthen public safety preparedness and response.	Develop criteria	Criteria not developed

See accompanying Independent Auditors' Report.
Required Supplementary Information

Other Accompanying Information (unaudited)

TAX BURDEN/ TAX GAP

The Compliance Measurement (CM) Program was initiated in fiscal year 1995 for the purpose of collecting objective statistical data to determine the compliance level of commercial imports with U.S. trade laws, regulations, and agreements, and to estimate the revenue gap. CM data is also used in risk management decisions to identify high-risk areas and measure the effectiveness of actions taken to improve compliance in those areas.

The preliminary overall trade compliance rate for fiscal year 2005 is 95%, a significant improvement from 89% percent in fiscal year 1998. With overall compliance at a high level, CBP has been able to emphasize matters of significant trade risk.

In fiscal year 2002, CM methodology and contents were adapted for gathering information to address security issues. The utility of statistical sampling for monitoring many kinds of cross-border activity permits CM to support CBP's priority mission of keeping terrorists and terrorist weapons from getting into the United States, while maintaining its traditional contribution to trade compliance oversight.

In fiscal year 2004, CM exam report requirements were further expanded to capture data pertaining to the 24-Hour Advance Manifest law and, in addition, to report on mismatches between bill of lading and entry summary data.

CBP has also calculated the preliminary fiscal year 2005 revenue gap to be $409 million. The final overall trade compliance rate and estimated revenue gap for fiscal year 2005 will be issued in January 2006. This revenue gap is a calculated estimate that measures our potential loss of revenue due to noncompliance with trade laws, regulations, and agreements using a statistically valid sample of the revenue losses and overpayments detected during Compliance Measurement exams conducted throughout the year.

IMPROPER PAYMENTS

To comply with the requirements of the *Improper Payments Information Act of 2002* (IPIA) and related guidance from the Office of Management and Budget (OMB), the Department carried out the next phase of a plan begun in fiscal year 2004, to reduce its susceptibility for issuing improper payments. In fiscal year 2004, the Department completed a risk assessment of major programs. This risk assessment did not identify any programs as at high risk for issuing improper payments. In fiscal year 2005, each component completed statistically significant testing of fiscal year 2004 payments from their largest program (with the exception of FEMA, see below). All major payment types within the largest program were sampled. Estimated error rates and amounts were calculated. As in fiscal year 2004, no program was found to exceed the OMB defined high risk standards of $10 million and 2.5%.

FEMA's IPIA testing differed from other components as this entity faced unique circumstances and findings. FEMA's largest program in terms of fiscal year 2004 disbursements was state grants. This program is difficult to meaningfully test as the Department is not able to force states to complete IPIA compliant payment testing. FEMA's second largest program, the Individuals and Households Program (IHP), was the subject of a Department Office of Inspector General report (OIG-05-20, May 2005). Findings in this report indicated that FEMA's IHP might be at high risk for issuing improper payments. A first round of sample testing of IHP payments was inconclusive. A second round of testing showed that the program is not at high risk for issuing improper payments.

As a result of four Florida and two Gulf Coast hurricanes, FEMA issued a high level of payments in fiscal year 2005. The Department plans on extensively subjecting these payments to IPIA random sample payment testing in fiscal year 2006. If FEMA's programs are found to be at high risk, immediate actions will be taken to quantify the amount of improper payments issued, determine causes, implement corrective actions, and recover funds. The Department's Office of Inspector General has set up a new office which will exclusively examine Hurricane Katrina related payments. Additionally, the General Accounting Office is conducting an audit of purchase card payments, procedures, and controls as part of a government-wide analysis of the Federal response to Hurricanes Katrina and Rita.

Two major changes from fiscal year 2004 occurred as DHS' IPIA compliance program matured. The first change was in the definition of IPIA programs. In fiscal year 2004, an IPIA program was defined by the Future Years Homeland Security Program (FYHSP). FYHSP definitions offered consistent program reporting but proved unsuitable for IPIA sample testing as costs are allocated as a group and are not identified at the transaction level. In fiscal year 2005, DHS changed the definition of a program to Treasury Appropriation Fund Symbol (TAFS). This definition was supported by all component accounting systems at the transaction level. This change was approved by OMB and allowed for ready identification of each component's largest IPIA program.

The second major change to the Department's IPIA compliance program in fiscal year 2005 was the testing of major payment types for each component's largest program (as ranked by fiscal year 2004 disbursed dollars). Fiscal year 2004 program risk scores were based on internal control, human capital, programmatic risk and materiality of operating budget risk factors but did not consider individual payment types. Fiscal year 2005's disbursement dollar driven risk assessment reflects the use of common financial systems and payment processes to support all TAFS within a component. If sample

testing from the largest program showed a payment type to be at high risk for the issuance of improper payments, all TAFS within that component would be tested. As the reporting details show, no major payment type or program produced sizable enough errors to necessitate testing across all TAFS within any component. Major payment types tested included commercial, travel, grant, employee reimbursement, purchase card, and state and local.

Major IPIA programs were defined by exceeding $100 million in non-payroll, non-intergovernmental annual disbursements. Programs issuing fewer disbursements were assumed to be too small to exceed OMB's $10 million of erroneous payments reporting floor. Payroll disbursements were excluded because of their repetitive, stable nature and the extensive internal controls they are subjected to. Intergovernmental payments were excluded as they are internal payments which do not put the Federal Government, as a whole, at risk.

Looking to fiscal year 2006, the Department expects to enter a fully mature phase of its IPIA program. This phase will feature comprehensive component testing of all programs issuing more than $100 million of IPIA covered disbursements, independent payment sample testing, and strengthened internal control audit testing. Finally, extra controls may need to be put in place for components that switch to a new financial system or are restructured.

To further identify and recover improperly disbursed funds and to comply with Section 831 of the *Defense Authorization Act for Fiscal Year 2002*, the Department hired an independent contractor who conducted recovery audit work at two major components, ICE and CBP. This recovery audit work over all fiscal year 2004 disbursements identified more than $2.1 million of improper payments and recovered more than $1.2 million. DHS is considering expanding recovery audit work to other components in fiscal year 2006.

REPORTING DETAILS

I. Risk Assessment Process and IPIA Risk-Susceptible Programs

Risk Assessment Process

The Department uses Treasury Appropriation Fund Symbol (TAFS) to define IPIA programs. Within a component, the same financial systems and payment processes are shared across TAFS. This sharing of systems and people means that sample testing of the largest TAFS provides good risk assessment information on smaller TAFS. An exception would be a TAFS that had some unique payment process that was not tested under the largest TAFS. Each component tested their largest TAFS and calculated the resulting error amounts and rates. This information was used to judge the risk to smaller TAFS. All risk assessments were component self-assessed.

Independently assessed data came from two sources. In the second half of the year at CBP and ICE, Horn & Associates Inc. carried out contract recovery audit work. This work has supported the conclusions reached in the component self-assessments. In May of 2005, the Department's Office of Inspector General (OIG) issued report OIG-05-20, *Audit of FEMA's Individuals and Households Program (IHP) in Miami-Dade County, Florida, for Hurricane Frances*. This report listed improper payment findings including problems with training of key personnel, estimation and verification of losses, and payment system edits. Though some of these problems were unique to the multi-hurricane ravaged condi-

tions which occurred in Florida, many findings applied nationally. The findings listed in the report and an inconclusive first round of IPIA sample payment testing resulted in a second, roughly three times larger, second round of sample testing for the FEMA program. This second round of testing found that the IHP did not exceed OMB's $10 million and 2.5% thresholds for fiscal year 2004 disbursements.

IPIA Risk-Susceptible Programs

The Department has no programs which had improper payment information formerly reported under Section 57 of OMB Circular A-11. The Department has no programs which tested as at high risk for the issuance of improper payments based on sample testing of fiscal year 2004 disbursements.

At year-end, recovery audit contractor testing at ICE identified more than $2.1 million dollars and at CBP less than $50,000 of erroneous fiscal year 2004 payments across all programs. The recovery audit at ICE is mostly complete. An examination of telephone bills is estimated to yield around $1 million dollars in further erroneous payments. Significant recovery audit work at CBP remains. The $50,000 erroneous payment finding should be treated as a low estimate and not a final estimate. These audit recovery results are consistent with the self-assessed finding by ICE and CBP that their largest programs are not at high risk for issuing improper payments.

The majority of problems described in the OIG report on FEMA's Individuals and Households Program (IHP) pertain to fiscal year 2005 issued payments. FEMA has implemented many corrections suggested in the report. The IHP will continue to receive close IPIA related scrutiny and undergo independent payment review in fiscal year 2006. To date, sample payment testing has not shown the program to be at high risk for improper payments.

II. IPIA Statistical Sampling Process

Each component, except FEMA for reasons described earlier, identified their largest program based on the amount of fiscal year 2004 disbursements issued, excluding payroll and intergovernmental payments. If the largest program issued at least $100 million of non-excluded payments, the component completed a sampling for each major payment type. Per OMB Guidance, sample sizes were at least 126 payments supporting at a 90% confidence interval error rates up to 5.5%. Major payment types tested included: travel, employee reimbursements, commercial payments, grants, and contracts.

The projected error rate was the actual error rate from the sample. The projected error amount was the actual error amount multiplied by the disbursement population total divided by the sample disbursement total rounded. Thus, for example, if 2% of all disbursement dollars were sampled, the projected error amount for that TAFS was 50 times the actual error amount from the sample rounded. Any programs or segments found to issue anywhere near the $10 million and 2.5% OMB defined IPIA reporting thresholds had to either complete a larger, more precise sample or develop and implement corrective action plans with out year estimates of progress. Errors below $10 were ignored so long as, collectively, they did not exceed $100.

III. Corrective Action Plans

The lack of an identified high risk IPIA program meant that no formal corrective action plans were requested or completed by any component.

FEMA did implement several of the recommendations from the DHS OIG report on the Individuals and Households Program. Implemented corrections included: improving inspection guidelines, overhauling loss calculation methodology, improving loss documentation standards, ensuring that inspectors do not live in inspection areas, and improving pre- and post-payment financial system edits.

IV. Sample Test Results

All sample sizes were 126 except for FEMA's 2nd round of testing which had a sample size of 400. The OIG and FLETC did not have a TAFS program which exceeded $100 million in IPIA eligible fiscal year 2004 disbursements. Consequently, these two components did not perform IPIA sample payment testing.

Component	TAFS	Payment Type	% Error Rate (by $'s)	Sample Error Amount	Disbursement Total for Type	Projected Error Amount
CBP	70X0503	Commercial	0.0%	$1,382	$481,500,000	$84,900
	70X0503	Travel/Employee Reimbursements	0.1%	$347	$30,900,000	$26,100
FEMA	70X0702	Travel	0.1%	$229	$70,300,000	$69,900
	70X0702	Commercial	0.0%	$0	$262,300,000	$0
	70X0702	IHP (1st round)	3.5%	$5,100	$886,200,000	$31,321,000
	70X0702	IHP (2nd round)	0.8%	$3,976	$886,200,000	$6,986,000
ICE	7040540	Contract	0.2%	$6,264	$359,100,000	$753,900
	7040540	Travel/Employee Reimbursements	5.3%	$3,575	$48,000,000	$2,550,000
	70X5088	Contract	0.1%	$7,559	$254,400,000	$150,400
SLGCP	70X0511	Grant	0.0%	$0	$570,500,000	$0
	70X0511	Commercial	0.0%	$257	$51,800,000	$300
TSA	70X0550	Contract	0.7%	$59,403	$485,500,000	$3,300,000
	70X0550	Travel	1.3%	$5,672	$63,700,000	$842,000
USCG	7040610	Contract	0.0%	$0	$321,000,000	$0
	7040610	Travel	0.8%	$446	$134,000,000	$1,000,000
	7040610	All Other	0.0%	$0	$221,000,000	$0
USSS	70X0400	DC Pension	0.0%	$0	$126,000,000	$0
	7040400	Commercial	0.0%	$0	$110,000,000	$0

V. Recovery Audit Efforts

Recovery audit contract work is underway at ICE and CBP. The contractor is Horn & Associates, Inc. All fiscal year 2004 payments are under review. No payment groups are excluded. Collection efforts are carried out by component staff after the contractor has identified a set of payments as improper

and component staff have concurred. Collections efforts center on letters stating the facts behind each improper payment and demanding repayment.

An analysis of ICE improper payments has identified the following sources of error: human error, receipt of original invoices followed by faxed copies from program offices, multiple payment databases, and inadequate systems validations. All of these issues are currently being addressed by ICE management. CBP is too early in the recovery audit to meaningfully identify error patterns.

Component	Amount Subject to Review	Actual Amount Reviewed and Reported	Amounts Identified for Recovery	Amount Identified/ Actual Amount Reviewed	Amounts Recovered CY	Amounts Recovered PY(s)
ICE	$2,006,600,000	$2,006,600,000	$2,157,000	$1,700,000,000	$1,200,000	$0
CBP	$1,225,700,000	$1,225,700,000	$34,000	$777,000	$7,000	$0

VI. Holding Management Accountable

Supporting the President's Management Agenda (PMA) is a critical financial management goal of the Department. The Under Secretary for Management oversees implementation of the PMA and reports regularly to the Secretary. Given quarterly grading by OMB under the Erroneous Payments PMA Program Initiative, management is constantly under pressure to demonstrate progress in stopping and recovering improper payments.

VII. Information Systems Support

The Department has not set formal improper payment reduction targets as no program has been identified as at high risk for issuing improper payments. Components, particularly FEMA, have been successful in implementing improved improper payment edits using their existing financial systems. No specific IPIA related financial systems requests have been made to Congress.

VIII. Regulatory Barriers Which May Limit Corrective Action Plan Implementation

This standard is not yet applicable to the Department as there are no IPIA corrective action plans to limit.

IX. Additional Comments

In fiscal year 2005, the Department succeeded in carrying out improper payment sample payment testing on each component's largest program. The results indicate that though several million dollars of improper payments are issued each year, no program exceeds the OMB defined IPIA reporting thresholds of $10 million dollars and 2.5%. This testing consisted primarily of component self-assessments supplemented by independent review by the DHS Office of Inspector General and a recovery audit contractor. In fiscal year 2006, the Department will expand the use of independent review and expects to become fully IPIA compliant.

EFFECTS OF HURRICANES KATRINA AND RITA

The devastating effect of the Hurricanes Katrina and Rita on the Gulf States was unparalleled in recent history. The loss of life and property were unimagined until this time. The U.S. Government proceeded to create two supplemental appropriations for the Federal Emergency Management Agency totaling $60 billion to meet immediate needs arising from the consequences of Hurricane Katrina for fiscal year ending September 30, 2005, and for other purposes. The main DHS components to be affected by the hurricane are FEMA and the USCG. Other components that had minor costs related to Katrina were CBP, TSA and ICE.

FEMA

These appropriations included $100 million that has been transferred to the Emergency Preparedness and Response, Public Health Programs and $15 million that has been transferred to the Departmental Management and Operations, Office of Inspector General. In October 2005, Public Law 109-88 provided that $750 million of these funds is to be transferred to the Disaster Loan Program. In fiscal year 2005, FEMA obligated $15.8 billion and expended $3.5 billion of these appropriated funds.

Disaster Relief Fund
Statement of Budgetary Resources (in millions)

Budgetary Resources	
Budget Authority	$68,542
Net Transfers, current year	(115)
Unobligated balance, brought forward	713
Recoveries of prior year obligations	548
Total Budgetary Resources	$69,688
Status of Budgetary Resources	
Obligations Incurred, Direct	$23,159
Unobligated balance, available	46,358
Unobligated balance, unavailable	171
	$69,688
Obligated balance, net Oct 1	$6,385
Obligated balance, net, end of period:	
Accounts Receivable	(1)
Undelivered Orders	16,255
Accounts Payable	895
Obligated balance, net, end of period	$17,149
Outlays	
Disbursements	$11,846

Disaster Relief Emergency Supplemental Appropriations (in millions)

Appropriated (on 9/5/2005)	$10,000
Appropriated (on 9/12/2005)	50,000
Transferred	(115)
Net appropriation	$59,885
Obligated	$15,845
Less: Expended	3,514
Unliquidated obligations at 9/30/05	$12,331

	Obligated	Expended	Unliquidated
Katrina Florida	$13	$1	$12
Katrina Louisiana	8,536	2,405	6,132
Katrina Mississippi	4,348	566	3,782
Katrina Alabama	1,401	97	1,304
Rita Texas	728	229	499
Rita Louisiana	499	173	325
States with Katrina Evacuees	320	43	277

COAST GUARD

Hurricanes Katrina and Rita have resulted in an unprecedented number of oil spills to navigable waters and adjoining shorelines. OSLTF funds have not been expended thus far in response to this disaster. The $255 million in Stafford Act funding for pollution response falls short of the total estimated costs of continued Federal cleanup response, as well as the economic and environmental damage compensation anticipated. The USCG is working with FEMA, EPA and the Department of Homeland Security to ensure either continued availability of Stafford Act funding, or replacement of Stafford Act funding with something similar that shields the OSTLF from Hurricane Katrina and Rita impacts.

Various categories of USCG PP&E assets have suffered damage from Hurricane Katrina along the Gulf Coast. Damage assessments are continuing to be received. Some damage assessments have been completed, and to date have resulted in thirty-three (33) buildings, structures, and general purpose property being destroyed with a total net book value of $886,702. The estimated cost to rebuild or replace these damaged assets is over $14.2 million dollars. Damage assessments are on-going, and as the USCG receives them, additional adjustments to specific assets will be required. In addition to destroyed assets, numerous categories of USCG PP&E buildings and structures ranging from USCG Stations, Air Stations, Aids to Navigation (Range Lights), Storage Buildings, Marine Safety Units, Integrated Support Commands, Sector Commands, Recruiting Offices, other miscellaneous assets have suffered damage, and although operational in some capacity, will require repairs or potential replacement once assessments are complete. The USCG is currently compiling projected resource requirements for all assets affected by Katrina and Rita and will be requesting supplemental funding.