INSPECTOR GENERAL AUDIT REPORT: CONSOLIDATED FINANCIAL STATEMENTS FOR FISCAL YEARS 2003 AND 2002

DEPARTMENT OF TRANSPORTATION

Report Number: FI-2004-031

Date Issued: January 30, 2004

Memorandum

U.S. Department of Transportation
Office of the Secretary of Transportation
Office of Inspector General

Subject: ACTION: Report on Consolidated Financial Statements for Fiscal Years 2003 and 2002, DOT FI-2004-031

Date: January 30, 2004

From: Kenneth M. Mead
Inspector General

Reply to Attn. of: JA-20:x61496

To: The Secretary

I respectfully submit the Office of Inspector General (OIG) report on the Department of Transportation (DOT) Consolidated Financial Statements for Fiscal Years (FY) 2003 and 2002 (see attachment). This report is required by the Chief Financial Officers Act of 1990, as amended by the Government Management Reform Act of 1994.

UNQUALIFIED OPINION

This audit report concludes that DOT's Consolidated Financial Statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles. This is the third fiscal year in a row—2001, 2002, and 2003—in which DOT achieved an unqualified or "clean" opinion. The clean audit opinion signals to users of the financial statements that they can rely on the information presented.

I want to acknowledge the extraordinary efforts made by each of the Operating Administrations, the Department's Office of Financial Management, and KPMG LLP and Clifton Gunderson LLP (contractors we engaged to audit the Federal Aviation Administration (FAA) and the Highway Trust Fund (HTF) financial statements). Also, this clean opinion would not have been possible without your long-standing commitment to improving financial management practices and your guidance to Department officials to take the actions necessary to overcome significant problems encountered this year when the Federal Highway Administration (FHWA) and the Federal Motor Carrier Safety Administration (FMCSA) converted to Delphi, the Department's new accounting system.

In FY 2004, the Department will continue to face significant challenges to complete its financial statements and obtain a clean opinion by the Office of Management and Budget's accelerated reporting date of November 15, 2004. As a result, we all need to focus immediately on implementing corrective actions to ensure that the Department meets the November 15, 2004 reporting date. Ultimately, the financial statement audit should be a routine task that does not divert excessive resources from ongoing financial management activities. This will require significant improvements in the systems, processes, and discipline needed to generate timely and reliable financial statements and the needed improvements are described on pages 3 to 6 of this letter. Implementing these improvements will also provide a solid foundation for more effective day-to-day financial management practices and better tools for ensuring the integrity of financial activities.

In terms of the size of its financial operations, DOT is comparable to several large corporations. In terms of year-end assets, DOT is similar to Chevron-Texaco, Hewlett-Packard, and Microsoft. In terms of year-end liabilities, DOT is similar to Home Depot and Microsoft. In terms of program costs (expenses), DOT is similar to IBM, Boeing, Hewlett-Packard, and Home Depot.

The DOT Consolidated Financial Statements for FY 2003 show year-end assets of about $71 billion, year-end liabilities (debts) of $13 billion, costs of operations (program costs) of $58 billion, and total budgetary resources (available financial resources) of $128 billion. It is important to note that, over the years, DOT has invested billions of dollars to build transportation infrastructure and to improve safety. Because most of those investments were in the form of grants to states and local governments, the resulting assets—highways, transit systems, and airport runways—are not included as assets on DOT's books. In contrast, investments related to the acquisition of property and equipment, such as radars and air traffic control computer systems, are considered DOT assets, and are reflected in the financial statements. The majority of DOT's budgetary resources come from two trust funds, the Highway Trust Fund and the Airport and Airway Trust Fund. Tax collections deposited into those Trust Funds totaled $45 billion during FY 2003 to be used for surface and airway transportation investments.

Comparisons between the FY 2002 and FY 2003 DOT Consolidated Financial Statements need to recognize that both the Transportation Security Administration (TSA) and the U. S. Coast Guard transferred to the Department of Homeland Security on March 1, 2003. Consequently, the financial picture of DOT on September 30, 2003, is very different than it was on September 30, 2002. On March 1, 2003, when they transferred, TSA had a net value (assets less liabilities) of $6.3 billion and Coast Guard had a negative net value of –$14.9 billion. These amounts were off DOT's books entirely on September 30, 2003. However, TSA and Coast Guard financial activities (such as revenues, costs, and budgetary resources) for the first 5 months of FY 2003 are reflected in the DOT financial statements on September 30, 2003. So, for example, $4.6 billion of the $58 billion costs of operations during FY 2003 were incurred by TSA and Coast Guard.

INTERNAL CONTROLS

Extraordinary effort by DOT employees and the auditors were required to obtain this unqualified opinion. In particular this year, the HTF agencies,[1] the Department's Office of Financial Management, and the auditors had to overcome significant financial management and accounting deficiencies in order to generate auditable financial

[1] Federal Highway Administration (FHWA), National Highway Traffic Safety Administration (NHTSA), Federal Transit Administration (FTA), Federal Railroad Administration (FRA), Federal Motor Carrier Safety Administration (FMCSA), and the Bureau of Transportation Statistics (BTS).

information and complete the audit on time. This year, FAA generated its financial statements from the old DOT accounting system. Due to the manual adjustments necessary to prepare auditable financial statements, FAA did not provide complete financial statements to DOT for consolidation until November 14, 2003. FAA converted to Delphi in November 2003, and an effective transition to the new system will be critical to meeting next year's November 15, 2004 reporting date.

We categorized these problems into four material weaknesses and five reportable conditions. Responding to a draft of this report, DOT agreed with these findings and committed to take timely corrective action. On December 30, 2003, as required by the Federal Managers' Financial Integrity Act of 1982, the Secretary of Transportation also reported the four material weaknesses to the President and Congress.

Material Weaknesses

Material weaknesses are deficiencies in the design or operation of internal controls that do not reduce, to a relatively low level, the risk that significant errors, fraud, or noncompliance could occur and not be detected by employees in the normal course of performing their duties.

- **Information Security Program.** In September 2003, we issued our third annual report on DOT's Information Security Program as required by the Federal Information Security Management Act. DOT has made significant progress in protecting its systems against external attacks through the Internet. However, DOT is still behind in protecting its systems against internal attacks from employees, contractors, grantees, and industry associations. DOT must also do more to complete background checks on contractor employees performing sensitive work and to enhance contingency planning to ensure business continuity in an emergency. The Department has committed to correct these problems and is taking actions to do so.

- **Cost-Reimbursable Contracts at the Federal Aviation Administration (FAA).** We previously reported that FAA's management and oversight of billions of dollars of cost-reimbursable contracts, which have few inherent protections against cost overruns or improper payments for unallowable costs, were not adequate to ensure that the Government's interests were protected. FAA records indicate that over $15 billion worth of cost reimbursable contracts are active. Although FAA has made significant progress closing out completed cost-reimbursable contracts, about $3.4 billion worth of completed contracts remain to be closed. FAA needs to complete the closeout of cost-reimbursable contracts, ensure that it obtains appropriate audits for all active contracts, and strengthen the processes it uses to award and monitor cost-reimbursable contracts.

- **Financial Management and Reporting for Highway Trust Fund Agencies**. Material deficiencies exist in internal controls over financial management and reporting activities in the HTF agencies. HTF agencies lack adequate accounting and financial management policies and procedures. To illustrate, most HTF agencies did not routinely reconcile their accounts during the year, a basic management practice. Problems caused by these long-standing deficiencies were compounded this year because two major HTF agencies (FHWA and

FMCSA) had not adequately planned or implemented their conversions to Delphi in February 2003. In particular, because these agencies did not correct bad data from the old system before converting to the new system, many transactions were either processed incorrectly or rejected by the new system. Without major improvements in accounting policies and procedures at all HTF agencies, the FY 2004 financial statements may not be completed by the Office of Management and Budget's deadline of November 15, 2004. HTF agencies and DOT officials have recognized the significance of these deficiencies and have committed to take timely corrective actions.

- **Reconciling Transactions With Other Federal Agencies (Intra-governmental Transactions).** DOT has not implemented effective processes to reconcile its transactions with other Federal agencies. This problem occurs, for example, when FAA performs reimbursable work for the Department of Defense. To prepare reliable Government-wide financial statements, these transactions, which are internal to the Federal Government, must be tracked and eliminated. The General Accounting Office has reported that Federal agencies' inability to account for these transactions properly is a major impediment to a clean audit opinion on the Consolidated Financial Report on the United States. During FY 2003, some DOT agencies partially confirmed or reconciled their transactions with other Federal agencies, but most did not. DOT's asset, liability, and revenue balances included more than $4.5 billion of transactions with other Federal agencies in FY 2003. DOT has agreed to implement reconciliation procedures to correct this problem.

Reportable Conditions

Reportable conditions in internal controls, although not considered material weaknesses, represent significant deficiencies in the design or operation of internal controls that could adversely affect the DOT consolidated financial statements.

- **Delphi Computer Security.** In September 2003, we issued a report regarding the computer security and controls over DOT's new financial management system, Delphi. To achieve its full potential, DOT needs to enhance security and controls over Delphi operations. We also found that important security measures had not been implemented or enforced, system changes were not properly tested, and contingency planning was not adequate. DOT has agreed to correct the deficiencies and has begun to do so.

- **Financial Management Reviews of Grantees, FHWA.** FHWA frequently did not perform financial management reviews of grantees. FHWA relies on its Division Offices to periodically schedule and perform financial management reviews of grantees. However, Clifton Gunderson identified 25 instances when FHWA Divisions did not conduct financial reviews of grantees. One consequence of the lack of financial management reviews is the existence of unneeded obligations that could be used more productively on active projects. Preliminary results from our review of inactive obligations identified hundreds of millions of dollars of unneeded obligations that should be deobligated so the funds can be used on other active projects. This is especially important at a time of budget constraints.

- **Property, Plant and Equipment, FAA.** FAA has made substantial progress correcting material weaknesses in its controls over property, plant, and equipment. However, the value of these assets at September 30, 2003 was $13.4 billion, and FAA does not yet fully adhere to established policies and procedures to ensure its property, plant, and equipment accounts were properly reported. To illustrate, during FY 2003, FAA's property system was unable to communicate with the accounting system. This increased the likelihood of errors and required FAA to reconcile differences between the systems manually. Further, FAA had not implemented adequate controls to prevent errors when calculating property values and to record new assets in a timely manner. FAA agreed to implement recommendations to correct these problems.

- **Financial Management Practices, the Maritime Administration (MARAD).** MARAD needs to establish policies and procedures to ensure that its inventory, property, and environmental liabilities are reported properly. For example, we found that some new inventory purchases were not recorded and some inventory was incorrectly priced. On a related issue—MARAD's implementation of the Title XI loan guarantee program—we previously reported that MARAD needs to improve its oversight of the loan-application process; borrowers; vessels and shipyards constructed under loan guarantees; and foreclosed assets. MARAD is in the process of implementing our recommendations to improve its Title XI oversight processes. In this report, we are recommending that MARAD improve the accounting for inventory, property, and environmental liabilities.

- **Accounting for Loans in Delphi.** DOT needs to improve the accounting for loans receivable in Delphi. The new DOT accounting system, Delphi, does not include a module or subsidiary ledger system to accurately account for loans receivable, valued at more than $1 billion on September 30, 2003. FRA, FHWA, and MARAD recorded loan activity directly in the Delphi general ledger, and relied on information from outside the accounting system (such as commercial banks), for detailed loan transactions. In addition, FRA and FHWA did not routinely reconcile their recorded loan balances. We are making a recommendation to DOT to establish a module or subsidiary ledger system in Delphi to improve the accounting for loans receivable and permit routine reconciliations of loan balances.

Compliance with Laws and Regulations

Our tests of DOT's compliance with laws and regulations identified instances where DOT could improve its compliance with the following laws.

- **The Federal Financial Management Improvement Act of 1996 (FFMIA).** Because several large Operating Administrations had not completely implemented DOT's new accounting system, which is designed to comply with Federal standards, DOT did not meet FFMIA requirements to use a single integrated financial management system that substantially complies with Federal system requirements, Federal accounting standards, and the standard general ledger. DOT expects to meet these requirements when the Delphi system is fully implemented during FY 2004. When it completes this conversion, DOT expects to be the first cabinet level agency to have implemented, Department-wide, a commercial-off-the-shelf financial management system that meets Federal financial management system requirements.

- **The Anti-Deficiency Act.** Two instances of noncompliance with the Anti-deficiency Act were identified at FAA. One potential instance was identified at FHWA. In addition, two instances reported in 2002 have not been fully resolved.

- **The Federal Managers' Financial Integrity Act of 1982 (FMFIA).** HTF agencies have not fully implemented formal procedures to identify, assess, and monitor management controls over programs and resources, including financial information systems, as required by FMFIA.

- **The Single Audit Act.** DOT has not effectively implemented certain provisions of the Single Audit Act, including tracking the receipt of single audit reports, distributing the reports in a timely manner, and making timely management decisions to address report recommendations. DOT has agreed to take action to improve its implementation of the Single Audit Act.

This report includes two new recommendations to improve financial management practices in MARAD and loan accounting in Delphi. We provided a draft of this report to the Acting DOT Assistant Secretary for Budgets and Programs, who concurred with the findings and agreed to implement the recommendations. DOT and its Operating Administrations have initiated corrective actions to address the internal control and compliance issues identified by KPMG and Clifton Gunderson in their reports.

We appreciate the cooperation and assistance of DOT, KPMG, and Clifton Gunderson representatives. If we can answer any questions, please call me at (202) 366-1959, or Ted Alves, Assistant Inspector General for Financial and Information Technology Audits at (202) 366-1496.

Attachment

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DEPARTMENT OF TRANSPORTATION
INSPECTOR GENERAL'S INDEPENDENT AUDIT REPORT
ON THE DEPARTMENT OF TRANSPORTATION
CONSOLIDATED FINANCIAL STATEMENTS
FOR FISCAL YEARS 2003 AND 2002

To the Secretary

The Department of Transportation (DOT), Office of Inspector General (OIG), audited the DOT Consolidated Financial Statements and accompanying notes as of and for the years ended September 30, 2003, and September 30, 2002. In our audit of the DOT Consolidated Financial Statements for Fiscal Years (FY) 2003 and 2002, we found:

- the financial statements are fairly presented, in all material respects, in conformity with U.S. generally accepted accounting principles;

- four material internal control weaknesses concerning DOT's information security program, Federal Aviation Administration's (FAA) oversight of cost-reimbursable contracts, financial management and reporting activities at Highway Trust Fund agencies (HTF Agencies),[1] and DOT's reconciliation of intragovernmental balances; and five reportable conditions concerning Delphi system controls, grants financial management oversight in FHWA, controls over FAA property, financial management practices in Maritime Administration (MARAD), and accounting for loans in Delphi;

- instances of noncompliance with the Federal Financial Management Improvement Act of 1996 (FFMIA), the Anti-Deficiency Act, the Federal Managers' Financial Integrity Act (FMFIA), and the Single Audit Act;

- financial information in the Management Discussion and Analysis was materially consistent with the financial statements, except 19 of 31 performance measures were based on FY 2002 rather than FY 2003 performance data; and

- supplementary and stewardship information was consistent with management representations and the financial statements.

We performed our work in accordance with Government Auditing Standards and Office of Management and Budget (OMB) Bulletin 01-02, Audit Requirements for Federal Financial Statements. The following sections discuss these conclusions. Our audit objectives, scope, and methodology are discussed in Exhibit A. We believe that our audit provides a reasonable basis for our opinion.

[1] Federal Highway Administration (FHWA), National Highway Traffic Safety Administration (NHTSA), Federal Transit Administration (FTA), Federal Railroad Administration (FRA), Federal Motor Carrier Safety Administration (FMCSA), and the Bureau of Transportation Statistics (BTS).

A. UNQUALIFIED OPINION ON FINANCIAL STATEMENTS

In our opinion, the DOT Consolidated Balance Sheet, Statement of Net Cost, Statement of Changes in Net Position, and Statement of Financing; and the Combined Statement of Budgetary Resources, including accompanying notes, present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, the DOT assets, liabilities, and net position; net costs; changes in net position; budgetary resources; and reconciliation of net costs to budgetary obligations as of September 30, 2003, and September 30, 2002.

Under contract with OIG and under our supervision, KPMG LLP (KPMG) audited the financial statements of FAA as of and for the periods ended September 30, 2003, and September 30, 2002. KPMG rendered an unqualified opinion on the FAA financial statements. Also under contract with OIG and under our supervision, Clifton Gunderson LLP audited the financial statements of the Highway Trust Fund as of and for the period ended September 30, 2003. Clifton Gunderson rendered an unqualified opinion on the Highway Trust Fund financial statements. We audited the financial statements of the Highway Trust Fund as of and for the prior period ended September 30, 2002. We performed a quality control review of the work performed by KPMG and Clifton Gunderson and relied on their results in performing our work on the FY 2003 DOT Consolidated Financial Statements.

As discussed in Note 21, DOT restated the FY 2002 Statement of Budgetary Resources during the current year to reflect properly the amount and composition of Total Budgetary Resources. Clifton Gunderson audited these adjustments and concluded that they were appropriate and properly applied. We agree that the adjustments were appropriate and have been properly applied.

B. CONSIDERATION OF INTERNAL CONTROLS

In planning and performing our audit, we considered DOT's internal controls over financial reporting and compliance with laws and regulations. We do not express an opinion on internal controls and compliance because the purpose of our work was to determine our procedures for auditing the financial statements and to comply with OMB Bulletin 01-02 audit guidance, not to express an opinion on internal controls.

For the controls we tested, we found four material weaknesses. A material weakness is a condition 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 errors, fraud, or noncompliance that would be material to the financial statements, may occur and not be detected promptly by employees in the normal course of performing their duties. Our internal control work would not necessarily disclose all material weaknesses or reportable conditions.

Our work also identified five reportable conditions in internal controls over financial reporting. Reportable conditions in internal controls, although not considered material weaknesses, represent significant deficiencies in the design and operation of internal controls, which could adversely affect the DOT Consolidated Financial Statements.

Material Weaknesses

On December 30, 2003, as required by the Federal Managers' Financial Integrity Act of 1982, the Secretary of Transportation reported these four material weaknesses to the President and Congress. The following sections describe the material weaknesses that we identified.

DOT Information Security Program

In September 2003, we issued our third annual report on DOT's Information Security Program as required by the Federal Information Security Management Act. We found that despite the Department's significant progress toward improvement, the Department's information security program remains a material weakness. The Department's most noteworthy improvement was in protecting its computer systems from attack by outsiders, especially from the Internet. However, the Department still has a long way to go in securing its computer systems from unauthorized access by more than 60,000 insiders—employees, contractors, grantees, and industry associations. Unauthorized access to DOT information systems could jeopardize the integrity of financial information.

Specifically, we found over 260 telephone line (dial-up) computer connections that were not authorized; security certification reviews did not exist for 67 percent (421 out of 630) of DOT systems; support did not exist for security cost estimates for some major computer system investments; security certification reviews for some critical air traffic control systems were inadequate; background checks were not conducted on 45 percent of the contractor personnel we reviewed; and contingency plans did not exist for 73 percent (463 out of 630) of DOT systems. The Secretary has established a goal to have 90 percent of DOT computer systems reviewed and certified for security purposes by July 2004. During their tests of internal controls, KPMG and Clifton Gunderson also identified material weaknesses in general and application controls, including business continuity and disaster recovery plans for financial management systems in FAA and HTF agencies.

In addition, DOT needs to strengthen its computer system investment review process and have the Investment Review Board play a more proactive role in identifying high-risk investments for review. We made recommendations in separate reports to improve computer security and controls and the investment review process. DOT has agreed to implement those recommendations.

FAA Oversight of Cost-Reimbursable Contracts

In FY 2002, we reported that FAA's management and oversight of billions of dollars of cost-reimbursable contracts, which have few inherent protections against cost overruns or improper payments for unallowable costs, were not adequate to ensure that the Government's interests were protected. Specifically, FAA did not have effective processes in place to request audits of billions of dollars of expenditures, to ensure that reliable cost estimates were prepared and used, or to properly account for billings and expenditures for these contracts.

This year, FAA made significant progress closing out completed cost-reimbursable contracts. Of 459 contracts totaling over $6 billion that had been completed for 3 years or more, FAA closed 279 contracts totaling $2.6 billion. However, to resolve this material weakness, FAA needs to complete the closeout of cost-reimbursable contracts, ensure that it obtains appropriate audits for all active contracts, and strengthen the processes it uses to award and monitor cost-reimbursable contracts.

In a series of reports, we made several recommendations to ensure that FAA significantly improves oversight of its management of cost-reimbursable contracts. FAA has agreed to implement those recommendations. Therefore, we are not making additional recommendations in this report.

HTF Agencies' Financial Management and Reporting Activities

HTF agencies lack adequate accounting and financial management policies and procedures. Problems caused by these longstanding deficiencies were compounded this year because two major HTF agencies (FHWA and FMCSA) had not adequately planned or implemented their conversions to the Department's new accounting system, called Delphi. Without major improvements in accounting policies and procedures at all HTF agencies, the financial statements for FY 2004 may not be completed by the accelerated OMB deadline of November 15, 2004. HTF agencies and DOT officials have recognized the significance of these deficiencies and have committed to take timely corrective actions.

Material deficiencies exist in financial management and reporting activities in HTF agencies. Even though the audit of the FY 2003 financial statements was completed by the January 30, 2004 OMB deadline, the HTF agencies expended a tremendous amount of manual effort to "clean up" their accounting records in order to prepare auditable financial statements as of September 30, 2003. Required accounting processes, including processes to prepare and analyze financial statements and to reconcile accounting transactions, did not operate effectively during the year. These problems were compounded at FHWA and FMCSA because they had not adequately prepared for their February 2003 conversion to the Delphi accounting system.

To illustrate, the process used to generate financial statements is labor-intensive and prone to error. Rather than using the accounting system to prepare financial statements, HTF agencies manually re-enter data generated by the accounting system into spreadsheets to prepare consolidated agency financial statements. This increases the risk of errors and limits resources available to analyze financial statement presentations. Similarly, because HTF agencies did not follow guidance, the statements were not initially prepared in accordance with OMB guidance.

HTF agencies, in particular FHWA, also did not perform many required account reconciliations during the year, including fund balance with Treasury, grants, and non-exchange revenue. To illustrate, rather than reconciling its fund balance with Treasury accounts, FHWA adjusted its general ledger balances to agree with balances reported by Treasury. As a result, in order to assert that the September 30, 2003 balances were reasonably stated, FHWA was required to perform an exhaustive and labor-intensive high-level reconciliation after year-end. Similarly, FTA did not perform grant reconciliations to ensure that it was properly accounting for obligations and expenditures. Unreconciled differences totaled hundreds of millions of dollars at the end of the year.

In addition, FHWA and FMCSA did not adequately plan and implement their conversions to the new DOT accounting system, Delphi. Flaws in the conversion included inaccurate beginning balances; inability to process activity associated with pre-FY 2003 transactions; and inability to post numerous FY 2003 transactions. For example, rather than correcting the errors as they occurred, FHWA maintained the rejected transactions in a temporary file of un-posted transactions.

Clifton Gunderson made a series of recommendations to improve financial management and reporting activities in its financial statement audit report, dated January 13, 2004. DOT agreed to implement the recommendations. Therefore, we are not making additional recommendations in this report.

Reconciling Intragovernmental Balances

DOT has not implemented effective processes to reconcile its transactions with other Federal agencies. During FY 2003, some DOT agencies partially confirmed or reconciled their intragovernmental balances, but most did not. As a result, DOT intragovernmental asset, liability, and revenue amounts totaling more than $4.5 billion were not confirmed or reconciled with the other agencies.

OMB Bulletin 01-09, Form and Content of Agency Financial Statements, requires that reporting entities reconcile intragovernmental asset, liability, and revenue amounts by confirming balances with other agencies. The General Accounting Office (GAO) has also reported that inaccurate accounting and disclosure of billions of dollars of transactions among Federal agencies is a major impediment to a clean audit opinion on the Consolidated Financial Report of the United States. DOT has agreed to implement corrective actions. Therefore, we are not making additional recommendations in this report.

Reportable Conditions

Reportable conditions in internal controls, although not considered material weaknesses, represent significant deficiencies in the design or operation of internal controls that could adversely affect the DOT consolidated financial statements. We identified five reportable conditions related to Delphi computer system controls, grants financial management oversight in FHWA, controls over FAA property, financial management practices in MARAD, and accounting for loans in Delphi.

Delphi Computer System Controls

In September 2003, we issued a report regarding the computer security and controls over DOT's new financial management system, Delphi. To achieve its full potential, DOT needs to enhance security and controls of Delphi operations. We found 35 Delphi users were given authority to perform both payment request and approval functions without any management review, and over 120 unsecured telephone lines could allow intruders to launch attacks on Delphi networks. We also found that critical security measures had not been implemented or enforced, which included over 400 Delphi users who were inappropriately given permission to access sensitive information. In addition, we determined that system changes were not properly tested, and contingency planning was not adequate. Based on the existence and magnitude of these vulnerabilities, we concluded that the control environment for Delphi operations must be improved. Accordingly, we made a total of 17 recommendations to correct the problems. DOT agreed with all findings and recommendations and has initiated or completed corrective actions on all recommendations.

Grants Financial Management and Oversight in FHWA

FHWA frequently did not perform financial management reviews of grantees. FHWA relies on its Division Offices to periodically schedule and perform financial management reviews of grantees. These reviews should address procurement and billing system issues to provide assurance that grant disbursements were properly supported. However, Clifton Gunderson's tests of 45 FHWA grant transactions identified 25 instances where required financial management reviews of grantees were not performed.

One consequence of the lack of financial management reviews is the existence of unneeded obligations that could be used more productively on active projects.

Preliminary results from our review of inactive obligations identified hundreds of millions of dollars of obligations at FHWA that are no longer needed. These amounts should be deobligated, so the funds can be used on other active projects.

Clifton Gunderson made recommendations to improve grants financial management oversight, and we will issue a separate report to FHWA on inactive obligations. Therefore, we are not making additional recommendations in this report.

Controls Over FAA Property, Plant, and Equipment

KPMG audited the FY 2003 FAA financial statements and reported that FAA has made substantial progress correcting material weaknesses in its controls over property, plant, and equipment. KPMG continued to report, however, that FAA did not fully adhere to established policies and procedures to ensure its property, plant, and equipment accounts were properly reported. The value of these assets at September 30, 2003 was $13.4 billion. To illustrate, during FY 2003, FAA's property system was unable to communicate with the accounting system. This increased the likelihood of errors and required FAA to reconcile differences between the systems manually.
KPMG made recommendations to FAA to continue to improve property accounting. FAA agreed and indicated that it expects the problems to be resolved in FY 2004 as it implements the new DOT accounting system Delphi, which has an integrated property subsidiary system.

Improving Financial Management Practices in MARAD

MARAD implemented the new DOT accounting system, Delphi, in June 2003. MARAD now needs to establish policies and procedures to ensure that it reports its inventory, property, and environmental liabilities accounts in accordance with generally accepted accounting principles. These accounts had a value of $1.9 billion as of September 30, 2003.

For example, new inventory purchases were sometimes not recorded or incorrect prices were recorded in subsidiary records. Also, MARAD was not using a work-in-process subsidiary ledger to track and report construction and improvement activity. In addition, since FY 2000, MARAD has used the same estimate per ship for environmental cleanup and decommissioning. To improve the accuracy of environmental liability estimates for future financial reporting, MARAD needs to use actual cost data from ongoing environmental cleanup and decommissioning contracts.

On a related issue, MARAD's implementation of the Title XI loan guarantee program, we previously reported that MARAD needs to improve its oversight of the loan-application process; borrowers; vessels and shipyards constructed under loan guarantees; and foreclosed assets. MARAD is in the process of implementing our recommendations to improve its Title XI oversight processes.

Recommendation 1. We recommend that MARAD establish and implement procedures to improve the accounting for inventory, property, and environmental liabilities.

Accounting for Loans in Delphi

DOT needs to improve the accounting for loans receivable in Delphi. The new DOT accounting system, Delphi, does not include a module or subsidiary ledger system to accurately account for loans receivable, valued at more than $1 billion at

September 30, 2003. FRA, FHWA, and MARAD recorded loan activity directly in the Delphi general ledger, and relied on information from outside the accounting system (such as commercial banks), for detailed loan transactions. In addition, FRA and FHWA did not routinely reconcile their recorded balances. As a result, adjustments were needed to the loans receivable balances in order to prepare the FY 2003 financial statements.

Recommendation 2. We recommend that DOT establish a module or subsidiary ledger system in Delphi to improve the accounting for loans receivable, and require FRA and FHWA to routinely reconcile loans receivable balances.

C. COMPLIANCE WITH LAWS AND REGULATIONS

In planning and conducting our audit, we performed limited tests of DOT's compliance with laws and regulations as required by OMB guidance. It was not our objective to express, and we do not express, an opinion on compliance with laws and regulations. Our work was limited to testing selected provisions of laws and regulations that would be reportable under Government Auditing Standards or under OMB guidance. Our work disclosed the following instances of noncompliance with laws and regulations.

Federal Financial Management Improvement Act of 1996

Under FFMIA, we are required to report whether or not DOT financial management systems substantially comply with: (1) Federal financial management system requirements, (2) applicable Federal accounting standards, and (3) the U.S. Government Standard General Ledger at the transaction level. On January 4, 2001, OMB issued Revised Implementation Guidance for the Federal Financial Management Improvement Act, including factors for determining compliance and responsibilities for auditor reporting.

Clifton Gunderson reported that the HTF agencies did not substantially comply with Federal financial management system requirements, applicable Federal accounting standards, and the Standard General Ledger at the transaction level. For example, the HTF agencies were not able to use the accounting system to prepare reliable and timely financial statements as required by Federal financial management system requirements. Existing financial management deficiencies were compounded during FY 2003 because FHWA and FMCSA did not adequately plan and implement their conversion to Delphi. Similarly, KPMG found that FAA was still using the old DOT accounting system to process and record financial transactions, and that the old system did not comply with Federal financial management system requirements or with the Standard General Ledger at the transaction level. FAA converted to the new DOT accounting system, Delphi, during November 2003.

Clifton Gunderson also reported the HTF agencies were not in compliance with Statement of Federal Financial Accounting Standards (SFFAS) 4, Managerial Cost Accounting Concepts and Standards for the Federal Government, and that HTF financial statements did not fully allocate all costs to programs or measure the cost-effectiveness of programs. KPMG reported that although FAA was producing limited cost accounting data for its Air Traffic Services and Commercial Space Transportation lines of business, it has not fully implemented the managerial cost accounting standard. FAA has been developing its cost accounting system for 7 years, at a cost of $44 million. FAA recently reorganized, which will affect how it implements the cost accounting system. FAA needs to complete its cost accounting system for all lines of business, including implementing a labor distribution system.

With FAA's November 2003 conversion to Delphi, all DOT entities now use the Delphi accounting system. Delphi is designed to produce financial statements, as well as cost accounting information. DOT still needs to implement cost accounting standards and prepare a compliant Statement of Net Cost by September 30, 2004. DOT's goal is to be compliant with cost accounting standards by July 2004. When it completes this conversion, DOT expects to be the first cabinet level agency to have implemented, Department-wide, a commercial-off-the-shelf financial management system that meets Federal financial management system requirements.

Anti-deficiency Act

Title 31, United States Code, Section 1517 provides that an officer or employee of the U.S. Government may not make or authorize an expenditure or obligation exceeding an amount available in an allotment.

Two instances of noncompliance with the Anti-deficiency Act were identified at FAA. One potential instance was identified at FHWA. In addition, two instances reported in 2002 have not been fully resolved. DOT has reported the two prior instances as required, plans to report the two FAA instances, and is researching the FHWA instance to determine whether a violation actually occurred.

Federal Managers' Financial Integrity Act

The HTF agencies did not have formal procedures in place to identify, assess, and monitor management controls over their programs and resources, including their financial information systems. FMFIA requires agencies to implement formal procedures to identify, assess, and monitor management controls in order to provide management with reasonable assurance that controls remain effective.

Single Audit Act

DOT has not effectively implemented certain provisions of the Single Audit Act, including tracking the receipt of single audit reports, distributing the reports in a reasonable period of time, and ensuring that timely management decisions are made to address report recommendations. DOT has agreed to take action to improve its implementation of the Single Audit Act.

D. CONSISTENCY OF OTHER INFORMATION

Managements Discussion and Analysis, required supplementary information (including stewardship information), and other accompanying information contain a wide range of data, some of which are not directly related to the financial statements. We are not required to, and we do not, express an opinion on this information. As required by OMB guidance, we compared this information for consistency with the DOT Consolidated Financial Statements and discussed the methods of measurement and presentation with DOT officials. Based on this work, except for 19 of 31 FY 2003 performance measures that were based on FY 2002 performance data, we found no material inconsistencies with the DOT Consolidated Financial Statements or nonconformances with OMB guidance. Further, because DOT does not have systems in place to allocate costs by major program, the performance measures did not provide information about cost-effectiveness, and were not linked to the cost of achieving targeted results or to the Statement of Net Cost.

E. PRIOR AUDIT COVERAGE

Our report on the DOT Consolidated Financial Statements for FYs 2002 and 2001 expressed an unqualified opinion and made one recommendation that the DOT Chief Financial Officer verify that DOT agencies confirm and reconcile intragovernmental balances with trading partners. As discussed in Section B, additional work is still needed in this area. In March 1998, we also recommended that DOT ensure DAFIS, or its replacement, is the primary source of information for preparing financial statements. This item remains open until DOT uses Delphi to provide the information needed to prepare the DOT Consolidated Financial Statements.

Since we issued our report on the DOT Consolidated Financial Statements for FYs 2002 and 2001, we issued nine reports related to the DOT Consolidated Financial Statements. The reports are listed in Exhibit B.

This report is intended for information and use by DOT, the Office of Management and Budget, GAO, and Congress. This report is a matter of public record, and its distribution is not limited.

Kenneth M. Mead
Inspector General

EXHIBIT A. OBJECTIVES, SCOPE, AND METHODOLOGY

Our audit objectives for the DOT Consolidated Financial Statements for FYs 2003 and 2002 were to determine whether: (1) principal DOT Consolidated Financial Statements and accompanying notes are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles; (2) DOT has adequate internal controls over financial reporting, including safeguarding assets; (3) DOT has complied with laws and regulations that could have a direct and material effect on the DOT Consolidated Financial Statements or that have been specified by OMB, including FFMIA; (4) financial information in the Management Discussion and Analysis is materially consistent with the information in the principal DOT Consolidated Financial Statements; (5) internal controls ensured the existence and completeness of reported data supporting performance measures; and (6) supplementary, stewardship, and other accompanying information is consistent with management representations and the DOT Consolidated Financial Statements.

DOT is responsible for (1) preparing the DOT Consolidated Financial Statements for FYs 2003 and 2002 in conformity with U.S. generally accepted accounting principles; (2) establishing, maintaining, and assessing internal controls to provide reasonable assurance that broad control objectives of the Federal Managers' Financial Integrity Act are met; (3) ensuring that DOT financial management systems substantially comply with FFMIA requirements; and (4) complying with other applicable laws and regulations.
We are responsible for obtaining reasonable assurance whether the DOT Consolidated Financial Statements for FY 2003 and FY 2002 are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles. DOT is responsible for preparing financial statements in conformity with U.S. generally accepted accounting principles, and establishing and maintaining an effective system of internal controls. The objectives of these controls are:

- Financial reporting: Transactions are properly recorded, processed, and summarized to permit the preparation of financial statements and stewardship information in conformity with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.

- Compliance with laws and regulations: Transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and Governmentwide policies identified by OMB audit guidance.

We are also responsible for (1) obtaining sufficient understanding of internal controls over financial reporting and compliance to plan the audit, (2) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and (3) performing limited procedures with respect to certain other information appearing in the DOT Consolidated Financial Statements for FYs 2003 and 2002.

To fulfill these responsibilities, we (1) examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements; (2) assessed the accounting principles used and significant estimates made by management; (3) evaluated the overall presentation of the financial statements; (4) obtained an understanding and performed limited tests of internal controls related to financial reporting, compliance with laws and regulations, and performance measures reported in Management's Discussion and Analysis; and (5) tested compliance with selected provisions of certain laws, including the Federal Financial Management Improvement Act.

Under contract with OIG and under our supervision, KPMG LLP (KPMG) audited the financial statements of FAA as of and for the periods ended September 30, 2003, and September 30, 2002. KPMG rendered an unqualified opinion on the FAA financial statements. Also under contract with OIG and under our supervision, Clifton Gunderson LLP audited the financial statements of the Highway Trust Fund as of, and for the period ended September 30, 2003.[2] Clifton Gunderson rendered an unqualified opinion on the Highway Trust Fund financial statements. OIG audited the financial statements of the Highway Trust Fund as of and for the prior period ended September 30, 2002. We reviewed the work of KPMG on the FAA financial statements, and Clifton Gunderson on the Highway Trust Fund financial statements, and determined that the work was performed in accordance with Government Auditing Standards. We relied on their work.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act, such as those controls relevant to ensuring that programs achieve their intended results and resources are used consistent with agency missions. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal controls, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. We also caution that our internal control testing may not be sufficient for other purposes and that projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate.

We did not test compliance with all laws and regulations applicable to DOT. We limited our tests of compliance to those laws and regulations required by OMB audit guidance that we deemed applicable to the DOT Consolidated Financial Statements for FY 2003 ended September 30, 2003, and FY 2002 ended September 30, 2002. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

The Chief Financial Officers of DOT and each Administration have been assigned the responsibility to address the weaknesses identified in this report. Attached to this report (Appendix) are management's response to the findings and recommendations.
We performed our work in accordance with Government Auditing Standards and OMB Bulletin 01-02, Audit Requirements for Federal Financial Statements.

[2] Clifton Gunderson also performed audit procedures related to Appropriated accounts and balances in the FY 2003 DOT consolidated financial statement related to Highway Trust Fund agencies, which we relied on.

EXHIBIT B. FINANCIAL-RELATED REPORTS

TITLE	***REPORT NUMBER***	***DATE ISSUED***
Quality Control Review of the Highway Trust Fund FY2003 Financial Statements	QC-2004-029	January 23, 2004
Quality Control Review of FAA's FY2003 Financial Statements	QC-2004-008	December 19, 2003
Quality Control Review of TSA's Balance Sheet as of February 28, 2003	QC-2004-005	December 01, 2003
Computer Security of Delphi Financial Financial Management System	FI-2003-094	September 30, 2003
Computer Security of Grant Management and Payment Systems, FTA	FI-2003-093	September 30, 2003
Information Security Program, DOT	FI-2003-086	September 25, 2003
Use of Government Travel Charge Cards	FI-2003-049	August 28, 2003
FAA's Overobligation of ICE-MAN Funds	FI-2003-044	June 12, 2003
2002 Status Assessment of Cost Accounting System and Practices, FAA	FI-2003-043	June 3, 2003

U.S. Department of Transportation

Office of the Secretary of Transportation

400 Seventh St., S.W.
Washington, D.C. 20590

January 28, 2004

MEMORANDUM TO: Kenneth M. Mead
Inspector General

FROM Phyllis Scheinberg
Acting Assistant Secretary for Budget and Programs/CFO

SUBJECT: Management Response – Report of the Office of Inspector General (IG) on the Consolidated Financial Statements for Fiscal Years (FY) 2002 and 2003

The Department is please to respond to your audit report on the Consolidated Financial Statements for FY 2002 and 2003. For the third consecutive year we have achieved an unqualified audit on the Consolidated Financial Statements.

We concur with the four material weaknesses and five reportable conditions contained in the report. Corrective actions have already been initiated to address many of these items. The Department will submit a detail Action Plan to your office by February 15th to address the findings contained in the report. We agree, in general, with the recommendations listed in the report and will utilize them to create corrective action measures.

The Department recognizes that achieving an unqualified audit was accomplished through our joint efforts by employing, in several critical areas, labor intensive procedures in order to compensate for financial management weaknesses. We will be working with the Operating Administrations, and the various audit groups to ensure that steps are taken that will improve the financial reporting and financial management throughout the Department.

I would like to express my appreciation for the professionalism displayed by your office and your contractors during the course of the audit.