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 2004 and 2003, DOT FI-2005-009

Date: November 15, 2004

From: Kenneth M. Mead
Inspector General

Reply to Attn. of: JA-20

To: The Secretary

I respectfully submit the Office of Inspector General report on the Department of Transportation (DOT) Consolidated Financial Statements for Fiscal Years (FY) 2004 and 2003 (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 fourth fiscal year in a row—2001, 2002, 2003, and 2004—that DOT has 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. This occurred as the Department completed its transition to a new, commercial off-the-shelf accounting system, called Delphi. According to DOT officials, DOT is the first cabinet-level agency to have implemented, Department-wide, a modern commercial off-the-shelf accounting system.

The DOT Consolidated Financial Statements for FY 2004 show year-end assets of about $68 billion, year-end liabilities (debts) of $13 billion, costs of operations (program costs) of $54 billion, and total budgetary resources (available financial resources) of $105 billion. A significant portion of DOT's budgetary resources come from two trust funds, the Highway Trust Fund (HTF) and the Airport and Airway (Aviation) Trust Fund, which are supported by a mixture of passenger, fuel, and user taxes. Tax collections deposited into those trust funds totaled $44.4 billion during FY 2004.

On a cautionary note, less revenue than expected has been flowing into the trust funds for several years. The reduction is due to changes in the aviation and highway sectors, including the economic downturn and lower average airfares. At the same time, the costs of building, operating, and maintaining the systems have continued to increase. Historically, shortfalls have been subsidized by the U.S. Treasury's General Fund, but with the significant Federal deficit, this option may prove increasingly difficult in the future.

The Department made progress correcting the internal control deficiencies we reported last year. The Department made sufficient progress correcting two of the material weaknesses—the Department's information security program and FAA's oversight of cost-reimbursable contracts—that we are not reporting them as material weaknesses this year.

FAA deserves credit for addressing significant challenges this year. FAA encountered difficulties when it implemented DOT's Delphi accounting system and FAA's new procurement system, called Prism, in November 2003. For the most part, FAA financial managers were able to identify problems, track financial activities that were not properly processed, and develop timely corrective action plans because they have implemented more disciplined financial management processes over the last 3 years.

HTF agencies, on the other hand, were less successful overcoming the financial management deficiencies we reported last year. Because of the severity of the problems and the limited time available to implement corrective actions, the Federal Highway Administration (FHWA) was not able to make enough progress to correct the underlying process deficiencies. The deficiencies required HTF agency executives and financial managers, as well as the Office of Financial Management to make a concerted effort to clean up bad data and generate reliable financial statements. That largely manual effort was the key to obtaining a clean opinion this year. Continued executive-level attention, backed by skilled resources to implement disciplined processes, will be critical to correct the remaining deficiencies.

I want to acknowledge the extraordinary efforts made by each of the Operating Administrations, the Assistant Secretary for Budgets and Programs/Chief Financial Officer, and KPMG LLP and Clifton Gunderson LLP (contractors we engaged to audit the Federal Aviation Administration [FAA] and the HTF financial statements). Also, this clean opinion would not have been possible without your longstanding commitment to improving financial management practices and the priority you repeatedly placed on meeting the Office of Management and Budget's accelerated reporting date of November 15, 2004.

INTERNAL CONTROLS

FAA, the HTF agencies,[1] the Department's Office of Financial Management, and the auditors had to exert extraordinary efforts to overcome significant financial management deficiencies in order to meet the accelerated due date for audited financial statements. These deficiencies were due to weaknesses in internal controls, which are the policies, procedures, and practices that need to operate effectively to produce reliable and timely financial information. We categorized the problems we identified into four material weaknesses and four reportable conditions. Responding to a draft of this report, DOT agreed with these findings and committed to taking timely corrective action.

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.

- **Financial Management and Reporting for Highway Trust Fund Agencies**. Last year we reported that HTF agencies lacked the financial management procedures needed to generate reliable financial statements, and this deficiency also existed this year. As a result, the financial statements FHWA submitted for audit contained several large, multi-billion dollar errors and omissions. For example, FHWA incorrectly added about $2 billion to program costs. FHWA also incorrectly reallocated costs among programs, resulting in a total of $8 billion in changes to program line items. These errors were corrected in the published financial statements, but the repeated substantial changes demonstrated that financial management and reporting processes were not operating effectively.

- **Financial Oversight of Highway and Transit Grants.** FHWA and the Federal Transit Administration (FTA) must do more to ensure that grant funds are protected from fraud, waste, and abuse. In FY 2004, FHWA needed to improve financial oversight on 41 of the 45 highway grant projects (valued at $113 million) that we reviewed. In June 2003, we pointed out that a random

[1] Federal Highway Administration, National Highway Traffic Safety Administration, Federal Transit Administration, Federal Railroad Administration, Federal Motor Carrier Safety Administration, and the Bureau of Transportation Statistics.

sample of construction payments we reviewed showed that 7 percent of the payments were not adequately supported ($7 million of the $98 million). FHWA plans to begin reviewing state payment processes and testing a sample of payments during FY 2005. The key to achieving sustained improvements in this area will be follow-through to ensure that the reforms are implemented and that they operate effectively. While FTA has systems in place to monitor resources provided to transit authorities and municipalities, it too could do a better job of protecting Federal funds. For example, we recently found that FTA's oversight did not take action on significant irregularities in change orders on a $2.25 billion project until they had accumulated to several hundred million dollars.

- **Reconciling Transactions Within DOT and With Other Federal Agencies.** Last year, we reported that DOT did not fully reconcile its transactions with other Federal agencies. To prepare DOT's financial statements, transactions among DOT's Operating Administrations must be tracked and eliminated to avoid overstating DOT's financial statement results. Similarly, Federal agencies' inability to account for transactions with other agencies is a major impediment to a clean audit opinion on the Financial Report of the United States Government. During FY 2004, DOT did not adequately track transactions among DOT Operating Administrations, which required management to perform extensive manual adjustments to prepare DOT's consolidated financial statements. DOT has begun taking steps to better account for transactions with other Federal agencies, but at the end of September 2004, it still had not identified the other agency associated with about half of the $55 billion of intra-governmental transactions processed in FY 2004 and reported to Treasury.

- **Financial System Controls.** Last year, we reported that controls over the Delphi accounting system needed to be improved. Important security measures had not been implemented, system changes were not properly tested, and contingency planning was not adequate. DOT has made significant progress to correct these problems, but for most of FY 2004 the vulnerabilities continued to exist. This year, both Clifton Gunderson and KPMG identified other security issues affecting other financial systems that provide financial data to Delphi. These deficiencies increase the risk that erroneous financial transactions could occur, either intentionally or inadvertently, resulting in unreliable information being included in financial reports without being detected in a timely manner by management.

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.

- **Cost-Reimbursable Contracts at FAA.** Last year we reported a material weakness in FAA’s management of cost-reimbursable contracts. During FY 2004, FAA management took aggressive actions to implement better controls by identifying all cost-reimbursable contracts and closing most old completed contracts. FAA also obtained $3 million to audit cost-reimbursable contracts and used the funds to request 185 audits. A reportable condition continues because FAA still has about $1.5 billion associated with overage contracts that it must close. FAA is continuing to review and close these old contracts and is taking other steps to strengthen its oversight of cost-reimbursable contracts.

- **DOT’s Information Security Program.** Last year, based on audits of the Department’s overall information system security program, we reported DOT’s information security program as a material internal control weakness. The most noteworthy improvements made during FY 2004 include increased oversight of information technology investment management and security controls, strengthened protection of DOT’s network infrastructure against attacks, and enhanced security protection of individual computer systems. Continued action is needed to improve security certification reviews, configure computers according to security standards, and develop and test system contingency and continuity plans.

- **MARAD’s Oversight of Title XI Loan Guarantees.** Last year, we reported that the Maritime Administration (MARAD) needed to better ensure that inventory, property, and environmental liabilities are reported properly. This year, we found that MARAD has corrected those problems. Last year we also reported that MARAD needed to improve its oversight of the Title XI loan guarantee program. During FY 2004, MARAD designed procedures to strengthen its oversight process for Title XI loan guarantees. What remains to be done is to aggressively and effectively implement the new procedures. This will be critical to ensure that MARAD’s $3.6 billion loan guarantee portfolio is properly managed. This is of considerable importance because MARAD has determined that over 25 percent of its portfolio is at an elevated risk of default.

- **Accounting for Loans in Delphi.** In FY 2003, we reported that DOT needed to improve how it accounts for the direct loans it provides to grantees in Delphi, and this condition still exists as of September 30, 2004. The Delphi accounting system does not include a process to account for expected loan repayments from grantees, which were valued at $604 million on September 30, 2004. Instead, DOT relied on information from outside the accounting system (such as commercial banks) to track loan transactions, and some Operating Administrations did not routinely reconcile their loan balances. This year, the Department established a task force to identify a corrective action plan.

We provided a draft of this report to the DOT Assistant Secretary for Budgets and Programs/Chief Financial Officer, who concurred with the findings and agreed to implement the recommendations. DOT and its Operating Administrations have also 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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