



COMPLIANCE WITH LEGAL AND REGULATORY REQUIREMENTS

The Department is committed to management excellence and recognizes the importance of strong financial management, financial systems, and internal controls to ensure accountability, integrity, and reliability. Each Operation Administration's (OA) Administrator submits an annual statement of assurance to the Office of the Secretary, on the overall assurance of management controls.

During the fiscal year that ended September 30, 2004, DOT continued its efforts to ensure that the Department has an efficient and effective system of financial programs and administrative controls. When specific internal control weaknesses were identified, the process of developing and implementing corrective action was put into action immediately.

Federal Managers' Financial Integrity Act

During FY 2004, in accordance with the requirements of the Federal Managers' Financial Integrity Act (FMFIA) and using the guidelines of the Department and of OMB, the Department reviewed our management control system. The objectives of our management control system are to provide assurance that the following occur:

- Our obligations and costs are in compliance with applicable laws.
- Our assets are safeguarded against waste, loss, unauthorized use, or misappropriation.
- The revenues and expenditures applicable to agency operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial reports and to maintain accountability over assets.
- All programs are efficiently and effectively carried out in accordance with applicable laws and management policy.

The efficiency of the Department's operations is continually evaluated using information obtained from reviews conducted by the GAO, OIG, specifically-requested studies, and observations of daily operations. These reviews ensure that our systems and controls comply with the standards established by FMFIA. Managers throughout the Department are responsible for ensuring that effective controls are implemented in their areas of responsibility. Individual assurance statements from the Administrator of each OA serve as a primary basis for the Department's assurance that our management controls are adequate. The assurance statements are based upon an evaluation of progress made in correcting any previously reported problems; new problems identified by the GAO, OIG, and other management reports; and the management environment within each OA.

Section 2. Internal Controls, Material Weaknesses

Fiscal Year	Number reported for the first time	Number that have been corrected	Number still pending
Prior Years	146	146	0
2000 Report	0	0	0
2001 Report	1	1	0
2002 Report	3	3	0
2003 Report	2	0	2
2004 Report	1	0	1

Status of FY 2004 Material Weaknesses

DOT has five material weaknesses, three for Section 2 and two for Section 4. Three of the material weaknesses are carried over from FY 2003 and two are new. The three Section 2 material weaknesses are:

Financial Management and Reporting for Highway Trust Fund Agencies. Last year we reported that Highway Trust Fund Agencies lacked the financial management procedures needed to generate reliable financial statements, and this deficiency also exists this year. As a result, the financial statements that FHWA submitted for audit contained several large, multi-billion dollar errors and omissions.

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 did not provide financial oversight on 41 of the 45 highway grant projects (valued at \$113 million) reviewed by the Office of the Inspector General (OIG). FHWA plans to begin reviewing State payment processes and testing a sample of payments during FY 2005.

Reconciling Transactions Within DOT and With Other Federal Agencies

Last year we reported that DOT did not fully reconcile its transactions within DOT and 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. During FY 2004, DOT did not adequately track these transactions, which required management to perform extensive manual adjustments to prepare DOT's consolidated financial statements. Similarly, Federal agencies' inability to account for and eliminate transactions with other agencies is a major impediment to a clean audit opinion on the Consolidated Financial Report on the United States. DOT has begun taking steps to better account for these transactions, but at the end of September 2004, it still had not identified the other agencies associated with about

half of the \$55 billion of intragovernmental transactions processed in FY 2004 and reported to Treasury.

Federal Information Systems Management Act (FISMA)

FISMA requires Federal agencies to identify and provide security protections commensurate with the risk and magnitude of harm resulting from the loss of, misuse of, unauthorized access to, or modification of information collected or maintained by or on behalf of an agency. Because DOT maintains one of the largest portfolios of information technology (IT) investments of Federal civilian agencies, it is critical that DOT protect its systems and sensitive data. In FY 2004, DOT's information technology budget totaled about \$2.7 billion.

DOT has 12 Operating Administrations (OA) and the Office of Inspector General with 485 computer systems. DOT is also responsible for operating the air traffic control system, which has been designated as part of the Nation's critical infrastructure by the President (Homeland Security Presidential Directive 7, December 2003). DOT systems include safety-sensitive air traffic control and surface transportation systems, as well as financial systems that disburse over \$50 billion in Federal funds each year.

For the last three years, DOT has reported its information security program as a material internal control weakness under the Federal Managers' Financial Integrity Act (FMFIA). A material internal control weakness is a significant deficiency in an agency's overall information systems security program or management control structure, or within one or more information systems that (1) significantly restricts the capability of the agency to carry out its mission, or (2) compromises the security of its information, information systems, personnel, or other resources, operations, or assets. The risk is great enough that the agency head and outside agencies must be notified and immediate or near-immediate corrective action must be taken. (OMB Guidance on FY 2004 Reporting Instructions for the Federal

Information Security Management Act, M-04-25, August 23, 2004.)

During FY 2004, DOT made a concerted effort to correct weaknesses identified in previous years. The most noteworthy improvements DOT has made since we began the annual information security review in FY 2001 include:

- Increased oversight of IT investment management and security controls. During FY 2004, the departmental Investment Review Board expanded its review of OA investment projects and directed OAs to evaluate cost-saving opportunities by consolidating systems of common interests, such as grant management. The Office of the Chief Information Officer (CIO office) also performed more in-depth reviews of IT budget requests submitted by OAs than in prior years.
- Strengthened protection of DOT's network infrastructure against internal and external attacks. During FY 2004, DOT expanded its vulnerability checks to cover not only its public Web sites but also computers on OA private networks. The CIO office also issued guidelines for configuring computers in a secure manner to prevent vulnerabilities.
- Improved integrity, confidentiality, and availability of DOT program operations that depend on computer systems support. During FY 2004, DOT increased the percentage of systems completing the security certification review from 33 percent to over 90 percent.

Although DOT has made significant progress, there are some remaining issues such as the CIO office and OAs needing better coordination of IT budget requests in order to more effectively use IT funds, the quality of security certification reviews needing improvement, and DOT's air traffic control system security needing enhancement.

Information Security Program. Last year, DOT reported its information security program as a material weakness. The Inspector General's audit of FISMA (dated October 1, 2004) recognized noteworthy improvements in DOT's IT security. In recognition of this progress, the IT security material weakness from the FY 2003 financial audit has been downgraded to a reportable condition in the FY 2004 financial audit. No recommendations in the FY 2004 FISMA audit related solely to financial systems. The most noteworthy improvements made during FY 2004 include increased oversight of IT 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.

As identified by the Office of the Inspector General, for FISMA improvements, DOT needs better cost estimates for information technology (IT) investments, define project management and budget responsibilities for IT consolidation initiatives, review of IT investment projects, complete vulnerability checks, complete Security Certification Reviews, and assure system contingency and continuity planning.

Section 4. Systems, Non-Conformances

Fiscal Year	Number reported for the first time	Number that have been corrected	Number still pending
Prior Years	59	59	0
2000 Report	1	1	0
2001 Report	0	0	0
2002 Report	0	0	0
2003 Report	1	1	0
2004 Report	2	0	2

Status of FY 2004 Material Nonconformances

Nonconformances (Section 4) in internal controls represent significant deficiencies in the design or operation of internal controls that could adversely affect the DOT consolidated financial statements. The two material nonconformances are:

Material System Security Controls. Last year, the Department reported that important security controls over the Delphi financial management system needed to be improved. In FY 2004, 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. These deficiencies increase the risk that erroneous financial transactions could occur, either intentionally or inadvertently, resulting in material misstatements on financial statements without being detected in a timely manner by management.

FFMIA of 1996 Noncompliance Issues. DOT reported again this year that the Department was not in compliance with FFMIA. For FY 2004 this noncompliance consists of three issues: preparation of financial statements, use of a Standard General

Ledger (credit reform/loans), and Federal Accounting Standards (cost accounting).

Scorecard on the President's Management Agenda

The status column in the following table indicates where DOT progress is in meeting the President's Management Agenda (PMA). Agencies in the Federal Government receive a *green* rating by reaching the required score. Agencies must maintain achievements between evaluations to maintain a *green*.

- Indicates that the agency has met all of OMB's core criteria for the initiative.
- ▲ Indicates achievement of some but not all of OMB's core criteria for the initiative and that the agency has no red conditions.
- ◆ Indicates that at least one of the conditions identified by OMB for that initiative is in need of correction.

The progress column measures the rate at which DOT is moving toward *green*. Agencies get a *green* rating when implementation is advancing according to plan.

Scorecard on the President's Management Agenda

INITIATIVE	FY 2004 STATUS	PROGRESS	HOW DOT IS MEETING PMA CHALLENGES
<p>Human Capital: Develop a Department-wide human capital workforce strategy to address future workforce gaps, eliminate skill gaps in critical occupations, develop performance-based incentives for the workforce, ensure citizen-centered, delayed, and mission-focused organizations; strengthen leadership skills, and ensure a robust leadership pipeline; improve the measurement and evaluation of human capital strategies; and integrate e-Government and Competitive Sourcing strategies.</p>	●	●	<p>In FY 2002, DOT developed a Human Capital Plan aligned with the President's Management Agenda and the OPM/OMB Standards for Success. Following this blueprint, the Department:</p> <ul style="list-style-type: none"> • linked its strategic plan with human capital strategies, including linking 89% of individual performance plans and performance awards; • institutionalized annual workforce planning and analysis, integrating competitive sourcing; • restructured functions and organizations to improve mission focus and effectiveness; • improved the recruitment, selection, training, and evaluation of agency leaders; instituted succession planning; and conducted knowledge management pilots; • set up a framework that has increased management accountability for improved diversity and achieved measurable progress; • improved corporate recruitment in a way that integrates with other strategies; and • strengthened our ability to track and evaluate progress and continuous improvement.
<p>Competitive Sourcing: Implementation of Competitive Sourcing Plan.</p>	●	●	<p>DOT received a <i>green</i> status rating from OMB for its competitive sourcing initiative. OMB approved DOT's green competitive sourcing plan in July of 2004.</p> <p>DOT has completed competitions for 288 positions with anticipated annual savings of over \$1 million. In its approved green plan, DOT has committed to competing an additional 442 positions through the end of FY 2005 and will begin evaluation of 4000 additional positions for competition by the end of FY 2009. Additionally, the FAA is currently conducting the largest and most complex public/private competition ever, covering over 2700 positions and 58 facilities for its automated flight service station function. A final performance decision on the FAA competition is expected in March 2005.</p> <p>In developing its green plan, DOT required that OAs develop their competitive sourcing plans in conjunction with their workforce planning efforts. To further emphasize the critical relationship between the two functions, DOT has merged competitive sourcing and workforce planning under a single organization.</p> <p>DOT will initiate an Executive Steering Committee for competitive sourcing which will explore the opportunity for cross-organizational competitions throughout the Department and bring more consistency to DOT's competitive sourcing efforts throughout DOT.</p>

Scorecard on the President's Management Agenda

INITIATIVE	FY 2004 STATUS	PROGRESS	HOW DOT IS MEETING PMA CHALLENGES
<p>E-Government: Better justify and track costs and performance of information technology projects, as well as participate in government-wide initiatives that automate and simplify how the public deals with the government and reduce redundancies and increase efficiencies across government-wide.</p>	●	●	<p>Capital Planning: Participation in capital planning process expanded across departments. Over 1000 participants attended CPIC training sessions held to improve the quality of the business case analysis. DOT Departmental Investment Review Board (IRB) reviewed and approved the FY 2005 portfolio in support of the budget and Department mission and goals. IRB established a systematic quarterly review process to monitor major projects against business case baseline. Implemented an integrated CPIC and Enterprise Architecture (EA) policy and governance structure to ensure alignment between the two areas.</p> <p>IT Security: DOT has certified and accredited 90 percent of all IT systems and implemented plans to address remaining certification and accreditation weaknesses. DOT continues to conduct weekly vulnerability scanning of all public facing and e-Government Web servers. Plans are in place to expand the vulnerability scanning to internal servers as well. To date, DOT has 100 percent of systems scanned, and decreased vulnerabilities by over 90 percent.</p> <p>Enterprise Architecture (EA): Released DOT Modernization Blueprint including As-Is and To-Be architecture for the DOT common IT infrastructure. The EA Framework and Reference Models are aligned with the OMB Federal Enterprise Architecture Program Management Office Framework. OAs have completed EAs for their unique business/mission areas.</p> <p>Government-wide Initiatives: DOT participates in 18 e-Government initiatives that span four categories. The e-Government project managers work closely with Managing Partners to identify implementation requirements and detailed work plans. The OCIO tracks schedule milestones and performance issues/risks for all e-Government projects. Major schedule and performance issues are brought to the IRB for further review and action. DOT will complete implementation of a Department-wide Learning Management System in all modes except the FAA in the fourth quarter of 2004 and eliminate some of the redundant training systems in the fourth quarter of 2004 and the first quarter of 2005. DOT has implemented Quickhire in all modes except FAA. DOT Government to Business (G2B) and Government to Citizen (G2C) forms have been integrated (via hyperlinks) with the current Business Gateway Initiative Federal Forms Portal thus allowing DOT customers ready access to the forms they require.</p>

Scorecard on the President's Management Agenda

INITIATIVE	FY 2004 STATUS	PROGRESS	HOW DOT IS MEETING PMA CHALLENGES
<p>Budget/Performance Integration: Better integrate budget and performance functions by integrating respective staff work; developing plans and budget with outcome goals, output targets, and resources requested in the context of past results; charging full budgetary costs of programs; and documenting program effectiveness.</p>	●	●	<p>In FY 2004, DOT achieved its goals in this area and earned a <i>green</i> score on the scorecard by completing the following:</p> <ul style="list-style-type: none"> • DOT identified efficiency measures for all programs that have been scored by the Program Assessment Rating Tool (PART) and remaining Operating Administrations (OA). • DOT selected OAs to participate in a pilot project to demonstrate the ability to estimate the marginal cost of performance for the Safety strategic objective. <p>In addition, DOT continued to refine its performance based budget justifications to better link funding with performance. DOT will continue to work on the President's Management Agenda goals and embrace them as a regular management practice.</p> <p>DOT Performance Plan and Reports. DOT's Performance and Accountability Report has consistently garnered a high standing from George Mason University's Mercatus Center, and shared Mercatus' top rating last year.</p>
<p>Improved Financial Management: Develop financial management systems capable of producing more timely and accurate information, and maintain a record of unqualified opinions on our financial statements.</p>	⬇	●	<ul style="list-style-type: none"> • DOT received its fourth unqualified audit opinion. The audit groups report no opinion drivers that would qualify the opinion. • DOT produced its FY 2004 statements by the deadline and met its target for November 15, 2004 deadline for audit completion. • DOT satisfied statutory requirements with the conversion to Delphi. • DOT demonstrated a pilot system for four safety programs that provides performance and financial information to program managers. DOT is implementing an automated Dashboard and has submitted a draft plan to OMB on expanding the dashboard. By December 2004, it will be available agency-wide. • Financial data from Delphi is available on demand and is being used throughout the Department to help manage programs on a daily basis. • DOT has requested legislative fixes for its outstanding Antideficiency Act violations.

Improper Payment Program for FY 2004 and Agency Plans for FY 2005–2007

In 2004, the Department of Transportation (DOT) engaged KPMG, LLP to conduct an improper payments review of FY 2003 payments for ten identified programs for compliance with the Improper Payments Information Act of 2002 (IPIA). The objectives of the review were to (1) assess and report the amount and causes of improper payments, (2) to give us a methodology to use for remaining DOT programs, and (3) to identify action plans for reducing improper payments for each program identified as having significant improper payments. Based on the Office of Management and Budget guidance, improper payments are considered significant if the annual improper payments in a program exceed both 2.5 percent of program payments and \$10 million.

KPMG statistically reviewed the following ten programs identified by Operating Administration (OA):

- Federal Highway Administration (FHWA)—Federal Aid (section 57 program)
- Federal Transit Administration (FTA)—Formula Grants (section 57 program)
- Federal Transit Administration—Capital Investment Grants (section 57 program)
- Federal Aviation Administration (FAA)—Airport Improvement Program (section 57 program)
- Federal Highway Administration—Federal Lands
- Department of Transportation—Payroll
- Office of the Secretary of Transportation (OST)—Working Capital Fund
- Federal Railroad Administration (FRA)—Grant Program
- Federal Aviation Administration—Operations
- Federal Aviation Administration—Facilities and Equipment

For the ten completed programs, KPMG did not find significant improper payments exceeding both 2.5 percent of program payments and \$10 million, which would require reporting for the IPIA. However, KPMG's scope was limited in three ways. First, there was an inadvertent sample population reduction in the FHWA Federal Aid program based on the extract requirements provided by FHWA. DOT and KPMG will work to identify the missing population amounts and review the additional program. Second, FAA was not able to provide sufficient data or answers to outstanding questions for the FAA Operations and FAA Facilities and Equipment programs on time. Therefore, the items with outstanding data were considered and projected as questionable transactions.

The third limitation was due to limited grant data being available for grants processed electronically based on the requirements of the Federal Financial Assistance Management Improvement Act of 1999 (PL 106-107). PL 106-107 streamlines the payment process for grants. As a result, documentation was not available to permit KPMG to test whether the payment was calculated correctly, whether discounts and credits were properly taken and if all costs were allowable. In other words, information was available to track the flow of funds from the Federal Treasury to the first-tier grant recipients, which are State Departments of Transportation in the case of the Federal Aid Highways program. However, information was not available to determine how Federal highway funds are allocated to subgrantees and if funds are used for eligible purposes under the program. For example, KPMG was able to test electronically processed grants for eligibility, award and payment approval, incurrence of cost during the funding period, payment within the award or other funding limitations, and that payment was sent to the proper recipient. It should be noted that all Federal agencies with electronically processed grants in compliance with PL 106-107 would encounter this same limitation.

To resolve the issue of limited data in support of grant payments made in compliance with

PL 106-107, DOT has devised an innovative research and development (R&D) strategy. This strategy involves using a proof of concept project to test the feasibility of using the Single Audit process to provide the information needed to determine if grant payments made in compliance with PL 106-107 meet the improper payment estimation and remediation requirements of the IPIA. This proposal has been approved by OMB, and with OMB's concurrence, DOT has executed a contract with a consultant to begin the process of this proof of concept effort.

To ensure full compliance with both the letter and the spirit of IPIA, DOT has conducted an improper payment risk assessment on all DOT programs including those that clearly would not meet the OMB reporting thresholds. DOT's initial risk assessment methodology (developed by KPMG) was used by DOT to review all remaining DOT programs not included in KPMG's review of the top ten DOT programs. This clearly will meet the legislative requirement to review all programs and activities. Furthermore, to ensure senior

management review, DOT has required that all Operating Administration CFOs review and sign their program risk assessments. To date, none of the remaining DOT programs received a high-risk assessment.

DOT also has a Department-wide recovery audit program well underway since 2002. During 2004, recovery audits were expanded to include all financial transactions more than one year old. While audit recoveries have not been significant, the recovery auditor has had full access to DOT financial records and cooperation by the OAs has been outstanding.

DOT's annual goal is to refine its internal process and procedures for IPIA measurement, to review means to automate the collection and sampling strategies used in the first IPIA assessment and to execute the R&D project strategy to allow us to further improve and measure improper payments at the grant level.

IPIA reporting details can be found in Appendix B.