

**Independent Auditors'
Report on U.S. Customs
and Border Protection's
Fiscal Year 2016
Consolidated Financial
Statements**





DHS OIG HIGHLIGHTS

Independent Auditors' Report on U.S. Customs and Border Protection's Fiscal Year 2016 Consolidated Financial Statements

February 6, 2017

Why We Did This Audit

U.S. Customs and Border Protection (CBP) prepares annual financial statements to comply with the Office of Management and Budget's requirements. We contracted with KPMG LLP to audit CBP's fiscal year 2016 financial statements to express an opinion over the fairness of presentation of those statements.

What We Recommend

KPMG LLP made 18 recommendations to improve internal control over financial reporting and increase the reliability of financial systems and operations. These recommendations address the five significant deficiencies identified in the report.

For Further Information:

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

What We Found

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

The report identifies five significant deficiencies in internal control, three of which are considered material weaknesses. The material weaknesses are in information technology controls and financial systems functionality; financial reporting; and refunds and drawbacks of duties, taxes, and fees. The two other significant deficiencies in internal control are related to entity-level controls and custodial revenue-entry process.

Management's Response

CBP concurred with the three material weaknesses and the two significant deficiencies identified in the report and indicated that management will continue to work to resolve all identified weaknesses.



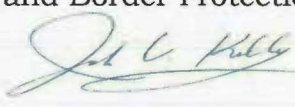
OFFICE OF INSPECTOR GENERAL

Department of Homeland Security

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

February 6, 2016

MEMORANDUM FOR: Jaye M. Williams
Chief Financial Officer
U.S. Customs and Border Protection

FROM: John V. Kelly 
Deputy Inspector General

SUBJECT: *Independent Auditors' Report on U.S. Customs and
Border Protection's Fiscal Year 2016 Consolidated
Financial Statements*

Attached for your action is our final report, *Independent Auditors' Report on U.S. Customs and Border Protection's Fiscal Year 2016 Consolidated Financial Statements*. We have incorporated the formal comments from U.S. Customs and Border Protection (CBP) in the final report.

The report presents the results of CBP's consolidated financial statements audits for fiscal years 2016 and 2015. We contracted with the independent public accounting firm KPMG LLP (KPMG) to perform the audits. KPMG concluded that CBP's consolidated financial statements as of and for the years ended September 30, 2016 and 2015 are presented fairly, in all material respects, in accordance with U.S. generally accepted accounting principles.

The independent auditors' report also contains observations and 18 recommendations related to internal control weaknesses that are considered significant deficiencies and are required to be reported in the financial statements audit report. Your office concurred with the five significant deficiencies in internal control presented below, the first three of which are considered to be material weaknesses:

Significant Deficiencies in Internal Control

- A. Information Technology Controls and Financial Systems Functionality
- B. Financial Reporting
- C. Refunds and Drawback of Duties, Taxes, and Fees
- D. Entity-Level Controls
- E. Custodial Revenue - Entry Process



OFFICE OF INSPECTOR GENERAL

Department of Homeland Security

KPMG is responsible for the attached independent auditors' report dated January 18, 2017, and the conclusions expressed in the report. To ensure the quality of the audit work performed, we evaluated KPMG's qualifications and independence, reviewed the approach and planning of the audit, monitored the progress of the audit at key points, reviewed and accepted KPMG's audit report, and performed other procedures that we deemed necessary. Additionally, we provided oversight of the audit of financial statements and certain accounts and activities conducted at CBP. Our review disclosed no instances where KPMG did not comply, in all material respects, with generally accepted government auditing standards.

Consistent with our responsibility under the *Inspector General Act*, we will provide copies of our report to congressional committees with oversight and appropriation responsibility over the Department of Homeland Security. We will post the report on our website for public dissemination.

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

Attachment



OFFICE OF INSPECTOR GENERAL
Department of Homeland Security

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KPMG LLP
Suite 12000
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Washington, DC 20006

Independent Auditors' Report

Inspector General
U.S. Department of Homeland Security

Commissioner
U.S. Customs and Border Protection

Report on the Financial Statements

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

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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



Opinion on the Financial Statements

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

Other Matters

Interactive Data

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

Required Supplementary Information

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

Other Information

Our audits were conducted for the purpose of forming an opinion on the basic consolidated financial statements as a whole. The information in the Introduction, Performance Section, Message from the Chief Financial Officer, and Other Information, as reflected in CBP's *Fiscal Year 2016 Performance and Accountability Report*, is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the basic consolidated financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Other Reporting Required by Government Auditing Standards

Internal Control Over Financial Reporting

In planning and performing our audit of the consolidated financial statements as of and for the year ended September 30, 2016, we considered CBP's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the consolidated financial statements, but not for the purpose of expressing an opinion on the effectiveness of CBP's internal control. Accordingly, we do not express an opinion on the effectiveness of CBP's internal control. We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that have not been



identified. However, as described in the accompanying exhibits, we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. The following deficiencies described in the accompanying Exhibit I have been identified to be material weaknesses.

- A. Information Technology Controls and Financial Systems Functionality
- B. Financial Reporting
- C. Refunds and Drawbacks of Duties, Taxes, and Fees

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies described in the accompanying Exhibit II to be significant deficiencies.

- D. Entity-Level Controls
- E. Custodial Revenue - Entry Process

Compliance and Other Matters

As part of obtaining reasonable assurance about whether CBP's consolidated financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests of compliance disclosed no instances of noncompliance or other matters that are required to be reported herein under *Government Auditing Standards* or OMB Bulletin No. 15-02. With respect to other matters, we noted the Department of Homeland Security (DHS) is currently reviewing two potential violations of the *Antideficiency Act*. As of the date of this report, no final noncompliance determination has been made for these incidents.

CBP's Response to Findings

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

Purpose of the Other Reporting Required by Government Auditing Standards

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

KPMG LLP

Washington, D.C.
January 18, 2017

Independent Auditors' Report

Introduction to Exhibits on Internal Control over Financial Reporting

The internal control weaknesses in financial reporting presented herein were identified during our audit of the U.S. Customs and Border Protection (CBP) consolidated financial statements as of and for the year ended September 30, 2016. Our findings are presented in two Exhibits:

Exhibit I Findings that individually or in aggregate are considered material weaknesses in internal control over financial reporting affecting CBP's consolidated financial statements.

Exhibit II Findings that individually or in aggregate are considered significant deficiencies in internal control over financial reporting, which are less severe than a material weakness, yet important enough to merit attention of CBP's management and others in positions of CBP oversight.

Criteria Index of Financial Reporting and Internal Control Criteria

The determination of which findings rise to the level of a material weakness or significant deficiency is based on an evaluation of how identified deficiencies, considered in aggregate, may affect CBP's consolidated financial statements as of and for the year ended September 30, 2016.

We have reported the following three material weaknesses and two significant deficiencies at CBP as of and for the year ended September 30, 2016:

Material Weaknesses (Exhibit I):

| Finding | Financial Statement Area |
|---------|---|
| I-A | Information Technology Controls and Financial Systems Functionality |
| I-B | Financial Reporting |
| I-C | Refunds and Drawbacks of Duties, Taxes, and Fees |

Significant Deficiencies (Exhibit II):

| Finding | Financial Statement Area |
|---------|-----------------------------------|
| II-D | Entity-Level Controls |
| II-E | Custodial Revenue - Entry Process |

The criteria supporting our findings, such as references from technical accounting standards, various rules and regulations, including requirements issued by OMB and the U.S. Treasury, and internal Department of Homeland Security (DHS) and CBP directives, are presented in the *Index of Financial Reporting and Internal Control Criteria* behind Exhibit II.

Independent Auditors' Report
Exhibit I – Material Weaknesses in Internal Control over Financial Reporting

I-A Information Technology Controls and Financial Systems Functionality

Background:

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

During our fiscal year (FY) 2016 assessment of GITCs and business process application controls, performed in connection with the financial statement audit, we determined that CBP made progress in remediating IT findings that were reported in FY 2015. However, in some cases, the timing of the remediation over certain pervasive findings was not present for the entire fiscal year, which impacted the ability to rely on application controls and system generated reports. In addition, new findings were identified in FY 2016.

Conditions Related to GITCs:

Due to an expanded scope, we identified a greater number of control deficiencies in GITCs this fiscal year as compared to prior years, which represent an elevated risk of misstatement of the CBP financial statements. In summary, we identified the following deficiencies in GITCs that, in aggregate, resulted in a material weakness:

1. *Access Controls:*

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

Independent Auditors' Report
Exhibit I – Material Weaknesses in Internal Control over Financial Reporting

2. *Configuration Management:*

- Vulnerability management activities were not consistently performed. Weaknesses in the following activities were identified: performing internal scans of financial applications and system software, monitoring vulnerabilities identified, and implementing vendor-recommended patches to address known vulnerabilities.
- Configuration management activities were not consistently performed. Weaknesses in the following activities were identified: authorizing changes prior to implementation, and maintaining sufficient documentation over test plans, test results, development authorization, and separation of the developers and migrators.

3. *Segregation of Duties:*

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

4. *Contingency Planning:*

- Controls over the performance of daily and weekly system backups were not fully implemented.

Conditions Related to Financial Systems Functionality:

We also evaluated and considered the impact of system functionality on financial reporting. In recent years, we identified limitations in the functionality of CBP's financial systems that inhibit CBP's ability to implement and maintain effective internal control, and to effectively and efficiently process and report financial data. Certain key financial and feeder systems have not been substantially updated since being inherited from legacy agencies over a decade ago.

Our observations related to pervasive functionality issues noted for certain CBP systems are described below:

- System software supporting key financial applications, feeder systems, and general support systems lacked the required functionality to implement effective controls. This resulted in unmitigated vulnerabilities that exposed underlying data to potential unauthorized and undetected access and exploitation.
- GITCs and financial process areas were implemented or supported by manual processes, outdated or decentralized systems, or records management processes with limited automated capabilities. These limitations introduced a high risk of error and resulted in inconsistent, incomplete, or inaccurate control execution and supporting documentation.

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

Independent Auditors' Report

Exhibit I – Material Weaknesses in Internal Control over Financial Reporting

Cause:

The control deficiencies described in this finding stem from numerous systemic root causes. In many cases, inadequately designed and implemented, or ineffectively operating controls were caused by the following: timing of remediation efforts; resource limitations; ineffective or inadequate management oversight; lack of awareness and training; reduced efforts on remediating legacy system processes due to competing priorities related to the modernization of the financial information system; the complex, highly interrelated yet decentralized nature of systems and system components; a lack of communication between CBP offices regarding GITC ownership; a lack of continual self-review and risk assessments performed over GITCs; and error-prone manual processes.

Effect:

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

The conditions supporting our findings collectively limit CBP's ability to process, store, and report financial data in a manner that ensures accuracy, confidentiality, integrity, and availability. Some of the weaknesses could result in material errors in CBP's financial data that are not detected in a timely manner through the normal course of business. Because of the presence of IT control and financial system functionality weaknesses, there is added pressure on mitigating controls to operate effectively. Such mitigating controls often were not implemented (see **Finding I-B, Financial Reporting**). However, when implemented, mitigating controls often were more manually focused, increasing the risk of human error that could materially affect the consolidated financial statements. Deficiencies identified related to the design, implementation, and operating effectiveness of manual mitigating controls contributed to the findings reported in Exhibits I and II. Furthermore, due to these GITC deficiencies, we were unable to rely on application controls and information produced by the entity and used by management in the operation of certain key manual controls at CBP.

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

Criteria:

We do not present all relevant criteria for IT controls and financial systems functionality in *Index of Financial Reporting and Internal Control Criteria*, after Exhibit II due to the sensitive nature of CBP's systems. Relevant criteria is provided in limited distribution (For Official Use Only) Notices of Findings and Recommendations (NFRs) and a separate IT management letter (ITML) to CBP and DHS management.

Recommendations:

We recommend that CBP management implement the necessary improvements to CBP's financial management systems and supporting IT security controls as they continue their financial systems modernization initiative. Specific, more detailed recommendations were provided in limited distribution NFRs and a separate ITML to CBP and DHS management.

Independent Auditors' Report
Exhibit I – Material Weaknesses in Internal Control over Financial Reporting

I-B Financial Reporting

Background:

Financial reporting relates to the preparation of financial information to be included in the consolidated financial statements and related disclosures and includes the activities for initiation, authorization, recording, and processing of transactions into the general ledger. It includes procedures over the selection and application of generally accepted accounting principles (GAAP) and accounting policies, as well as management's oversight of the process.

Conditions:

In FY 2016, the following financial reporting control deficiencies were identified that, collectively, were deemed a material weakness in internal control over financial reporting.

We noted that CBP:

1. Did not have effective controls to ensure that the information contained in the *Performance and Accountability Report* agreed to CBP's underlying accounting records.
2. Did not maintain effective internal control related to service organizations. This included the failure to perform effective reviews of service organization control (SOC) reports, as well as the failure to consider complementary end user controls identified in the SOC reports.
3. Lacked fully effective controls to ensure the proper classification of unobligated balances as apportioned or unapportioned.
4. Did not design and implement sufficient controls surrounding year-end reporting. Specifically, CBP did not properly identify subsequent events, such as changes to taxes, duties, and trade receivables. Additionally, CBP did not ensure the proper classification of bulk purchases as capital expenditures rather than as operating expenses.
5. Did not have effective controls related to the preparation and review of manual journal entries, including underlying information.
6. Did not have effective controls over the input and review of seized and forfeited information at the port level. In addition, controls over the presentation of disclosures related to seized and forfeited items were not designed at a level of precision to detect material misstatements.
7. Did not have effective process level controls surrounding the preparation and review of the contingent legal liability schedule, non-GAAP analysis of lease related transactions, and reporting of certain adjustments to the DHS Office of Financial Management.

Cause/Effect:

Controls over the preparation and review of the *Performance and Accountability Report* were not operating effectively. In some cases, CBP did not properly identify the necessary controls to mitigate financial reporting risks. In other instances, CBP personnel did not follow the existing policies or procedures. Further, CBP did not perform a sufficient risk assessment to determine areas that may require adjustments at year-end due to their nature.

In addition, as a complex entity with a high volume and a high dollar amount of transactions, CBP lacks a sufficient number of skilled accounting personnel to oversee and monitor the financial reporting processes. Deficiencies in financial reporting resulted in significant adjustments to the current period consolidated financial statements and disclosures. Despite these control deficiencies, CBP was able to adequately support its FY 2016 account balances.

Independent Auditors' Report

Exhibit I – Material Weaknesses in Internal Control over Financial Reporting

Criteria:

Presented in Index of Financial Reporting and Internal Control Criteria, after Exhibit II.

Recommendations:

We recommend that CBP:

1. Enforce existing procedures for the preparation and review of the *Performance and Accountability Report* and update existing policies and procedures to include additional reviews.
2. Appropriately align knowledgeable resources to assess SOC reports and design and implement formal policies and procedures for identification and mapping of the required complementary end user controls to CBP's internal control process.
3. Establish new, or improve existing policies, procedures, and internal controls to ensure proper classification of unobligated balances as apportioned or unapportioned.
4. Establish new, or improve existing policies, procedures, and internal controls to ensure subsequent events with potential financial reporting implications are identified (through development of a "look-back" analysis, evaluation of specific items, and/or comparison of available data sets).
5. Enforce existing policies, procedures, and related internal controls to ensure that the review of manual journal entries is sufficiently precise to identify errors, and that the underlying information utilized in the preparation of the entries is complete and accurate.
6. Enforce existing policies, procedures, and controls at the port level to ensure information recorded in the system of record for seized and forfeited items is complete and accurate. In addition, improve existing controls surrounding the review of financial disclosures related to seized and forfeited narcotics to ensure proper reporting.
7. Enforce existing procedures over certain process-level controls, including preparation and review of contingent legal liability schedule, non-GAAP analysis, and reporting of certain adjustments to DHS.
8. Attract and deploy additional skilled resources and align them to financial reporting oversight roles.

I-C Refunds and Drawbacks of Duties, Taxes, and Fees

Background:

CBP performs an important revenue collection function for the Federal government. Refund and drawback claims are a remittance, in whole or in part, of duties, taxes, or fees previously paid by an importer. Refund claims typically occur when an importer overpays the duties, taxes or fees associated with imported goods. Reasons for a refund claim include but are not limited to, duplicate payment, incorrect duty rate and settlement of court cases. Drawback claims typically occur when imported goods on which duties, taxes, or fees have been previously paid are subsequently exported from the United States or destroyed prior to entering the commerce of the United States. The *Trade Facilitation and Trade Enforcement Act of 2015* (TFTEA) contains provisions for drawback modernization that simplify the rules for determining if exports are eligible for refunds, expand the timeframe for drawback claims, and eliminate certain documentation requirements.

In 2014, the President issued an executive order that requires full implementation of the International Trade Data System by December 2016. In order to meet this requirement, CBP has been transitioning various trade functions, including quota and cargo release, from the Automated Commercial System (ACS), which is the current IT system for custodial collections, to the Automated Commercial Environment

Independent Auditors' Report

Exhibit I – Material Weaknesses in Internal Control over Financial Reporting

(ACE) system. The remaining functions, including the recording of collections and payment of drawback claims, are scheduled for migration to ACE in FY 2017.

Many of the conditions cited below have existed for several years. Management has stated in the past that the timeframe for remediation of these conditions is dependent on successful implementation of IT system upgrades and necessary legislative changes. The TFTEA provisions contain the statutory changes CBP sought and provides for a path forward to implement the necessary system enhancements to strengthen CBP's internal controls over drawback claims and underlying imports. The pending system development and implementation of TFTEA provisions will require policy decisions, regulatory updates, and issuance of policies and procedures to balance requirements for implementing TFTEA and ACE development with the needs and capabilities of the Trade community to adapt to those requirements. CBP has two years from the date of enactment of the TFTEA to fully implement all provisions of the law, leading to an effective date of February 24, 2018. The new law also allows an additional transition year under which drawback claimants may submit claims under either existing regulations or the updated regulations, effectively making the final implementation of drawback simplification February 24, 2019.

Conditions:

We identified the following internal control deficiencies related to refunds and drawbacks of duties, taxes, and fees that, collectively, resulted in a material weakness in internal control for financial reporting:

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

Cause/Effect:

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

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

Independent Auditors' Report
Exhibit I – Material Weaknesses in Internal Control over Financial Reporting

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

Criteria:

Presented in Index of Financial Reporting and Internal Control Criteria, after Exhibit II.

Recommendations:

We recommend that CBP:

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

Independent Auditors' Report
Exhibit II – Significant Deficiencies in Internal Control over Financial Reporting

II-D Entity-Level Controls

Background and Criteria:

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

The conditions below should be read in conjunction with **Finding I-A, Information Technology Controls and Financial Systems Functionality**; **Finding I-B, Financial Reporting**; **Finding I-C, Refunds and Drawbacks of Duties, Taxes, and Fees**; and **Finding II-E, Custodial Revenue - Entry Process**.

Conditions, Cause/Effect, and Recommendations:

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

Control Environment:

During our audit we identified weaknesses in CBP's control environment, which serves as the foundation of an internal control system. As a result, individual process-level controls have a greater risk for not being designed, implemented appropriately or operating effectively. CBP's control environment should be improved to ensure:

- Formalized reporting structures are in place, including when undergoing an organizational realignment.
- Accounting policies and standard operating procedures are formally documented, complete, and revised in a timely manner.
- Existing management directives are sufficiently specific that controls are performed consistently at all locations.

Risk Assessments:

CBP does not have a mature risk assessment process. As a result, events and transactions that have a greater likelihood of error do not always receive an appropriate level of attention. Risk assessments should be performed annually and updated during the year as needed. Examples of areas that should be addressed annually and updated periodically are:

- Needs for technical and resource support to remediate severe control deficiencies and continually evaluate areas where material financial statement errors could occur and not be identified and corrected timely.
- Training needs assessments for personnel to match skills with roles and responsibilities and identify gaps that could lead to financial statement errors.

Independent Auditors' Report

Exhibit II – Significant Deficiencies in Internal Control over Financial Reporting

- Identification of financial accounts and transactions that are susceptible to error due to weaknesses in IT general controls and IT systems functionality. Refer to **Finding I-A, Information Technology Controls and Financial Systems Functionality**.
- Robust continuous monitoring and testing of IT general controls necessary to identify weaknesses, assess the resulting risks created by IT deficiencies, and respond to those risks through compensating controls.

Information and Communications:

Communications within CBP between headquarters, program offices, and field personnel should be improved to ensure:

- Roles and responsibilities of program and field personnel that provide key financial information are defined and that those personnel understand and comply with policies.
- Monitoring across CBP, an organization that is large and complex with decentralized operations, to verify that internal control over financial reporting and compliance with direct and material laws and regulations have been properly designed and implemented and are operating effectively across the organization.

Monitoring Controls:

CBP should design continuous monitoring controls to ensure transactions with a higher risk of error are adequately examined. Detective controls intended to compensate or mitigate weak preventive or process-level controls (e.g., management review controls of the consolidated financial statements) are not always designed at a level of precision to identify significant errors or operating effectively. Consequently, errors, or a combination of errors, in the consolidated financial statements could go undetected.

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

II-E Custodial Revenue - Entry Process

Background:

CBP collected \$40.3 billion in custodial revenue in FY 2016. The majority of CBP's collections are from merchandise, which enters the United States from foreign ports of origin, against which CBP assesses import duties, taxes, and fees. Receipts of import duties and related refunds are presented in the statement of custodial activity. To ensure the subsequent collection of these duties, taxes, and fees, CBP requires bonds from parties that import merchandise into the United States. The assessment of liquidated damages against a bond serves to promote compliance with laws and regulations.

Independent Auditors' Report

Exhibit II – Significant Deficiencies in Internal Control over Financial Reporting

Conditions:

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

1. Management did not fully implement and communicate policies and procedures that identified risk points and key controls for the entry functions that were transitioned to ACE and updates that were required due to changes in governing statutes during FY 2016.
2. Existing policies and procedures (1) were not consistently followed for review and verification of duties within entry edit and exception reports; (2) did not clearly establish consistent procedures for completing and documenting the review of the entry edit and exception and Budget Clearing Account (BCA) reports; and (3) lacked a requirement for locations to implement controls to ensure the completeness and accuracy of alternative reports used when locations elected to modify the standard system-generated reports.
3. In addition to deficiencies in the design and implementation of controls over the BCA report, we also identified specific instances of untimely removal from the BCA collections related to fines, penalties, and forfeitures receivables and liabilities for deposit accounts.
4. Controls over the review of Single Transaction Bonds (STBs) were not operating effectively. The system for processing STBs was operational for the entire fiscal year, however, it was not designed to replace the requirements for a manual review. Additionally, CBP was unable to provide documentation to support the manual review of bonds processed through the system.

Cause/Effect:

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

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

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

Criteria:

Presented in Index of Financial Reporting and Internal Control Criteria, after Exhibit II.

Independent Auditors' Report
Exhibit II – Significant Deficiencies in Internal Control over Financial Reporting

Recommendations:

We recommend that CBP:

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

Independent Auditors' Report
Index of Financial Reporting and Internal Control Criteria
(Listed Alphabetically by Criteria Source)

| Criteria | Reference | Report Exhibit |
|---|---|----------------|
| CBP 2013 Drawback Handbook, (HB 3700-01B) | Section 5.2 | I-C, II-E |
| CBP Collection and Deposits Handbook (HB 5300-12B) | Section 7.3 | I-C, II-E |
| CBP Directive 3710-004B, <i>Refund of Miscellaneous Collections</i> | Section 2.2 Section 5.71 | I-C, II-E |
| CBP Directive 5610-004B, <i>Resolving Certain ACS Exception and Error Reports</i> | Section 5.4 Section 5.6 Section 5.11 | I-C, II-E |
| CBP Seized Asset Management and Enforcement Procedures Handbook (SAMEPH) | Chapter 17 | I-B |
| CBP Standard Operating Procedure (SOP), SF 132/133 Reconciliation | Section 5 | I-B |
| Code of Federal Regulations, Title 19 | §111.23, §111.25, §113.15, §113.26, §113.65, §163.4, §191.15, §191.38, §191.51, §191.92 | I-C |
| | §113.13 | I-C, II-E |
| Component Requirements Guide for Financial Reporting in FY 2016, Version 4.0, March 2016 | Section 3.6 Section 8.12 Section 9.4 Section 9.5 | I-B |
| DHS Sensitive Systems Policy Directive 4300A, Version 12.0, February 2016 | Section 2.1.6.d Section 4.1.3.a Section 4.1.4.a-b Section 4.1.6.a,d Section 4.8.4.f Section 5.2.a Section 5.3.b,h | I-A |
| Executive Order 13659, <i>Streamlining the Export/Import Process for America's Business</i> | Section III | II-E |

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

| Criteria | Reference | Report Exhibit |
|---|---|----------------|
| Federal Accounting Standards Board (FASAB) Technical Release No. 4, <i>Reporting on Non-Valued Seized and Forfeited Property</i> | Background | I-B |
| <i>Federal Managers' Financial Integrity Act of 1982</i> | Section 2 | I-C |
| GAO <i>Standards for Internal Control in the Federal Government</i> | Principle 10.12 Principle 11.11 Principle 11.12 Principle 11.13 Principle 11.14 | I-A |
| | Principle 10.02 Principle 10.03 Principle 11.03 Principle 12.05 | I-B, I-C, II-E |
| | Foreword OV2.01 Control Environment Overview Control Activities Overview | II-D |
| National Institute of Standards and Technology (NIST) Special Publication 800-53, <i>Security and Privacy Controls for Federal Information Systems and Organizations</i> , Revision 4, April 2013 | AC-2.e-j AC-5.a-c AC-6 AU-2.d AU-6.a CM-5 RA-5.c-d PS-4.a-b PS-5.c | I-A |
| OMB Circular No. A-11, <i>Preparation, Submission, and Execution of the Budget</i> , July 2013 | Section 130 | I-B |
| Public Law 114-125, <i>Trade Facilitation and Trade Enforcement Act of 2015</i> | Section 912 | II-E |
| Statement of Federal Financial Accounting Standards No. 6, <i>Accounting for Property, Plant, and Equipment</i> | Paragraph 34 | I-B |

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

| Criteria | Reference | Report Exhibit |
|---|--------------|----------------|
| Statement of Federal Financial Accounting Standards No. 7, <i>Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting</i> | Paragraph 53 | I-B, II-E |
| Statement of Federal Financial Accounting Standards No. 13, <i>Accounting for Leases</i> | 15 | I-B |



OFFICE OF INSPECTOR GENERAL
Department of Homeland Security

Appendix A

Management's Comments to the Draft Report

1300 Pennsylvania Avenue NW
Washington, DC 20229



**U.S. Customs and
Border Protection**

MEMORANDUM FOR: John V. Kelly
Deputy Inspector General
U.S. Department of Homeland Security

FROM: Jaye M. Williams
Chief Financial Officer

SUBJECT: Management's Response to the Independent Auditor's Report on
the U.S. Customs and Border Protection Fiscal Year 2016
Consolidated Financial Statements

On behalf of the U.S. Customs and Border Protection (CBP), I am responding to the Independent Auditor's Report on CBP's Fiscal Year (FY) 2016 Consolidated Financial Statements, which will be included in our FY 2016 Performance and Accountability Report.

I accept the independent public accounting firm's (KPMG LLP), unmodified opinion on CBP's FY 2016 Consolidated Financial Statements, which concluded that CBP's consolidated financial statements are fairly presented in all material respects in conformity with generally accepted accounting principles.

CBP concurs with the three material weaknesses and the two significant deficiencies reported in the IAR. The material weaknesses were found in the areas of information technology controls and financial systems functionality; financial reporting; and refunds and drawbacks of duties, taxes and fees. The significant deficiencies were in the areas of internal control in entity-level controls and custodial revenue-entry process. Mission Action Plans outlining CBP's strategy to correct these conditions have been provided to the U.S. Department of Homeland Security, Office of Financial Management. CBP will aggressively work to resolve all the deficiencies identified during the audit.

CBP appreciates the opportunity to review this year's audit report and looks forward to continuing our professional auditing relationship with your office. If you have any questions or would like additional information, please contact me at (202) 344-2364 or via email at Jaye.M.Williams@cbp.dhs.gov, or Martin N. Finkelstein, Executive Director, Financial Operations Directorate, at (202) 344-1628 or via email at marty.n.finkelstein@cbp.dhs.gov.



OFFICE OF INSPECTOR GENERAL

Department of Homeland Security

Appendix B

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Department of Homeland Security

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