OFFICE OF INSPECTOR GENERAL

Independent Auditors' Report on DHS' FY 2019 Financial Statements and Internal Control over Financial Reporting

Homeland Security

November 15, 2019

OIG-20-03

DHS OIG HIGHLIGHTS

Independent Auditors' Report on DHS' FY 2019 Financial Statements and Internal Control over Financial Reporting

November 15, 2019

Why We Did This Audit

The *Chief Financial Officers Act of 1990* (Public Law 101-576) and the *Department Of Homeland Security Financial Accountability Act* (Public Law 108-330) require us to conduct an annual audit of the Department of Homeland Security's (DHS) consolidated financial statements and internal control over financial reporting.

What We Recommend

KPMG LLP made 28 recommendations that, when implemented, would help improve the Department's internal control.

For Further Information:
Contact our Office of Public Affairs at (202) 981-6000, 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 DHS' consolidated financial statements for fiscal years 2019 and 2018. KPMG noted that the financial statements present fairly, in all material respects, DHS' financial position as of September 30, 2019 and 2018.

KPMG issued an adverse opinion on DHS' internal control over financial reporting as of September 30, 2019. KPMG identified material weaknesses in internal control in two areas and other significant deficiencies in three areas. KPMG also reported two instances of noncompliance with laws and regulations.

Material Weaknesses

- Information Technology Controls and Financial Systems
- Financial Reporting

Other Significant Deficiencies

- Property, Plant, and Equipment
- Custodial Activities: Entry Processing, Refunds and Drawbacks, and Seized and Forfeited Property
- Grants Management

Noncompliance with Laws and Regulations

- *Federal Managers' Financial Integrity Act of 1982*
- *Federal Financial Management Improvement Act of 1996*

Management's Response

DHS concurred with all of the recommendations.

November 15, 2019

MEMORANDUM FOR: The Honorable Chad Wolf
Acting Secretary
Department of Homeland Security

FROM: Jennifer L. Costello
Deputy Inspector General

SUBJECT: *Independent Auditors' Report on DHS' FY 2019 Financial Statements and Internal Control over Financial Reporting*

The attached report presents the results of an audit of the Department of Homeland Security's (DHS) consolidated financial statements for fiscal years (FY) 2019 and 2018 and internal control over financial reporting as of September 30, 2019. This audit is required by the *Chief Financial Officers Act of 1990,* as amended by the *Department of Homeland Security Financial Accountability Act of 2004*. We contracted with the independent public accounting firm KPMG LLP (KPMG) to conduct the audit. The contract required that the audit be performed in accordance with U.S. generally accepted government auditing standards, Office of Management and Budget audit guidance, and the GAO/CIGIE *Financial Audit Manual.* This report is incorporated into the Department's FY 2019 *Agency Financial Report.*

The Department continued to improve financial management in FY 2019 and achieved an unmodified (clean) opinion on all financial statements. However, KPMG issued an adverse opinion on DHS' internal control over financial reporting because of material weaknesses in internal control.

Summary

KPMG identified material weaknesses in internal control in two areas and other significant deficiencies in three areas. KPMG also reported two instances of noncompliance with laws and regulations.

Below are the material weaknesses and other significant deficiencies and two instances of noncompliance with laws and regulations:

Material Weaknesses

- Information Technology Controls and Financial Systems
- Financial Reporting

Other Significant Deficiencies

- Property, Plant, and Equipment
- Custodial Activities: Entry Processing, Refunds and Drawbacks, and Seized and Forfeited Property
- Grants Management

Noncompliance with Laws and Regulations

- *Federal Managers' Financial Integrity Act of 1982*
- *Federal Financial Management Improvement Act of 1996*

Moving DHS' Financial Management Forward

The Department continued its commitment to identifying areas for improvement, developing and monitoring corrective actions, and establishing and maintaining effective internal control over financial reporting this past fiscal year. Looking forward, the Department must continue remediation efforts and stay focused in order to sustain its clean opinion on its financial statements and obtain a clean opinion on its internal control over financial reporting.

*****

KPMG is responsible for the attached Independent Auditors' Report dated November 14, 2019, 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. Our review, as differentiated from an audit in accordance with generally accepted government auditing standards, was not intended to enable us to express, and we do not express, an opinion on DHS' financial statements or internal control over financial reporting or provide conclusions on compliance with laws and regulations. Our review disclosed no instances where KPMG did not comply, in all material respects, with U.S. generally accepted government auditing standards.

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

We request that the Department provide us with a corrective action plan that demonstrates progress in addressing the report's recommendations.

Please call me with any questions, or your staff may contact Sondra F. McCauley, Assistant Inspector General for Audits at (202) 981-6000, or Maureen Duddy, Deputy Assistant Inspector General for Audits, at (617) 565-8723.

Attachment

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Appendixes

KPMG LLP
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Washington, DC 20006

Independent Auditors' Report

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

Report on the Financial Statements and Internal Control

We have audited the accompanying consolidated financial statements of the U.S. Department of Homeland Security (DHS), which comprise the consolidated balance sheets as of September 30, 2019 and 2018, 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. We also have audited DHS's internal control over financial reporting as of September 30, 2019, based on criteria established in the *Standards for Internal Control in the Federal Government*, issued by the Comptroller General of the United States.

Management's Responsibility for the Financial Statements and Internal Control over Financial Reporting

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 effective internal control over financial reporting relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. Management is also responsible for its assessment about the effectiveness of internal control over financial reporting, included in the accompanying *Management's Report on Internal Control over Financial Reporting*.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements and an opinion on DHS's internal control over financial reporting based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, in accordance with the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, and in accordance with Office of Management and Budget (OMB) Bulletin No. 19-03, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 19-03 require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement and whether effective internal control over financial reporting was maintained in all material respects.

An audit of financial statements involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the 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 financial statements in order to design audit procedures that are appropriate in the circumstances. An audit of financial statements 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 financial statements.

An audit of internal control over financial reporting involves performing procedures to obtain audit evidence about whether a material weakness exists. The procedures selected depend on the auditors' judgment, including the assessment of the risks that a material weakness exists. An audit of internal control over financial reporting also involves obtaining an understanding of internal control over financial reporting and testing and evaluating the design and operating effectiveness of internal control over financial reporting based on the assessed risk.

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

Definition and Inherent Limitations of Internal Control over Financial Reporting

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with U.S. generally accepted accounting principles. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction, of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the consolidated financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct, misstatements. Also, projections of any assessment of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

We did not test all internal controls relevant to operating objectives as broadly defined by the *Federal Managers' Financial Integrity Act of 1982*.

Opinion on 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. Department of Homeland Security as of September 30, 2019 and 2018, 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.

Basis for Adverse Opinion on Internal Control over Financial Reporting

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. Material weaknesses have been identified in the following areas as described in the accompanying Exhibit I and included in the accompanying *Management's Report on Internal Control over Financial Reporting*.

A. Information Technology Controls and Financial Systems
B. Financial Reporting

We considered the material weaknesses identified above in determining the nature, timing, and extent of audit procedures applied in our audit of the fiscal year 2019 consolidated financial statements, and these material weaknesses do not affect our opinion on the financial statements.

Adverse Opinion on Internal Control over Financial Reporting

In our opinion, because of the effect of the material weaknesses described in the Basis for Adverse Opinion paragraph above on the achievement of the objectives of the control criteria, DHS has not maintained effective internal control over financial reporting as of September 30, 2019, based on criteria established in *Standards for Internal Control in the Federal Government*, issued by the Comptroller General of the United States.

Emphasis of Matter

As discussed in Note 15 to the consolidated financial statements, DHS had intragovernmental debt used to finance the *National Flood Insurance Program* (NFIP) of approximately $21 billion as of September 30, 2019 and 2018. The loan and interest payments are financed by the flood premiums from policyholders. Given the current rate structure, DHS will not be able to pay its debt from the premium revenue alone; therefore, DHS does not anticipate repaying the debt. Congress enacted the *Additional Supplemental Appropriations for Disaster Relief Requirements Act* on October 26, 2017. This act provided debt relief by cancelling $16 billion of DHS's debt to the U.S. Department of the Treasury in fiscal year 2018. Our opinion is not modified with respect to this matter.

Other Matters

Interactive Data

Management has elected to reference to information on websites or other forms of interactive data outside the *Agency Financial 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, Required Supplementary Information, and Required Supplementary Stewardship 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 About This Report, Message from the Secretary, Message from the Chief Financial Officer, Introduction, Other Information section, and Acronym List as listed in the Table of Contents of the *Agency Financial 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 accordance with *Government Auditing Standards*, we are required to report findings of significant deficiencies. 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 deficiencies in the following areas as described in Exhibit II to be significant deficiencies.

C. Property, Plant, and Equipment
D. Custodial Activities: Entry Processing, Refunds and Drawbacks, and Seized and Forfeited Property
E. Grants Management

Compliance and Other Matters

As part of obtaining reasonable assurance about whether DHS's consolidated financial statements as of and for the year ended September 30, 2019 are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of 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 disclosed an instance of noncompliance or other matter that is required to be reported under *Government Auditing Standards* or OMB Bulletin No. 19-03, and is described in Exhibit III.

F. Federal Managers' Financial Integrity Act of 1982

We also performed tests of its compliance with certain provisions referred to in Section 803(a) of the *Federal Financial Management Improvement Act of 1996* (FFMIA). Providing an opinion on compliance with FFMIA was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances, described in Exhibit III, in which DHS's financial management systems did not substantially comply with the (1) Federal financial management systems requirements, (2) applicable Federal accounting standards, and (3) United States Government Standard General Ledger at the transaction level.

DHS's Responses to Findings

DHS's responses to the findings identified in our audit are described in Appendix A. DHS's responses were not subjected to the auditing procedures applied in the audit of the consolidated financial statements and, accordingly, we express no opinion on the responses.

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 deficiencies we consider to be significant deficiencies, and the scope of our testing of compliance and the results of that testing, and not to provide an opinion on compliance. Accordingly, this communication is not suitable for any other purpose.

KPMG LLP

Washington, D.C.
November 14, 2019

The weaknesses in internal control existed as of September 30, 2019 and the instances of noncompliance with certain provisions of laws, regulations, contracts, and grant agreements were identified during the year ended September 30, 2019. The determination of which control deficiencies rise to the level of a material weakness or a significant deficiency is based on an evaluation of the impact of control deficiencies identified in all Components, considered individually and in the aggregate, on the U.S. Department of Homeland Security (DHS) consolidated financial statements as of September 30, 2019. The associated entity level controls, as defined by the *Standards for Internal Control in the Federal Government* issued by the Comptroller General of the United States (Green Book), are also identified in relation to the control activities in the corresponding areas of the following Exhibits.

The findings are presented in three Exhibits:

Exhibit I Material Weaknesses. A material weakness is a deficiency, or 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. DHS has material weaknesses within the following areas:

A. Information Technology Controls and Financial Systems
B. Financial Reporting

Exhibit II Significant Deficiencies. A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by DHS management and others in positions of DHS oversight. DHS has significant deficiencies within the following areas:

C. Property, Plant, and Equipment
D. Custodial Activities: Entry Processing, Refunds and Drawbacks, and Seized and Forfeited Property
E. Grants Management

Exhibit III Compliance and Other Matters. The compliance and other matters identified included instances of noncompliance with certain provisions of laws, regulations, contracts, and grant agreements, and other matters that are required to be reported under *Government Auditing Standards* or Office of Management and Budget (OMB) Bulletin No. 19-03, *Audit Requirements for Federal Financial Statements*. DHS has instances of noncompliance as follows:

F. *Federal Managers' Financial Integrity Act of 1982*
G. *Federal Financial Management Improvement Act of 1996*

Criteria DHS's internal control over financial reporting is based on the criteria established by the Green Book.

I-A Information Technology Controls and Financial Systems

Background:

Information technology (IT) controls are a critical subset of an entity's internal control. There are two main types of IT controls: IT general controls (ITGCs) and application controls. ITGCs operate over entire or large portions of systems and represent the foundation of an IT control structure. They are applied at the entity-wide, operating system, database, or application level, and include controls over access control, configuration management, segregation of duties, and contingency planning. Effective ITGCs are necessary to create the foundation for the operation of application controls. Application controls are those controls that directly relate to specific IT applications and ensure completeness, accuracy, validity, confidentiality, and availability of data. The deficiencies indicated in this Exhibit are representative of ITGC and application control deficiencies at various Components across DHS.

Conditions:

DHS did not design and implement the entity's information systems and related control activities to achieve objectives and respond to risks as required by Green Book principles 11, *Design Activities for the Information System*, and 12, *Implement Control Activities*. Specifically, DHS had:

- Ineffective design, implementation, and operating effectiveness of ITGCs over IT operating systems, databases, and IT applications supporting financial reporting processes across DHS in the following areas:

  Access control and segregation of duties

  - User, service, privileged, and generic (including emergency, temporary, developer, and migrator) accounts not properly authorized, recertified, and revoked timely;
  - The principles of least privilege and segregation of duties not applied;
  - Password security not properly configured for data protection and inactivity;
  - Audit logging activity requirements not defined;
  - Audit logs not generated, reviewed, analyzed, and protected;
  - Development and production environment duties not segregated between conflicting roles;

  Configuration management

  - Configuration management processes including documented policies and procedures; and systems not properly configured;
  - System changes including change implementation, testing, and approval dates not documented; and
  - Periodic reviews of the results of vulnerability scans not performed.

- Ineffective ITGCs performed by service organizations that provide infrastructure support for various IT systems.
- Ineffective application controls and manual controls that are dependent upon the information derived from DHS financial reporting systems.

DHS continued to have deficiencies in its design and implementation of controls over IT Controls and Financial Systems. These deficiencies have persisted since the inception of DHS. As a result, DHS did not remediate identified internal control deficiencies on a timely basis as required by Green Book principle 17, *Evaluate Issues and Remediate Deficiencies*. Specifically, DHS had:

- Ineffective design and implementation of controls to remediate IT findings, including insufficient corrective action to address deficiencies that have existed for several years in multiple information systems.

Causes:

These deficiencies are a result of the failure of entity level controls as follows:

Green Book principle 7 requires that "Management should identify, analyze, and respond to risks related to achieving the defined objectives." DHS did not effectively implement and operate Green Book principle 7. Specifically,

- DHS did not fully implement a robust risk assessment of ITGCs that is necessary to identify weaknesses, nor did it assess the resulting risks created by IT deficiencies.
- DHS did not resolve the risks created by historic limitations in the functionality of DHS's financial systems.
- DHS did not successfully mitigate the risk created by implementing manual controls to compensate for risks created by decentralized systems and records management processes or utilities with limited automated capabilities.

Green Book principle 16 requires that "Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results." DHS did not effectively implement and operate Green Book principle 16. Specifically,

- DHS did not implement a formalized process to monitor the third party service organizations responsible for maintaining the infrastructure support for various IT systems.
- DHS established corrective action plans, but had not monitored them to ensure they were tracking the progress toward remediation of deficiencies in a timely manner.

Effects:

Deficiencies in access controls and segregation of duties increase the risk that current employees, separated employees, or contractors may obtain unauthorized or inappropriate access to financial systems or data. Such access could lead to unauthorized activities or inappropriate disclosures of sensitive data. Deficiencies in 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 is reliable, valid, and complete.

In addition, system limitations contribute to deficiencies in multiple financial process areas across DHS. Many key DHS financial systems are not compliant with Federal financial management system requirements as defined by the *Federal Financial Management Improvement Act of 1996* (FFMIA), as noted in Exhibit III. These functionality limitations cause a greater risk of error and result in inconsistent, incomplete, or inaccurate control execution.

Collectively, DHS not performing an appropriate risk assessment to identify and mitigate the ITGC and application control deficiencies limits DHS's ability to process, store, and report financial data in a manner that ensures accuracy, confidentiality, integrity, and availability. In response to these deficiencies, DHS intended to utilize manual controls; however, these manual controls often were not properly designed or implemented, or did not operate effectively as reported in Exhibits I and II.

Recommendations:

We recommend that DHS:

1. Office of the Chief Financial Officer (OCFO), in coordination with the Office of the Chief Information Officer (OCIO), the Office of the Chief Information Security Officer (OCISO), and Component IT and financial management, complete a comprehensive risk analysis and develop a mitigation plan to reduce risks related to ITGC and application control deficiencies;

2. OCFO, in coordination with the OCIO, the OCISO, and Component IT and financial management, design and implement an effective internal control process, including manual controls, to ensure that the risk of errors due to IT system functionality issues and the inability to rely on application controls are compensated for until system deficiencies are remediated;

3. OCFO, in coordination with the OCIO, the OCISO, and Component IT and financial management, make the necessary improvements to DHS's ITGC and application controls. Specific, detailed recommendations were provided in individual limited distribution Notices of Findings and Recommendations to DHS and Component management; and

4. OCISO, the OCIO, and Component IT management sufficiently monitor IT vulnerabilities and limitations, and coordinate with the OCFO and Component financial management to implement manual controls to mitigate risk.

I-B Financial Reporting

Background:

Internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, and is designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with U.S. generally accepted accounting principles.

Conditions:

DHS did not design control activities to achieve objectives and respond to risks as required by Green Book principle 10, *Design Control Activities*, or implement the entity's information systems and related control activities through policies as required by Green Book principles 11, *Design Activities for the Information System*, and 12, *Implement Control Activities*. Specifically, DHS had:

- Ineffective design, implementation, and operating effectiveness of controls supporting financial reporting processes across DHS in the following areas:

  Beginning balances

  - Beginning balances not reviewed for completeness and accuracy at the transaction level;

  Journal entries

  - Manual journal entries not reviewed and approved;
  - Journal entry amounts not validated with appropriate supporting documentation;
  - Transactions not reviewed for correct U.S. Standard General Ledger (USSGL) accounts;

- Transaction codes not reviewed and approved prior to permitting the transaction codes to be used in the system;
- Journal entry descriptions of the business events not aligned to the supporting documentation provided for the entry;

Actuarially derived estimates

- The underlying data used in the valuation of the pension liability not validated for completeness and accuracy;
- Assumptions used in the valuation of the actuarial liabilities not reviewed at an appropriate level of precision or evaluated for reasonableness at fiscal year-end;

Service organization control (SOC) reports

- Service provider risks not addressed by obtaining and effectively reviewing a SOC report, or by assessing the risks when a SOC report does not exist; and

Application Controls and Information Produced by the Entity

- Baseline assessments of application controls and information produced by the entity not reviewed for completeness and accuracy.

DHS continued to have deficiencies in its design and implementation of controls over Financial Reporting. The deficiencies have persisted since the inception of DHS. As a result, DHS did not remediate identified internal control deficiencies on a timely basis as required by Green Book principle 17, *Evaluate Issues and Remediate Deficiencies*.

Causes:

These deficiencies are a result of the failure of entity level controls as follows:

Green Book principle 4 requires that "Management should demonstrate a commitment to recruit, develop, and retain competent individuals." DHS did not effectively implement and operate Green Book principle 4. Specifically,

- DHS did not provide timely training on requirements for supporting documentation to individuals with responsibilities to review journal entries.
- DHS did not sufficiently develop and retain individuals responsible for the recording of journal entries.

Green Book principle 5 requires that "Management should evaluate performance and hold individuals accountable for their internal control responsibilities." DHS did not effectively implement and operate Green Book principle 5. Specifically,

- DHS did not enforce accountability of control operators responsible for the review of the SOC reports.

Green Book principle 7 requires that "Management should identify, analyze, and respond to risks related to achieving the defined objectives." DHS did not effectively implement and operate Green Book principle 7. Specifically,

- DHS did not fully implement a robust risk assessment of ITGCs that is necessary to identify weaknesses, nor did it assess the resulting risks created by IT deficiencies.
- DHS did not assess the resulting risks created by IT deficiencies and their impact on other controls.

- DHS did not perform a risk assessment to design standard operating procedures to perform a robust review of the actuarial pension report.

Green Book principle 13 requires that "Management should use quality information to achieve the entity's objectives." DHS did not effectively implement and operate Green Book principle 13. Specifically,

- DHS did not process data into quality information that was useable for operating controls effectively.
- DHS did not perform baseline testing of information generated by applications prior to relying on that information as part of a control.
- DHS did not identify the appropriate information requirements to support proposed journal entries.
- DHS did not obtain quality information from its Components to achieve the entity's objectives.

Green Book principle 16 requires that "Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results." DHS did not effectively implement and operate Green Book principle 16. Specifically,

- DHS did not monitor the status of corrective action plans.
- DHS did not monitor the assigned processes and controls performed by service organizations.
- DHS did not monitor the service organization's controls surrounding the compilation of the National Flood Insurance Program (NFIP) financial statements and the related IT systems used to process insurance policies.
- DHS did not design and implement sufficient procedures to review SOC reports.

Effects:

The failure to adequately design, implement, and operate internal controls over beginning balances increases the risk that beginning balances could contain undetected misstatements.

The failure to adequately design, implement, and operate internal controls over journal entries increases the risk that misstatements can occur without being prevented, or detected and corrected in a timely fashion.

The failure to develop and retain individuals and provide timely training increases the risk that unsupported or incorrect journal entries will be recorded.

The failure to adequately design, implement, and operate internal controls over actuarially derived estimates increases the risk that misstatements can occur without being prevented, or detected and corrected in a timely fashion. This resulted in over $1.2 billion of auditor-identified errors, approximately 2% of estimated actuarial pension and other retirement benefits liabilities.

The failure to adequately design, implement, and operate internal controls related to oversight of service organizations increases the risk that misstatements can occur without being prevented, or detected and corrected in a timely fashion.

The failure to adequately design, implement, and operate internal controls related to the baseline assessment of application controls and information produced by the entity prevents management from relying on application controls. It also prevents management from relying on the information produced by the entity that is used in the recording of journal entries and performance of manual controls.

In addition, the lack of compensating controls for IT deficiencies results in noncompliance with Federal financial management system requirements as defined by FFMIA, and reported in Exhibit III.

Recommendations:

We recommend that DHS:

5. develop new policies, or improve and reinforce existing policies, procedures, and related internal controls, that:
    a. beginning balances are recorded at the transaction level in the correct underlying general ledger systems in order to improve the quality of information in each system;
    b. journal entries are adequately researched, supported, and reviewed before and after recording in the general ledger;
    c. assumptions used in significant estimates are sufficiently reviewed on a timely basis with an appropriate level of precision, and that the results of the reviews are properly documented;
    d. reviews of assumptions used in significant estimates are maintained and the validity of those assumptions are routinely evaluated; and
    e. the underlying census data to actuarially derived estimates is reviewed at least annually; and
    f. information used in the operations of controls is determined to be complete and accurate;
6. provide training and enforce accountability for adherence to policies and procedures and provide the necessary financial reporting oversight;
7. improve the process for identification, analysis, and response to risks related to financial reporting;
8. align knowledgeable resources to monitor and evaluate the roles of service organizations, assess controls at those service organizations, and identify and assess complementary user entity controls within the Components relying on those service organizations; and
9. improve monitoring controls over remediating internal control deficiencies.

II-C Property, Plant, and Equipment

Conditions:

DHS did not design control activities to achieve objectives and respond to risks as required by Green Book principle 10, *Design Control Activities*, or implement control activities through policies as required by Green Book principle 12, *Implement Control Activities*. Specifically, DHS had:

- Ineffective design and implementation of control activities to ensure completeness of capitalized assets, appropriate tracking of asset activity at a transaction level, and timely and accurate recording of asset additions, deletions, or other adjustments to property, plant, and equipment.

Causes:

These deficiencies are a result of the failure of entity level controls as follows:

Green Book principle 5 requires that "Management should evaluate performance and hold individuals accountable for their internal control responsibilities." DHS did not effectively implement and apply Green Book principle 5. Specifically,

- DHS did not hold personnel accountable for performing assigned responsibilities related to the timely capitalization of real property assets.

- DHS failed to enforce policies and procedures in regards to timely and accurate recording of asset additions and retirements.

Green Book principle 9 requires that "Management should identify, analyze, and respond to significant changes that could impact the internal control system." DHS did not effectively implement and operate Green Book principle 9. Specifically,

- DHS did not identify risks related to new or changing business operations and their impact on the capitalization of real property.

Green Book principle 13 requires that "Management should use quality information to achieve the entity's objectives." DHS did not effectively implement and operate Green Book principle 13. Specifically,

- DHS did not completely identify all of the appropriate information requirements to support the adjustment of capitalization of real property assets.

Effects:

DHS experienced difficulties in providing complete and accurate data to support operating controls and year-end property, plant, and equipment balances. The aggregate impact of the property, plant, and equipment deficiencies at DHS results in a risk that misstatements related to the completeness, existence, and accuracy of property, plant, and equipment are not prevented, or detected and corrected in a timely manner. The potential errors identified for property, plant, and equipment were approximately $124 million, approximately 0.5% of General Property, Plant, and Equipment, Net.

Recommendations:

We recommend that DHS:

10. enforce accountability for adherence to policies and procedures and provide the necessary financial reporting oversight;
11. reinforce controls over the timely recording of asset addition and retirement activity to ensure personnel respond to risks when new or changing business operations are identified; and
12. identify the appropriate information requirements to support the recording of asset addition and retirement activity.

II-D Custodial Activities: Entry Processing, Refunds and Drawbacks, and Seized and Forfeited Property

Background:

The majority of DHS's custodial collections are from merchandise entering the United States from foreign ports of origin, against which DHS assesses import duties, taxes, and fees.

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. 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 drawback refunds, expands the timeframe for drawback claims, and eliminates some of the documentation requirements, all of which could eliminate some of the conditions identified below. TFTEA was implemented in February 2019. All drawback claims filed after the implementation date are filed under the regulations in Code of Federal Regulations (CFR) 190. Drawback claims filed prior to the TFTEA implementation date were filed under the regulations in CFR 191.

DHS is also responsible for reporting seized and forfeited property that is in its custody. DHS seizes various items, including prohibited drugs and counterfeit goods. DHS relies on several of its Components to enter case information, including weights and measures, into the seized and forfeited property system.

Conditions:

DHS did not design and implement control activities to achieve objectives and respond to risks as required by Green Book principles 10, *Design Control Activities*, and 11, *Design Activities for the Information System*, or implement control activities through policies as required by Green Book principle 12, *Implement Control Activities*. Specifically, DHS had:

- Ineffective design, implementation, and operating effectiveness of controls supporting custodial activities in the following areas:

  <u>*Entry processing:*</u>

  - Policies and procedures over the review of entry edit and exception reports not established;

Refunds and drawbacks:

- Policies and procedures not updated for the review and approval of refunds prior to disbursement;
- System configuration not designed to properly calculate the interest for refund payments;
- Application controls not designed to prevent, or detect and correct, excessive drawback claims;
- Drawback claims not configured to link to imports at a sufficiently detailed level;
- Essential information on drawback claims not compared, verified, and tracked to the related underlying consumption entries and export documentation upon which the drawback claims were based;
- Policies and procedures not documented that require timely coordination with all applicable parties for drawback claims;

Seized and forfeited property:

- Seized and forfeited asset transactions not recorded properly and timely in the seized and forfeited assets tracking system; and
- Input, extraction, and reporting of seized and forfeited property activity, including identification of unusual weight and measure variances needing further investigation not reviewed.

Causes:

These deficiencies are a result of the failure of entity level controls as follows:

Green Book principle 3 requires that "Management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity's objectives." DHS did not effectively implement and operate Green Book principle 3. Specifically,

- DHS did not document its internal control to meet its operational needs related to refunds.

Green Book principle 4 requires that "Management should demonstrate a commitment to recruit, develop, and retain competent individuals." DHS did not effectively implement and operate Green Book principle 4. Specifically,

- DHS did not sufficiently train individuals to develop competencies for key roles in executing the internal control objectives related to the custodial revenue note to the financial statements and the seized and forfeited property note to the financial statements.

Green Book principle 7 requires that "Management should identify, analyze, and respond to risks related to achieving the defined objectives." DHS did not effectively implement and operate Green Book principle 7. Specifically,

- DHS did not analyze and respond to identified risks related to drawback claims submitted prior to the implementation of TFTEA.
- DHS did not complete a thorough risk assessment related to seized and forfeited property.

Green Book principle 13 requires that "Management should use quality information to achieve the entity's objectives." DHS did not effectively implement and operate Green Book principle 13. Specifically,

- DHS did not process data into quality information that was useable for operating controls effectively.

Green Book principle 14 requires that "Management should internally communicate the necessary quality information to achieve the entity's objectives." DHS did not effectively implement and operate Green Book principle 14. Specifically,

- DHS did not improve and update interim policy documents, which prevented the communication of quality information to enable its personnel to perform key roles.

Green Book principle 15 requires that "Management should externally communicate the necessary quality information to achieve the entity's objectives." DHS did not effectively implement and operate Green Book principle 15. Specifically,

- DHS did not communicate quality information to claimants and brokers related to the document retention period for drawback claims.

Green Book principle 16 requires that "Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results." DHS did not effectively implement and operate Green Book principle 16. Specifically,

- DHS did not identify compensating controls to detect and correct material data input errors prior to the preparation of the seized and forfeited property note to the financial statements.
- DHS did not effectively monitor the internal control system over interest calculations for refund requests.

Effects:

The failure to fully establish and define control activities related to the entry process could lead to potential misstatements of net taxes, duties and trade receivables on the Balance Sheet and total cash collections on the Statement of Custodial Activity.

Until all CFR 191 drawback claims are processed, DHS's failure to implement effective controls over the drawback process may subject DHS to financial loss 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 for years, it will take several years for claims filed under CFR 191 to be completed.

Failure to fully establish and define control activities related to seized and forfeited property results in misstatements of the Seized and Forfeited Property note to the financial statements. The errors in the seized and forfeited property data resulted in overstatements of 5,011 kg in seized property, and 9,538 kg in forfeited property, of which management subsequently corrected 3,497 kg and 4,168 kg, respectively, in the Seized and Forfeited Property note to the consolidated financial statements.

Recommendations:

We recommend that DHS:

Entry processing:

13. update and redistribute guidance to appropriate personnel regarding the relevant directives to ensure consistent performance of controls across all DHS locations;
14. provide training to all personnel on new policies to ensure consistent implementation at all DHS locations;

Refunds and drawbacks:

15. update policies and procedures over the review and approval of refunds;

16. update the system configuration to properly calculate interest on refunds;
17. conduct a robust risk assessment over the drawback claims process, and document responses to the identified risks;
18. continue to enhance manual controls to prevent, or detect and correct excessive drawback claims filed before the implementation of TFTEA as they are processed through the drawback lifecycle;
19. track and monitor the progress made in reducing the risk caused by the backlog of drawback claims;
20. communicate the appropriate retention period to claimants and brokers to ensure supporting documentation is maintained;

Seized and forfeited property:

21. design and implement succession and contingency plans for operational staff responsible for completing destruction of seized and forfeited property;
22. sufficiently train individuals to develop competencies for key seized and forfeited property accounting roles;
23. improve internal communication of the policies and procedures over seized and forfeited property; and
24. improve controls to monitor that the input of weights and measures into the seized and forfeited property system are complete and accurate.

II-E Grants Management

Background:

DHS manages multiple Federal disaster and non-disaster grant programs. In fiscal year (FY) 2018, DHS began implementation of the process to standardize all grant management activities, which continued into FY 2019. This included coordination among the grant regional offices and central management as well as among the various grant programs. In order to monitor the spending of the disaster and non-disaster grant funding, DHS performs site visits and monitors Federal Financial Reports submitted by grantees. The internal control deficiencies related to grants management were reported in prior years and persisted in FY 2019.

Conditions:

DHS did not design control activities to achieve objectives and respond to risks as required by Green Book principle 10, *Design Control Activities*. Specifically, DHS had:

- Insufficient design of the controls over the completeness and accuracy of the site visit monitoring tracking tool responsible for monitoring grantees and related corrective action plans from the findings identified from site visits; and
- Insufficient design of the controls over the completeness and accuracy of the Cash Analysis Reporting Template (CART) responsible for monitoring grantee's Federal Financial Reports.

DHS did not implement control activities through policies as required by Green Book principle 12, *Implement Control Activities*. Specifically, DHS had:

- Inconsistent implementation of procedures over the delegation of authority for and the review of disaster and non-disaster grant obligations and deobligations;

- Inconsistent implementation of procedures over the review of the non-disaster grant obligations and deobligations to ensure that evidence of grant recipient acceptance was received in a timely manner; and
- Inconsistent implementation of procedures over grant close-outs, including the untimely close-out and failure to notify grantees upon close-out of non-disaster grants.

Causes:

These deficiencies are a result of the failure of entity level controls as follows:

Green Book principle 13 requires that "Management should use quality information to achieve the entity's objectives." DHS did not effectively implement and operate Green Book principle 13. Specifically,

- DHS failed to maintain reliable data throughout the monitoring of the Federal Financial Reports and site visits.

Green Book principle 14 requires that "Management should internally communicate the necessary quality information to achieve the entity's objectives." DHS did not effectively implement and operate Green Book principle 14. Specifically,

- DHS lacked consistent lines of communication to ensure that the appropriate authorities review disaster grant obligations and deobligations.
- DHS lacked consistent lines of communication for the review, approval, and notification of non-disaster grant obligations and deobligations.
- DHS failed to establish internal lines of communication to facilitate the tracking of grantee site visits and grantee Federal Financial Reports.

Effects:

The failure to use quality information and internally communicate policies and procedures to implement standardized internal controls within DHS during FY 2019 caused ineffective monitoring of grantees. Ineffective monitoring may result in inaccurate or unauthorized expense reporting by grantees and increases the risk that DHS may not identify corrective actions for grantees in a timely manner. In addition DHS's failure to use quality information and internally communicate that grants are eligible for closeout elevates the risk of invalid obligations due to untimely closure of grants. The failure to effectively communicate also increases the risk that obligations are improperly created and elevates the risk of *Antideficiency Act* violations.

Recommendations:

We recommend that DHS:

25. improve the quality of information used in the continuous quality assurance and grants monitoring process, including review of corrective actions resulting from procedures over obtaining, timely reviewing, and reconciling required quarterly grantee reports and procedures to create and track comprehensive lists of grants eligible for closeout; and
26. identify and correct barriers to effectively communicate policies and procedures implemented as a result of the grants management standardization process throughout DHS.

III-F *Federal Managers' Financial Integrity Act of 1982*

The *Federal Managers' Financial Integrity Act of 1982* (FMFIA) requires agencies to establish effective internal control and financial systems and to continuously evaluate and assess the effectiveness of their internal control. DHS's implementation of OMB Circular No. A-123 facilitates compliance with FMFIA. DHS has implemented a multi-year plan to achieve full assurance on internal control. However, the DHS *Secretary's Assurance Statement*, dated November 14, 2019, as presented in *Management's Discussion and Analysis* of DHS's FY 2019 *Agency Financial Report*, acknowledged the existence of control activities demonstrating material weaknesses, and therefore provided qualified assurance that internal control over financial reporting was operating effectively as of September 30, 2019. Management's findings were similar to the control deficiencies described in Exhibits I and II. However, continuous monitoring and testing of both IT and financial controls was not performed for all significant areas.

While DHS progressed toward full compliance with FMFIA, DHS did not fully establish effective systems, processes, policies, and testing procedures to ensure that internal controls were operating effectively throughout DHS. Deficiencies related to monitoring the internal control system are discussed in Exhibit I, Comments **I-A**, *Information Technology Controls and Financial Systems* and **I-B**, *Financial Reporting*.

Recommendations:

We recommend that DHS:

27. continue its corrective actions to address internal control deficiencies in order to ensure full compliance with FMFIA, and implement the recommendations provided in Exhibits I and II.

III-G *Federal Financial Management Improvement Act of 1996*

The *Federal Financial Management Improvement Act of 1996* (FFMIA) Section 803(a) requires that agency Federal financial management systems comply with: (1) applicable Federal accounting standards; (2) Federal financial management system requirements; and (3) the USSGL at the transaction level. FFMIA emphasizes the need for agencies to have systems that can generate timely, reliable, and useful information with which to make informed decisions to ensure ongoing accountability.

As of September 30, 2019, DHS's financial management systems do not comply substantially with Federal financial management system requirements, applicable Federal accounting standards, and application of the USSGL at the transaction level, as described in Exhibits I and II. The DHS Secretary stated in the *Secretary's Assurance Statement,* dated November 14, 2019, that DHS's financial management systems do not substantially conform to government-wide requirements mandated by FFMIA. DHS's remedial actions and related timeframes are also presented in Table 3 of *Management's Discussion and Analysis* in the FY 2019 *Agency Financial Report*.

Recommendation:

We recommend that DHS:

28. improve its financial management systems to ensure compliance with FFMIA, and implement the recommendations provided in Exhibits I and II.

Appendix A
Management Comments to the Draft Report

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

Homeland Security

November 15, 2019

MEMORANDUM FOR: Jennifer Costello
Deputy Inspector General

FROM: for Stacy Marcott
Acting Chief Financial Officer

SUBJECT: Fiscal Year 2019 Financial and Internal Controls Audit

Thank you for your audit report on the Department's financial statements and internal controls over financial reporting for fiscal years (FY) 2019 and 2018. We concur with the Independent Public Accountant's conclusions. We are pleased to have earned an unmodified financial statement audit opinion for the seventh consecutive year.

We acknowledge the internal control challenges noted in the report. We have implemented multi-year corrective action plans which have strengthened controls and lessened the severity of conditions noted in prior years. We are pleased that the audit report recognizes our progress.

Many of the information technology control challenges noted in the report are the result of outdated financial and business systems, some of which have been in operation longer than the Department has been in existence. We continue to implement and monitor compensating controls to mitigate systems risks. Furthermore, we are in midst of a long-term financial systems modernization effort which when complete will ensure that all DHS Components have modern, compliant financial systems and follow standard business practices.

I look forward to working collaboratively with the Office of Inspector General and the Independent Public Accountant in the years ahead to further strengthen DHS financial management and internal control.

Appendix B
Report Distribution

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