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DEPARTMENT OF HOMELAND SECURITY

Challenges and Steps in Establishing Sound Financial Management

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Financial Management and Assurance

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Highlights

Highlights of GAO-03-1134T, a testimony before the Subcommittee on Government Efficiency and Financial Management, House Committee on Government Reform, House of Representatives

Why GAO Did This Study

Based on its budget, the Department of Homeland Security (DHS) is the largest entity in the federal government that is not subject to the Chief Financial Officers (CFO) Act of 1990. The department, with an estimated $39 billion in assets, an almost $40 billion fiscal year 2004 budget request, and more than 170,000 employees, does not have a presidentially appointed CFO subject to Senate confirmation and is not required to comply with the Federal Financial Management Improvement Act (FFMIA) of 1996. In addition, we designated implementation and transformation of DHS as high risk based on three factors: (1) the implementation and transformation of DHS is an enormous undertaking that will take time to achieve in an effective and efficient manner, (2) components to be merged into DHS already face a wide array of existing challenges, and (3) failure to effectively carry out its mission would expose the nation to potentially very serious consequences.

In light of these conditions, the Subcommittee asked GAO to testify on the financial management challenges facing DHS, steps for establishing sound financial management and business processes at DHS, and GAO's comments on H.R. 2886, The Department of Homeland Security Financial Accountability Act.

www.gao.gov/cgi-bin/getrpt?GAO-03-1134T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact McCoy Williams at 202-512-6906 or williamsm1@gao.gov.

FINANCIAL MANAGEMENT

Department of Homeland Security: Challenges and Steps in Establishing Sound Financial Management

What GAO Found

The Homeland Security Act of 2002 brought together 22 agencies to create a new cabinet-level department focusing on reducing U.S. vulnerability to terrorist attacks, and minimizing damages and assisting in recovery from attacks that do occur. Meeting this mission will require a results-oriented environment with a strong financial management infrastructure.

Creating strong financial management at DHS is particularly challenging because most of the entities brought together to form the department have their own financial management systems, processes, and in some cases, deficiencies. Four of the seven major agencies that transferred to DHS reported 18 material weaknesses in internal control for fiscal year 2002 and five of the seven major agencies had financial management systems that were not in substantial compliance with FFMIA. For DHS to develop a strong financial management infrastructure, it will need to address these and many other financial management issues.

Through the study of several leading private and public sector finance organizations (*Creating Value Through World-class Financial Management*, GAO/AIMD-00-134), GAO has identified success factors, practices, and outcomes associated with world-class financial management. Four steps DHS can take to begin developing sound financial management and business processes are to: (1) make financial management an entitywide priority, (2) redefine the role of the finance organization, (3) provide meaningful information to decision makers; and (4) build a team that delivers results.

H.R. 2886 can help facilitate the creation of a first-rate financial management architecture at DHS by providing the necessary tools and setting high expectations. The bill would (1) make DHS a CFO Act agency, (2) require DHS to obtain an opinion on its internal controls, and (3) require DHS to include program performance information in its performance and accountability reports. GAO fully supports the objectives of the CFO Act to provide reliable financial information and improve financial management systems and controls and believes DHS should be included under the act and therefore also subject to FFMIA. Further, GAO strongly believes that auditor reporting on internal control can be a critical component of monitoring the effectiveness and accountability of an organization and supports DHS, as well as other CFO Act agencies, obtaining such opinions. In addition, GAO supports agencies including program performance information in their performance and accountability reports and strongly encourages DHS to report this information voluntarily. Finally, as introduced, H.R. 2886 provided a waiver allowing DHS to forego a financial statement audit for fiscal year 2003. We understand an agreement has been reached to remove this waiver from the proposed legislation. DHS has committed to a 2003 financial statement audit, which is already underway. GAO supports dropping this provision from H.R. 2886.

United States General Accounting Office
Washington, D.C. 20548

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the major financial management challenges facing the Department of Homeland Security (DHS), steps for establishing sound financial management and business processes, and our comments on H.R. 2886, The Department of Homeland Security Financial Accountability Act. The perspective we offer in this testimony is derived from an extensive body of work on these topics completed by inspector generals, independent auditors, as well as from GAO reports; executive guidance; and testimony related to financial management and DHS.

The Homeland Security Act of 2002 brought together 22 diverse agencies and created a new cabinet-level department to help prevent terrorist attacks in the United States, reduce the vulnerability of the United States to terrorist attacks, and minimize the damage and assist in recovery from attacks that do occur. Efforts to improve homeland security will require a results-oriented approach to ensure mission accountability and sustainability over time, and DHS must have a strong financial management infrastructure to support these goals. As stated in the President's Management Agenda, accurate and timely financial information is needed to secure the best performance and highest measure of accountability for the American people.

DHS has stated its commitment to becoming a model of efficiency and effectiveness for the federal government. To achieve this goal, it must first overcome significant challenges in integrating 22 separate agencies and their systems into a single, effective department, as well as correct the wide array of existing management challenges in the inherited components. Developing a financial management architecture with integrated systems and business processes is one of the many difficult challenges the new department faces. We designated implementation and transformation of DHS as high risk based on three factors: (1) the implementation and transformation of DHS is an enormous undertaking that will take time to achieve in an effective and efficient manner, (2) components to be merged into DHS already face a wide array of existing challenges, and (3) failure to effectively carry out its mission would expose the nation to potentially very serious consequences.[1] Our high-risk program has helped the executive branch and the Congress to galvanize efforts to seek lasting solutions to high-risk problems and challenges.

[1]*High-Risk Series: An Update*, GAO-03-119 (Washington, D.C.: January 2003).

Complicating DHS's efforts to develop a strong financial management infrastructure are the many known financial management weaknesses and vulnerabilities in the agencies DHS inherited. For example, for four of the seven major agencies[2] that transferred to DHS on March 1, 2003—the Immigration and Naturalization Service (INS), the Transportation Security Administration (TSA), the Customs Service, and the Federal Emergency Management Agency (FEMA)—auditors reported 18 material weaknesses[3] in internal control for fiscal year 2002. Further, for five of the seven major agencies, auditors reported that the agencies' financial management systems were not in substantial compliance with the Federal Financial Management Improvement Act (FFMIA) of 1996.[4]

Building an effective financial management infrastructure will require sustained leadership from top management. Currently, based on its budget, DHS is the largest entity in the federal government that is not subject to the Chief Financial Officers (CFO) Act of 1990.[5] As such, this department, with a fiscal year 2004 budget request of nearly $40 billion and currently more than 170,000 employees, does not have a presidentially appointed CFO subject to Senate confirmation and is not required to comply with FFMIA. The goals of the CFO Act and related financial reform legislation, such as FFMIA, are to provide the Congress and agency management with reliable financial information for managing and making day-to-day decisions and to improve financial management systems and controls to properly safeguard the government's assets. DHS should not be the only cabinet-level department not covered by what is the cornerstone for pursuing and achieving the requisite financial management systems and capabilities in the federal government.

[2]The seven major agencies that were transferred to DHS are: Immigration and Naturalization Service, Federal Emergency Management Agency, Customs Service, Transportation Security Administration, the Office of Domestic Preparedness, the U.S. Coast Guard, and the Secret Service.

[3]A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that misstatements, losses, or noncompliance, which are material in relation to the financial statements or to stewardship information, would be prevented or detected on a timely basis.

[4]FFMIA requires auditors, as part of CFO Act agencies' financial statements, to report whether agencies' financial management systems substantially comply with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the federal government's standard general ledger at the transaction level.

[5]Pub. L. No. 101-576, 104 Stat. 2838 (1990).

The creation of DHS presents an opportunity for the federal government to ensure that it designs and implements a world-class organization with a first-rate financial management systems architecture. Providing DHS with the necessary tools, which would be facilitated by the passage of H.R. 2886, and setting high expectations are of paramount importance to its success. First, however, DHS must overcome many financial management challenges, which I will now discuss.

DHS Faces Significant Financial Management Challenges

Although many of the larger agencies that transferred to DHS have been able to obtain unqualified or "clean" audit opinions on their annual financial statements, most employed significant effort and manual work-arounds to do so in order to overcome a history of poor financial management systems and significant internal control weaknesses. Furthermore, some of the entities that transferred may also have weaknesses not yet identified or reported on merely because the problems were considered small or immaterial in relation to their large parent departments, such as the Department of Defense or the U.S. Department of Agriculture. Such weaknesses may become evident now that these smaller agencies are proportionately larger as a part of DHS, add to the known extensive existing challenges, and may therefore be subjected to increased levels of audit scrutiny. Cumulatively, these weaknesses and the efforts needed to resolve them to achieve sound financial management and business processes are an important reason for amending the CFO Act to include DHS and measuring DHS's financial management systems and internal control against the same important financial reform legislation and performance expectations as other federal departments and agencies.

DHS, like other federal agencies, has a stewardship obligation to prevent fraud, waste, and abuse, to use tax dollars appropriately, and to ensure financial accountability to the President, the Congress, and the American people. For the most part, DHS's component entities are using legacy financial management systems that have a myriad of problems, such as disparate, nonintegrated, outdated, and inefficient systems and processes. DHS will need to focus on building future systems as part of its enterprise architecture approach to ensure an overarching framework for the agency's integrated financial management processes. Plans and standard accounting policies and procedures must be developed and implemented to bridge the many financial environments in which inherited agencies currently operate to an integrated DHS system.

Another significant challenge for DHS is fixing the previously identified weaknesses that the agencies bring with them to DHS, a number of which I will now discuss.

Immigration and Naturalization Service

While receiving unqualified audit opinions on its fiscal year 2001 and 2002 financial statements,[6] the former INS under the Department of Justice (DOJ) faces numerous challenges in achieving a sound financial management environment. Although INS was abolished and split into multiple bureaus within DHS, its prior financial management weaknesses will still need to be addressed and could be further complicated by this realignment.

For fiscal year 2002, INS's financial statement auditors reported three material internal control weaknesses and that its systems were not in substantial compliance with FFMIA. Specifically, auditors noted limitations in the design and operation of INS's financial accounting system, thereby requiring it to use stand-alone systems or obtain the required financial information via manual processes and nonroutine adjustments as part of the financial statement preparation process. Having systems that can routinely produce information for financial reporting on demand for day-to-day decision making is one of the expected results of the President's Management Agenda, as well as one of the goals of FFMIA.

In addition, for both fiscal years 2001 and 2002, auditors reported that INS did not have a reliable system for providing regular, timely data on the numbers of completed and pending immigration applications, and the associated collections of fees valued at nearly $1 billion for fiscal year 2002. Accordingly, INS was not able to accurately and regularly determine fees it earns without relying on an extensive servicewide, year-end physical count of over 5.4 million pending applications, as was the case in fiscal year 2002. INS has been developing a new tracking system to facilitate its inventory process. However, until the new system is implemented, INS must rely on inefficient manual processes that significantly disrupt its operations. These and other inherent weaknesses in INS's financial management process limit its ability to produce useful, accurate, and timely financial information.

[6]U.S. Department of Justice, Office of Inspector General, *Immigration and Naturalization Service Financial Statements, Fiscal Year 2002*, Audit Report No. 03-22 (Washington, D.C.: May 2003).

Despite the importance and prevalence of information technology (IT) systems in accomplishing its core missions, INS has not yet established and implemented effective controls for managing its IT resources.[7] The root cause of INS's systems problems has been an absence of effective enterprise architecture management and an IT investment management process. To address such weaknesses, INS has been developing an enterprise architecture, including a current and target architecture, as well as a transition plan. Similarly, INS has taken steps to implement rigorous and disciplined investment management controls. However, with the transfer to DHS and the splitting of INS, these plans will have to be reanalyzed, further delaying implementation of effective systems and complicating DHS's ability to produce reliable, timely, and accurate financial statements and information.

Federal Emergency Management Agency

FEMA, the only CFO Act agency to transfer in its entirety to DHS, faces several major financial management challenges, in spite of receiving an unqualified opinion on its fiscal year 2002 financial statements.[8] In fiscal year 2002 FEMA's auditors reported six material internal control weaknesses and that FEMA's financial management systems were not in substantial compliance with the requirements of FFMIA. One major weakness was FEMA's inability to efficiently prepare accurate financial statements as called for in the President's Management Agenda. For example, auditors reported that for fiscal year 2002, FEMA did not have an integrated financial reporting process that could generate financial statements as a byproduct of already existing processes, and that its financial statements were prepared late and required significant revisions.

In addition, auditors reported in fiscal year 2001 and again in fiscal year 2002 that FEMA did not have adequate accounting systems and processes to ensure that all property, plant, and equipment were properly recorded, accurately depreciated, and tracked in accordance with its polices and applicable federal accounting standards. As a result, FEMA's property management system cannot track items to supporting documentation or to a current location. Furthermore, FEMA lacks procedures to ensure that

[7] U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of Justice*, GAO-03-105 (Washington, D.C.: January 2003).

[8] Federal Emergency Management Agency, *Annual Performance and Accountability Report Fiscal Year 2002* (Washington, D.C.: Jan. 24, 2003).

(1) equipment is consistently recorded on either a system or a component basis, (2) procedures are in place to ensure that property inventories are performed properly, and (3) all equipment is entered into its personal property management system. As a result, there is an increased risk that equipment and other property could be lost, stolen, or improperly recorded in its accounting records.

Since FEMA was the only agency to transfer to DHS in its entirety, it, unlike all of the other agencies, is left without a legacy department to prepare financial statements for the first 5 months of activity for fiscal year 2003 or an Office of Inspector General (OIG) to audit them, leaving FEMA's financial management information for the first 5 months of this fiscal year vulnerable to omissions, errors, and ultimately material misstatements. Given the weaknesses in, among other things, FEMA's property controls, we are initiating a review of FEMA's disbursement activity and property management controls covering this 5-month period. We will keep this Subcommittee informed of our progress in this review. Until corrective actions are implemented to address weaknesses, FEMA will not be able to achieve effective financial accountability or ensure that property is properly accounted for.

U.S. Customs Service

In fiscal year 2002, Customs under Treasury received a qualified opinion on a limited scope review[9] of its internal controls. This qualified opinion was due to the identification of four material weaknesses in Customs' internal controls by its independent auditors.[10] For example, auditors reported that Customs' financial systems did not capture all transactions as they occurred during the year; did not record all transactions properly; were not fully integrated; and did not always provide for essential controls with respect to override capabilities. As a result, extensive manual procedures and analysis were required to process certain routine transactions and prepare year-end financial statements.

[9]A limited scope review was performed in lieu of a financial statement audit due to security clearance procedures and other matters related to the access and handling of sensitive information, which delayed the start of the IT evaluation and thus prevented the auditors from completing test work on IT general and application controls.

[10]U.S. Department of the Treasury, Office of Inspector General, *Financial Management: Report on Internal Control Over Financial Reporting of the U.S. Customs Service for Fiscal Year 2002*, OIG-03-033 (Washington, D.C.: Dec. 16, 2002).

Customs, which typically collects and processes over $23 billion in fees annually, was found to have poor collection procedures throughout the agency. Ongoing weaknesses in the design and operation of Customs' controls over trade activities and financial management and information systems continue to inhibit the effective management of these activities and protection of trade revenue. For example, auditors reported that Customs' Automated Commercial System could not provide summary information on the total unpaid assessments for duties, taxes, and fees by individual importer. The system also could not generate periodic management information on outstanding receivables, the age of receivables, or other data necessary for managers to effectively monitor collection procedures. Such a capability would allow Customs to give managers timely access to program revenue information and more effectively present performance measures, which is critical for implementation of the President's Management Agenda.

Despite Customs' progress in implementing recommendations GAO and others have made over the years, numerous weaknesses continue to hinder progress toward developing Customs' planned import system, the Automated Commercial Environment (ACE).[11] ACE is intended to replace the current system used for collecting import-related data and ensuring, among other things, that trade-related revenue is properly collected and allocated. To ensure proper implementation of these initiatives, DHS's management must continue to provide a sustained level of commitment to its successful implementation. Until this system is fully implemented, billions in trade-related revenue will continue to be tracked by systems with inadequate controls. In addition, like INS, Customs faces additional financial management challenges because it was split into various components.

Transportation Security Administration

TSA was created by the Aviation and Transportation Security Act[12] under the Department of Transportation (DOT) in November 2001, to develop transportation security policies and programs that contribute to providing secure transportation for the American public. Despite its short history, the

[11]U.S. General Accounting Office, *Customs Service Modernization: Automated Commercial Environment Progressing, but Further Acquisition Management Improvements Needed*, GAO-03-406 (Washington, D.C.: February 2003).

[12]Pub. L. No. 107-71, 115 Stat. 597 (2001).

former TSA brings to DHS numerous financial management issues. In fiscal year 2002, auditors reported five material weaknesses and that TSA's systems were not in substantial compliance with FFMIA.[13] Specifically, auditors found that TSA management had not established written accounting policies and procedures to properly perform TSA's financial management and budgeting functions during fiscal year 2002. This is an example of what can happen when a newly created entity does not thoroughly develop and implement standard accounting policies and procedures. DHS should carefully review TSA's weaknesses to avoid experiencing them on a departmentwide basis.

Auditors also reported that TSA did not maintain complete and accurate records of its passenger and baggage screening equipment, most notably its Explosive Detection System (EDS) equipment. For example, a significant amount of fixed assets were found to not be recorded in the financial statements and an adjustment of approximately $149 million was made after year-end to properly record construction in progress for the manufacture of EDS equipment. Until such weaknesses are resolved, millions of dollars spent on new equipment and other fixed assets could go unaccounted for or be improperly recorded, leaving TSA and DHS vulnerable to fraud, waste, and abuse.

Another weakness reported by DOT's OIG was TSA's inadequate controls over security screener contracts. Policies and procedures were not established to provide an effective span of control to monitor contractor costs and performance. This lack of oversight enabled contractors to charge TSA up to 97 percent more than the contractors charged air carriers prior to the federalization of the screener workforce. This weakness provides further evidence of the importance of carefully documenting policies and procedures early in the implementation of a new organization.

Office of Domestic Preparedness

Established in 1998, the former Office of Domestic Preparedness (ODP) under DOJ's Office of Justice Programs provides grant funds and direct support to, among other things, help address the equipment, training, and technical assistance needs of state and local jurisdictions for responding to terrorism and terrorist-related activities.

[13]U.S. Department of Transportation, Office of Inspector General, *Quality Control Review of Audited Financial Statements for Fiscal Year 2002, TSA*, QC-2003-016 (Washington, D.C.: Jan. 27, 2003).

Since its inception, auditors have reported deficiencies in ODP's ability to administer grant funds.[14] In fiscal year 2002, we reported grant management as one of DOJ's major performance and accountability challenges.[15] DOJ's OIG has found that while millions of dollars had been awarded, the funds were not awarded expeditiously, and grantees were very slow to spend the requested monies.[16] According to the OIG, more than half of the monies requested and granted over the past few years remained unspent and some of the equipment purchased by state and local jurisdictions was unavailable for use because grantees did not properly distribute the equipment, could not locate it, or were inadequately trained to use it.

Since the DOJ OIG reported on this issue in fiscal year 2002, DHS has released more than $4.4 billion in grants to state and local governments and private sector organizations. This increased level of grants will only exacerbate these problems unless DHS works with grantees to improve the accountability over these funds.

Coast Guard

Unlike many of the larger agencies that transferred to DHS, the Coast Guard did not have a stand-alone financial statement audit, but was audited as part of DOT's consolidated audit. Although the auditors for DOT have not reported significant financial management weaknesses at the Coast Guard in recent years, the Coast Guard still uses DOT's Departmental Accounting and Financial Information System, which, among other things, was unable to produce auditable financial statements based on the information within the system. In addition, we have listed the Coast Guard as part of DHS's major management challenges due to its dual missions of maritime safety and homeland security.[17]

[14]U.S. Department of Justice, Office of Inspector General, *Office of Justice Programs: State and Local Domestic Preparedness Grant Programs*, 02-15 (Washington, D.C.: March 2002).

[15]U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of Justice*, GAO-03-105 (Washington, D.C.: January 2003).

[16]U.S. Department of Justice, *Fiscal Year 2002 Performance and Accountability Report* (Washington, D.C.: Jan. 31, 2003).

[17]U.S. General Accounting Office, *Major Management Challenges and Program Risks: Department of Homeland Security*, GAO-03-102 (Washington, D.C.: January 2003).

Concerns have also been reported regarding the Coast Guard's Deepwater Procurement Project, which currently has an estimated cost of $17 billion over 20 years. It is intended to replace or modernize by 2022 all assets used in missions that generally occur offshore. However, due to the events of September 11th and the Coast Guard's expanded role in homeland security, additional project requirements have been identified, including accelerating the project to be completed in 10 years. These changes may result in increased annual funding needs for the project, thus increasing the vulnerability to ineffective and inefficient use of funds.

Secret Service

The Secret Service, formerly under the Department of the Treasury (Treasury), has also not had a stand-alone financial statement audit, but was audited as part of Treasury's consolidated audit. Although from an audit perspective the Secret Service was relatively small in relation to the Internal Revenue Service and Bureau of the Public Debt at Treasury, its missions of protecting the President and investigating financial crimes are sensitive. Auditors for Secret Service may identify internal control weaknesses that were not previously known, but may now be identified since the Secret Service is proportionately a larger component of DHS than it was under Treasury, and may therefore be subjected to increased levels of audit scrutiny.

Other Entities

Aside from the known weaknesses at the 7 larger component agencies comprising DHS, some of the 15 smaller entities that transferred to DHS may also have weaknesses not previously identified. As with the Secret Service, these entities may be proportionately more significant at DHS than they were at their legacy departments. In addition, once combined, certain areas may be cumulatively subject to more audit scrutiny than when they were dispersed throughout other departments. Any such weaknesses will only exacerbate the extensive existing challenges.

Financial Reporting Challenges

DHS plans to prepare financial statements for the 7 months ending September 30, 2003. We support DHS's decision to do so, but recognize that it will be very challenging given the problems DHS inherited, compounded by the additional complexity of merging a number of diverse entities, which literally has had to hit the ground running from day one. Obtaining a consolidated DHS financial statement audit for that same period will be equally challenging, but also worthwhile.

Since DHS is a new entity, its auditors have already begun performing audit procedures on beginning balances (i.e., transferred balances) as of March 1, 2003, the activity for the 7 months ending September 30, 2003, and ending balances. The transfer date of March 1 represents a unique challenge because it does not fall on the end of a typical accounting period, such as the end of the fiscal year or reporting quarter. In addition, legacy departments' goals of reaching accelerated reporting dates[18] for fiscal year 2003 may be impaired if DHS cannot provide intragovernmental information needed by these departments on time. OMB and Treasury require agencies to reconcile selected intragovernmental activity and balances with their "trading partners" (i.e., other agencies) and to report on the extent and results of intragovernmental activity and balance reconciliation efforts. This information is necessary, not only for the agencies' financial statements and reports, but also for the U.S. Consolidated Financial Statements.

These are unique challenges that must be addressed to ensure that accounts and amounts transferred to DHS are complete and accurate and that legacy departments' reporting is not negatively impacted. Any significant problems encountered could also negatively impact the preparation and audit of the U.S. government's fiscal year 2003 financial statements.

In the longer term, DHS can only overcome its many challenges if it establishes systems, processes, and controls that help to ensure effective financial management and insists on the adherence to strong financial practices. In addition to addressing the many ongoing challenges existing in the programs of incoming agencies, DHS will need to focus on building future systems as part of its enterprise architecture approach to ensure an overarching framework for the agency's integrated financial management processes. Plans and standard accounting policies and procedures must be developed and implemented to bridge these financial environments into an integrated DHS system.

[18]The Office of Management and Budget (OMB) has issued accelerated reporting requirements that require agencies to prepare financial statements close to the end of the reporting period. Under these requirements, agency performance and accountability reports for fiscal year 2002 were due to OMB by February 1, 2003, and by fiscal year 2004 agencies will be required to submit these reports by November 15, 2004. In addition, in fiscal year 2003, agencies are required to prepare and submit quarterly financial statements no later than 45 days after the end of the reporting period.

Mr. Chairman, I would now like to discuss steps DHS should take to establish sound financial management and business processes.

Steps for Establishing Sound Financial Management and Business Processes

Successful financial management of DHS will depend on the department producing financial information that provides useful information for executive decision making. In April 2000, we issued an executive guide that provided guidance in creating value through financial management.[19] After studying the financial management practices and improvement efforts of nine leading private and public sector finance organizations, we identified several success factors, practices, and outcomes associated with world-class financial management. The organizations we studied include The Boeing Company, Chase Manhattan Bank, General Electric Company, Hewlett-Packard, Owens Corning, Pfizer Inc., and the states of Massachusetts, Texas, and Virginia.

First and foremost, establishing the following goals is key to developing a world-class finance organization with sound financial management and business processes: (1) make financial management an entitywide priority, (2) redefine the role of the finance organization, (3) provide meaningful information to decision makers, and (4) build a team that delivers results. I will discuss each of these goals in more detail below, including several best practices that are critical in meeting these goals. These practices lead to finance organizations that provide timely information that is relevant to management, useful in the decision-making process, and adds value to the organization. Since it is a newly created entity, DHS has a unique opportunity to implement the identified practices when developing financial policies and activities to establish sound financial management and business processes.

Establish Financial Management as an Entitywide Priority

Based on our study of world-class financial organizations, making financial management an entitywide priority is encouraged through the following best practices: (1) providing clear, strong, executive leadership, (2) building a foundation of control and accountability, and (3) using training to change the culture and engage line managers.

[19]U.S. General Accounting Office, *Executive Guide: Creating Value Through World-class Financial Management*, GAO/AIMD-00-134 (Washington, D.C.: April 2000).

Top leadership involvement is essential for a successful realignment of this magnitude. Top leadership is responsible for allocating the resources needed to improve financial management and for building and maintaining the organization's commitment to doing business in a new way. The CFO Act established the position of CFO in 24 agencies (app. I lists the original 24 CFO Act agencies—FEMA has transferred to DHS since the act was enacted) in the federal government. These CFOs are given oversight authority regarding financial management matters and are responsible for ensuring that sound financial management is in place. As you know, DHS is not currently subject to the provisions of the CFO Act, and thus has no legal requirement to comply with its provisions. Although Secretary Ridge pledged financial management as a priority in his May 1, 2003, testimony, passage of H.R. 2886, which would amend the CFO Act to include DHS, is important to ensure the department's long-term commitment to establishing sound financial management and business processes.

Further, as DHS continues to integrate its 22 entities, it must build a strong overall foundation of control and accountability. Management should begin by considering any significant control issues with agencies that are being integrated to form DHS, many of which I have already highlighted. These issues must be addressed within the specific agencies, as well as departmentwide to ensure they do not continue to be control issues within the newly formed department. Additionally, increases in accountability should be encouraged through the production of financial and performance reports for major programs on a regular and frequent basis to help in the decision-making process and strategic planning. Ultimately, the foundation for regular and frequent reporting will be through development of an integrated financial management system—one capable of capturing data at an appropriate level of detail and producing relevant and reliable information for users based on their needs. In the case of DHS, the challenge of combining, integrating, modernizing, and in some cases replacing the systems of many disparate agencies will require careful planning if the conversion is to be successful.

Redefine the Role of the Finance Organization

As discussed earlier, many of the larger agencies that transferred to DHS have a history of poor systems and inadequate financial management. In order to establish sound financial management and business processes, we found that world-class finance organizations redefined the role of the finance organization and implemented an integrated financial management structure that: (1) assessed the finance organization's role in meeting the department's mission, (2) maximized the efficiency of day-to-day accounting activities, and (3) organized the finance organization to add value.

The ever-increasing competition for resources requires careful allocation of funds. Without the support of an effective finance organization, program managers may not be able to determine costs associated with government activities, defend those costs, or identify the benefits derived from them. The finance organization must understand the department's mission and be able to provide information in support of that mission. Of key importance is the ability of the finance organization to efficiently complete routine accounting activities, thus freeing resources to focus on other finance-related priorities that are in support of the department's mission. As I previously discussed, many of the larger agencies that transferred into DHS spend significant time preparing financial statements using manual work-arounds and have a history of poor financial management systems and significant internal control weaknesses. Such a time-consuming method of routine financial statement preparation does not allow for efficient use of finance staff. As DHS develops its financial management and businesses processes, it should focus on developing the abilities to (1) efficiently and effectively complete routine processing activities and (2) compile the data needed to measure performance so that information is available to management on a day-to-day basis.

Provide Meaningful Information for Decision Makers

The overarching goal of the President's Management Agenda is the improvement of government performance. The finance organization must play a pivotal role in providing decision makers with the information they need to measure performance. To efficiently and effectively provide reliable information to decision makers, we identified three best practices in our study of world-class finance organizations: (1) develop systems that support the partnership between finance and operations, (2) reengineer processes in conjunction with new technology, and (3) translate financial data into meaningful information.

To help agencies set goals and measure performance, the Congress enacted the Government Performance and Results Act (GPRA) in 1993. As part of GPRA, agencies, including DHS, are required to prepare a 5-year performance plan and annual performance reports. These required reports provide a strategic planning and management framework intended to improve federal performance and hold agencies accountable for achieving results. GPRA was intended, in part, to improve congressional decision making by giving the Congress comprehensive and reliable information on the extent to which federal programs are fulfilling their statutory intent. Additionally, the President's Management Agenda includes improved financial management performance as one of the five governmentwide management goals. This initiative is aimed at ensuring that federal financial systems produce accurate and timely information to support operating, budget, and policy decisions. The finance organization is a key component of a department's ability to meet its requirements under GPRA and the objectives of the President's Management Agenda.

Build an Effective Finance Team

Over the years, the federal government has had difficulty attracting and retaining talented financial management officials. Improving financial performance is difficult without experienced leadership and staff who are committed to success. Our study of several world-class finance organizations indicated the following as best practices to build a team that can deliver results: (1) develop a finance team with the right mix of skills and competencies, and (2) attract and retain talent.

Given the current demand on resources and the competition for qualified employees, developing and retaining a talented finance team that is capable of meeting the changing demands of the federal financial workplace is an important goal. The lack of highly qualified financial management professionals can hamper effective federal financial management operations. The CFO Act requires OMB's Deputy Director for Management to develop and maintain qualification standards for agency CFOs and their deputies; provide advice to agencies on the qualification, recruitment, performance, and retention of financial management personnel; and assess the adequacy of financial management staffs throughout the government. Additionally, the CFO Act places responsibility with the CFO to recruit, select, and train finance personnel.

To help department leaders manage their people and integrate human capital considerations into daily decision making and the program results they seek to achieve, we developed a strategic human capital model.[20] This model is applicable to department leadership as a whole but is also applicable to finance organization leadership as they seek to attract, develop, and retain talent. The two critical success factors identified in our model to assist organizations in creating results-oriented cultures are

[20]U.S. General Accounting Office, *A Model of Strategic Human Capital Management*, GAO-02-373SP (Washington, D.C.: Mar. 15, 2002).

(1) linking unit and individual performance to organizational goals and (2) involving employees in the decision-making process. Agency leaders have other opportunities for displaying their commitment to human capital. Continuous learning efforts, employee-friendly workplace policies, competency-based performance appraisal systems, and retention and reward programs are all ways in which agencies can value and invest in their human capital. The sustained provision of resources for such programs can show employees and potential employees the commitment agency leaders have to strategic human capital management. DHS should adopt these success factors in building a financial management team that delivers results.

It is well recognized that mergers of the magnitude of DHS carry significant risks, including lost productivity and inefficiencies. Successful transformations of large organizations generally can take from 5 to 7 years to achieve. Necessary management capacity, communication and information systems, as well as sound financial management and business processes must be established. Though creating and maintaining these structures will be demanding and time consuming, it is necessary to effectively implement the national homeland security strategy.[21]

Over the past several months, we have met with DHS's CFO, Acting Inspector General and Assistant Inspector General for Audits, and its independent auditors performing its financial statement audit for 2003. We are committed to working in a coordinated effort with the Congress, DHS, and its auditors to provide advice to DHS on developing a sound financial management structure that will facilitate, and not hamper, its mission of securing the homeland. We believe that passage of H.R. 2886 will further assist DHS in meeting this goal.

Comments on H.R. 2886

Mr. Chairman, as you know, H.R. 2886 as introduced on July 24, 2003 would amend the CFO Act to (1) add DHS as a CFO Act agency and remove FEMA as a CFO Act agency, (2) require DHS to obtain an audit opinion on its internal controls, and (3) require DHS to include program performance

[21]GAO convened a forum on September 24, 2002, to identify and discuss useful practices and lessons learned from major private and public sector organizational mergers, acquisitions, and transformations. U.S. General Accounting Office, *Highlights of a GAO Forum: Mergers and Transformation: Lessons Learned for a Department of Homeland Security and Other Federal Agencies*, GAO-03-293SP (Washington, D.C.: November 2002).

information in its performance and accountability reports. In addition, H.R. 2886 as introduced would have provided a waiver allowing DHS to forego a financial statement audit for fiscal year 2003. We understand an agreement has been reached to remove this waiver from the proposed legislation. DHS's 2003 audit is already underway and the department has stated it is committed to obtaining this audit. The waiver option is, therefore, no longer needed, and we support dropping the provision from H.R. 2886.

Inclusion of DHS as a CFO Act Agency

We supported passage of the CFO Act in 1990 and continue to strongly support its objectives of (1) giving the Congress and agency decision makers reliable financial, cost, and performance information both annually and, most important, as needed throughout the year to assist in managing programs and making difficult spending decisions, (2) dramatically improving financial management systems, controls, and operations to eliminate fraud, waste, abuse, and mismanagement and properly safeguard and manage the government's assets, and (3) establishing effective financial organizational structures to provide strong leadership. Achieving these goals is critical for establishing effective financial management, and we fully support amending the CFO Act to include DHS.

In developing the CFO Act, the Congress viewed the CFO as being a critical player in the management of an agency. At the time, financial management was not a priority in most federal agencies and was all too often an afterthought. All too often, the top financial management official wore many hats, which left little time for financial management; did not necessarily have any background in financial management; and focused primarily on the budget. By establishing statutorily the position of CFO, requiring that the person in the position have strong qualifications and a proven track record in financial management, and giving this person status as a presidential appointee, the Congress sought to change the then existing paradigm. Of the 24 agencies named in the 1990 CFO Act, 16 were designated as Level IV, Presidential appointee Senate confirmation positions and eight were career positions. Today, CFOs have become influential across government and the quality of the appointees has borne out the wisdom of the Congress's insistence that this position be elevated (meaning it reported to the top and had standing with other top officials). We have seen an evolution of the CFO position and a quantum change in the expertise and abilities of CFOs and the attractiveness of this position to someone having the type of proven track record in financial management that is needed in the federal government. In the end, the key attribute is the quality of the person in the position to affect change and carry out the role of CFO and whether the head of the agency supports the CFO and empowers that person to do the job needed. Appointment of the CFO by the President, subject to Senate confirmation, is one way to help ensure that the goals of the CFO Act are met and that has proven itself over time.

The CFO Act, as expanded by the Government Management Reform Act of 1994, also requires agencies to prepare and have audited financial statements. The Congress added further emphasis to the importance of sound financial management when it enacted FFMIA. Under the Accountability of Tax Dollars Act of 2002,[22] DHS, as an executive branch agency with budget authority greater than $25 million, would be required to obtain annual financial statement audits; however, its auditors would not have to report on compliance with FFMIA. Although DHS has appropriately contracted with independent auditors to report on its systems compliance with FFMIA for fiscal year 2003, it is not legally required to do so. FFMIA requires that agencies implement and maintain financial management systems that substantially comply with (1) federal systems requirements, (2) federal accounting standards, and (3) the U.S. Government Standard General Ledger. The ability to produce the data needed to efficiently and effectively manage the day-to-day operations of the federal government and provide accountability to taxpayers has been a long-standing challenge at most federal agencies. As we discussed earlier, auditors reported that many of the larger agencies that transferred to DHS were not in substantial compliance with FFMIA prior to their transfer to DHS. Given these preexisting compliance issues, in addition to issues that may arise with system integration initiatives, it is critical that DHS be legally required to comply with these important financial management reforms.

Opinion on Internal Controls

Current OMB guidance for audits of government agencies and programs[23] requires auditor reporting on internal control, but not at the level of providing an opinion on internal control effectiveness. However, we have long believed and the Comptroller General has gone on record in

[22]Pub. L. No. 107-289, 116 Stat. 2049 (2002).

[23]Office of Management and Budget, *Audit Requirements for Federal Financial Statements*, Bulletin 01-02 (Washington, D.C.: Oct. 16, 2000).

congressional testimony[24] that auditors have an important role in providing an opinion on the effectiveness of internal control over financial reporting and compliance with laws and regulations in connection with major federal departments and agencies. For a number of years, we have provided separate opinions on internal control effectiveness for the federal entities that we audit because of the importance of internal control to protecting the public's interest. Specifically, we provide separate opinions on internal controls and compliance with laws and regulations for our audits of the U.S. government's consolidated financial statements, the financial statements of the Internal Revenue Service and Federal Deposit Insurance Corporation, the Schedules of Federal Debt managed by the Bureau of the Public Debt, and numerous small entities' operations and funds. Our reports and related efforts have engendered major improvements in internal control.

As part of the annual audit of our own financial statements, we practice what we recommend to others and contract with an independent public accounting firm for both an opinion on our financial statements and an opinion on the effectiveness of our internal control over financial reporting and compliance with laws and regulations. Our goal is to lead the way in establishing the appropriate level of auditor reporting on internal control for federal agencies, programs, and entities receiving significant amounts of federal funding. Additionally, three agencies, Social Security Administration (SSA), General Services Administration (GSA), and the Nuclear Regulatory Commission (NRC) voluntarily obtain separate opinions on internal control effectiveness from their auditors, which is commendable.

Another consideration as the Congress decides whether to enact new requirements is that an opinion on internal controls is what has been prescribed by the Congress for publicly traded corporations. A final rule issued by the Securities and Exchange Commission in June 2003 and effective in August 2003 provides guidance for implementation of Section 404 of the Sarbanes-Oxley Act of 2002,[25] which requires publicly traded companies to establish and maintain an adequate internal control structure and procedures for financial reporting and include in its annual report a

[24]U.S. General Accounting Office, *Fiscal Year 2002 U.S. Government Financial Statements: Sustained Leadership and Oversight Needed for Effective Implementation of Financial Management Reforms*, GAO-03-572T.

[25]Pub. L. No. 107-204, 116 Stat. 745 (2002).

statement of management's responsibility for and management's assessment of the effectiveness of those controls and procedures in accordance with standards adopted by the Securities and Exchange Commission. The final rule defines this requirement and requires applicable companies to obtain a report in which a registered public accounting firm expresses an opinion, or states that an opinion cannot be expressed, concerning management's assessment of the effectiveness of internal controls over financial reporting.

Auditor reporting on internal control is a critical component of monitoring the effectiveness of an organization's accountability. GAO strongly believes that this is especially important for very large, complex, or challenged entities. By giving assurance about internal control, auditors can better serve their clients and other financial statement users and better protect the public interest by having a greater role in providing assurances of the effectiveness of internal control in deterring fraudulent financial reporting, protecting assets, and providing an early warning of internal control weaknesses. We believe auditor reporting on internal control is appropriate and necessary for publicly traded companies and major public entities alike. We also believe that such reporting is appropriate in other cases where management assessment and auditor examination and reporting on the effectiveness of internal control add value and mitigate risk in a cost-beneficial manner.

We know that some will point to increased costs as a reason to remove this provision from the legislation. We believe that auditors who follow the *Financial Audit Manual*—which was jointly developed by GAO and the President's Council on Integrity and Efficiency (PCIE)[26]—should ordinarily have little to no incremental costs associated with such reporting.

We fully support having DHS, as well as all CFO Act agencies, obtain an opinion on its internal control. If DHS is truly committed to becoming a model federal agency, it should begin obtaining opinions on internal control as soon as practical and set an example for other agencies to follow and in keeping with the actions already taken by SSA, GSA, NRC, and GAO.

[26]Generally referred to as the GAO/PCIE *Financial Audit Manual.*

Inclusion of Performance Information in Accountability Reports

We also support agencies including program performance information in agency performance and accountability reports, so that relevant performance and financial information is presented in a consolidated and useful manner. Agencies currently have the discretion to include this information in a consolidated format. We strongly encourage DHS to consolidate this information in its accountability report beginning with fiscal year 2003.

In closing, the American people have increasingly demanded accountability from government and the private sector. The Congress has recognized, through legislation such as the CFO Act, that the federal government must be held to the highest standards. We already know that many of the larger agencies transferred to DHS have a history of poor financial management systems and significant internal control weaknesses. These known weaknesses provide further evidence that DHS's systems and financial controls should be subject to provisions of the CFO Act and thus FFMIA. We also strongly encourage DHS to become a model agency and, as soon as practical, obtain an opinion on its internal controls and report performance information in its accountability reports.

Mr. Chairman, this concludes my statement. I would be happy to answer any questions you or other Members of the Subcommittee may have at this time.

Contacts and Acknowledgments

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CFO Act Agencies

24 CFO Act Agencies

The Department of Agriculture
The Department of Commerce
The Department of Defense
The Department of Education
The Department of Energy
The Department of Health and Human Services
The Department of Housing and Urban Development
The Department of Interior
The Department of Justice
The Department of Labor
The Department of State
The Department of Transportation
The Department of the Treasury
The Department of Veterans Affairs
The Environmental Protection Agency
The National Aeronautics and Space Administration
The Agency for International Development
The Federal Emergency Management Agency[1]
The General Services Administration
The National Science Foundation
The Nuclear Regulatory Commission
The Office of Personnel Management
The Small Business Administration
The Social Security Administration

[1] Under the Homeland Security Act of 2002, FEMA transferred to DHS and under H.R. 2886 would no longer be considered a CFO Act agency.

Related GAO Products

Fiscal Year 2002 U.S. Government Financial Statements: Sustained Leadership and Oversight Needed for Effective Implementation of Financial Management Reform. GAO-03-572T. Washington, D.C.: April 8, 2003.

Transportation Security Administration: Actions and Plans to Build a Results-Oriented Culture. GAO-03-190. Washington, D.C.: January 2003.

High-Risk Series: An Update. GAO-03-119. Washington, D.C.: January 2003.

Major Management Challenges and Program Risks: Federal Emergency Management Agency. GAO-03-113. Washington, D.C.: January 2003.

Major Management Challenges and Program Risks: Department of the Treasury. GAO-03-109. Washington, D.C.: January 2003.

Major Management Challenges and Program Risks: Department of Justice. GAO-03-105. Washington, D.C.: January 2003.

Major Management Challenges and Program Risks: Department of Homeland Security. GAO-03-102. Washington, D.C.: January 2003.

Financial Management: FFMIA Implementation Necessary to Achieve Accountability. GAO-03-31. Washington, D.C.: October 1, 2002.

Homeland Security: Critical Design and Implementation Issues. GAO-02-957T. Washington, D.C.: July 17, 2002.

A Model of Strategic Human Capital Management. GAO-02-373SP. Washington, D.C.: March 2002.

Executive Guide: Creating Value Through World-class Financial Management. GAO/AMID-00-134. Washington, D.C.: April 2000.

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