I respectfully submit the Office of Inspector General report on the Department of Transportation (DOT) Consolidated Financial Statements for Fiscal Years (FY) 2006 and 2005 (see Attachment). This year, our audit concluded that DOT’s consolidated financial statements are fairly presented, in all material respects, in conformity with generally accepted accounting principles, with one exception. That exception concerns the FY 2006 Construction in Progress (CIP) balance, which is a subcomponent of the Property, Plant, and Equipment line item on the Department’s balance sheet.

KPMG LLP, under contract to us and under our supervision, audited the Federal Aviation Administration’s (FAA) financial statements and rendered a qualified opinion because deficiencies in FAA’s accounting for CIP prevented FAA from providing adequate support to verify that reported CIP balances were reliable.\(^1\) Because FAA’s property, including CIP, represents about 95 percent of the Property, Plant, and Equipment line item on the Department’s consolidated balance sheet, the Department’s consolidated financial statements must be similarly qualified.

We recognize that you, the Department’s Chief Financial Officer, and other Department leaders are concerned that deficiencies in FAA’s CIP accounting process resulted in this qualification to the Department’s consolidated financial statement. The Department’s leaders have demonstrated a longstanding

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\(^1\) FAA uses a complicated process to track and account for billions of dollars in capital investments. The majority of these investments are needed to modernize the air traffic control system—a critical national infrastructure. This multiyear development effort involves the extensive use of advanced technologies. While under development, all spending must be carefully tracked and recorded in the CIP account. When commissioned into use, these investments must be reclassified as in-service assets, which are then subject to depreciation.
commitment to improving financial management in the Department and in each Operating Administration. As reflected in our prior financial statement audit reports, that commitment has substantially improved the Department’s ability to track and properly report financial results. We also recognize your history of strong support for improved financial management processes, as reflected by the critical and effective leadership that you demonstrated in correcting longstanding financial issues in the Federal Highway Administration (FHWA) during your tenure as the Administrator.

FAA’s process for accounting for CIP is a longstanding concern. Auditors reported material weaknesses concerning FAA’s Property, Plant, and Equipment account balances, including inaccurate and untimely CIP transaction processing, annually from FY 1992 through FY 2002. Although FAA substantially corrected the deficiencies by FY 2003, the problems recurred during FY 2004 and subsequent years. At that time, FAA replaced key CIP manual processes with an automated project accounting module but did not implement adequate controls and oversight to ensure that the new process worked effectively.

In FY 2005, KPMG reported a material weakness related to deficiencies in FAA’s ability to process transactions and reconcile account balances in a timely manner, including its ability to ensure that CIP transactions were timely and accurately recorded when assets were placed in service. Although FAA management agreed to correct those deficiencies during FY 2006, the corrective actions were not implemented effectively. As a result, the CIP balance presented to KPMG in August 2006 contained material errors, and FAA was not able to complete its review of CIP or to properly state the CIP balance as of September 30, 2006. Consequently, FAA management was unable to represent to KPMG that the CIP balance, reported to be $4.7 billion, was fairly stated. Accordingly, KPMG could not complete its audit of CIP balances. KPMG also identified CIP process deficiencies as a material weakness.

The lack of controls over CIP-related transactions was one of several concerns included in last year’s material weakness reporting. This year, KPMG reported that, except for CIP-related processing, FAA has taken adequate corrective actions to ensure timely recording of obligations, supporting advances and prepayments, clearing suspense accounts, reconciling budgetary to proprietary accounts, and reconciling subsidiary to general ledger account balances. If FAA stays focused on fixing CIP-related operations, it should be able to produce the same results in FY 2007. However, we are concerned that this correction effort may become diverted.

Responding to this year’s report, FAA hired a contractor and committed to taking aggressive action to ensure that capitalized assets are properly valued and transactions are recorded in a timely manner by improving policies and
procedures, enhancing communications between program officials and accounting personnel, and conducting a comprehensive evaluation of CIP balances to make appropriate accounting adjustments. However, FAA has first directed the contractor to analyze a sample of CIP assets in order to generate a more reliable estimate of the CIP balance as of September 30, 2006. FAA then intends to provide this additional information to KPMG, requesting that KPMG continue auditing the FY 2006 balance and issue a new report, sometime during FY 2007, that provides a restatement on FAA’s FY 2006 financial statements. In our view, diverting resources to generate a new estimate of the FY 2006 CIP balance and to reissue the FY 2006 financial statement audit report will further delay efforts to fix the CIP process deficiencies and will increase the risk that FAA will again not be able to correct its underlying material weakness during FY 2007.

Successfully implementing these corrective actions in FY 2007 is critical for two reasons. First, FAA has stated that its goal is to implement sound financial management processes. This must include establishing stronger processes to account for its property. In doing so, FAA will be in a substantially stronger position to correct the material weakness and obtain a clean opinion on its financial statements in FY 2007.

Second, the FAA deficiencies may adversely affect DOT’s ability to meet the Office of Management and Budget’s FY 2007 internal control requirements under Circular A-123—the Federal version of the Sarbanes/Oxley Act. Circular A-123 requires the Department’s leaders to implement adequate management and financial controls to deliver the best value with the resources entrusted to the agency. At the end of FY 2007, the Department will be required, for the first time, to provide specific assurance that it has adequate controls to provide reasonable assurance that property is accounted for properly. The adequacy of FAA’s controls will be key to whether the Secretary will be able to provide that assurance.

The Department’s Chief Financial Officer also recognizes the importance of correcting the underlying process deficiencies. She told us that her office will now closely monitor FAA’s efforts to correct CIP process deficiencies to ensure that FAA implements timely and effective corrective actions. Given the importance of correcting these deficiencies, we agree that this is appropriate.

Turning now to the audit of the Highway Trust Fund (HTF) financial statements, KPMG rendered an unqualified (clean) opinion this year—the eighth consecutive clean opinion since FY 1999. However, FHWA continued to experience problems preparing reliable draft HTF financial statements in a timely manner, primarily due to difficulties analyzing and consolidating underlying data. To illustrate, the HTF finances operations in multiple DOT Operating Administrations: FHWA, the Federal Transit Administration, the National Highway Traffic Safety
Administration, the Federal Motor Carrier Safety Administration, the Federal Railroad Administration, and the Research and Innovative Technology Administration. In addition, 17 other agencies outside of DOT receive HTF appropriations through FHWA. Together, these agencies disbursed about $37 billion in Federal funds during FY 2006. To compile the HTF statements, FHWA had to monitor fund transfers, collect reliable information about how funds were used from all of these Operating Administrations and outside agencies, and reconcile related account balances. KPMG’s audit report also identified deficiencies in other accounting operations and financial oversight that make it more difficult for FHWA to generate timely and reliable HTF financial statements.

Our report identifies two financial management matters that KPMG and we consider material and several other reportable conditions that are significant but not material. The material matters are that:

- FAA must take immediate action to correct the underlying process deficiencies that limit its ability to properly account for CIP-related transactions; and

- FHWA and other HTF Operating Administrations must enhance their financial accounting operations and oversight in several areas, such as better control over journal entries to process accounting adjustments, more timely correction of abnormal account balances, improved coordination with non-DOT agencies that receive HTF appropriations through FHWA, and validation of the accrual methodology used to estimate unpaid grant expenses.

Generating timely, reliable, and useful financial information is no small task and requires continued senior management attention. DOT is a complex organization that is accountable for substantial resources. DOT’s FY 2006 financial statements show total assets of $65 billion, liabilities of almost $14 billion, program costs of nearly $62 billion, and available financial resources of more than $112 billion. In FY 2006, DOT received appropriations (revenue) of $61 billion. More than $49.5 billion (about 81 percent) of DOT’s revenue sources came from two trust funds, the HTF and the Airport and Airway Trust Fund.

We provided a draft of this report to the DOT Assistant Secretary for Programs and Budget/Chief Financial Officer, who concurred with its findings and agreed to implement its recommendations. We appreciate the cooperation and assistance of DOT and KPMG representatives. If we can answer any questions, please call me at (202) 366-1959; Ted Alves, Principal Assistant Inspector General for Auditing and Evaluation, at (202) 366-1992; or Rebecca Leng, Assistant Inspector General for Financial and Information Technology Audits, at (202) 366-1496.

Attachment
To the Secretary

The Department of Transportation (DOT) Office of Inspector General (OIG) audited the DOT Consolidated Financial Statements for the years ended September 30, 2006, and September 30, 2005. In our audit, “DOT Consolidated Financial Statements for Fiscal Years 2006 and 2005,” we found:

- Except for the accuracy and completeness of the Construction in Progress (CIP) account, financial statements are fairly presented, in all material respects, in conformity with generally accepted accounting principles.

- Two material internal control weaknesses: timely processing of transactions and accounting for the Federal Aviation Administration (FAA) CIP account; and financial management, reporting, and oversight for the Highway Trust Fund (HTF) agencies.²

- Seven reportable conditions: reporting of earmarked funds for the Federal Transit Administration, financial system controls, DOT’s information security program, reconciling intragovernmental transactions, deobligating unneeded funds in the HTF agencies, FAA grants management, and FAA contract management.


- Financial information in the Management Discussion and Analysis was materially consistent with the financial statements.

- Supplementary and stewardship information, and other accompanying information, was materially consistent with management representations and the financial statements.

We performed our work in accordance with Generally Accepted Government Auditing Standards and Office of Management and Budget (OMB) Bulletin 06-03, “Audit Requirements for Federal Financial Statements.” The following sections discuss these conclusions. Our audit objectives, scope, and methodology can be found in Exhibit A. We believe that our audit provides a reasonable basis for our opinion.

A. QUALIFIED OPINION ON FINANCIAL STATEMENTS

In FY 2005, KPMG reported a material weakness related to deficiencies in FAA’s ability to process transactions and reconcile account balances in a timely manner, including its ability to ensure that CIP transactions were promptly and accurately recorded when assets were placed in service. Although FAA management agreed to correct those deficiencies during FY 2006, the corrective actions were not implemented effectively. As a result, the CIP balance presented to KPMG in August 2006 contained material errors, and FAA was not able to develop a reliable and supportable CIP balance prior to the issuance of DOT’s FY 2006 Performance and Accountability Report. Accordingly, KPMG could not complete its audit of CIP balances. FAA’s CIP balance, which is included as a component of the Property, Plant, and Equipment line item in footnote number 9 on the balance sheet, was reported to be $4.7 billion as of September 30, 2006. Because FAA’s Property, Plant, and Equipment balance represents 95 percent of the Department’s property as of September 30, 2006, potential errors in FAA’s CIP balance could have a material impact on the Department’s financial statement.

In our opinion, except for the FY 2006 CIP account balance (a component of Property, Plant, and Equipment on DOT’s consolidated financial statements), the DOT consolidated financial statements, including the accompanying notes, present fairly, in all material respects, in conformity with generally accepted accounting principles, the DOT assets, liabilities, and net position; net costs; changes in net position; budgetary resources; and reconciliation of net costs to budgetary obligations as of September 30, 2006, and September 30, 2005, and for the years then ended. This qualification occurred because, as discussed in the paragraph above, material adjustments to the CIP balance would be likely had FAA management completed its review of CIP transactions and had we been able to apply sufficient procedures to complete our audit.

Under contract with OIG and under our supervision, KPMG audited the financial statements of FAA as of and for the years ended September 30, 2006, and September 30, 2005. KPMG qualified its opinion on the FY 2006 FAA financial statements because of concerns over the accuracy of the CIP account and rendered an unqualified opinion on the FY 2005 FAA financial statements. KPMG also audited the financial statements of the HTF as of and for the year ended
September 30, 2006, and rendered an unqualified opinion on the HTF financial statements. Clifton Gunderson, LLP, previously audited and rendered an unqualified opinion on the financial statements of the HTF as of and for the year ended September 30, 2005. We performed quality control reviews of the work performed by KPMG and Clifton Gunderson and relied on their results in performing our work on the FY 2006 and FY 2005 DOT consolidated financial statements.

Also, as discussed in financial statement footnote numbers 1 and 18, DOT adopted the provisions of Statement of Federal Financial Accounting Standards 27, “Identifying and Reporting Earmarked Funds,” effective October 1, 2005. As discussed in financial statement footnote numbers 1 and 21, the accompanying financial statements reflect actual excise tax revenues deposited in the HTF and the Airport and Airway Trust Fund through March 31, 2006, and excise tax receipts estimated by the Department of the Treasury Office of Tax Analysis for the two quarters ended June 30, 2006, and September 30, 2006.

**B. CONSIDERATION OF INTERNAL CONTROLS**

In planning and performing our audit, we considered DOT’s internal controls over financial reporting and compliance with laws and regulations. We do not express an opinion on internal controls and compliance because the purpose of our work was to determine our procedures for auditing the financial statements and to comply with OMB Bulletin 06-03 audit guidance, not to express an opinion on internal controls.

For the controls we tested, we found two material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce, to a relatively low level, the risk that errors, fraud, or noncompliance that would be material to the financial statements may occur and not be detected promptly by employees in the normal course of performing their duties.

Our work identified seven reportable conditions in internal controls. Reportable conditions in internal controls, although not considered material weaknesses, represent significant deficiencies in the design and operation of internal controls that could adversely affect the ability of DOT to meet its internal control objectives. Our internal control work would not necessarily disclose all material weaknesses or reportable conditions.
MATERIAL WEAKNESSES
The following sections describe the material weaknesses that we identified.

Timely Processing of and Accounting for the FAA Construction in Progress Transactions

In FY 2005, KPMG reported a material weakness related to deficiencies in FAA’s ability to process transactions and reconcile account balances in a timely manner. The account most affected was the CIP component of the Property, Plant, and Equipment (PP&E) line item. To illustrate, in order to prepare reliable financial statements, FAA had to commit substantial resources to properly categorize $1.1 billion of CIP transactions during the last month of the fiscal year and $180 million during the first 2 weeks after the fiscal year ended.

KPMG’s FY 2005 audit report recommended that FAA improve its processes and controls to ensure that PP&E is consistently and accurately capitalized. That report also noted that, without substantial changes to FAA’s processes and controls over recording transactions and reconciling accounts throughout the year, FAA might not be able to meet future financial statement reporting deadlines.

Although FAA management agreed to correct those deficiencies during FY 2006, the corrective actions were not implemented effectively. As a result, FAA again had to devote substantial resources at the end of the year. This year, however, the CIP balance presented to KPMG in August 2006 contained material errors, and FAA was not able to complete its review of CIP or to properly state the CIP balance as of September 30, 2006, before the issuance of the Department’s Performance and Accountability Report. FAA management was also unable to represent to KPMG that the CIP balance, reported to be $4.7 billion, was fairly stated. Accordingly, KPMG could not complete its audit of CIP balances.

In its FY 2006 audit report, KPMG again identified CIP process deficiencies as a material weakness. Specifically, KPMG noted that FAA lacks adequate policies, procedures, and controls to monitor its CIP activity and balances in a routine and timely fashion. KPMG reported that FAA: (1) needs to strengthen accounting policies and procedures, (2) lacks controls to ensure that CIP transactions are properly accounted for in a timely manner, (3) does not have a process to ensure that documentation adequately supports the basis for CIP transactions, and (4) does not adequately monitor the process to ensure that CIP balances are routinely reconciled to subsidiary listings and supporting detail.

- Strengthening accounting policies and procedures. KPMG noted that FAA’s policies and procedures did not describe how to determine when Research and Development costs should be capitalized; treat bulk purchases; allocate costs when equipment is deployed to multiple locations; capitalize
costs of long-term projects when deployments occur over several years; account for agency prototypes; address recognition of operational feasibility; and expense costs of delayed or postponed projects.

- **Ensuring that CIP transactions are properly accounted for in a timely manner.** KPMG reported that FAA does not have front-end and in-process controls to ensure that all CIP projects are accurately and completely accounted for in a timely manner. For example, FAA has not established adequate processes or controls to ensure that CIP is capitalized to PP&E within 30 days of being placed in service, as required by FAA policy. KPMG found that 96 percent of the items it tested were not capitalized within the 30-day period.

FAA does not have adequate policies and procedures to identify errors and make timely corrections to the underlying accounting records. KPMG found that even when errors were identified on project activity reports, they were not investigated and resolved or reported to senior management. FAA also lacks a routine and effective process to identify and correct projects that are improperly set up, either as expense or capital activities. In one case, KPMG identified a project with a CIP balance of $101 million that should have been expensed.

- **Ensuring that documentation is maintained that adequately supports the basis for CIP transactions.** KPMG found that FAA does not have a process to ensure that adequate documentation is maintained to support management’s decisions and accounting transactions. For example, FAA could not provide documentation without spending several days locating supporting evidence. When provided, documentation showed clear inconsistencies with the classification of assets in the accounting system. KPMG noted a 50 percent error rate between documentation provided and data in the accounting system.

Also, key documentation was not always available. In particular, two documents are key to determining when assets have been placed into service; however, in numerous instances, those documents were not available. Decisions regarding asset classifications were made without adequate supporting documentation. For example, KPMG identified over $200 million in 8 CIP projects that had been expensed from CIP in FY 2006 but subsequently had to be reversed after FAA provided documentation that contradicted the initial entry recorded by FAA.

- **Monitoring and reconciling CIP balances.** KPMG reported that FAA does not provide adequate monitoring and supervision of CIP processes and that the accounting system lacks controls to ensure that CIP balances are reconciled to
subsidiary listings and supporting details. KPMG also reported that a lack of clear lines of authority and communication among accounting organizations in the Office of Financial Management, the Air Traffic Organization, and the Office of Regions, Centers, and Operations has led directly to inaccurate or untimely accounting for CIP activity.

KPMG made 10 recommendations to correct these deficiencies, and FAA committed to implement the recommendations, including improving policies and procedures to ensure that capitalized assets are properly valued and transactions are recorded in a timely manner; enhancing communications between program officials and accounting personnel; and conducting a comprehensive evaluation of CIP balances to make appropriate accounting adjustments.

The lack of controls over CIP-related transactions was one of several concerns included in last year’s material weakness reporting. This year, KPMG reported that, except for CIP-related processing, FAA has taken adequate corrective actions to ensure timely recording of obligations, supporting advances and prepayments, clearing suspense accounts, reconciling budgetary to proprietary accounts, and reconciling subsidiary to general ledger account balances. If FAA stays focused on fixing CIP-related operations, it should be able to produce the same results in FY 2007. However, we are concerned that this correction effort may become diverted.

FAA hired a contractor to assist the review of CIP transaction processing. However, FAA has first directed the contractor to analyze a sample of CIP assets in order to generate a more reliable estimate of the CIP balance as of September 30, 2006. FAA then intends to provide this additional information to KPMG, requesting that KPMG continue auditing the FY 2006 balance and issue a new report, sometime during FY 2007, providing a restatement on FAA’s FY 2006 financial statements.

In our view, diverting resources to generate a new estimate of the FY 2006 CIP balance and to reissue the FY 2006 financial statement audit report will further delay efforts to fix the CIP process deficiencies and will increase the risk that FAA will again not be able to correct its underlying material weakness during FY 2007.

Successfully implementing these corrective actions in FY 2007 is critical for two reasons. First, FAA has stated that its goal is to implement sound financial management processes. This must include establishing stronger processes to account for its property. In doing so, FAA will be in a substantially stronger position to correct the material weakness and obtain a clean opinion on its financial statements in FY 2007.
Second, the FAA deficiencies may adversely affect DOT’s ability to meet OMB’s FY 2007 internal control requirements under Circular A-123—the Federal version of the Sarbanes/Oxley Act. Circular A-123 requires the Department’s leaders to implement adequate management and financial controls to deliver the best value with the resources entrusted to the agency. At the end of FY 2007, the Department will be required, for the first time, to provide a specific assurance that it has adequate controls to provide reasonable assurance that property is accounted for properly. The adequacy of FAA’s controls will be key to whether the Secretary will be able to provide that assurance.

The Department’s Chief Financial Officer also recognizes the importance of correcting the underlying process deficiencies. She told us that her office will now closely monitor FAA’s efforts to correct CIP process deficiencies to ensure that FAA implements timely and effective corrective actions. Given the importance of correcting these deficiencies, we agree that this is appropriate.

**HTF Agencies’ Financial Management, Reporting, and Oversight Activities**

Since the audit of the FY 2003 HTF financial statements, we reported that material weaknesses existed in internal controls over financial management and reporting activities in the HTF agencies. During FY 2006, the HTF agencies implemented significant improvements over several previously reported deficiencies. As a result, some issues—cleaning up suspense accounts and reconciling the Fund Balance with Treasury—have been downgraded to reportable conditions for HTF financial statement reporting. Other issues—implementation of managerial cost accounting and tracking intragovernmental transactions—were closed.

However, KPMG continued to identify deficiencies in the area of financial management, reporting, and oversight. These deficiencies include: (1) the preparation, approval, and processing of journal entries; (2) the preparation and analysis of the HTF financial statements; (3) the analysis of abnormal account balances; (4) the analysis of proprietary and budgetary account relationships; (5) the coordination with non-DOT agencies that receive HTF appropriations through FHWA; and (6) the estimation and reporting of grant accruals.

- **Preparation, Approval, and Processing of Journal Entries.** A significant number of accounting transactions are recorded into Delphi (the departmental accounting system for financial statement compilation) through the use of journal entries during FY 2006. The HTF agencies used manual journal entries to process routine transactions, such as recording and distributing budget authority, recording and reversing accruals, and recording cash draw-downs. Use of journal entries to process routine transactions increases the risk of error and misstatement as users can enter transactions that do not comply with
Treasury standard general ledger posting logic. HTF agencies should use journal entries to process non-routine transactions, such as recording one-time adjustments.

To ensure a controlled journal-entry process, when appropriate, the HTF agencies developed standardized forms to include the name of the preparer, reason for the entry, type of supporting documentation provided, and signature by the approver. However, key information required on the form was frequently missing. KPMG reviewed 183 journal entries and identified 12 instances where the name of the preparer was not provided, 16 instances where the journal entries were not approved before they were recorded in Delphi, and 33 instances where either no supporting documentation was provided or the documentation provided was insufficient. In addition, documentation to support eight journal entries could not be located and three journal entries could not be traced to the general ledger.

• **Preparation and Analysis of the HTF Financial Statements.** KPMG identified several concerns associated with compilation of HTF financial statements. Specifically, agencies are required to report net cost of operations by major programs on the Statement of Net Cost. In addition, OMB asked agencies to allocate net cost of operations by the agency’s strategic goals in financial statement note disclosures for information purposes. During FY 2006, the HTF agencies revised the methodology used to allocate the $37 billion net cost of operations by DOT’s strategic goals. However, KPMG determined that the new methodology and the allocation results were not properly supported. As a result, HTF agencies reported cost allocations by three major programs—Federal Aid Highways, Mass Transit, and Other programs—in the Statement of Net Cost note disclosure. The information about the cost associated with DOT’s strategic goals was instead presented as Other Accompanying Information to the financial statements. KPMG also found deficiencies in the Management Discussion and Analysis section in the financial statements. For example, HTF agencies initially presented information not relevant to the HTF, which had to be eliminated. Also, the performance measures had to be revised to conform to OMB requirements.

• **Analysis of Abnormal Account Balances.** The HTF agencies did not have effective processes to identify and resolve abnormal balances at the Treasury appropriation fund symbol level. Abnormal balances, such as a credit balance in asset accounts or a debit balance in liability accounts, normally result from incorrect transaction processing. Each HTF agency has the ability to produce a standard report from the Delphi accounting system, entitled “Account Balance Exception Report,” but did not routinely produce or review the report, document the review, or resolve exceptions identified. According to
departmental officials, the existing Delphi report was inappropriately designed to identify discrepancies within each Treasury symbol. During FY 2006, the Department developed an alternative solution to report discrepancies at the Treasury symbol level. However, HTF agencies only began using the alternative report during the fourth quarter of FY 2006.

- **Analysis of Proprietary and Budgetary Account Relationships.** Federal agencies are required to perform dual-postings to proprietary (e.g., operating expenses) and budgetary (e.g., obligations incurred) accounts to record certain business transactions. Balances in these two sets of accounts need to be reconciled to ensure consistency. Account relationship tests between proprietary and budgetary accounts are an effective tool to ensure that general ledger accounts have integrity and that incorrect transactions are detected and corrected. To be fully effective, account relationship tests should be performed at the Treasury symbol level.

During FY 2006, HTF agencies developed various account relationship tests—both automated and manual. While these tests did not identify material discrepancies between proprietary and budgetary accounts, KPMG found that HTF agencies did not have effective processes for analyzing and assessing the impact of discrepancies on financial statement reporting. For example,

- FHWA had 21 separate account relationship tests, including one performed automatically by Delphi and one still under development at June 30, 2006. However, it did not assess the impact of account relationship discrepancies at yearend.

- FTA had 16, and the remaining 4 HTF agencies had 6, separate account relationship tests. However, these tests were performed only at the appropriations summary level. As a result, discrepancies at the Treasury symbol level could have occurred without being detected.

- **Coordination with Non-DOT Agencies that Receive HTF Appropriations through FHWA.** During FY 2006, FHWA took action to resolve accounting discrepancies related to the reporting of allocation transfers of budgetary authority to 17 other Federal agencies outside DOT. These non-DOT agencies receive HTF appropriations through FHWA, such as the Forest Service and the Army Corps of Engineers. However, FHWA must further strengthen procedures to obtain information from these non-DOT agencies to support HTF financial statement assertions related to transactions processed by the other agencies that are included in the HTF Consolidated financial statements.
**Estimating and Reporting Grant Accruals.** For year-end reporting, the HTF agencies calculate and record an estimate ($3.6 billion at September 30, 2006) for the amount of work performed by grantee contractors but not yet billed to and reimbursed by the Federal agency. During FY 2006, FHWA did not ensure the grant accrual estimate included the total time between when work was accepted by grantees and when it was reimbursed by FHWA. As a result, in October 2006, FHWA had to initiate a special effort to confirm the accrual amounts with grantees in all states, which resulted in about a $200 million adjustment to the original estimate. Also, FTA made a material mathematical error in the calculation of its grant accrual estimate, which resulted in about a $600 million adjustment in the HTF financial statements.

KPMG made a series of recommendations to improve financial management, reporting, and oversight activities in its financial statement audit report, dated November 6, 2006. FHWA and DOT agreed to implement the recommendations. Therefore, we are not making additional recommendations in this report.

**REPORTABLE CONDITIONS**

The following sections describe the reportable conditions that we identified.

**Reporting of Earmarked Funds for Federal Transit Administration**


At September 30, 2006, the Federal Transit Administration (FTA) had seven Treasury accounts that included a mixture of earmarked and non-earmarked funds. Since they were financed predominantly by non-earmarked funds, they should not have been reported as earmarked funds. However, these seven accounts were initially reported as earmarked in the draft DOT Consolidated Balance Sheet and Statement of Changes in Net Position. This material error occurred because FTA incorrectly applied the DOT guidance at the summary level instead of at the Treasury symbol level. Consequently, adjustments totaling $5.2 billion were required to the net position amounts ($3.5 billion to Unexpended Appropriations and $1.7 billion to Cumulative Results of Operations) before the FY 2006 DOT Performance and Accountability Report was issued.
Financial System Controls

Last year, we reported DOT’s financial system controls as a reportable condition. This included weaknesses in Delphi computer controls and computer security deficiencies in several FAA, FHWA, and FTA systems that provide financial data to Delphi. In FY 2006, DOT made significant progress in improving controls over Delphi. The enhanced operational environment enabled auditors to rely on Delphi financial management system controls when conducting this year’s financial statement audits. However, continued improvement is needed, and there are still deficiencies in FAA, FHWA, and FTA subsidiary financial systems that provide information to Delphi. Therefore, financial system controls continue to be a reportable condition.

According to KPMG, four FAA financial systems had access control vulnerabilities that could diminish the reliability of computerized data and increase the risk of data destruction or inappropriate disclosure. In addition, KPMG found that two FTA mission-critical systems, which track grants and feed information to the Department-wide Delphi financial management system, had access controls weaknesses that could have a material effect on HTF’s financial statements. KPMG also found opportunities to improve the FAA, FHWA, and FTA financial systems security planning, segregation of duties, and service continuity.

KPMG’s audit reports, dated November 3, 2006 (FAA) and November 6, 2006 (HTF), included recommendations to improve financial system controls. The DOT Chief Financial Officer agreed with the recommendations; therefore, we are not making any additional recommendations.

DOT Information Security Program

In October 2006, we issued our sixth annual report on DOT’s Information Security Program and reported a noticeable improvement in tracking, prioritizing, and correcting security weaknesses—a major concern last year. The Department also took actions to identify systems containing personally identifiable information for security protection and provide oversight to major IT investments. However, like last year, the Department continues to face a challenge in recertifying systems security.

FY 2007 will be especially challenging for DOT because it must recertify about 230 systems—half of the Department’s total inventory, including many major financial subsidiary systems. Meanwhile, DOT must upgrade systems security to meet new Government standards, relocate its Headquarters and more than 75 information systems, and implement a consolidated IT infrastructure in the new Headquarters building. The consolidated IT operations will require a higher level of security protection because of the potential impact of disruptions on multiple
Operating Administrations, not just one. However, the plan and schedule to implement and test this new infrastructure are still evolving, due to a variety of move-related problems.

We made a series of recommendations to help the Department strengthen its information security program. The departmental Chief Information Officer agreed with them. Therefore, we are not making additional recommendations in this report.

**Intragovernmental Transactions**

During the audits of the FY 2003 and FY 2004 DOT Consolidated Financial Statements, we reported a material weakness in the DOT processes and procedures to reconcile transactions among its Operating Administrations and its transactions with other Federal agencies. During FY 2005, we found intra-DOT activity of $402 million ($293 million in assets and $109 million in non-exchange revenue) that was not eliminated in the DOT Consolidated Financial Statements. Since the amount was significantly lower than the year before, the issue was downgraded from a material weakness to a reportable condition.

While DOT continued to make progress during FY 2006, DOT again did not fully eliminate its intragovernmental activity within DOT in the draft FY 2006 DOT Consolidated Financial Statements. We found intra-DOT activity of $169 million ($84 million in assets and liabilities and $85 million in non-exchange revenue) that was not eliminated in the draft DOT Consolidated Financial Statements.

The DOT Chief Financial Officer has advised that the Office of Financial Management will continue working with the Operating Administrations to implement new processes and procedures to identify and eliminate intragovernmental activity during FY 2007. Therefore, we are not making additional recommendations in this report.

**Deobligating Unneeded Funds in the HTF Agencies**

Title 31, United States Code, Section 1501, requires amounts to be recorded as an obligation of the United States only when supported by documentary evidence of a binding agreement in writing between a Federal agency and another entity (including an agency) for a purpose authorized by law and executed before the end of the period of availability. Undelivered orders reflect obligations for goods or services that have not been delivered or received. DOT financial policy requires the agencies to monitor their open obligations on a quarterly basis to ensure timely deobligation of unneeded obligations prior to year end, so that funds could become available for other use.
KPMG sampled 107 Undelivered Orders, totaling $994.2 million, that had no activity for a period of 1 year or more as of June 30, 2006. KPMG found 14 obligations, totaling $118.6 million, that were invalid and no longer needed (see details in Table 1).

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<td>2.1</td>
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<tr>
<td>NHTSA</td>
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<td>7.8</td>
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<td>0</td>
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<tr>
<td>RITA</td>
<td>10</td>
<td>6.5</td>
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</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>107</strong></td>
<td><strong>$994.2</strong></td>
<td><strong>14</strong></td>
<td><strong>$118.6</strong></td>
</tr>
</tbody>
</table>


The HTF agencies agreed to deobligate these obligations for the sample items for FY 2006 year-end reporting.

**FAA Grants Management**

In our report on the FY 2005 DOT Consolidated Financial Statements, we reported FAA Grants Management as a Reportable Condition. FAA is responsible for establishing and maintaining accounting and internal controls over expenditures related to the Airport Improvement Program (AIP). The program’s growth (from $2.8 billion to $3.9 billion between FY 2004 and FY 2006), availability of resources, and reliance on sponsors, among other risks, led to the potential for waste, fraud, and abuse of Federal funds, especially within the oversight and monitoring phases of the grants management process.

According to KPMG, FAA’s specific internal control weaknesses in grants management include: (1) lack of an effective, risk-based approach to oversight and monitoring of AIP grant sponsorship activities; (2) inadequate policies and procedures describing the roles and responsibilities of regional managers; and (3) disproportionate reliance on OMB Circular A–133, “Single Audit Act,” for assurances that grant recipients are administering Federal funds properly and have sufficient internal controls. More reliable grants administration and monitoring processes feature preventive front-end and early-detection controls.
Last year FAA agreed with the KPMG recommendations to implement a risk-based approach to monitor AIP grants. However, FAA decided to defer the implementation to FY 2007. According to KPMG, the new grants monitoring approach was implemented on October 1, 2006, so we are not making any additional recommendations.

**FAA Contract Management**

In our report on the FY 2005 DOT Consolidated Financial Statements, we reported FAA Contract Management as a Reportable Condition because of weaknesses in the management and oversight of cost-reimbursable and support service contracts—two significant vehicles used to support modernization of the air traffic control system. During FY 2006, FAA made progress in both fronts. For example, FAA reduced the backlog of completed cost-reimbursable contracts awaiting closeout process, and dissolved one of the multiple-award “umbrella” programs used to procure support services. The OIG found that the support service procurement program was not properly structured and FAA would incur $24 million to $44 million in higher costs if all option years were exercised under that program.

While FAA has taken steps to enhance controls over support services procurement, more follow-through actions are needed. In August 2005, the FAA Administrator issued a directive requiring FAA-wide procurement enhancements. However, the OIG found that FAA had not implemented Agency-wide oversight to ensure consistent fulfillment of FAA’s Acquisition Management System requirements by its diverse procurement workforce. FAA has agreed to implement an oversight program. Therefore, we are not making any additional recommendations.

**C. COMPLIANCE WITH LAWS AND REGULATIONS**

In planning and conducting our audit, we performed limited tests of DOT’s compliance with laws and regulations, as required by OMB guidance. It was not our objective to express, and we do not express, an opinion on compliance with laws and regulations. Our work was limited to testing selected provisions of laws and regulations that would have a direct and material impact on the financial statements and be reportable under *Generally Accepted Government Auditing Standards* or under OMB guidance. Our work disclosed the following instances of noncompliance with laws and regulations.
FEDERAL FINANCIAL MANAGEMENT IMPROVEMENT ACT
OF 1996
Under FFMIA, we must report whether DOT’s financial management system substantially complies with Federal requirements and standards. FFMIA requires agencies to produce timely, auditable financial statements based on data from the agency’s financial system. KPMG concluded that four FAA and seven HTF systems were not in compliance for the year ended September 30, 2006. These key financial systems—which support data entered into Delphi—do not substantially comply with FFMIA compliance categories listed in OMB Circular A-127 (section 7), such as implementation of adequate internal controls and adherence to Computer Security Act requirements. KPMG recommended that FAA, FHWA, and FTA resolve the weaknesses noted in the key financial systems used to compile financial statements.

ANTIDEFICIENCY ACT
Title 31, United States Code, Section 1517, provides that an officer or employee of the U.S Government may not make or authorize an expenditure or obligation exceeding an amount available in an allotment. In our report on the FY 2005 DOT Financial Statements, we reported that FHWA still needed to resolve a $5 million violation first identified in FY 2003, and FAA needed to report a $1.9 million violation associated with the Small Community Air Service program to the President and Congress.

According to KPMG, FHWA resolved the $5 million violation with Treasury in September 2006. However, FAA still has not reported the $1.9 million violation to the President and Congress. FAA is working with the Office of the Secretary of Transportation to report the violation during FY 2007.

IMPROPER PAYMENTS INFORMATION ACT OF 2002 (IPIA)
OMB Circular A-123, Appendix C, issued on August 10, 2006, entitled “Requirements for Effective Measurement and Remediation of Improper Payments,” implements the requirements of IPIA and is effective for FY 2006 reporting. The bulletin defines an improper payment as any payment that should not have been made or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirements. Incorrect amounts include overpayments and underpayments, payments made to an ineligible recipient or for an ineligible service, duplicate payments, payments for services not received, and payments for the incorrect amount.

The bulletin prescribes a four-step approach for use by agencies in evaluating improper payments: (1) review all programs and identify those susceptible to significant erroneous payments; (2) statistically estimate the annual amount of
improper payments; (3) implement a plan to reduce erroneous payments; and (4) report estimates of the annual amount of improper payments and progress in reducing them.

During FY 2005, DOT reported the results of its review of the 10 programs susceptible to significant improper payments. The review found no significant improper payments and did not address payments made by DOT grantees.

During FY 2006, DOT concentrated on testing improper payments made by DOT grantees under FHWA’s Federal-aid Program, FTA’s formula grants program, and FAA’s AIP. Among these three Operating Administrations, FHWA was the only one that was able to statistically estimate the amount of improper payments. However, due to the constraints of the methodology used, FHWA could not estimate the annual amount of improper payments made under the Federal-aid Program. Instead, the estimation was limited to a period of 5 months—about $30 million.

FTA and FAA are still in the early stage of implementing the improper payment testing requirements. During FY 2006, FAA performed testing of grant payments made by one airport authority, and FTA tested payments made by two transit grantees.

DOT (i.e., FHWA, FTA, and FAA) must continue to implement IPIA so that annual (12-month) estimates are reported, plans are identified and implemented to reduce erroneous payments, and progress in reducing improper payments can be reported.

D. CONSISTENCY OF OTHER INFORMATION

The Management Discussion and Analysis, Required Supplementary Information, Required Supplementary Stewardship Information, and Other Accompanying Information contain a wide range of data, some of which are not directly related to the financial statements. We are not required to, and we do not, express an opinion on this information. As required by OMB guidance, we inquired of management about the methods of preparing this information, and we compared this information for consistency with the DOT Consolidated Financial Statements and other knowledge obtained during the audit of the financial statements. Based on this work, we found no material inconsistencies with the DOT Consolidated Financial Statements or nonconformance with OMB guidance.

E. PRIOR AUDIT COVERAGE

Our report on the DOT Consolidated Financial Statements for FY 2002 and FY 2001 made one recommendation: that DOT confirm and reconcile intra-governmental balances with trading partners. DOT must continue to work to improve the accounting for intra-governmental balances with trading partners, timely de-obligation of unneeded transactions, and testing of improper payments. Exhibit B displays the status of the prior year’s and new issues.

Since we issued our report on the DOT Consolidated Financial Statements for FY 2005 and FY 2004, we issued 19 reports related to the DOT Consolidated Financial Statements. The reports are listed in Exhibit C.

The Assistant Secretary for Budgets and Programs/Chief Financial Officer provided comments on a draft of the report (see Appendix). The response agreed with the material weaknesses and reportable conditions in this report and stated that corrective actions have already been initiated. Management agreed to provide a detailed action plan addressing each finding by December 29, 2006.

This report is intended for the information of and use by DOT, OMB, the Government Accountability Office, and Congress. This report is a matter of public record, and its distribution is not limited.

Calvin L. Scovel III
Inspector General
EXHIBIT A. OBJECTIVES, SCOPE, AND METHODOLOGY

Our audit objectives for the DOT Consolidated Financial Statements for FY 2006 and FY 2005 were to determine whether (1) principal DOT Consolidated Financial Statements and accompanying notes are presented fairly, in all material respects, in conformity with generally accepted accounting principles; (2) DOT has adequate internal controls over financial reporting, including safeguarding assets; (3) DOT has complied with laws and regulations that could have a direct and material effect on the DOT Consolidated Financial Statements or that have been specified by OMB, including FFMIA; (4) financial information in the Management Discussion and Analysis, Required Supplementary Information, Required Supplementary Stewardship Information, and Other Accompanying Information is materially consistent with the information in the principal DOT Consolidated Financial Statements; and (5) internal controls ensured the existence and completeness of reported data supporting performance measures.

DOT is responsible for (1) preparing the DOT Consolidated Financial Statements for FY 2006 and FY 2005 in conformity with generally accepted accounting principles; (2) establishing, maintaining, and assessing internal controls to provide reasonable assurance that broad control objectives of FMFIA are met; (3) ensuring that DOT financial management systems substantially comply with FFMIA requirements; and (4) complying with other applicable laws and regulations. DOT is responsible for maintaining an effective system of internal controls. The objectives of these controls are explained below.

- **Financial reporting.** Transactions are properly recorded, processed, and summarized to permit the preparation of financial statements and stewardship information in conformity with generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.

- **Compliance with laws and regulations.** Transactions are executed in accordance with laws governing the use of budget authority and with other laws and regulations that could have a direct and material effect on the financial statements and any other laws, regulations, and Government-wide policies identified by OMB audit guidance.

- **Reliability of Performance Reporting.** Transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit the preparation of required performance information.

To fulfill these responsibilities, we (1) examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements; (2) assessed
the accounting principles used and significant estimates made by management; (3) evaluated the overall presentation of the financial statements; (4) obtained an understanding and performed limited tests of internal controls related to financial reporting, compliance with laws and regulations, and performance measures; and (5) tested compliance with selected provisions of certain laws, including FFMIA.

We did not evaluate all internal controls relevant to operating objectives as broadly defined by FFMIA, such as those controls relevant to ensuring that programs achieve their intended results and that resources are used consistent with agency missions. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal controls, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected.


We did not test compliance with all laws and regulations applicable to DOT. We limited our tests of compliance to those laws and regulations required by OMB audit guidance that we deemed applicable to the DOT Consolidated Financial Statements for the years ended September 30, 2006, and September 30, 2005. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

The Chief Financial Officers of DOT and each Operating Administration have been assigned the responsibility to address the weaknesses identified in this report. Management’s response to the findings and recommendations in this report is contained in the Appendix.

We performed our work in accordance with Generally Accepted Government Auditing Standards and OMB Bulletin 06-03, “Audit Requirements for Federal Financial Statements.”

Exhibit A. Objectives, Scope, and Methodology
## EXHIBIT B. STATUS OF PRIOR YEAR’S AND NEW ISSUES

<table>
<thead>
<tr>
<th>Issue</th>
<th>As Reported 9/30/2005</th>
<th>As Reported 9/30/2006</th>
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<tr>
<td>Timely Processing of and Accounting for the FAA Construction-in-Progress Transaction</td>
<td>Material Weakness</td>
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<tr>
<td>HTF Agencies’ Financial Management, Reporting, and Oversight Activities</td>
<td>Material Weakness</td>
<td>Material Weakness</td>
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<tr>
<td>Financial Oversight of Highway Grants</td>
<td>Material Weakness</td>
<td>Reportable Condition (Deobligating Unneeded Funds)</td>
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<tr>
<td>Reporting of Earmarked Funds for FTA</td>
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<tr>
<td>Financial System Controls</td>
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<td>Intragovernmental Transactions</td>
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<td>FAA Grants Management</td>
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</tr>
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<td>FAA Contract Management</td>
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<td>MARAD Oversight of Title XI Loan Guarantees</td>
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<td>Federal Managers’ Financial Integrity Act</td>
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<td>Management Letter</td>
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<td>Government Performance and Results Act</td>
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<td>FAA Franchise Fund Enabling Legislation</td>
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# EXHIBIT C. FINANCIAL-RELATED REPORTS

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<tr>
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<tr>
<td>Audit of Special-Purpose Financial Statements for Fiscal Year 2005, Fiscal Year 2004</td>
<td>FI-2006-015</td>
<td>November 18, 2005</td>
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<td>Independent Accountant's Agreed-Upon Procedures for Intragovernmental Activity and Balances</td>
<td>FI-2006-017</td>
<td>December 2, 2005</td>
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<td>FAA Has Opportunities To Reduce Academy Training Time and Costs by Increasing Educational Requirements for Newly Hired Air Traffic Controllers</td>
<td>AV-2006-021</td>
<td>December 7, 2005</td>
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<td>Internal Controls Over the Emergency Disaster Relief Transportation Services Contract</td>
<td>AV-2006-032</td>
<td>January 20, 2006</td>
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<td>Inspector General Review of Fiscal Year 2005 Drug Control Funds</td>
<td>FI-2006-033</td>
<td>February 1, 2006</td>
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<td>FAA Telecommunications Infrastructure Program: FAA Needs To Take Steps To Improve Management Controls and Reduce Schedule Risks</td>
<td>AV-2006-047</td>
<td>April 27, 2006</td>
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<td>Internal Controls Over Payments for Emergency Disaster Relief Transportation Services</td>
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<td>Use of Airport Revenues by the Greater Orlando Aviation Authority</td>
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<td>Mississippi Department of Transportation's Award of Selected Hurricane Katrina Emergency Repair Contracts</td>
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<td>Federal Aviation Administration's RESULTS National Contracting Service</td>
<td>FI-2006-072</td>
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<td>DOT’s Information Security Program</td>
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<td>Top Management Challenges</td>
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<td>November 15, 2006</td>
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Exhibit C. Financial-Related Reports
APPENDIX. ASSISTANT SECRETARY FOR BUDGET AND PROGRAMS/CHIEF FINANCIAL OFFICER RESPONSE TO AUDIT REPORT

November 14, 2006

MEMORANDUM TO: Calvin L. Scovell, III
Inspector General

FROM: Phyllis F. Scheinberg


The Department is pleased to respond to your audit report on the Consolidated Financial Statements for FY 2006 and FY 2005.

This year’s audit concluded that DOT’s consolidated financial statements are fairly presented, in all material respects, in conformity with generally accounting principles, with one exception: the FY 2006 Construction in Progress (CIP) balance on Footnote 9, which is a subcomponent of the Property, Plant and Equipment line item on the consolidated balance sheet for the Department.

We concur with the two material weaknesses and seven reportable conditions described in your report and are developing corrective actions to resolve them. By December 29th, we will send you our detailed action plan to address all the findings in your report. Our action plan will also address the findings in the audits of the Highway Trust Fund (HTF) and the Federal Aviation Administration (FAA).

This year the Department made significant progress in resolving long standing financial management internal control issues, including the following highlights:

- The Federal Highway Administration (FHWA) eliminated the FY 2005 material weakness in improving financial accounting processes. This year the FHWA produced financial statements from the core accounting system with very few adjustments. The FHWA was also able to produce the data required for Treasury’s FACTS II reporting directly from the core accounting system with very few minor adjustments. Over the past year, the FHWA also revised its journal entry process, resulting in a reduction of more than 50 percent in the number of journal entries.
• The FHWA successfully implemented the FIRE program in all FHWA field offices, which resolved the material weakness in grants management that had been identified in FY 2004. The FIRE program also focused attention on inactive obligations, resulting in deobligating funding on more than 1,000 projects during the year. This action addressed a particular concern of your office over the last several years.

• In FY 2005, the FAA had one material weakness consisting of six different areas of timely processing and reconciling of transactions that needed improvement. In FY 2006, five of these areas were resolved. The FAA has further improved its accounting by consolidating all nine regional accounting offices to DOT’s Enterprise Service Center in Oklahoma City. This produced significant cost savings and improved the reliability and timeliness of FAA accounting data.

We also made significant progress on the Department’s Improper Payments Information Act (IPIA) program. Based on the methodology we developed during FY 2005 to test the improper rate of payments made by our grantees to their contractors, the FHWA sampled a total 1,500 projects covering all States and has developed a nationwide improper payment rate. In addition, the FAA and the Federal Transit Administration have developed component improper payment rates for their major grant programs.

In addition, we completed the first year of our two-year approved Implementation Plan for the Office of Management and Budget’s Circular A-123, Management’s Responsibility for Internal Control. We documented, assessed risk and tested the first six key business processes and developed action plans to address all the findings. During FY 2007, we will review on-going corrective actions, document the remaining key business processes, and complete the second year testing under our A-123 Plan.

We generally agree with the recommendations listed in the audit reports and will use them to develop our corrective action plan. We will work closely with the Operating Administrations and the various audit groups to ensure that the Department continues to make strong progress in improving financial management in FY 2007.

I would like to express my appreciation for the cooperation and professionalism displayed by your staff during the course of the audit. Please refer any questions to Laurie Howard, Director of Financial Management, at extension 62135.