



2001 M Street, NW  
Washington, DC 20036

## Independent Auditors' Report

Office of Inspector General, Federal Emergency Management Agency and  
Director, Federal Emergency Management Agency:

We have audited the accompanying consolidated balance sheets of the Federal Emergency Management Agency (FEMA) as of September 30, 2002 and 2001, and the related consolidated statements of net cost for the years then ended, and the related consolidated statement of changes in net position, combined statement of budgetary resources, and consolidated statement of financing for the year ended September 30, 2002 (hereinafter referred to as consolidated financial statements). The objective of our audits was to express an opinion on the fair presentation of these consolidated financial statements. In connection with our audits, we also considered FEMA's internal control over financial reporting and tested FEMA's compliance with certain provisions of applicable laws and regulations that could have a direct and material effect on its consolidated financial statements.

### Summary

As stated in our opinion on the consolidated financial statements, we concluded that FEMA's consolidated financial statements presented in the *Fiscal Year 2002 Annual Performance & Accountability Report* as of and for the years ended September 30, 2002 and 2001, are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America.

Our opinion includes a reference to a restatement of the fiscal year 2001 consolidated balance sheet and consolidated statement of net cost, and to the beginning balances reported on the 2002 combined statement of budgetary resources. In addition, our opinion indicates that the claims settlement liability under the Cerro Grande Fire Assistance Act is estimated based on known probable and estimable losses, a portion of which is unfunded.

Our consideration of internal control over financial reporting resulted in the following conditions being identified as reportable conditions, the first six of which we consider to be material weaknesses:

- Information Security Controls for FEMA's Financial Systems Environment Need Improvement
- FEMA's Financial System Functionality Needs Significant Improvement
- FEMA Must Improve Its Financial Reporting Process
- FEMA Must Improve Its Real and Personal Property System Processes
- FEMA Must Improve Its Account Reconciliation Processes
- FEMA Must Improve Its Accounts Receivable Processes
- FEMA Must Improve Its Cerro Grande Estimation Processes

The results of our tests of compliance with certain provisions of laws and regulations disclosed instances of noncompliance with the following laws and regulations that are required to be reported under *Government Auditing Standards*, issued by the Comptroller General of the United States, and Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*:

- Government Information Security Reform Act
- Federal Managers' Financial Integrity Act
- Cerro Grande Fire Assistance Act
- Federal Financial Management Improvement Act

The following sections discuss our opinion on FEMA's consolidated financial statements, our consideration of FEMA's internal control over financial reporting, our tests of FEMA's compliance with certain provisions of applicable laws and regulations, and management's and our responsibilities.

### **Opinion on the Consolidated Financial Statements**

We have audited the accompanying consolidated balance sheets of the Federal Emergency Management Agency as of September 30, 2002 and 2001, and the related consolidated statements of net cost for the years then ended, and the related consolidated statement of changes in net position, combined statement of budgetary resources, and consolidated statement of financing for the year ended September 30, 2002.

In our report dated February 6, 2002, we qualified our opinion on the fiscal year 2001 consolidated financial statements for the effects of such adjustments, if any, as might have been necessary had we been able to apply adequate procedures to two matters: (1) FEMA's equipment balances, and (2) an unsupported \$77 million adjustment to the combined statement of budgetary resources. As described in Note 18 to the fiscal year 2002 consolidated financial statements, during fiscal year 2002, FEMA inventoried and valued its equipment and restated its fiscal year 2001 consolidated balance sheet to conform with accounting principles generally accepted in the United States of America. This restatement had no effect on the fiscal year 2001 consolidated statement of net cost. Accordingly, our present opinion on the fiscal year 2001 consolidated balance sheet and consolidated statement of net cost, as presented herein, is different from that expressed in our previous report. The unsupported \$77 million adjustment, discussed above, does not affect the beginning obligated balances reported in the fiscal year 2002 combined statement of budgetary resources.

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the financial position of FEMA as of September 30, 2002 and 2001, and its net costs for the years then ended, and its changes in net position, budgetary resources, and reconciliation of net costs to budgetary obligations for the year ended September 30, 2002, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Notes 18 and 24 to the consolidated financial statements, the fiscal year 2001 consolidated balance sheet, consolidated statement of net cost, and the beginning unobligated and obligated balances on the fiscal year 2002 combined statement of budgetary resources have been restated.

As discussed in Note 11 to the consolidated financial statements, FEMA has been designated by Congress to administer entitlement claims under the Cerro Grande Fire Assistance Act (CGFAA). The claims

settlement liability is estimated based on known probable and estimable losses, a portion of which are unfunded.

The information in the Management's Discussion and Analysis, Required Supplementary Information, and Required Supplementary Stewardship Information sections is not a required part of the consolidated financial statements, but is supplementary information required by accounting principles generally accepted in the United States of America or OMB Bulletin No. 01-09, *Form and Content of Agency Financial Statements*. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of this information. However, we did not audit this information and, accordingly, we express no opinion on it. We determined that FEMA did not complete the intragovernmental balance reconciliations with its trading partners semi-annually, as required by OMB Bulletin No. 01-09.

### **Internal Control over Financial Reporting**

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect FEMA's ability to record, process, summarize, and report financial data consistent with the assertions by management in the consolidated financial statements.

Material weaknesses are reportable conditions 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 misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

In our fiscal year 2002 audit, we noted certain matters, described in Appendix I, involving internal control over financial reporting and its operation that we consider to be reportable conditions, the first six of which we consider to be material weaknesses. The status of prior year material weaknesses is also discussed in Appendix I.

We also noted other matters involving internal control over financial reporting and its operation that we will report to the management of FEMA in a separate letter.

### **Compliance with Laws and Regulations**

Our tests of compliance with certain provisions of laws and regulations, as described in the Responsibilities section of this report, exclusive of those referred to in the *Federal Financial Management Improvement Act* (FFMIA), disclosed instances of noncompliance with the following laws and regulations that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 01-02, and are described below.

- The *Government Information Security Reform Act* (GISRA), passed as part of the *Defense Authorization Act of 2000*, mandates that federal agencies implement sufficient information security program management processes, including security planning, implementation, and evaluation. As part of our financial audit procedures, we conducted information security testing of FEMA's security program and practices. We found that FEMA needs to make improvements to fully comply with GISRA.

- The *Federal Managers' Financial Integrity Act of 1982* (FMFIA) is implemented in part through policy guidance in OMB Circular A-127, *Financial Management Systems* and OMB Circular A-123, *Management Accountability and Control*. OMB Circular A-123 requires agencies and individual federal managers to take measures to (i) develop and implement management controls; (ii) assess the adequacy of management controls; (iii) identify needed improvements; (iv) take corresponding corrective action; and (v) report annually on management controls. OMB Circular A-127 states that financial management systems must be in place to process and record financial events effectively and efficiently, and to provide complete, timely, reliable and consistent information for decision makers and the public. However, we found that FEMA does not fully meet the requirements of FMFIA, OMB Circular A-123, and OMB Circular A-127 as described in Appendix I.
- The *Cerro Grande Fire Assistance Act* (CGFAA) directed FEMA to expeditiously investigate victims' claims and to determine and compensate victims of the Cerro Grande fire in northern New Mexico in May 2002. The CGFAA requires FEMA to submit a report to Congress on an annual basis related to CGFAA activities. The 2002 annual report was due to Congress by August 28, 2002, but it was submitted on December 17, 2002.

The results of our tests of compliance with other laws and regulations, exclusive of FFMIA, disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02.

The results of our tests of FFMIA disclosed instances, described in Appendix I, in which FEMA's financial management systems did not substantially comply with federal financial management systems requirements or with applicable federal accounting standards. Appendix I includes our recommendations to the Acting Chief Financial Officer and to the Chief Information Officer. The results of our tests disclosed no material instances in which FEMA did not substantially comply with the United States Government Standard General Ledger at the transaction level.

## Responsibilities

### *Management's Responsibilities*

The *Government Management Reform Act of 1994* (GMRA) requires each federal agency to report annually to Congress on its financial status and any other information needed to fairly present its financial position and results of operations. To meet the GMRA reporting requirements, FEMA prepares annual consolidated financial statements.

Management is responsible for:

- Preparing the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America;
- Establishing and maintaining internal controls over financial reporting, and preparation of the Management's Discussion and Analysis (including the performance measures), Required Supplementary Information, and Required Supplementary Stewardship Information; and
- Complying with laws and regulations, including FFMIA.

In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies. Because of inherent limitations in internal control, misstatements, due to error or fraud, may nevertheless occur and not be detected.

#### *Auditors' Responsibilities*

Our responsibility is to express an opinion on the consolidated financial statements of FEMA based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in *Government Auditing Standards*, and OMB Bulletin No. 01-02. Those standards and OMB Bulletin No. 01-02 require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement.

An audit includes:

- Examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall consolidated financial statement presentation.

We believe that our audits provide a reasonable basis for our opinion.

In planning and performing our fiscal year 2002 audit, we considered FEMA's internal control over financial reporting by obtaining an understanding of FEMA's internal control, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 01-02 and *Government Auditing Standards*. We did not test all internal controls relevant to operating objectives as broadly defined by the FMFIA. The objective of our audit was not to provide assurance on internal controls over financial reporting. Consequently, we do not provide an opinion thereon.

As required by OMB Bulletin No. 01-02, we considered FEMA's internal control over Required Supplementary Stewardship Information by obtaining an understanding of FEMA's internal control, determining whether these internal controls had been placed in operation, assessing control risk, and performing tests of controls. Our procedures were not designed to provide assurance on internal control over required supplementary stewardship information and, accordingly, we do not provide an opinion thereon.

As further required by OMB Bulletin No. 01-02, with respect to internal control related to performance measures determined by management to be key and reported in the Management's Discussion and Analysis, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions. Our procedures were not designed to provide assurance on internal control over performance measures and, accordingly, we do not provide an opinion thereon.

As part of obtaining reasonable assurance about whether FEMA's fiscal year 2002 consolidated financial statements are free of material misstatement, we performed tests of FEMA's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain provisions of other laws and regulations

specified in OMB Bulletin No. 01-02, including certain provisions referred to in FFMIA. We limited our tests of compliance to the provisions described in the preceding sentence, and we did not test compliance with all laws and regulations applicable to FEMA. Providing an opinion on compliance with laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion.

Under OMB Bulletin No. 01-02 and FFMIA, we are required to report whether FEMA's financial management systems substantially comply with (1) federal financial management systems requirements, (2) applicable federal accounting standards, and (3) the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

#### **Distribution**

This report is intended for the information and use of FEMA's management, FEMA's Office of Inspector General, OMB, and the U.S. Congress, and is not intended to be and should not be used by anyone other than these specified parties.

*KPMG LLP*

January 24, 2003