Independent Auditor's Report

U.S. Department of State's Financial Statements

September 30, 2007 and 2006

AUD/FM-08-05, November 2007

Leonard G. Birnbaum and Company, LLP
Certified Public Accountants
6285 Franconia Road
Alexandria, Virginia 22310
(703) 922-7622

LEONARD G. BIRNBAUM AND COMPANY, LLP

CERTIFIED PUBLIC ACCOUNTANTS
WASHINGTON OFFICE
6285 FRANCONIA ROAD
ALEXANDRIA, VA 22310-2510

(703) 922-7622
FAX: (703) 922-8256

LESLIE A. LEIPER
LEONARD G. BIRNBAUM
DAVID SAKOFS
CAROL A. SCHNEIDER
DORA M. CLARKE

WASHINGTON, D.C.
SUMMIT, NEW JERSEY
REDWOOD CITY, CALIFORNIA

INDEPENDENT AUDITOR'S REPORT

To the Secretary, Department of State:

We were engaged to audit the Department of State's (Department) Consolidated Balance Sheet, Consolidated Statement of Net Cost, Consolidated Statement of Changes in Net Position, and Combined Statement of Budgetary Resources (Annual Financial Statements) as of, and for the years ended, September 30, 2007 and 2006. We have considered internal control over financial reporting as of, and during the year ended, September 30, 2007, and we have tested compliance with selected laws and regulations.

Except as explained in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits set forth in *Government Auditing Standards,* and Office of Management and Budget (OMB) Bulletin 07-04, *Audit Requirements for Federal Financial Statements.*

We are unable to express an opinion on the Department's 2007 annual financial statements as of, and for the year ended, September 30, 2007, because of limitations on the scope of our work. The Department was unable to respond to requests for evidential material in a timely manner, and we were not able to perform other auditing procedures to satisfy ourselves as to the accuracy of the financial statements in time to meet the November 15, 2007, deadline imposed by OMB for issuing our report. Therefore, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the 2007 financial statements.

In our opinion, the Department's 2006 annual financial statements, including the notes thereto, present fairly, in all material respects, the Department's financial position as of September 30, 2006, and its net cost of operations, changes in net position, and use of budgetary resources for the year then ended, in accordance with accounting principles generally accepted in the United States of America. We issued our report thereon dated December 12, 2006.

We found the following:

- certain deficiencies in the Department's internal control that we considered to be significant deficiencies and other deficiencies that we considered to be material weaknesses,

- instances of noncompliance with selected provisions of applicable laws and regulations involving the Department's financial management systems, and

- that the Department's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996.

Each of these conclusions is discussed in more detail below. This report also discusses the scope of our work.

ANNUAL FINANCIAL STATEMENTS

Because the Department was unable to respond to requests for evidential material in a timely manner and we were not able to perform other auditing procedures to satisfy ourselves as to the accuracy of the 2007 financial statements in time to meet the November 15, 2007, deadline imposed by OMB for issuing our report, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the annual financial statements as of, and for the year ended, September 30, 2007.

In our opinion, the Department's 2006 annual financial statements, including the notes thereto, present fairly, in all material respects, the Department's financial position as of September 30, 2006, and the net cost of operations, the changes in net position, and the use of budgetary resources, for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the annual financial statements, in 2006 the Department implemented new Statements of Federal Financial Auditing Standards related to earmarked funds and heritage assets. The Department also changed its treatment of major components installed on aircraft to the purchase method. In 2006 and 2007, the Department implemented new OMB reporting requirements. In addition, in 2007, the Department revised the presentation of the Statement of Net Cost to reflect the modification of the Department's strategic goals.

INTERNAL CONTROL

In planning and performing our audits of the Department's annual financial statements as of, and for the years ended, September 30, 2007 and 2006, in accordance with auditing standards generally accepted in the United States of America, we considered the Department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the annual financial statements but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control. We limited our consideration of internal control to those controls necessary to achieve the objectives described in OMB Bulletin 07-04. We did not consider all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations.

The purpose of internal control is to provide management with reasonable, but not absolute, assurance that the following objectives are met:

- transactions are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over assets;

- funds, property, and other assets are safeguarded against loss from unauthorized acquisition, use, or disposition;

- transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements and other laws and regulations that OMB, Department management, or the Office of Inspector General has identified as being significant for which compliance can be objectively measured and evaluated; and

- data that support reported performance measures are properly recorded and accounted for to permit preparation of reliable and complete performance information.

Our consideration of the internal control over financial reporting would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies and other deficiencies that we consider to be material weaknesses.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. Under standards issued by the American Institute of Certified Public Accountants, a significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the following four deficiencies to be significant deficiencies in internal control:

- The Department's financial and accounting system as of September 30, 2007, was inadequate. There is a risk of materially misstating financial information under the current conditions. This condition is a significant reason that the Department was unable to provide complete financial statements or respond to requests for evidential material in a timely manner, which led to our inability to express an opinion on the 2007 financial statements. The principal areas of inadequacy were the following:

    - During 2007, the Department used several systems for the management of grants and other types of financial assistance. The systems lacked standard data classifications and common processes and were not integrated with the Department's core financial management system. Further, the Department could not produce reliable financial information that defined the universe of grants and other federal financial assistance. The Department has undertaken an initiative jointly with the United States Agency for International Development to establish a grants management system. Implementation of such a system was expected to begin in FY 2007, but as yet, it has not been funded.

    - The Department is unable to produce year-end financial data to be included in its Agency Financial Report in a timely manner.

  This deficiency was initially observed in our audit of the Department's 1997 financial statements and cited in subsequent audits.

- Although the Department complied with certain aspects of SFFAS Number 4, *Managerial Cost Accounting Standards* (for instance, it chose reasonable responsibility segments, recognized the cost of goods and services that it receives from other entities, and used an appropriate allocation methodology), it has not implemented an effective process to routinely collect managerial cost accounting information or establish outputs for each responsibility segment.

Until this is done, we do not believe the information will be useful as a management decision-making tool. This condition was reported in our audit of the Department's 2000 financial statements and subsequent audits.

- The Department is unable to determine the extent of its unfunded actuarial liability accruing from defined benefit supplemental pension plans for locally employed staff.

- As discussed in this report, a number of significant deficiencies have been reported for several years. The Department has not taken appropriate action to either correct these significant deficiencies or conclude that they cannot be corrected.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. We believe that the following two deficiencies constitute material weaknesses:

- The Department's internal control process related to the management of undelivered orders was inadequate. The Department has made some improvements in this area over the past several years. The Bureau of Resource Management (RM) has actively worked with other Department bureaus to validate undelivered orders and has successfully cleared up a significant number of obligations that were outstanding from past years. The Department, however, needs to perform additional work to correct this condition. Our tests indicated that excess obligations as of September 30, 2007, were more than $550 million. Also, we noted that the Department's undelivered orders balance had grown to $13.4 billion as of September 30, 2007. The Budget and Accounting Procedures Act of 1950 requires that the Department's accounting system provide effective control over funds. Failure to deobligate funds in a timely manner may result in the loss of availability of those funds. The deficiencies in this process were cited in our report on the Department's 1997 financial statements and in subsequent reports.

- We have identified deficiencies related to the recording of personal property and related depreciation expense and accumulated depreciation. The Department's control over property in the hands of contractors, while improved, is still in development. Further, the Department's controls over vehicles and other personal property are less than fully effective. Our tests disclosed a continuation of assets acquired in prior years being reported as current year accessions and errors in depreciation resulting from incorrect inservice dates. This deficiency was initially observed in our audit of the Department's 2005 financial statements and cited again in our 2006 audit.

We are required to review the Department's current FMFIA report and disclose differences with the material weaknesses in our report. The Department's 2007 report did not identify control over personal property as a material weakness.

Finally, with respect to internal control related to performance measures reported in Management's Discussion and Analysis, we obtained an understanding of the design of significant controls relating to the existence and completeness assertions and determined whether those controls had been placed in operation as required by OMB Bulletin 07-04. Our procedures were not designed to provide assurance on internal control over reported performance measures, and accordingly, we do not provide an opinion on such controls.

We noted certain other internal control issues that we have reported to Department management in a separate letter dated November 14, 2007.

COMPLIANCE WITH LAWS AND REGULATIONS

Department management is responsible for complying with laws and regulations applicable to the Department. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the Department'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 other laws and regulations specified in OMB Bulletin 07-04, including the requirements in FFMIA. We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to the Department. The objective of our audit of the annual financial statements, including our tests of compliance with selected provisions of applicable laws and regulations, was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements or violations of prohibitions in statutes and regulations that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements or that sensitivity warrants disclosure thereof.

The results of our tests of compliance with the laws and regulations described above, exclusive of FFMIA, disclosed the following instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing*

Standards, issued by the Comptroller General of the United States, and OMB Bulletin 07-04.

- Budget and Accounting Procedures Act of 1950. This act requires an accounting system to provide full disclosure of the results of financial operations; adequate financial information needed in the management of operations and the formulation and execution of the budget; and effective control over income, expenditures, funds, property, and other assets. However, we found that the Department's financial system (1) does not provide effective control over personal property, (2) does not manage undelivered orders effectively, and (3) is unable to issue year-end financial data in a timely manner.

- Federal Managers' Financial Integrity Act of 1982. This act requires the implementation of internal accounting and administrative controls that provide reasonable assurance that (1) obligations and costs are in compliance with applicable laws; (2) funds, property, and other assets are safeguarded against waste, loss, unauthorized use, or misappropriation; and (3) revenues and expenditures applicable to Department operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and statistical reports and to maintain accountability over the assets. However, as discussed above, we found that the Department's financial system does not provide effective control over personal property and does not manage undelivered orders effectively. Hence, assets are not adequately protected from waste or loss.

- Chief Financial Officers Act of 1990. This act requires the development and maintenance of an integrated accounting and financial management system that (1) complies with applicable accounting principles, standards and requirements, and internal control standards; (2) complies with such policies and requirements as may be prescribed by the Director of OMB; (3) complies with any other requirements applicable to such systems; and (4) provides for (i) complete, reliable, consistent, and timely information that is prepared on a uniform basis and that is responsive to the financial information needs of agency management; (ii) the development and reporting of cost information; (iii) the integration of accounting and budgeting information; and (iv) the systematic measurement of performance. However, we found that the Department's financial system does not produce year-end financial data in a timely manner.

- OMB Circular A-127, *Financial Management Systems*. This circular requires the Department to establish and maintain an accounting system that provides for (1) complete disclosure of the financial results of the activities of the Department; (2) adequate financial information for Department management and for formulation and execution of the budget; and (3) effective control over revenue, expenditure, funds, property, and other assets. However, we found again that the financial system did not maintain effective control over personal property and undelivered orders. Further, the Department's failure to implement an effective managerial cost accounting system precludes effective control over revenues and expenditures.

The above areas of noncompliance were cited in our audit of the Department's 1997 financial statements and subsequent audits.

The results of our tests of compliance with other laws and regulations disclosed no material instances of noncompliance. Compliance with FFMIA is discussed below.

Under FFMIA, we are required to report whether the Department's financial management systems substantially comply with federal financial management system requirements, applicable accounting standards, and the U.S. Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance using the implementation guidance for FFMIA issued by OMB on January 4, 2001. OMB implementation guidance states that, to be in substantial compliance with this requirement, the Department must adhere to all applicable SFFASs; meet specific requirements of OMB Circular A-127, including the computer security controls required by OMB Circular A-130, *Management of Federal Information Resources*; and receive an unqualified opinion on its financial statements that discloses no material weaknesses in internal control that affect the Department's ability to prepare financial statements and related disclosures.

The results of our tests disclosed instances, described below, where the Department's financial management systems did not, in our view, substantially comply with the requirement to follow the federal financial management system requirements, nor did it comply with applicable accounting standards.

- SFFAS No. 4, as noted above, requires implementation of an effective process to routinely collect managerial cost accounting information and establish outputs for each responsibility segment. We found, as discussed above, that the Department had not met this requirement.

- Circular A-127 requires that the Department's systems support management's fiduciary role by providing complete, reliable, consistent, timely, and useful financial management information. Based on the deficiencies related to financial management systems discussed in the report on internal controls and the preceding paragraphs in the report on compliance with laws and regulations, we determined that the Department was not substantially in compliance with this standard.

In addition, we were unable to express an opinion on the annual financial statements as of, and for the year ended, September 30, 2007, because of limitations on the scope of our work. The Department was unable to respond to requests for evidential material in a timely manner, and we were not able to satisfy ourselves as to the accuracy of the 2007 financial statements in time to meet the November 15, 2007, deadline imposed by OMB for issuing our report.

RM has overall responsibility for the Department's financial management systems. The foregoing noncompliance has its roots in the lack of organization and integration of the Department's financial management systems. In our audits of the Department's financial statements since 1997, we observed that the Department's financial management systems were not in compliance with FFMIA and recommended, in connection with our audits of the Department's 1997 and 1998 Principal Financial Statements, that a remediation plan be prepared. RM submitted its plan to remediate noncompliance with FFMIA to OMB on March 16, 2000. Although RM has made significant progress in completing several phases of its plan, the plan has not effectively dealt with the issues related to managerial cost accounting.

We noted certain other instances of noncompliance that we reported to the Department's management in a separate letter dated November 14, 2007.

RESPONSIBILITIES AND METHODOLOGY

Department management has responsibility for the following:

- preparing the annual financial statements, required supplementary information, and other accompanying information in conformity with accounting principles generally accepted in the United States of America,
- establishing and maintaining effective internal control, and
- complying with applicable laws and regulations.

We are responsible for obtaining reasonable assurance about whether management maintained effective internal control. We are also responsible for testing compliance with selected provisions of applicable laws and regulations that may materially affect the financial statements.

In order to fulfill these responsibilities, we took the following actions:

- We examined, on a test basis, evidence supporting the amounts on the annual financial statements and related disclosures.
- We assessed the accounting principles used and significant estimates made by management.
- We evaluated the overall presentation of the annual financial statements.
- With respect to the Department's internal control over financial reporting, we obtained an understanding of the design effectiveness of internal controls, determined whether they had been placed in operation, assessed control risk, and performed tests of controls.
- With respect to performance measures included in Management's Discussion and Analysis, we obtained an understanding of the design of internal controls relating to the existence and completeness assertions and determined whether they had been placed in operation.
- We obtained an understanding of the process by which the agency identifies and evaluates weaknesses required to be reported under FMFIA and related agency implementing procedures.
- We tested compliance with selected provisions of laws and regulations that may have a direct and material effect on the financial statements.
- We obtained written representations from management.
- We performed other procedures as we considered appropriate under the circumstances.

We performed our work in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in the *Government Auditing Standards,* and the provisions of OMB Bulletin 07-04. We considered the limitations on the scope of our work in forming our conclusions.

The Management's Discussion and Analysis and Required Supplementary Information are supplementary information required by OMB Circular A-136, *Financial Reporting Requirements*, and the Federal Accounting Standards Advisory Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

This report is intended solely for the information and use of Department management, the Inspector General of the U.S. Department of State and Broadcasting Board of Governors, OMB, the Government Accountability Office, the Department of the Treasury, and the Congress and is not intended to be and should not be used by anyone other than those specified parties. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Comments by Department management on this report are presented as Appendix A to this report. The written response by Department management to the material weaknesses and significant deficiencies identified in our report has not been subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we do not express an opinion on these comments.

Leonard G. Birnbaum and Company, LLP

Alexandria, Virginia
November 14, 2007

United States Department of State

Washington, D.C. 20520

November 15, 2007

MEMORANDUM

TO: OIG – Mr. Howard J. Krongard

FROM: RM – Bradford R. Higgins

SUBJECT: Draft Audit Report on the Department of State's 2007 and 2006 Financial Statements

This is in response to your request for comments on the draft report titled "Audit of the U.S. Department of State's 2007 and 2006 Financial Statements" (Report).

The Department operates in over 260 locations in 172 countries, while conducting business in 150 currencies and an even larger number of languages. Thousands of talented financial professionals around the world plan, budget, allocate, obligate, disburse, and account for billions of dollars in annual resources. Very few agencies or corporations have the depth and variety of challenges that the men and women of the Department of State (Department) face daily. Despite these complexities, the Department pursues a commitment to financial integrity, transparency, and accountability that is the equal of any multi-national corporation.

Given the breadth, depth and complexity of our financial operations, it will always be a challenge for the Department to meet OMB's November 15 deadline. In addition, each year will bring new challenges (such as accounting for contractor held property in Iraq/Afghanistan, increased spending through allocations to other agencies such as for HIV/AIDS, etc). Adding to that complexity this year, the Department implemented the new Global Financial Management System (GFMS) as the next step in our multiyear effort to establish a single global financial system. GFMS replaces the Department's 20 year old Central Financial Management System (our core accounting system) and centrally accounts for the Department's billions of dollars of finances through millions of annual transactions by 1,000 users and over 25 "handshakes" with other internal and external systems. As part of this implementation, the Department also installed integrated acquisitions and fixed assets modules, a managerial cost allocation module, and a new data warehouse. Upgrading a financial system of this size and complexity is a large and challenging undertaking.

Working closely with the Independent Auditor and your office, the Department has a proud tradition of unqualified opinions on our financial statements for the past decade. Due to the complexity of the matters involved with installing a new core financial system, it took the Department slightly longer to close our books this year. Consequently, the Department was unable to provide financial statements and certain evidential documentation in a timely fashion, and the Independent Auditor issued a disclaimer of opinion on our FY 2007 financial statements.

In addition to accomplishing the upgrade of our core financial system, we continued our efforts to resolve significant internal control weaknesses. Our priority was on those items that were reported as material weaknesses in recent years and that were downgraded last year to significant deficiencies (formerly reportable conditions) – IT Security, Accounting for Real Property, and Accounting for Personal Property. As a result of our efforts, the Independent Auditor downgraded the IT Security and Accounting for Real Property to deficiencies (from a significant deficiency). With the introduction of new definitions by SAS 112, which in effect "raises the bar" on moving items down in terms of severity, we think this is a significant achievement.

With respect to the Independent Auditor reporting the Accounting for Personal Property as a material weakness, we respectfully disagree with this determination. Our continuing progress to address the many causes of this weakness for our multitude of global assets (aircraft, vehicles, security equipment) is perhaps not as fast as we would like. However, we believe our actions have improved our controls from a year ago (when it was downgraded to a significant deficiency). As a result of the improved status by September 30, 2007, the Department's Management Control Steering Committee (MCSC) voted to downgrade this item from a significant deficiency to a deficiency. In FY 2007, management did complete its assessment of the controls over personal property, noting additional improvements in conducting inventories of vehicles, both held by the Department and by contractors; the successful implementation of tools in ILMS to manage its vehicle fleet; and improvements in guidance and policy. Further corrective actions are planned for FY 2008, including expanding the capabilities for overseas posts to report acquisitions and disposals in the Integrated Logistics Management System. In 2008, the MCSC will ensure that efforts continue to further strengthen the controls over the accounting for personal property.

The Report cites a new material weakness for the management of unliquidated obligations, and notes that there have been improvements in this area. We are already refocusing our efforts to establish adequate processes and controls. Improvements in the management of unliquidated obligations is a priority for the Department in FY 2008, and corrective actions are already underway including the distribution of aging reports, and using recently developed enhancements to our Global Financial Management System's capabilities to automate deobligations. In addition, actions to improve contract closeout procedures relative to unliquidated obligations will be established, and the Senior Assessment Team will be actively engaged with the implementation and oversight of these corrective actions.

Significant improvements in the Department's management of Federal financial assistance were made in 2007. To address the need for increased training, two new FSI courses, quarterly assistance meetings, an annual symposium, and periodic audio-conferences on financial management issues have been established. Outreach efforts include the creation of a new "Ask

Grants" electronic bulletin board, as well as continued updates of three linked websites that offer comprehensive information on assistance. Key achievements in the standardization of policies have been the issuance of sixteen updated and four new Grant Policy Directives and a Payment Management System (PMS) User Handbook; newly-standardized Terms & Conditions have been finalized. A new Grants Officer's Handbook and FAM/FAH updates are being circulated for clearance. The existing Grants Database Management System (GDMS) was upgraded to accommodate the data reporting requirements of the Federal Funding Accountability & Transparency Act (FFATA). In addition, all domestic offices completed the transition to using the HHS *Payment Management System* (PMS) for all assistance disbursements (one-time payments are exempt from mandatory use) and an automated system to apply for and receive grants warrants was implemented. Development of an automated assistance management system that will track assistance activities from solicitation to post-award monitoring and closeout continues; configuration is approximately 80% complete.

The Department continues to make progress in implementing Managerial Cost Accounting Standards (MCAS). In 2005, the Department established a project team, which includes consultants with experience implementing Cost Accounting Systems. In 2006, the team surveyed other agencies and organizations for lessons learned and best practices; conducted an assessment of offices to determine business needs for cost information, current cost accounting practices, outputs and outcomes, and unmet needs; evaluated a managerial cost software module and confirmed usability; and developed a strategic approach and implementation strategy. In 2007, the Department implemented CGI's Momentum Cost Allocation module, and an initial cost model was developed that assigns costs to bureaus. The MCA model contains three cost components: 1) central payroll, 2) bureau managed funds, and 3) overhead/support. This model was run for each quarter of FY 2007. The next phase in FY 2008 will be to incorporate bureaus' specific cost allocations. The Department's new data warehouse will be used to generate all managerial cost reports.

With respect to the significant deficiency for defined benefit supplemental pension plans for locally employed staff, the Department will undertake efforts in FY 2008 to establish an accurate inventory of these plans. This will serve as a basis to work and establish an appropriate approach to determining any unfunded actuarial amounts.

We thank you for the opportunity to comment on the draft report. Our work with the Independent Auditor and your office over the past 10 years has been collaborative, productive, and a catalyst for positive change. We would like to extend our appreciation to Leonard G. Birnbaum and Company, LLP, for their dedicated efforts on this year's audit. We believe, as detailed above, that considerable progress on a number of matters has been made over the years, and the Department remains committed to improving the management of its programs and the quality of its financial reporting.