




United States Department of State
and the Broadcasting Board of Governors

Office of Inspector General

MAR 30 2010

MEMORANDUM

TO: RM – Mr. James L. Millette, Acting

FROM: OIG/DIG – Harold W. Geisel 

SUBJECT: Management Letter Related to the Audit of the U.S. Department of State 2009
Financial Statements (AUD/FM-10-18)

The management letter related to the audit of the U.S. Department of State's 2009 financial statements is attached for your review and action. This management letter, prepared by Kearney & Company, P.C, an independent external auditor, discusses a number of internal control weaknesses that were identified during the audit of the financial statements. These weaknesses, although of concern, did not rise to the level necessary to be included in the report on the financial statement audit. Kearney & Company has included the Bureau of Resource Management's (RM) response, dated March 18, 2010, to the draft management letter as an attachment to the final report. In the response, RM indicated that it did not have any additional comments beyond those that it made on the Notices of Findings and Recommendations (NFR) during the audit. Therefore, Kearney & Company has incorporated a summary of management's comments to the NFRs in the management letter.

OIG will not track the recommendations made in the management letter through its formal compliance process. However, the financial statement auditors will evaluate compliance during future audits of the financial statements.

If you or members of your staff have any questions, please contact me or Evelyn R. Klemstine, Assistant Inspector General for Audits, at (703) 284-2604 or by e-mail at klemstinee@state.gov. You may also call Gayle L. Voshell, Director of the Financial Management Division, at (703) 284-2681.

Attachment: As stated.

cc: RM/DCFO – Christopher H. Flaggs
RM/EX – Philip J. Schlatter, Acting
Kearney & Company, P.C. – Jeffrey W. Green

MANAGEMENT LETTER

Mr. James L. Millette
Acting Chief Financial Officer
U.S. Department of State
1969 Dyess Avenue
Charleston, SC 29405

Dear Mr. Millette:

We have audited the consolidated financial statements of the U.S. Department of State (the Department) as of and for the year ended September 30, 2009, and have issued our report thereon dated December 14, 2009.¹ In planning and performing our audit of the consolidated financial statements, we considered the Department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing an opinion on the consolidated financial statements and not to provide assurance on internal control over financial reporting.

During our audit of the Department's FY 2009 consolidated financial statements, we noted certain matters related to internal control over financial reporting and operations that we consider to be material weaknesses or significant deficiencies under standards established by the American Institute of Certified Public Accountants. A material weakness is a deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis. A significant deficiency is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

In our Independent Auditor's Report, we reported three matters related to internal control that we consider to be material weaknesses. The report also describes three matters related to internal control that we consider to be significant deficiencies.

Our procedures were designed primarily to enable us to form an opinion on the Department's consolidated financial statements and therefore may not identify all weaknesses in policies and procedures. However, we would like to use the knowledge we gained during our audit of the Department to provide comments and suggestions that we hope can be useful to you.

Although not considered to be material weaknesses or significant deficiencies, we noted certain matters involving internal controls and other operational matters that are presented in this letter for the Department's consideration. These comments and recommendations are intended to

¹ *Independent Auditor's Report on the U.S. Department of State 2009 and 2008 Financial Statements* (AUD/FM-10-03), Dec. 2009.



assist in improving the Department's internal controls or result in other operating efficiencies. We have not considered the Department's internal control since the date of our report.

As discussed in our Independent Auditor's Report, the scope of our work was not sufficient to enable us to express an opinion on the Department's Combined Statement of Budgetary Resources for the year ended September 30, 2009. We were also unable to obtain sufficient evidential support for property and equipment amounts presented in the FY 2009 Consolidated Balance Sheet and Consolidated Statement of Changes in Net Position. Had we been able to perform all of the procedures necessary to express such opinions, other matters involving internal control may have been identified and reported.

We appreciate the assistance provided by the Department's personnel during our audit. We would be pleased to discuss these comments and recommendations with Office of Inspector General (OIG) or Department staff.

Comments by Department management on this report are attached. In the response, the Bureau of Resource Management indicated that it did not have any additional comments beyond those that it made on the Notices of Findings and Recommendations (NFR) during the audit. Therefore, we have incorporated a summary of management's comments to the NFRs in the management letter.

This letter is intended solely for the information and use of the Department and OIG and is not intended to be, and should not be, used by anyone other than these specified parties.

A handwritten signature in blue ink that reads "Kearney & Company". The signature is written in a cursive, flowing style.

February 1, 2010
Alexandria, Virginia

MANAGEMENT LETTER COMMENTS

I. Fund Balance with Treasury (FBWT)

Finding:

Treasury Symbol 19F3875 – Budget Clearing Account, Suspense

The Department submitted a waiver request to the Department of the Treasury (Treasury) on January 31, 2008, for continued use of the suspense account. The Department's request documented a justification to continue to use specific accounts and included confirmation that all transactions would be cleared within 60 days. Treasury approved the waiver on April 2, 2008. Kearney & Company (Kearney) reviewed the clearing account activity and identified the following issues:

- Balances Over 60 Days Old – Suspense accounts contained a net balance of negative \$1.4 million, which was more than 60 days old. Kearney was unable to obtain documentation from the Department to substantiate that all transactions were being cleared in accordance with the agreement with Treasury. This balance comprised over 90,000 transactions, indicating that suspense account transactions were a significant posting source.
- Use of Non-Approved Suspense Accounts – The Treasury waiver authorized the use of three suspense accounts. The Department used seven other suspense accounts that were not authorized by Treasury.
- Improper Use of Suspense Accounts for Payments – The Treasury waiver specifically prohibited payments from suspense account 19F3875 because of Anti-Deficiency Act concerns. Detailed transaction downloads listed 118,790 transactions, netting to \$396 million, which were posted to this account.

Recommendation:

Kearney recommends that the Department use only the specific suspense accounts approved by Treasury and discontinue the use of those accounts that are not included. Kearney also recommends that the Department clear all transactions posted to approved suspense accounts within 60 days. Finally, only collection transactions should be posted to suspense accounts. The Department should cease posting disbursements to the suspense accounts.

Department Response to Finding

The Department indicated that it had discontinued the use of the non-waivered accounts. The Department of the Treasury (Treasury) imposed a February 28, 2009, deadline by which non-waivered accounts had to have a zero balance in the Treasury Government-Wide Accounting (GWA) system module. The Department met this deadline, and all non-waivered accounts had a zero balance in GWA as of month-end reporting for February 2009. The non-waivered account balances at September 30, 2009, continue to reflect a zero balance in GWA. The Department reported that it had closed these accounts to use in its financial systems. It had been using only the approved (waivered) accounts for new activity. The Department requested and received a waiver for the use of 19F3875.010. As stated in the approved waiver request, the Department needs significant time to make the requisite system and business process changes to completely

discontinue the use of these accounts. Regarding Kearney's analysis of balances in the account, the Department cannot draw a conclusion on this subject because it had not seen or reviewed the method and analysis used by Kearney. Regarding the recommendation that only collections should be reported to the account, in February 2009, the Department discussed this issue with the Treasury. The Treasury indicated that payments could be made from accounts that received waivers for the specified purposes indicated in the waiver request. The Treasury reiterated the requirement that the Department eventually direct charge items rather than using clearing accounts. The Department agreed with the Treasury guidance, and its efforts, as described, are the first major step in meeting that goal.

Auditor Response

Kearney looks forward to working with the Department on the FBWT process, including gaining an understanding of any recently implemented refinements.

Finding:

FBWT Reconciliation Process

The Department utilizes the Cash Reconciliation Report to compare balances recorded by Treasury with those balances reported in the Department's general ledger and Global Financial Management System (GFMS) for each Treasury symbol. Kearney obtained and reviewed all Hyperion Journal Vouchers (JV) posted as part of the June 30, 2009, cash reconciliation process and noted the following:

- The Department processed a JV to close cancelled fund balances of approximately \$462,000 in the current fiscal year; however, the funds were cancelled in the preceding fiscal year.
- The Department recorded a \$2,181,000 journal entry for unrecorded Intra-governmental Payment and Collection (IPAC) transactions. This entry was ultimately posted to the suspense fund symbol. The Department could not produce a detailed transaction listing to support this JV.
- The Department recorded a \$354,000 JV to two suspense fund symbols. The amounts were related to differences that originated in 2003 and remained uncorrected as of June 30, 2009.
- A detailed reconciliation for one fund symbol did not exist.

Recommendation:

Kearney recommends that the Department enhance its procedures over the FBWT reconciliation process to facilitate more accurate and complete balances. These enhancements may include the following:

- Procedures to perform routine, detailed reconciliations of GFMS balances to Treasury for each fund symbol, not just for fund symbols exceeding variance thresholds.
- Procedures to close general ledger balances in the same year in which the funds are cancelled.
- Procedures to thoroughly review proposed adjustments, including those received from Global Financial Services, to ensure adjustments are valid and sufficiently supported.

- A thorough review to identify older reconciling items and take appropriate actions to clear these items from the monthly reconciliations.

Department Response to Finding

The Department concurred with this finding and recommendation.

II. Revenue

Finding:

Improper Exclusion of Reimbursable Agreements from Deferred Revenue Calculation

Various Department bureaus execute Reimbursable Agreements (RA) with other Federal agencies. These RAs require the Department to provide various goods and/or services on a per-item fee basis subject to billing caps. Generally accepted accounting principles (GAAP) permit recognition of revenue only when the goods and/or services are delivered. The Department's practice is to recognize the entire potential RA revenue when an agreement is executed.

Subsequently, as part of the financial statement preparation process, the Bureau of Resource Management analyzes RA delivery of goods and/or services by agency and defers RA revenue for goods and/or services that have not been delivered.

The Department's desk procedures, *Reimbursable Agreement Deferred Revenue Analysis*, provide the specific process and procedures used to calculate the quarterly deferred revenue amount. The procedures call for excluding certain types of RAs from the analysis, including the following:

- Intra-departmental activity
- International Cooperation Administrative Support Services
- Bureau of Overseas Buildings Operations (OBO)
- "Other Agencies" (special agencies)
- RAs between the Bureau of International Narcotics and Law Enforcement Affairs (INL) and the Department of Defense (DoD)

Most of the exclusions relate to RAs that the Department presumes will be completely provided in the current fiscal year. The Department separately calculates the DoD and INL deferred revenue amounts.

The Department could not provide support or analyses to substantiate the RAs excluded from the deferred revenue calculation. Kearney identified 19 OBO RAs, totaling \$68 million, with the potential to extend over multiple fiscal years, which should have been included in the deferred revenue calculation.

Recommendation:

Kearney recommends that the Department document and regularly validate the assumptions underlying exclusions from the deferred revenue calculation. The Department should develop

procedures to regularly review RAs excluded from the deferral calculation to validate that they do not have the potential to extend over multiple fiscal years.

Department Response to Finding

The Department did not respond to this finding.

III. Accounts Payable

Finding:

Untimely Disbursement of Payments to Vendors Pursuant to the Prompt Payment Act

The Department is subject to the Prompt Payment Act, which requires Federal agencies to pay vendor invoices within 30 days of receipt. The Department is unable to record and process transactions in a timely manner consistent with the Prompt Payment Act. We identified 10 invoices in a sample of 149 that were paid late. The disbursements totaled approximately \$9.7 million and resulted in \$25,000 of interest payments owed by the Department.

Recommendation:

Kearney recommends that the Department strengthen controls to ensure invoices are paid timely and enhance procedures surrounding the monitoring and oversight of the invoice certification process. The Department should also implement a communication strategy to notify delinquent contracting officer's representatives in a timely manner to ensure compliance with Prompt Payment Act requirements.

Department Response to Finding

The Department concurred with this finding and recommendation and reported that it had made on-time payments a priority issue.

Finding:

Reconciliation and Approval of Charge Card Transactions Need Improvement

The Department uses the Citibank centrally billed account (CBA) to pay for travel expenses. The Department uses the Citibank purchase card to pay for office and operating supplies. Cardholders are responsible for reconciling their charge card statements to the supporting documentation, and an approving official is responsible for reviewing the cardholder reconciliation and approving the statement. The Department pays one consolidated invoice to Citibank. Certifying Officers are responsible for ensuring that credit card payments have been properly reconciled to vendor billing statements, information on the voucher and supporting documents is proper and correct, and the amount of payment is accurate. We tested two payments to Citibank and identified exceptions in both:

- One purchase card disbursement contained a \$4,529,382.66 overpayment.
- One CBA disbursement was improperly approved, resulting in an overpayment of \$1,274,577.94.

Recommendation:

Kearney recommends that the Department emphasize the responsibilities of approving officials and Certifying Officers to ensure that disbursements are appropriately reconciled and approved. The Department should also consider enhanced real time monitoring of charge card anomalies to identify card misuse and avoid potential improper payments.

Department Response to Finding

The Department concurred with this finding and recommendation and reported that it was already taking action to improve controls related to this area.

IV. Accounts Receivable

Finding:

Policies and Procedures for Estimation of the Foreign Service Retirement and Disability Fund Allowance for Doubtful Accounts Needs Improvement

Estimates are inherent in the financial reporting process, and internal control best practices and GAAP require a subsequent evaluation of estimates against actual data to validate the reliability of the estimation process. The Department does not validate the amount it estimates for the Foreign Service Retirement and Disability Fund's (FSRDF) allowance for doubtful accounts. The allowance quantifies the collectability of overpayments and improper disbursements to employees.

The Department's Accounts Receivable Estimation for Allowance for Doubtful Accounts Process provides the specific procedures required to calculate the estimation on an annual basis. The Department calculates the allowance as a percentage of outstanding receivable balances based on the number of days outstanding. The Department implemented this methodology several years ago based upon an assessment of the actual collections of outstanding receivables. However, the Department could not provide this collectability analysis or any subsequent analysis to demonstrate its continued relevance.

Recommendation:

Kearney recommends that the Department design, document, and implement a comprehensive Allowance for Doubtful Accounts estimation and critique process to review, analyze, and validate amounts posted to the general ledger. The process should agree estimated amounts to subsequent actual activity.

Department Response to Finding

The Department partially concurred with this finding. The Department stated that the assertions related to the nature of the receivables are mistaken. The NFR states that the allowance estimations included "all Federal and non-Federal receivables." However, the allowance estimations related to FSRDF include only non-Federal receivables. Additionally, the finding states that the allowance is related to overpayments made to employees. These overpayments are made to annuitants, not to employees. Annuitants include survivors, former spouses, and former

employees. FSRDF had receivables with the public of \$823,000. The allowance for doubtful accounts was \$252,000 as of September 30, 2009, and the related expense for FY 2009 was \$231,000. While the Department does not want to diminish the importance of the amounts that are potentially uncollectible, overall, these amounts are not material to the Department's financial statements. Nevertheless, the Department strives to meet the requirements specified in SFFAS No.1. Specifically, receivables are grouped by debtor category (annuitants) and are stratified by risk characteristics using the risk factor of age to establish the allowance.

Auditor Response

Kearney looks forward to working with the Department on this issue. The risk of misstatement discussed in the finding was not intended to be communicated as being material to the financial statements.

V. Accounts Payable & Accounts Receivable

Finding:

Foreign Currency Exchange Rate Review

GAAP requires amounts denominated in foreign currency to be translated to U.S. dollars at the balance sheet date foreign exchange rate. The Department operates in approximately 260 international locations and conducts transactions in numerous foreign currencies. Amounts denominated in foreign currencies are translated into U.S. dollars at the existing exchange rate when transactions are initially entered into the accounting records; however, the Department does not adjust amounts denominated in foreign currencies, primarily open receivables and payables, to reflect the appropriate exchange rate as of the balance sheet date. Further, the Department cannot quantify amounts in the financial records denominated in foreign currencies to facilitate this analysis and adjustment. As a result, the Department does not record a foreign currency gain or loss to reflect the foreign exchange rate in effect as of the balance sheet date as required by GAAP.

Recommendation:

Kearney recommends that the Department conduct a review of open accounts receivable and accounts payable amounts owed or due in foreign currency to determine the foreign currency adjustment required by GAAP. Additionally, the Department should develop a reporting protocol to quantify amounts in the financial records denominated in foreign currencies. This conversion and analysis should utilize foreign currency exchange rates in effect as of the balance sheet date.

Department Response to Finding

The Department concurred with this finding and recommendation.

VI. Payroll

Finding:

Improper and Untimely Approvals of Personnel Actions and Leave

All Department employees who are U.S. direct hires report their time and attendance in the Consolidated American Payroll Processing System (CAPPS). Department policy and *The Guide to Processing Personnel Actions*, issued by the Office of Personnel Management (OPM), require that all SF-50s (Notification of Personnel Actions) be approved before their effective date. Additionally, the policy requires that all time and attendance reports and leave requests be approved by a supervisor before they are submitted to the main timekeeper. We selected the following samples for testing:

- 78 employees for which to test CAPPS internal controls over benefit elections and timekeeping
- 15 employees for which to test hiring internal controls for timeliness and proper authorizations
- 45 employees for which to test internal controls over the proper classification of Senior Executive Service (SES) employees and compensation.

As a result of the testing, the following instances of improper and untimely approvals were noted:

- Improper Approvals
 - CAPPS payroll – 9
 - New hire – 1
- Untimely Approvals
 - CAPPS payroll – 11
 - New hire – 11
 - SES compensation – 42

Recommendation:

Kearney recommends that the Department strengthen controls and procedures for monitoring employee personnel and payroll records. This may include increased training and responsibility awareness, management oversight, and communication across bureaus and offices. Monitoring controls and approvals of personnel files, payroll records, and time and attendance are essential to ensuring complete and accurate records.

Department Response to Finding

The Department concurred with this finding and recommendation.

Finding:

Improper and Untimely Processing of Employee Separations

The Department's policy requires that a separated employee be removed from all applicable pay systems in the pay period following the effective date on the SF-50 for his/her separation. We tested 15 current-year employee separations for timely and accurate removal from the applicable

pay systems and identified the following instances of untimely deactivation and improper payments:

- Four employee personnel records were not deactivated in the human resource system in the pay period following the SF-50 effective date.
- One employee received a \$373 post allotment after the separation date.

Recommendation:

Kearney recommends that the Department strengthen controls and procedures for processing employee separations. This may include increased training and responsibility awareness, management oversight, and communication across bureaus and offices. Prompt deactivation will help ensure that improper payments are not made to separated employees.

Department Response to Finding

The Department concurred with this finding and recommendation.

Finding:

Inconsistent and/or Incorrect Supporting Documentation

OPM requires the Department to maintain up-to-date, complete, and accurate personnel records for all employees. Records in the personnel folders should include all benefit election forms, as well as any elections resulting in deductions to an employee's pay. We tested the personnel records of 113 employees for completeness and compared the information to that in the applicable pay systems. We also confirmed that documentation supporting employees' standard work schedules, adjustments for leave actions, and adjustments for special pay provisions was properly authorized and maintained. We identified the following exceptions:

- Four instances in which the Department could not support an employee's annual salary in the applicable pay scale.
- Three instances in which employees' salary amounts on the SF-50 and the Earnings and Leave Statement (ELS) did not match.
- Fifty instances of missing information in personnel folders, including the following:
 - Flexible Spending Accounts HealthCare/Dependent Care
 - State tax withholdings
 - Federal tax withholdings
 - Combined Federal Campaign contributions
 - Immediate Benefits Plans
 - Dental/vision health benefit forms
- Nine instances in which employees' Federal Employees Group Life Insurance form elections and the SF-50 did not match.
- One instance in which an employee's Federal Employees Health Benefits form elections and the ELS did not match.
- One instance in which an employee's Thrift Savings Plan form elections and the ELS did not match.
- Four instances in which the Department could not provide an employee's timesheet.

- One instance in which the Department could not provide an employee's overtime request form.
- Four instances of unauthorized leave.
- One instance in which used leave was not properly updated on the ELS.
- One difference between used leave and leave requested on the OPM SF-71, Request for Leave or Approved Absence.

Recommendation:

Kearney recommends that the Department implement actions to ensure that controls over the payroll cycle are operating effectively. This may include increased training and responsibility awareness, management oversight, and communication across bureaus and offices. Such actions will ensure that payroll is initiated, reviewed, and maintained completely and accurately. The Department should also standardize the timekeeping function (for example, timecards and leave approvals) to ensure that all offices/bureaus prepare and process timekeeping actions consistently.

Department Response to Finding

The Department partially concurred with this finding. The Department agrees that improvements can be made in the existence and up-to-date status of documentation in employees' OPFs. The Department does not fully agree with the effect and, in particular, the statement that poor administrative controls over the payroll cycle and lack of documentation in the OPF may lead to the overstatement and understatement of pay. The Department believes that the control over the payroll cycle and the lack of documentation are two different issues and that the finding does not indicate poor administrative control over the payroll cycle (as the Department defines it).

Auditor Response

Kearney believes that effective management controls over payroll activities include effective recordkeeping. Human resources actions should be processed accurately and timely based on approved source records.

VII. Sensitive Payments

Finding:

Lack of Financial Disclosure Report

The Code of Federal Regulations (CFR) (5 CFR 2634.104, Executive Branch Financial Disclosure, Qualified Trusts, and Certificates of Divestiture, Subpart A – General Provisions) requires SES and Federal employees in positions of trust to submit annual Financial Disclosure Reports to the U.S. Office of Government Ethics that document potential conflicts of interest. We tested the reports of 45 SES employees for compliance and identified the following exceptions:

- 5 instances in which the Department could not provide Financial Disclosure Reports.

- 37 instances in which the Department could not support the identification and remediation of potential conflicts of interest.

Recommendation:

Kearney recommends that the Department actively monitor financial disclosure reporting requirements of all eligible SES employees to ensure accurate and complete reports are submitted in a timely manner. The Department should communicate applicable requirements to all newly eligible employees and send follow-up communications to new/existing employees as necessary to ensure full compliance with 5 CFR 2634.104. Records detailing the identification and remediation of potential conflicts of interest should be maintained to demonstrate compliance with the Federal regulations.

Department Response to Finding

The Department concurred with this finding and recommendation.

VIII. Annuity Payments

Finding:

Insufficient Supporting Documentation for Annuitants

The Department manages the FSRDF. OPM requires the Department to maintain up-to-date, complete, and accurate personnel records for each retiree. These personnel folders should include all benefit election forms, as well as any elections resulting in deductions to an annuitant's pay. We tested the personnel records of 78 annuitants and an additional 45 annuitants with current year status changes. We noted the following instances of missing personnel actions and payment election forms (for example, SF-50s, Federal Employees Health Benefit election forms, and death certificates):

- Missing Documentation
 - Annuitant payments – 7
 - Annuitant status changes – 2

Recommendation:

Kearney recommends that the Department implement actions to ensure that controls over annuity payments are operating effectively. This may include increased training and responsibility awareness, management oversight, and communication with annuitants. Effectively operating controls will ensure that complete and up-to-date personnel records are maintained for annuitants.

Department Response to Finding

The Department generally concurred with this finding and stated that it had instituted an enhanced internal process whereby a supervisor reviews and ensures that the electronic file for a new retiree is complete. However, as technology progresses, the annuitant will be able to initiate changes on-line that are automatically passed to the pay system, never producing a “hard-copy”

or “imaged” record for the personnel file. Additionally, there are approximately 16,000 active retirement payees, many of whom have been active for several years. It is not practicable or beneficial to review and update all these files with these documents and all other potential historical actions, especially since the retirees are not raising issues. If future audits were to sample these annuitants, similar results would be likely. Regardless, the Department will work to ensure an adequate audit and retrieval trail for all current and future transactions in such a manner that ensures the timely receipt of sufficient and accurate documentation when requested.

Auditor Response

Kearney looks forward to working with the Department on this issue, including updating its understanding of the document retention policies and any system enhancements.

IX. Actuarial Liability

Finding:

Refinement of Actuarial Assumptions

The Department is responsible for retiree benefit payments to participants in the Foreign Service Retirement and Disability System or Foreign Service Pension System (FSPS). The Department represents this liability for future periodic payments in its financial statements as the actuarial present value of projected plan benefits. The Department engages an actuarial firm to produce an annual liability valuation based on various assumptions and employee and annuitant data provided by the Department. Since both the economic and demographic experience change over time, the Department conducts periodic reviews of actual experience to adjust the assumptions in the valuation to reflect the most recent experience. The Department’s actuary completed such an experience study in FY 2009.

Kearney’s analysis of the actuarial model and underlying assumptions resulted in the following observations:

- In prior years, the Department’s actuarial valuation was based on the economic assumptions used by OPM. For the FY 2009 valuation, the Department utilized an investment rate of return of 5.75 percent, which was 50 basis points lower than the assumptions used by OPM. Although the Department should be commended for adopting economic assumptions more conservative than those of OPM, an argument could be made for even more conservative assumptions. Review of average returns on Federal bonds, as reported by the Federal Reserve, and actual investment returns provided by the Department over the last 10 years showed a consistent downward trend in return rates. The Department’s experience study anticipates expected yields on current assets to range from 5.21 percent to 4.96 percent over the next 5 years, while acknowledging that somewhat higher returns are likely to be available in the future.
- The Department does not use separate mortality rates for men and women. Although there is no apparent bias in this approach, liabilities for males may generally be overstated, and liabilities for females may generally be understated.

- Retirement rates do not distinguish between employees with more or less than 20 years of service at retirement. Because benefits are heavily back-loaded at 20 years of service, plan participants would be less likely to retire as they approach 20 years of service. Cost of living adjustments (COLA) are applied immediately to all retirees. It is our understanding that retirees with fewer than 20 years of service do not receive COLAs until age 62, and an early application of COLAs to all retirees overstates the Department's valuation. Our sensitivity analysis indicated that a refinement of the estimate could potentially increase the actuarial liability by \$14 million to \$29 million.
- COLAs are applied to supplemental benefits in the Department's valuation. It is our understanding that plan participants do not receive COLAs on supplemental benefits. The application of COLAs to supplemental benefits overstates the liability estimate.
- Retirement and withdrawal assumptions are analyzed only in total, not by age. This refinement of the estimate calculation may slightly impact the liability estimate.

Recommendation:

Kearney recommends that the Department continue to strengthen procedures related to the actuarial liability methodology and underlying data. This may include process refinements such as the following.

- Continuing to analyze economic assumptions and actual experience.
- Providing gender data to the contract actuary in order to update the mortality assumption from a unisex mortality assumption to a sex distinct assumption.
- Flagging FSPS inactive data for employees who have fewer than 20 years of service at retirement.
- Separately studying FSPS retirement experience for employees with more and less than 20 years of service at retirement and revising retirement rates as appropriate based on findings.
- Making the experience study more robust by adding an analysis of the expected versus actual experience for the retirement and withdrawal assumptions by age (as opposed to only in total).
- Delaying application of the FSPS COLA until age 62 for employees who retire with fewer than 20 years of service at age 62.
- Revising the valuation coding so that a COLA is not applied to the FSPS supplemental benefit.

Department Response to Finding

The Department stated that it is the opinion of the Department's actuary (i) that the current actuarial assumptions (as revised pursuant to the 2003-2008 experience study and used for the 2009 valuation) are reasonable and appropriate and determined in accordance with SFFAS No. 5 and generally accepted actuarial principles and (ii) that the September 30, 2009, actuarial

valuation results (resulting from the application of these assumptions) are, as well, a reasonable and appropriate measure of the liabilities and costs of the FSRDF.

The Department generally agreed with Kearney's findings, except for the issue related to distinguishing between employees who have more or less than 20 years of service at retirement. The Department said that the finding did not disclose that the finding resulted in a proposed audit adjustment. Also, the finding did not disclose that the adjustment, in the words of the actuaries, was a "best guess estimate." The approach/methodology underlying the estimated adjustment should be disclosed so that a reader would understand that the estimate was arbitrary. The Department also believes that the numerical estimate represents false precision in that the data are presented in a manner that implies better precision than is actually the case.

The Department agreed that it should consider ways to strengthen and refine its annual actuarial valuation processes. This has been the practice since 1994, and doing so will ensure that FSRDF valuation assumptions, methods, and procedures for handling the underlying census data will remain reasonable and appropriate. The Department believes that it has done this with the annual valuations and periodic experience studies, but it recognizes that external review is a valuable process. The Department considers the list of recommendations as possible "process refinements" and will consider each of these in connection with the 2010 actuarial valuation or future experience study as appropriate.

Auditor Response

Kearney's actuarial specialist estimated that a refinement of the retirement assumptions to consider those individuals who have more or less than 20 years of service could potentially increase the actuarial liability by \$14 million to \$29 million. The finding disclosed that this amount was an estimate and that a more detailed analysis could not be performed. The purpose of the estimate was to gauge the potential impact of the described refinements on the Department's valuation. The audit process requires us to assess and render a conclusion on the reasonableness of accounting estimates prepared by management. Our actuary's estimate facilitated this analysis.

X. Intra-governmental Activity

Finding:

Inability to Assign Trading Partner Codes

As an Executive Branch agency, the Department is responsible for establishing and maintaining a structure (that is, initiating, executing, recording, reconciling, and reporting procedures) and documenting and supporting the information recorded in its accounting records related to intra-governmental transactions in order to provide accurate information for the Financial Report of the U.S. Government as outlined in the Treasury Financial Manual (TFM) (Volume I, Part 2-Chapter 4700). The Department's primary accounting system, GFMS, does not contain a data field for Trading Partner (TP) codes and cannot produce intra-governmental data automatically. Instead, the Department must analyze and manually compile transactions as either Federal or Public outside of GFMS to comply with regulatory reporting requirements.

The Department typically identifies intra-governmental transactions as Vendor Type “A” (that is, other Federal agencies outside the Department) in GFMS during the voucher entry process and the onset of the transaction. As part of the quarterly intra-governmental review procedures, the Department extracts and downloads all Vendor Type “A” transactions from GFMS into an Excel spreadsheet for further analysis. At this time, the Department reviews and assigns a TP code to all “A” transactions based on vendor name, reference number, and/or document number. If, after review of these fields, the staff accountant cannot determine the TP code and the amount is material, the staff accountant typically contacts and works with the budget office of the relevant bureau(s) of the Department in an attempt to identify the TP code. If the amounts are not material, the Department typically assigns a TP code based on existing knowledge and prior experience with the particular type of transaction being researched.

Public transactions, which include those that occur with non-Federal entities, are identified as various Vendor Types in GFMS. The Department extracts only the Vendor Type “A” transactions from GFMS in order to exclude non-Federal transactions from the quarterly intra-governmental review process. However, transactions classified as Vendor Type “A” are sometimes determined to be intra-Departmental or non-Federal transactions that were incorrectly classified as Vendor Type “A” at the time of data entry. The Department must review the extract and remove all intra-Departmental and non-Federal transactions in order to complete the quarterly intra-governmental review process.

Reclassification Between Intra-governmental and Public Balances in the Financial Statements

The Department’s financial statements separately present intra-governmental and public account balances. However, the crosswalk from GFMS accounts to the financial statements does not automatically produce this classification. Instead, the Department must manually analyze accounts during the financial statement preparation process to determine whether separate classification between intra-governmental and public presentation is necessary. If required, the Department must then manually record journal entries to affect this reclassification. For the FY 2009 financial statements, the Department recorded 16 such journal entries. The manual efforts required to analyze accounts and prepare journal entries lengthen the financial reporting cycle and are prone to error. Additionally, because the process is not automated, it lengthens the time required to incorporate any adjustments and changes identified during the year-end close process in the financial statements.

Recommendation:

Kearney recommends that the Department develop and implement system capabilities, such as the use of TP codes in GFMS, to automatically account for Intra-governmental activity at the transaction level. Ultimately, the Department should establish procedures that require such codes to be assigned, reviewed, and approved during the initial recording of transactions. Such procedures will alleviate extensive manual workloads during quarterly and year-end reporting and ensure more accurate and reliable financial information.

Department Response to Finding

The Department partially concurred with this finding, stating that the auditor's description of how intra-governmental transactions are identified is mostly correct. The Department did not agree with the statement that the current process uses personnel resources inefficiently. However, the Department did agree that improvements could be made to the current process.

Auditor Response

Kearney looks forward to working with the Department on this issue.



United States Department of State

Chief Financial Officer


Washington, D.C. 20520

MAR 18 2010

UNCLASSIFIED

MEMORANDUM

TO: OIG/DIG – Harold W. Geisel

FROM: RM – James L. Millette 

SUBJECT: Draft Management Letter Related to the Audit of the U.S.
Department of State FY 2009 Financial Statements

We have reviewed Kearney and Company's draft report of the above-referenced subject. The Department does not have any additional comments beyond those provided in response to the NRF's. The Department looks forward to working with the OIG on correcting the areas addressed in the Draft Management Letter.