United States Department of State

The Inspector General

December 16, 2013

INFORMATION MEMO FOR THE SECRETARY

FROM: OIG – Steve A. Linick

SUBJECT: Independent Auditor's Report on the U.S. Department of State 2013 and 2012 Financial Statements (AUD-FM-14-10)

An independent certified public accounting firm, Kearney & Company, P.C., was engaged to audit the consolidated financial statements of the U.S. Department of State (Department) as of September 30, 2013 and 2012, and for the years then ended; to provide a report on internal control over financial reporting; to report on whether the Department's financial management systems substantially complied with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA); and to report any reportable noncompliance with laws, regulations, contracts, and grant agreements it tested. The contract required that the audit be performed in accordance with U.S. generally accepted government auditing standards and Office of Management and Budget audit guidance.

In its audit of the Department's 2013 and 2012 financial statements, Kearney & Company found

- the consolidated financial statements present fairly, in all material respects, the financial position of the Department as of September 30, 2013 and 2012, and its net cost of operations, changes in net position, and budgetary resources for the years then ended, in conformity with accounting principles generally accepted in the United States of America;

- no material weaknesses[1] in internal control over financial reporting; and

[1] 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.

- instances of reportable noncompliance with laws, regulations, contracts, and grant agreements tested, including instances in which the Department's financial management systems did not substantially comply with FFMIA.

Kearney & Company is responsible for the attached auditor's report, which includes the Independent Auditor's Report, the Report on Internal Control Over Financial Reporting, and the Report on Compliance With Applicable Provisions of Laws, Regulations, Contracts, and Grant Agreements, dated December 12, 2013, and the conclusions expressed in the report. The Office of Inspector General (OIG) does not express an opinion on the Department's financial statements or conclusions on internal control over financial reporting and compliance with laws, regulations, contracts, and grant agreements, including whether the Department's financial management systems substantially complied with FFMIA.

Comments on the auditor's report from the Bureau of the Comptroller and Global Financial Services are attached to the report.

OIG appreciates the cooperation extended to it and Kearney & Company by Department managers and staff during the conduct of this audit.

Attachment: As stated.

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INDEPENDENT AUDITOR'S REPORT
AUD-FM-14-10

To the Secretary and the Inspector General of the U.S. Department of State

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of the U.S. Department of State (Department), which comprise the consolidated balance sheets as of September 30, 2013 and 2012, the related consolidated statements of net cost and changes in net position and the combined statements of budgetary resources for the years then ended, and the related notes to the consolidated financial statements (hereinafter referred to as the "consolidated financial statements").

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements 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*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 14-02, *Audit Requirements for Federal Financial Statements*. Those standards and OMB Bulletin No. 14-02 require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate under the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion on the Consolidated Financial Statements

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Department as of September 30, 2013 and 2012, and its net cost of operations, changes in net position, and budgetary resources for the years then ended, in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matters

As discussed in Note 1 to the financial statements, in FY 2013, the Department adopted new accounting guidance issued by the Federal Accounting Standards Advisory Board (FASAB)—specifically, Technical Bulletin 2006-1, *Recognition and Measurement of Asbestos-Related Cleanup Costs*, and Statement of Federal Financial Accounting Standards No. 43 – *Funds from Dedicated Collections: Amending Statement of Federal Financial Accounting Standards 27, Identifying and Reporting Earmarked Funds*. Additional information on the Department's asbestos cleanup costs is provided in Note 9, and additional information on the restatement of the FY 2012 financial statements due to the retrospective application of the dedicated collections standard is provided in Note 14. Our opinion is not modified with respect to these matters.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis, condition assessments of Heritage Assets, Combining Schedule of Budgetary Resources, and Deferred Maintenance (hereinafter referred to as "required supplementary information") be presented to supplement the consolidated financial statements. Such information, although not a part of the consolidated financial statements, is required by OMB Circular A-136, *Financial Reporting Requirements*, and FASAB, which consider it to be an essential part of financial reporting for placing the consolidated financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing it for consistency with management's responses to our inquiries, the consolidated financial statements, and other knowledge we obtained during our audits of the consolidated financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The Financial Management Plans and Reports, the Management of Departmental Obligations, the Schedule of Spending, the Inspector General's Assessment of Management and Performance Challenges, the Management Challenges Response, the Summary of Financial Statement Audit and Management Assurances, and the Messages from the Secretary and the Comptroller are presented for purposes of additional analysis and are not a required part of the consolidated financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the consolidated financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards* and OMB Bulletin No. 14-02, we have also issued reports, dated December 12, 2013, on our consideration of the Department's internal control over financial reporting and on our tests of the Department's compliance with certain provisions of laws, regulations, contracts, and grant agreements for the year ended September 30, 2013. The purpose of those reports is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on internal control over financial reporting or on compliance. Those reports are an integral part of an audit performed in accordance with auditing standards generally accepted in the United States of America, *Government Auditing Standards*, and OMB Bulletin No. 14-02 in considering the Department's internal control over financial reporting and compliance.

Kearney & Company

Alexandria, Virginia
December 12, 2013

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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

To the Secretary and the Inspector General of the U.S. Department of State

We have audited the consolidated financial statements of the U.S. Department of State (Department) as of and for the year ended September 30, 2013, and have issued our report thereon dated December 12, 2013. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 14-02, *Audit Requirements for Federal Financial Statements*.

Internal Control Over Financial Reporting

In planning and performing our audit of the consolidated financial statements, we considered the Department's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate under the circumstances for the purpose of expressing our opinion on the consolidated 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 internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 14-02. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations.

A deficiency in internal control 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 and correct, misstatements on a timely basis. 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.

Our consideration of internal control was for the limited purpose described in the preceding paragraphs and was not designed to identify all deficiencies in internal control that might be material weaknesses. Given these limitations, during our audit, we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Our audit was also not designed to identify deficiencies in internal control that might be significant. 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. We consider the following deficiencies in the Department's internal control to be significant deficiencies.

Significant Deficiencies

I. Financial Reporting

The Department compiled its financial statements through a multistep process using a combination of manual and automated procedures. Neither the Department's Global Financial Management System (GFMS) nor Hyperion, which is the system used to produce the proprietary trial balance, is used to fully compile the statements. The inability of the financial management system to track the necessary attributes related to financial reporting forces the Department to use a manual, labor-intensive process to develop its balance sheet, statement of net cost (SNC), statement of changes in net position, and statement of budgetary resources (SBR). The necessary data was extracted from multiple systems and source files and was sometimes manually keyed into crosswalk files or statement preparation templates (Microsoft Excel workbooks), which ultimately created the Department's financial statements. Manual adjustments require an increased measure of internal control and review, reduce the Department's ability to produce statements in a timely manner, and increase the likelihood of errors in the statements.

In our report on the Department's FY 2009 financial statements, we identified financial reporting as a material weakness. During FY 2010, the Department developed a corrective action plan to address selected control deficiencies and financial reporting risks surrounding the financial statement preparation process to reduce the material weakness. In FY 2011 and FY 2012, the audit process identified additional control deficiencies, which, when combined, resulted in a material weakness. In FY 2013, the Department addressed selected control deficiencies and improved underlying data, which reduced the risk associated with financial reporting. For example, the Department improved procedures relating to abnormal account balances and routine analytical reviews. Although the Department had made some improvements, not all issues were addressed, and so financial reporting continues to be a significant deficiency.

- <u>Preparation of the Statement of Budgetary Resources</u> – The SBR is predominantly derived from an entity's budgetary general ledger in accordance with budgetary accounting rules. Information on the SBR should reconcile with budget execution information reported to the Department of the Treasury on Standard Form (SF) 133, Report on Budget Execution and Budgetary Resources, and with information reported in the Budget of the United States Government to ensure the integrity of the numbers presented. We found that the Department had made numerous adjustments related to budgetary resources outside the financial system, most of which originated from automated calculations as well as manual journal entries. We identified a number of significant discrepancies in the adjustments made during the manual preparation of the Department's SF 133 workbooks.

  The Department did not use the full functionality of its accounting systems to capture all budgetary accounting events and automate SBR reporting procedures. In some cases, GFMS was not programmed to process certain budgetary transaction types in complete compliance with USSGL posting models. The manual nature of the process the Department used to compile its SBR was high risk and resource intensive.

- Preparation of the Statement of Net Cost – The Department's SNC reports net costs by strategic goals based on the mapping of fund groups to individual strategic goals using data maintained in its accounting system. The mapping process originated in FY 2004, when the Department modified its Hyperion application to allocate costs and revenue among the Department's major programs based on its FY 2000 strategic goals. The Hyperion programming had not been updated to reflect the Department's current strategic goals. Therefore, in order to produce the SNC, the Department developed a multistep process using a combination of manual and automated procedures. The necessary data was extracted from multiple applications and source files. In FY 2013, the Department added an additional layer of manual mapping to allocate costs and revenues from the FY 2008 goals to the revised FY 2013 goals, which added to the complexity of the allocation methodology and SNC preparation.

  The Department did not take advantage of the full functionality of its accounting systems to capture cost accounting events and automate SNC reporting procedures. To automate the process, the Department would need to significantly reprogram the Hyperion application each time the Department's strategic goals were changed in order to align costs and revenues to the goals, which would require a commitment of time and resources. The manual and fragmented nature of the current allocation process for the compilation of the Department's SNC created a high risk of errors.

II. Property and Equipment

The Department reported over $17 billion in net property and equipment on its FY 2013 balance sheet. Real and leased property consisted primarily of facilities used for U.S. diplomatic missions abroad and capital improvements to these facilities. Personal property consisted of several asset categories, including aircraft, vehicles, security equipment, communication equipment, and software. Weaknesses in property were initially reported in the audit of the Department's FY 2005 financial statements and subsequent audits. In FY 2013, the Department's internal control structure continued to exhibit several deficiencies that negatively affected the Department's ability to account for real and personal property in a complete, accurate, and timely manner. We concluded that the combination of property-related control deficiencies was a significant deficiency. The individual deficiencies we identified are summarized as follows:

- Personal Property Acquisitions and Disposals – The Department uses several non-integrated systems to track, manage, and record personal property transactions, which are periodically merged or reconciled with the financial management system in order to centrally account for the acquisition and disposal of personal property. We noted a significant number of prior year personal property transactions that were not recorded until the current year. In addition, we noted that the acquisition value for a number of selected items could not be supported and the gain or loss on personal property disposals was not recorded properly for numerous items. The Department's control structure did not ensure that personal property acquisitions and disposals were recorded in a timely and accurate manner. In addition, the Department's monitoring activities were not always effective to ensure proper financial reporting for personal property. The errors resulted in misstatements to the Department's financial statements. The lack of effective control may result in the loss of accountability for asset custodianship, which could lead to undetected theft or waste.

- Recording Constructed Assets – The Department currently manages nearly $3 billion in overseas construction projects. All construction projects should be tracked in the Construction-in-Progress account until the project reaches completion. Once a construction project is complete, the Department transfers the asset to the real property asset account and the asset is depreciated over its estimated useful life. In FY 2013, we found that the Department had reclassified costs related to a large construction project that was completed in FY 2012. All costs relating to this project were incorrectly recorded as expenses during prior years. The Department used project codes to ensure construction activities were properly recorded; however, the unrecorded facility did not have a project code. The misclassification led to an understatement in property and an overstatement of expenses in the Department's financial statements.

  Operating Lease Disclosure – The Department manages over 15,600 real property leases throughout the world. The Department must disclose the future minimum lease payments (FMLP) related to the Department's operating lease obligations in the footnotes to the annual financial statements. We found numerous recorded lease terms that did not agree with supporting documentation and two leases that should have been capitalized but were inaccurately listed as operating leases. We also analyzed the Department's methodology for calculating the FMLP and found that the formulas did not sufficiently take into account payment escalations and inflationary adjustments. The Department's process to monitor lease information provided by posts was not always effective. The discrepancies identified in the Department's FMLP calculation methodology led to multiple errors in the Department's footnote disclosure. In addition, the misclassification of two leases that met the Department's criteria for capitalization resulted in an understatement of assets and liabilities on the Department's balance sheet.

III. Budgetary Accounting

The Department lacked sufficient reliable funds control over its accounting and business processes to ensure budgetary transactions were properly recorded, monitored, and reported. Beginning in our report on the Department's FY 2010 financial statements, we identified budgetary accounting as a significant deficiency. During FY 2013, the audit continued to identify control limitations, and we concluded that the combination of control deficiencies remained a significant deficiency. The individual deficiencies we identified are summarized as follows:

- Unsupported Obligations – Obligations are definite commitments that will result in outlays, immediately or in the future. The Department should record only legitimate obligations, which would include a reasonable estimate of potential future outlays. We identified a large number of low-value obligations for which the Department could not provide evidence of a binding agreement. The Department's financial system was designed to reject payments for invoices without established obligations. Because allotment holders were not always recording valid and accurate obligations prior to the receipt of goods and services, the Department established low-value obligations, which allowed invoices to be paid in compliance with the Prompt Payment Act but effectively bypassed system controls. The continued use of this practice could lead to a violation of the Antideficiency Act, and it increased the risk of fraud, misuse, and waste.

- Timeliness of Obligations – The Department should record an obligation in its financial management system when it enters into an agreement, such as a contract or a purchase order, to purchase goods and services. During our testing, we identified obligations that were not recorded within 15 days of execution of the obligating document and obligations that were posted subsequent to the receipt of goods and services. We also identified obligations that were recorded in the financial management systems prior to the formal execution of a contract. The Department did not have processes to ensure the accurate and timely creation, approval, and recording of obligations. Without an effective obligation process, controls to monitor funds and make timely payments may be compromised, which may lead to violations of the Antideficiency Act and the Prompt Payment Act.

- Capital Lease Obligations – The Department must obligate funds to cover the net present value of the Government's total estimated legal obligation over the life of a capital lease contract. However, the Department annually obligates funds equal to 1 year of the capital lease cost rather than the entire amount of the lease agreement. The Department obligated leases on an annual basis rather than the entire lease agreement period because that is the manner in which funds are budgeted and appropriated. Because of the unrecorded obligation, the Department's financial statements were misstated.

- Effectiveness of Allotment Controls – Federal agencies use allotments to allocate funds in accordance with OMB apportionments or other statutory authority. Allotments provide authority to agency officials to incur obligations as long as those obligations are within the scope and terms of the allotment authority. The Department's accounting systems did not have an automated control to prevent users from recording obligations that exceeded allotment amounts. Although the systems displayed a warning when users processed obligations in excess of allotted funds, users had the ability to override the warning. Overriding the allotment controls could lead to a violation of the Antideficiency Act and increased the risk of fraud, misuse, and waste.

IV. Validity and Accuracy of Unliquidated Obligations

Unliquidated obligations (ULO) represent the cumulative amount of orders, contracts, and other binding agreements not yet outlayed. The Department's policies and procedures provide guidance related to the periodic review, analysis, and validation of the ULO balances posted to the general ledger. We identified invalid ULOs amounting to approximately $243.7 million that had not been identified by the Department's review process. The current internal control structure was not operating effectively to comply with existing policy or facilitate the accurate reporting of ULO balances in the financial statements. The Department's internal controls were not sufficient to ensure that ULOs were consistently and systematically evaluated for validity and deobligation. As a result of the invalid ULOs, the Department's financial statements were misstated. In addition, funds that could have been used for other purposes might have remained in unneeded obligations. Weaknesses in controls over ULOs were initially reported in the audit of the Department's 1997 financial statements and subsequent audits.

V. Foreign Service Retirement and Disability Fund Data Inaccuracies and Timeliness

The Department's Foreign Service Retirement and Disability Fund (FSRDF) provides a variety of after-employment benefits to members of the Foreign Service, including active employees, retired annuitants, and surviving beneficiaries. The estimated liability for these benefits is calculated annually by an actuary for purposes of financial reporting and managing the FSRDF program. Annually, the Department provides certain data to the actuary, including information from its compensation and annuitant systems, to be used as the basis for the actuarial valuation. We identified errors in the data used for the FSRDF actuarial estimates, including specific amounts that had not been increased by allowable cost-of-living adjustments for several years. Further analysis by the Department and its actuary identified additional errors that also required correction.

Although the Department had implemented recurring data validation controls, these controls were ineffective in identifying and remediating the outdated annuitant information. The Department revalued its actuarial estimates to correct the understatement of liabilities that resulted from the outdated benefit information. The additional calculations and valuations required additional time and effort, which impacted the Department's ability to complete the FY 2013 reporting process in a timely manner.

VI. Information Technology

The Department's information technology (IT) internal control structure, both for the general support systems and critical financial reporting applications, exhibited limitations in several areas, including risk management strategies and user account management. The National Institute of Standards and Technology and the Government Accountability Office's *Federal Information System Controls Audit Manual* provide control objectives and evaluation techniques that we used during our audit. Weaknesses in IT controls have been reported as a significant deficiency since FY 2009.

In accordance with the Federal Information Security Management Act of 2002 (FISMA), the Office of Inspector General (OIG) performed a review of the Department's information security program for FY 2013.[1] Overall, OIG found that the Department had implemented an information security program and had made progress during FY 2013 to address IT deficiencies

[1] *Audit of the Department of State Information Security Program* (AUD-IT-14-03, Nov. 2013).

identified in prior FISMA reports, but OIG continued to identify weaknesses in the risk management framework, plans of action and milestones, and the continuous monitoring program, which were collectively reported as a FISMA significant deficiency. A significant deficiency is the highest level of severity under FISMA.

The scope of our audit was focused primarily on deficiencies that could lead to significant misstatements of or corruption to the Department's financial data. Based on IT deficiencies noted with the general support systems, we developed additional risk-based audit procedures to substantively test financial management system inputs and outputs. Our procedures did not identify any material misstatements that were caused by general support system deficiencies. In addition, we tested and confirmed certain compensating controls that would mitigate some of the risks that were attributable to the general support system weaknesses. Although the Department had addressed certain deficiencies in its financial reporting applications, we noted other IT deficiencies reported in prior years that had not been addressed and identified an additional deficiency. Collectively, the deficiencies noted by OIG during the FISMA evaluation and by us during the financial statement audit are considered to be a significant deficiency within the scope of our financial statement audit. The deficiencies noted during the financial statement audit are summarized as follows:

- <u>Segregation of Duties</u> – A fundamental element of internal control is the segregation of certain key duties. The basic idea underlying segregation of duties (SoD) is that no one individual should control all key aspects of a transaction or event. We found instances of SoD violations and incompatible functions in the Regional Financial Management System/Momentum (RFMS/M), the Consolidated American Payroll Processing System, and the Global Foreign Affairs Compensation System (GFACS). Additionally, the Department had not designed and implemented sufficient SoD controls for the Global Employment Management System. Inadequate SoD contributes to an overall weakening of the internal control environment and increases the risk that errors and irregularities can occur and remain undetected.

- <u>Monitoring Audit Logs for Financial Applications</u> – Monitoring activities or events within an application is a key control that is performed to detect suspicious behavior or malfunctions. An audit log is an automated record that contains specific events or activities within an application in an electronic form. The audit log enables administrators to have regular visibility into user access or other activities in a manageable way. In FY 2012, we found that the Department did not regularly review audit logs and investigate significant events for certain financial systems, including GFMS, RFMS, GFACS, and the Foreign Service National Payroll System. In FY 2013, the Department developed corrective action plans to implement effective monitoring procedures for each application; however, these action plans were not fully executed to mitigate existing weaknesses. By not reviewing the audit logs on a regular basis, the Department did not have reasonable assurance that inappropriate access or changes to user accounts would be identified in a timely manner.

- Alteration of Global Foreign Affairs Compensation System Annuitants Historical Data – GFACS Annuitants is an annuity payment application built from the Oracle PeopleSoft Human Resource Management System. The Oracle system provides users with the option to configure how transactional data is stored and changed. One configuration option is "correction mode," which allows a user to modify previously entered data—thus enabling the user to alter the historical records used to calculate payments. We identified three supervisors who had used the correction mode functionality to alter annuitants' historical records on multiple occasions. Therefore, GFACS Annuitants did not have sufficient historical records that could be used to track changes made to annuitant payments. In addition, we found that the Department had not implemented sufficient compensating controls to monitor the use of the correction mode, such as automated audit logs and periodic reviews by an independent party. The ability to alter historical annuitant pay records without adequate monitoring controls contributes to an overall weakening of the internal control environment and increases the risk that errors and irregularities can occur and remain undetected. Further, this situation could lead to fraudulent activity or impede an investigation if required as the original transactional data might no longer be available.

During the audit, we noted certain additional matters involving internal control over financial reporting that we will report to Department management in a separate letter.

Summary of Significant Internal Control Deficiencies

In the Report on Internal Control included in the audit report on the Department's FY 2012 financial statements,[2] we noted several issues that were related to internal control over financial reporting. The status of these issues are summarized in Table 1, in addition to issues identified in FY 2013.

[2] *Independent Auditor's Report on the U.S. Department of State 2012 and 2011 Financial Statements* (AUD-FM-13-08, Nov. 2012).

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Table 1. Summary of Significant Internal Control Deficiencies

Control Deficiency	FY 2012 Status	FY 2013 Status
Financial Reporting	Material Weakness	Significant Deficiency
Foreign Service National After-Employment Benefits	Significant Deficiency	Management Letter
Property and Equipment	Significant Deficiency	Significant Deficiency
Budgetary Accounting	Significant Deficiency	Significant Deficiency
Validity and Accuracy of Unliquidated Obligations	Significant Deficiency	Significant Deficiency
Foreign Service Retirement and Disability Fund Data Inaccuracies and Timeliness	Not Reported	Significant Deficiency
Information Technology	Significant Deficiency	Significant Deficiency

Department's Response to Findings

Department management has provided its response to our findings in a separate memorandum attached to this report. We did not audit management's response, and accordingly, we express no opinion on it.

Purpose of This Report

The purpose of this report is solely to describe the scope of our testing of internal control over financial reporting and the results of that testing and not to provide an opinion on the effectiveness of the Department's internal control. This report is an integral part of an audit performed in accordance with auditing standards generally accepted in the United States of America, *Government Auditing Standards*, and OMB Bulletin No. 14-02, in considering the entity's internal control over financial reporting. Accordingly, this report is not suitable for any other purpose.

Kearney & Company

Alexandria, Virginia
December 12, 2013

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INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE WITH APPLICABLE PROVISIONS OF LAWS, REGULATIONS, CONTRACTS, AND GRANT AGREEMENTS

To the Secretary and the Inspector General of the U.S. Department of State

We have audited the consolidated financial statements of the U.S. Department of State (Department) as of and for the year ended September 30, 2013, and have issued our report thereon dated December 12, 2013. We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 14-02, *Audit Requirements for Federal Financial Statements*.

Compliance

As part of obtaining reasonable assurance about whether the Department's consolidated financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material impact on the determination of financial statement amounts, and certain provisions of other laws and regulations specified in OMB Bulletin No. 14-02, including the provisions referred to in Section 803(a) of the Federal Financial Management Improvement Act of 1996 (FFMIA), that we determined were applicable. We limited our tests of compliance to these provisions and did not test compliance with all laws, regulations, contracts, and grant agreements applicable to the Department. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion.

The results of our tests, exclusive of those related to FFMIA, disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards* and OMB Bulletin No. 14-02 and which are summarized as follows:

- *Antideficiency Act*. This act prohibits the Department from (1) making or authorizing an expenditure from, or creating or authorizing an obligation under, any appropriation or fund in excess of the amount available in the appropriation or fund unless authorized by law; (2) involving the Government in any obligation to pay money before funds have been appropriated for that purpose, unless otherwise allowed by law; and (3) making obligations or expenditures in excess of an apportionment or reapportionment, or in excess of the amount permitted by agency regulations. Our audit procedures identified Department of the Treasury fund symbols with negative balances that were potentially in violation of the Antideficiency Act.

- *Prompt Payment Act*. This act requires Federal agencies to make payments in a timely manner, pay interest penalties when payments are late, and take discounts only when payments are made within the discount period. The Department did not always make payments within 30 days, as required. Additionally, we found that the Department did not consistently pay interest penalties for domestic and overseas payments in accordance with the Prompt Payment Act.

Under FFMIA, we are required to report whether the Department's financial management systems substantially comply with Federal financial management systems requirements, applicable Federal accounting standards, and the U.S. Standard General Ledger (USSGL) at the transaction level. The results of our tests of compliance with FFMIA noted certain instances, as described, in which the Department's financial management systems and related controls did not substantially comply with certain Federal systems requirements, Federal accounting standards, and the USSGL at the transaction level.

Federal Financial Management Systems Requirements

- During its annual evaluation of the Department's information security program, as required by the Federal Information Security Management Act, the Department's Office of Inspector General identified weaknesses with computer security that it reported collectively as representing a significant deficiency.[3]
- Certain subsidiary systems, including property systems, were not integrated with the core accounting system. An audit trail from data in the core financial system to detailed source transactions in feeder systems was not always readily available.
- There were deficiencies with the Department's account management processes for key financial applications, including inadequate monitoring of user access and changes to user accounts. In addition, adequate segregation of duties was not fully maintained in certain financial systems.
- The Department records numerous and material manual adjustments on a monthly basis to align budgetary balances to proprietary amounts. Without these adjustments, budgetary and proprietary accounts would not be in balance.
- Interest was not always paid on overdue domestic and overseas payments.

Applicable Federal Accounting Standards

- The Department's core accounting system did not produce complete, auditable financial statements without significant manual adjustments.

Standard General Ledger at the Transaction Level

- The Department's statements of budgetary resources and net cost were subject to numerous adjustments that were made outside the core accounting system and that could not be traced directly to USSGL account balances.

The Department had not implemented and enforced systematic financial management controls to ensure substantial compliance with FFMIA. The Department had not executed remediation

[3] *Audit of the Department of State Information Security Program* (AUD-IT-14-03, Nov. 2013).

plans to address all instances of noncompliance. The Department's ability to meet Federal financial management system requirements and produce complete financial statements from its core accounting system was hindered by systemic limitations in systems and processes.

Except as noted above, our tests of compliance with the provisions of selected laws, regulations, contracts, and grant agreements disclosed no other instances of noncompliance that would be reportable under the standards applicable to financial audits contained in *Government Auditing Standards* and OMB Bulletin No. 14-02.

During the audit, we noted certain additional matters involving compliance that we will report to Department management in a separate letter.

Department's Response to Findings

Department management has provided its response to our findings in a separate memorandum attached to this report. We did not audit management's response, and accordingly, we express no opinion on it.

Purpose of This Report

The purpose of this report is solely to describe the scope of our testing of compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's compliance. This report is an integral part of an audit performed in accordance with auditing standards generally accepted in the United States of America, *Government Auditing Standards*, and OMB Bulletin No. 14-02 in considering the entity's compliance. Accordingly, this report is not suitable for any other purpose.

Kearney & Company

Alexandria, Virginia
December 12, 2013

United States Department of State

Washington, D.C. 20520

UNCLASSIFIED

December 15, 2013

MEMORANDUM

TO: OIG – Steve A. Linick

FROM: CGFS – James L. Millette

SUBJECT: Draft Audit Report on the Department of State's Fiscal Year 2013 and 2012 Financial Statements

This memo is in response to your request for comments on the Draft Report of the Independent Auditor, Report on Internal Control, and Report of Compliance and other Matters (Report) on the U.S. Department of State's Fiscal Year 2013 and 2012 Financial Statements.

The Department operates in over 265 locations and 180 countries and in many challenging environments. The scale and complexity of Department activities and corresponding financial management requirements are immense. We understand and appreciate this dynamic as we pursue an efficient, accountable, and transparent financial management platform that enhances the Department's foreign affairs mission. Part of our accountability is the indispensable discipline of the annual external audit process and the disclosure of the Department's annual financial statements. Few outside the financial community likely realize the time and effort that go into conducting the audit and producing the AFR, as we all work to demonstrate our commitment to strong financial management practices. It is a robust and exhaustive process.

This year was no exception. It has been a concerted and dedicated effort by all stakeholders involved. While we may not agree on every aspect of the process and findings, we certainly appreciate the professionalism and commitment by all parties, including the Office of the Inspector General and Kearney & Company, to work together throughout the audit process. While we know there will always be new challenges and concerns given our global operating environment and the ever-expanding scope of compliance requirements, we believe the Independent Auditor's Report reflects the continuous improvement we strive to achieve in the Bureau of the Comptroller and Global Financial Services and across the Department's financial management community.

As outlined in the Independent Auditor's Report, we are pleased that the Department has received an unmodified ("clean") audit opinion on its FY 2013 and 2012 Financial Statements, and with no material weaknesses identified by the Independent Auditor. As noted by the Independent Auditor, improvements were made in several areas including financial reporting and accounting for FSN after-employment benefits.

We remain committed to strong corporate governance and internal controls as demonstrated by our robust system of internal controls overseen by our Management Control Steering Committee (MCSC) and validated by the senior leadership. For FY 2013, no material weaknesses in internal control over financial reporting were identified by the Senior Assessment Team, the MCSC or senior leadership. As a result, the Secretary was able to provide reasonable assurance for the Department's internal controls over financial reporting in accordance with the Federal Managers' Financial Integrity Act.

Thank you for the opportunity to comment on the Draft Report. I would also like to extend our thanks to your staff and Kearney & Company for the professional and collaborative manner in which the audit was conducted. We fully recognize that there are a number of items identified in the Draft Audit Report that will require our continued attention, action, and improvement. We will continue to direct focused efforts to resolve issues for all significant deficiencies in internal control identified by management and the Independent Auditor. We look forward to working with you and other stakeholders on addressing these issues in the coming year.