U.S. DEPARTMENT OF STATE

FINANCIAL STATEMENT
AND
INDEPENDENT AUDITOR'S REPORT

SEPTEMBER 30, 2006 AND 2005

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Audit of the U.S. Department of State's Financial Statements

September 30, 2006 and 2005

Independent Auditor's Report

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INDEPENDENT AUDITOR'S REPORT

To the Secretary, Department of State:

We were engaged to audit the accompanying Consolidated Balance Sheet, Consolidated Statement of Net Cost, Consolidated Statement of Changes in Net Position, Combined Statement of Budgetary Resources, and Consolidated Statement of Financing (Annual Financial Statements) as of, and for the years ended, September 30, 2006 and 2005. We have examined internal control over financial reporting as of, and during the year ended, September 30, 2006, and we have examined compliance with applicable laws and regulations.

We are unable to express an opinion on the Annual Financial Statements as of, and for the year ended, September 30, 2006, because of limitations on the scope of our work. Thus, the financial statements may be unreliable. The Department was unable to provide complete financial statements or respond to requests for evidential material in a timely manner, and we were not able to perform other auditing procedures to satisfy ourselves as to the accuracy of the financial statements in time to meet the November 15, 2006, deadline imposed by the Office of Management and Budget for issuing our report. Therefore, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the 2006 financial statements.

During FY 2006, the Department became aware of material amounts of real property that had not been reported properly in its 2005 financial statements. As a result, the Department has restated 2005 balances and activity. Accordingly, our report on the Department's 2005 financial statements, dated December 14, 2005, should not be relied upon.

We are unable to express an opinion on the Annual Financial Statements as of, and for the year ended, September 30, 2005, because of limitations on the scope of our work. Thus, the financial statements may be unreliable. The Department was unable to provide complete financial statements or respond to requests for evidential material on its restatement of the 2005 financial statements in a timely manner, and we were not able to perform other auditing procedures to satisfy ourselves as to the accuracy of the financial statements in time to meet the November 15, 2006, deadline imposed by the Office of Management and Budget for issuing our report. Therefore, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the 2005 financial statements.

We found the following:

- Reportable conditions on weaknesses in the Department's internal controls.
- Instances of noncompliance with selected provisions of applicable laws and regulations involving the Department's financial management system.
- The Department's financial management systems did not substantially comply with the requirements of the Federal Financial Management Improvement Act (FFMIA) of 1996.

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

ANNUAL FINANCIAL STATEMENTS

Because the Department was unable to provide complete financial statements or respond to requests for evidential material in a timely manner and we were not able to perform other auditing procedures to satisfy ourselves as to the accuracy of the 2006 financial statements in time to meet the November 15, 2006, deadline imposed by the Office of Management and Budget for issuing our report, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the financial statements as of and for the year ended September 30, 2006.

Because the Department was unable to provide complete financial statements or respond to requests for evidential material on its restatement of the 2005 financial statements (as detailed in Note 20) in a timely manner, and we were not able to perform other auditing procedures to satisfy ourselves as to the accuracy of the 2005 financial statements in time to meet the

November 15, 2006, deadline imposed by the Office of Management and Budget for issuing our report, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the restated financial statements as of and for the year ended September 30, 2005.

As discussed in Note 2, in FY 2005, the Department determined that major aircraft components – high dollar value items that are repairable and in serviceable condition – should be treated as general property and equipment and as such capitalized and depreciated over the life of the asset once installed on an aircraft. In FY 2006, the Department conducted an analysis that determined that the actual useful life of such components was less than two years and, as such, did not meet the definition of general property and equipment as provided for in the Statement of Federal Financial and Accounting Standards (SFFAS) Number 6, *Accounting for Property, Plant, and Equipment.* In addition, these components do not meet the definition of inventory as provided for in SFFAS Number 3, *Accounting for Inventory and Related Property.*

INTERNAL CONTROL

In planning and performing our audit work, we considered the Department's internal control over financial reporting. We did this to determine our procedures for auditing the financial statements and to comply with Office of Management and Budget (OMB) audit guidance. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin 06-03, *Audit Requirements for Federal Financial Statements*. 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. The objective of our audit was not to provide assurance on internal control. Consequently, we do not provide an opinion on internal control.

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

- Transactions are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over assets.
- Funds, property, and other assets are safeguarded against loss from unauthorized acquisition, use, or disposition.
- Transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements and other laws and regulations that OMB, Department

management, or the Inspector General have identified as being significant for which compliance can be objectively measured and evaluated.

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

Our consideration of the internal control over financial reporting would not necessarily disclose all matters of internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of internal control that, in our judgment, could adversely affect the Department's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors or irregularities in amounts, which would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

We are required to review the Department's current Federal Managers' Financial Integrity Act report and disclose differences with the material weaknesses in our report. We did not identify any discrepancies.

We noted six matters involving internal control that we consider to be reportable conditions as follows:

- We have identified deficiencies related to the recording of personal property and related depreciation expense and accumulated depreciation. The Department does not have an adequate system of controls to identify and record property in the hands of contractors. Further, the Department's controls over vehicles and other personal property are ineffective. Our tests disclosed (1) significant discrepancies between inventories of property reported by posts and bureaus and those maintained centrally and used as a source for reporting for financial statement purposes, (2) posts not submitting inventories of property with no investigation by responsible Department officials, (3) property not reported by posts and bureaus, (4) errors resulting from ineffective interface between IT applications related to property, and (5) errors in depreciation resulting from incorrect in-service dates.

- We have identified deficiencies related to information system security that we believe could be exploited to have a detrimental effect on the information used to prepare the financial statements. We believe that the information system networks for domestic operations are vulnerable to unauthorized access. Consequently, systems, including the Department's financial management system, that process data using these networks may also be vulnerable.

The two items above were reported as material weaknesses in our report on the 2005 financial statements.

- The Department's financial and accounting system, as of September 30, 2006, was inadequate. There is a risk of materially misstating financial information under the current conditions. This condition is a significant reason that the Department was unable to provide complete financial statements or respond to requests for evidential material in a timely manner, which led to our inability to express an opinion on the 2006 financial statements. The principal areas of inadequacy were the following:

  - Certain elements of the financial statements, including, but not limited to, personal property, capital leases, and certain accounts payable, are developed from sources other than the general ledger. The use of sources other than the general ledger to generate elements of the financial statements increases the potential for omission of significant transactions.

  - During 2006, the Department used several systems for the management of grants and other types of financial assistance. The systems lacked standard data classifications and common processes and were not integrated with the Department's centralized financial management system. Further, the Department could not produce reliable financial information that defined the universe of grants and other federal financial assistance. The Department has undertaken an initiative jointly with the U.S. Agency for International Development to establish a grants management system. Subject to funding approval, implementation of such a system is expected to begin in the FY 2007 time frame.

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

- The Department's internal control process related to the management of undelivered orders was inadequate. The Department has made significant improvements in this area over the past three years. The Department has actively worked with bureaus to validate undelivered orders and has successfully cleared up a significant number of obligations that were outstanding from past years. However, the Department needs to perform additional work to correct this condition. Our tests indicated that over $400 million of undelivered orders should have been deobligated as of September 30, 2006. Also, we noted that the Department's undelivered orders balance has grown to $10.7 billion as of September 30, 2006. The Budget and Accounting Procedures Act of 1950 requires that the Department's accounting system provide effective control over funds. Failure to deobligate funds in a timely manner may result in the loss of availability of those funds.

The above two reportable conditions were cited in our audit of the Department's 1997 financial statements and subsequent audits.

- Although the Department complied with certain aspects of SFFAS Number 4, *Managerial Cost Accounting Standards* (for instance, it chose reasonable responsibility segments, recognized the cost of goods and services that it receives from other entities, and used an appropriate allocation methodology), it did not implement an effective process to routinely collect managerial cost accounting information or establish outputs for each responsibility segment. Until this is done, we do not believe the information will be useful as a management decisionmaking tool.

The above condition was reported in our audit of the Department's 2000 financial statements and subsequent audits.

- The Department's controls related to the recording of real property and related depreciation expense and accumulated depreciation during most of FY 2006 and all of FY 2005 were inadequate, resulting in (1) significant amounts of construction costs being expensed rather than capitalized and (2) costs of completed projects not being moved from construction-in-progress on a timely basis.

These reportable conditions, although not considered material weaknesses, represent deficiencies in the design or operation of internal control, which could adversely affect any decision by management that is based, in whole or in part, on information that is inaccurate because of them. Unaudited financial information reported by the Department, including budget information, also may contain misstatements resulting from these deficiencies.

In addition, we considered the Department's internal control over Required Supplementary Information by obtaining an understanding of the Department's internal control, determining whether controls had been placed in operation, assessing control risk, and performing tests of controls as required by OMB Bulletin 06-03 and not to provide assurance on those internal controls. Accordingly, we do not provide an opinion on those controls.

Finally, with respect to internal control related to performance measures reported in Management's Discussion and Analysis, we obtained an understanding of the design of significant controls relating to the existence and completeness assertions and determined whether those controls had been placed in operation as required by OMB Bulletin 06-03. Our procedures were not designed to provide assurance on internal control over reported performance measures, and, accordingly, we do not provide an opinion on such controls.

We noted certain other internal control issues that we have reported to the Department's management in a separate letter dated November 14, 2006.

COMPLIANCE WITH LAWS AND REGULATIONS

The Department's management is responsible for complying with laws and regulations applicable to the Department. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the Department's compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin 06-03, including the requirements referred to in FFMIA. We limited our tests of compliance to these provisions, and we did not test compliance with all laws and regulations applicable to the Department. The objective of our audit of the Annual Financial Statements, including our tests of compliance with selected provisions of applicable laws and regulations, was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

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

The results of our tests of compliance with the laws and regulations described above, exclusive of FFMIA, disclosed the following instances of noncompliance with laws and regulations that are required to be reported under *Government Auditing Standards,* issued by the Comptroller General of the United States, and OMB Bulletin 06-03.

Overall, we found that the Department's financial management system did not comply with a number of laws and regulations as follows:

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

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

- Chief Financial Officers Act of 1990. This act requires the development and maintenance of an integrated accounting and financial management system that (1) complies with applicable accounting principles, standards and requirements, and internal control standards; (2) complies with such policies and requirements as may be prescribed by the Director of OMB; (3) complies with any other requirements applicable to such systems; and (4) provides for (i) complete, reliable, consistent, and timely information that is prepared on a uniform basis and that is responsive to the financial information needs of agency management; (ii) the development and reporting of cost information; (iii) the integration of accounting and budgeting information; and (iv) the systematic measurement of performance. However, we found that the Department's financial system did not provide complete information in that certain elements of the financial statements are developed from sources other than the general ledger, nor does the Department's financial management system produce year-end financial data to be included in its PAR in a timely manner.

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

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

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

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

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

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

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

- Circular A-130, Appendix III, requires that the Department ensure an adequate level of security for all agency automated information systems. Specifically, the Department should ensure that automated information systems operate effectively and have appropriate safeguards to ensure the integrity of those systems. Based on our concerns related to the financial management systems discussed in the report on internal control and the preceding paragraphs in the report on compliance with laws and regulations, we consider the Department to not substantially comply with this standard.

In addition, we were unable to express an opinion on the Annual Financial Statements as of, and for the years ended, September 30, 2006, because of limitations on the scope of our work. The Department was unable to provide complete financial statements or respond to requests for evidential material in a timely manner, and we were not able to perform other auditing procedures to satisfy ourselves as to the accuracy of the financial statements in time to meet the November 15, 2006, deadline imposed by the Office of Management and Budget for issuing our report.

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

We noted certain other instances of noncompliance that we reported to the Department's management in a separate letter dated November 14, 2006.

RESPONSIBILITIES AND METHODOLOGY

Department management has responsibility for the following:

- Preparing the Annual Financial Statements, required supplementary information, and other accompanying information in conformity with accounting principles generally accepted in the United States of America.

- Establishing and maintaining effective internal control.

- Complying with applicable laws and regulations.

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

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

- With respect to the Department's internal control over financial reporting, we obtained an understanding of the design of internal controls, determined whether they had been placed in operation, assessed control risk, and performed tests of controls.

- With respect to performance measures included in Management's Discussion and Analysis, we obtained an understanding of the design of internal controls relating to the existence and completeness assertions and determined whether they had been placed in operation.

- We obtained an understanding of the process by which the agency identifies and evaluates weaknesses required to be reported under FMFIA and related agency implementing procedures.

- We tested compliance with selected provisions of laws and regulations that may have a direct and material effect on the financial statements.

- We performed other procedures as we considered appropriate under the circumstances.

We performed our work in accordance with auditing standards generally accepted in the United States of America, the standards applicable to financial audits contained in the *Government Auditing Standards,* and the provisions of OMB Bulletin 06-03. We considered the limitations on the scope of our work in forming our conclusions.

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

This report is intended for the information of the Inspector General of the U.S. Department of State, the Department's management, OMB, and the Congress. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Comments by the Department's management on this report are presented as Appendix A.

Leonard G. Birnbaum and Company, LLP

Alexandria, Virginia
November 14, 2006

United States Department of State

Washington, D.C. 20520

NOV 1 5 2006

MEMORANDUM

TO: OIG – Mr. Howard J. Krongard

FROM: RM – Bradford R. Higgins

SUBJECT: Draft Audit Report on the Department of State's 2006 and 2005 Financial Statements

This is in response to your request for comments on the draft report titled "Audit of the U.S. Department of State 2006 and 2005 Financial Statements" (Report).

The Department is committed to effective internal controls. Throughout 2006 we worked closely with the Independent Auditor to address the material weaknesses in accounting for personal property and information systems security reported in their FY 2005 *Independent Auditor's Report*. As a result, and as reflected in the Report, the Independent Auditor downgraded these items to a reportable condition, and reports no material weaknesses in internal controls.

To strengthen internal controls in 2006, the Department committed to, and fully implemented, the requirements of Appendix A, Internal Control over Financial Reporting, of OMB Circular A-123. During the implementation of Appendix A, and other work during FY 2006, Department management identified a material weakness related to accounting for real property construction-in-progress. Recognizing the severity of the deficiency, the Department developed more detailed procedural guidance for establishing projects to ensure construction costs are properly capitalized, and implemented monitoring controls for both project establishment and project completion. As a result of the corrective actions taken, the material weakness was resolved by September 30, 2006.

Unfortunately, due to the complexity of the matters involved in addressing the real property deficiencies, the accelerated financial reporting requirements, and our commitment and focus to successfully resolve the material weaknesses noted above, the Department was unable to provide timely financial statements or documentation on the appropriateness of the associated restatement to satisfy the Independent Auditor with regard to the presentation of real property in time for this Report. As a result and as more fully explained in the *Independent Auditor's Report,* the independent auditors issued a disclaimer of opinion on our FY 2006 and restated FY 2005 financial statements. We are committed to continuing to work with the Independent Auditor on this issue until such time as they can satisfy themselves about the amounts presented as real property, and other accounts as necessary.

In relation to internal controls, the Report cites six reportable conditions in (1) the recording and related depreciation of personal property, (2) the Department's security of information systems networks, (3) the inadequacy of the Department's financial management systems, (4) the management of unliquidated obligations, (5) the recording and related deprecation of real property, and (6) the implementation of Managerial Cost Accounting Standards. The Department's financial management systems are also reported as noncompliant with laws and regulations, including the Federal Financial Management Improvement Act of 1996 (FFMIA). Each of the matters identified in the *Independent Auditor's Report* will be addressed as well as other deficiencies noted during their audit.

In October 2005, the Department's Management Control Steering Committee (MCSC) – the body charged with overseeing the Department's management control program under the Federal Managers' Financial Integrity Act (FMFIA) -- created a subcommittee to address the weaknesses in personal property. In 2006, improvements were implemented in the methods used to identify and report armored vehicle costs, aircraft, property held by contractors, and Department-owned vehicles. In 2007, the MCSC and senior Department management will ensure that efforts continue to further strengthen the controls over the accounting for personal property.

For information systems security, the Department remains intensely aware of the value and sensitivity of its information and information systems and is dedicated to the vigilance required to ensure their adequate protection. Accordingly, the

Department continues to monitor this area through the MCSC. In FY 2007, in addition to improved certification and accreditation processes, our efforts will focus on obtaining a clear inventory of systems, addressing the many new OMB and NIST system requirements, patch management, and ensuring the Department has the latest versions of protections in place.

Compliance with Federal financial systems requirements remains a top priority. In 2006, the MCSC voted unanimously to categorize this issue as a financial system deficiency, a significant improvement from its long-standing status as a material or reportable non-conformance. In 2007, domestic users will be converted to the same platform and software that services overseas users, thereby establishing the Global Financial Management System (GFMS). As part of the GFMS implementation, the most up-to-date module for accounting for fixed assets will be installed, and a new data warehouse is being built that will provide for better reporting capabilities for users.

To improve the management of grants and other types of financial assistance, the Department is developing, in collaboration with USAID, the Joint Assistance Management System (JAMS). JAMS will provide the capability to centrally track and manage Federal financial assistance issued by the Department. The Department plans to conduct a pilot phase in 2007, followed by deployment through 2008.

Strengthening the management of undelivered orders (UDOs) is an important financial management initiative. The Independent Auditor's Report notes that there have been improvements in this area, and we continue our efforts to establish adequate processes and controls. New capabilities in the Department's Central Financial Management System allow for the automatic deobligation of UDOs based on a wide range of criteria (e.g., age, object class, dollar amount). In addition, as part of our efforts on the President's Management Agenda Initiative for Improved Financial Performance, we chart and report on the percentage of UDOs with no activity for the past 12 months.
These actions have resulted in the deobligation of thousands of items with a value exceeding $200 million during 2006.

The Department continues to make progress in implementing Managerial Cost Accounting Standards (MCAS), but acknowledges that additional work is needed to substantially comply with these standards. In 2005, the Department established a project team, which includes consultants with experience implementing Cost Accounting Systems. In 2006, the team surveyed other agencies and organizations for lessons learned and best practices; conducted an assessment of offices to determine business needs for cost information, current cost accounting practices, outputs and outcomes, and unmet needs; evaluated a managerial cost software module and confirmed usability; and developed a strategic approach and implementation strategy. In 2007, the team will conduct pilots to test the strategy, to be followed by a phased implementation department-wide.

We thank you for the opportunity to comment on the draft report. We would also like to extend our appreciation to your staff and to your contractor, Leonard G. Birmbaum and Company, LLP, for the professional and collaborative manner in which they conducted the audit. We believe considerable progress on a number of matters has been made over the past year, and the Department remains committed to improving the management of its programs and the quality of its financial reporting.